Five exit options for China private equity

In the second of two articles, Jack Lange and Marcia Ellis consider how investors in a Chinese company might realize their gains

The investment horizon of most private equity funds is between three and five years. Fund managers and general partners want to return capital to their investors at heroic rates of return, earning their carried interests and building their records for future fund raising.

In the first part of this article, published in last month's issue of IFLR, we considered a hypothetical investment by two private equity funds in MouCo, a PRC consumer products company. We considered how the funds, who planned to acquire a 40% interest in the business, would structure their investment to give maximum flexibility for the exit they hoped to achieve within a few years. We concluded that they should own their interests through a Cayman Islands company (CaymanCo), with a Mauritius company (MauritiusCo) as an intermediate holding company, and should try to get the 30% held by MouCo's CEO, Mr Mou, offshore with them. Here we will look at each of the principal exit routes that the funds might consider when the time comes to cash out.

Initial public offering

An initial public offering (IPO) would probably be the first choice of an exit route for all of the parties to work toward. The path to a public listing is the one that is most likely to bring the interests of both the funds and Mr Mou into alignment. For the funds, it creates a public market into which they can sell their interests over time, at a valuation that is likely to be higher than the valuation achievable in a trade sale. For Mr Mou, an IPO allows him to keep his substantial shareholding and continue to manage the company – a company that now gives him the prestige of a stock market listing and a ready source of future equity financing.

In the past, many investors have had an excessively optimistic view of the prospects for a successful IPO exit. That is because China's domestic capital markets have developed more slowly as a financing platform for foreign invested enterprises (FIEs) than many investors expected. Nonetheless, there has been a growing number of successful exits through offshore listings.

With the structure that they have put in place, the funds have several possibilities to consider in contemplating an IPO of the MouCo business: an onshore IPO of MouCo itself (that is, a public offering and listing of MouCo on a stock exchange within mainland China); an offshore IPO of MouCo (that is, a public offering and listing of MouCo on a stock exchange outside of mainland China – for example, in Hong Kong or New York); and an offshore IPO of CaymanCo.

The stock exchange in the jurisdiction in which the portfolio company is located is usually the most promising market for a listing of the company's shares. Not so in China. Two types of shares are traded on the Shanghai and Shenzhen stock exchanges, mainland China's principal stock markets: A Shares and B Shares. Trading in A Shares is denominated in Renminbi and is restricted to PRC nationals and, since about two years ago, certain so-called Qualified Foreign Institutional Investors. Foreign private equity investors have long sought access to the A Share market for listing companies, because of the high price-to-earnings (PE) ratios at which A Shares tend to trade. Unfortunately, the A Share market has been used mostly for listing of state owned enterprises, and it has been essentially closed to FIEs.

B Share trading is denominated in US dollars, and foreign investors can buy or sell B Shares. The B Share market is more open to FIEs as issuers. However, the PE ratios tend to be considerably lower than in the A Share market, and liquidity is poor.

There are some major disadvantages to using a PRC company as a listing vehicle – whether for on A Share or B Share listing or for an offshore, so-called H share, listing. If the shareholders wanted to list MouCo, that company would first have to be converted from an Chinese-foreign equity joint venture company (EJV) into a foreign invested company limited by shares (FICLS). MauritiusCo, as a *promoter* of the FICLS, would than be subject to a three year lock-up, during which it would not be able to sell any of its shares – even in a private transaction. And after that lock-up expired, the shares would still not be freely tradeable on the relevant domestic or foreign stock exchange. They would be *unlisted foreign capital shares*, which could be converted into listed shares only with PRC governmental approval – occasioning further delay, and perhaps the imposition of a further lock up as a condition to the approval. This is a demoralizing picture for private equity investors.

That leaves an offshore IPO of CaymanCo as the most attractive alternative for the funds. Although there are many markets around the world on which such an IPO could be executed, they would probably narrow their choice to Hong Kong and New York. Venture-backed technology companies often choose Nasdaq, primarily because of the strong valuations it offers in robust markets. The Stock Exchange of Hong Kong Limited (SEHK) is a common choice for companies with PRC-based operations, especially mid-sized companies in traditional industries. Issuers on the SEHK generally find better research coverage and less volatility than on Nasdaq – and don't find the burdens and anxieties of compliance with Sarbanes-Oxley.

Having with great pain negotiated some strong redemption provisions in their investment documents, the funds are hoping never to have to read those provisions again

Large PRC-based companies often do dual listings on the SEHK and the New York Stock Exchange. Two companies that have foreign minority private equity investment – Ping An Insurance (Group) Company of China Ltd and China Netcom Group Corporation (Hong Kong) Limited – have completed such dual listings in 2004.

Regardless of the exchange on which the funds seek a listing for their MouCo investment, the applicable listing requirements will have to be satisfied. One issue that they would have to contend with in Hong Kong is the requirement that there be continuity of management of the business for the three year period prior to the IPO. If the funds want to do a listing of CaymanCo within three years of their investment, they will need to convince the SEHK that the restructuring described in the first part of this article did not constitute a break in this continuity of management.

The funds will also have to consider PRC government approval requirements. An offshore listing of a PRC company clearly requires governmental approval. The jurisdiction asserted by the PRC government to approve offshore listings by non-PRC companies with assets in mainland China – for example, a Hong Kong listing of CaymanCo – is not clearly spelled out and as a practical matter depends upon various factual considerations, including among others the level of ownership by state owned enterprises.

Trade sales

In the still-short history of foreign private equity investment in China, trade sales have been by far the most useful exit route, at least in traditional industries. The main advantages of trades sales over stock market listings are that trade sales are less subject to the cyclical highs and lows with which capital markets are fraught, are easier to execute and allow investors to take advantage of the strong interest in China among strategic investors.

Control is the main issue in using trade sales as a means of exit. Strategic investors are rarely interested in acquiring minority stakes. Thus, if a private equity fund does not hold or is not able to put together a control block (or the support of enough other shareholders to be able to transfer control in the aggregate) a trade sale to a strategic investor will probably be impossible.

Control has been difficult to obtain, especially in industries in which foreign investment is restricted to a minority stake or in situations in which business considerations make it impossible to reduce the stake of the Chinese partner below 50%. Structures like the one selected for the MouCo investment can at least ensure that a majority stake (that is, the aggregate stake held by Mr Mou and the two funds) is kept together in one package conveniently ready for sale.

As with a stock market listing, a trade sale is easier to execute if it is carried out offshore. In our case, Mr Mou and the two funds can sell control to a strategic investor simply by selling to that investor all of the shares of MauritiusCo. This structure allows the transaction to be executed without Chinese governmental approval (unless, as discussed below, anti-monopoly review is triggered) and without incurring Chinese capital gains tax, and ensures (through the structural drag-along feature discussed in part one of this article) that minority shareholders of CaymanCo will not be in a position to prevent or disrupt the sale.

Regulatory developments in China over the past several years have both helped and, in some cases, hindered the development of options for M&A activity, including trade sales in China. The most important regulatory development has been the promulgation of the Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors in March 2003. In addition to providing, for the first time, a clear legal basis for acquisitions by foreign investors of equity interests in non-foreign invested companies and the conversion of those companies into foreign-invested companies and raising the possibility of swaps of assets or equity of Chinese companies for shares of offshore entities, these M&A rules introduced some burdensome new requirements.

These new requirements include anti-monopoly review and the requirement that the consideration paid by a foreign investor in each transaction covered by the rules not be significantly less than the appraised value of the assets or equity being purchased. Unlike in the past, this latter rule applies even in cases in which state-owned assets are not involved. The anti-monopoly review provisions of the M&A rules purport to cover both onshore and offshore transactions, and the circumstances that would trigger review are drafted broadly enough to require review under many circumstances in which the transactions involved would have no anti-competitive effect.

The decision on whether to file for review with the relevant government authorities under these rules has been the subject of extensive discussion in many recent trade sale transactions. These discussions are complicated by the fact that even the most basic terms such as *market share* are not defined in the M&A rules. Although the provisions with respect to anti-monopoly review of offshore transactions have not been repealed, it is our understanding that the relevant authorities are now of the opinion that the provisions were too broadly drafted and are not, in fact, requiring submissions of offshore transactions for anti-monopoly review in most cases.

Trade sales by private equity funds are often complicated by the fact that once the purchase price is received by a fund it will normally be required to distribute the amounts received promptly to its investors. Thus, the fund will be severely restricted in its ability to satisfy any claims made by the purchaser pursuant to any breach of representations made by the fund in connection with the sale.

As a result, the purchaser will inevitably insist on a portion of the purchase price being held back either by the purchaser and not paid until a certain period has elapsed in which the purchaser can determine whether it has any claims or held in an escrow account and not released to the seller for such period of time.

Neither option is attractive to the fund, which wants to maximize its return by receiving the entire purchase price on the closing date of the sale. In addition, leaving a portion of the purchase price either in the hands of the purchaser or in an escrow account necessarily incentivizes the purchaser to make claims that it would not otherwise make. An internal audit will probably be conducted immediately prior to the date on which the held back amount will be released to the seller, which will often result in the recommendation that various minor claims (that the purchaser would not otherwise have bothered to make) be made.

Thus, a significant portion of the time spent negotiating a trade sale by a company with private equity investment will be spent on discussions of the form of the hold back, the amount of the hold back and the period during which the hold back will be maintained in an escrow account or in the hands of the purchaser.

Sale to other financial investors

In a more developed private equity market, funds often exit an investment by selling their interest to another investment fund. This is a natural result of the tiering and specialization of private investment funds in these markets, with funds typically focusing on specific stages of a company's development.

This kind of tiering and specialization is only just beginning to develop in China. In addition, the PRC domestic investment fund industry is in its infancy. However, things are changing fast. Other investment funds will increasingly become buyers of private equity investment interests, and growing pools of domestic capital will become a source of liquidity.

The funds' interest in MouCo might be of interest to pre-IPO stage investment funds. A sale to such a fund would be easier to execute than an IPO, and might raise fewer issues regarding transfer of control than a trade sale.

Leveraged recapitalization

In a leveraged recapitalization, the investee company incurs debt and uses the proceeds, together with any other available cash, to pay a special dividend or other distribution to shareholders. If the investee company's operating cash flow is strong, this form of partial exit can often allow private equity investors to recover their initial investment in full, plus some return, while preserving their entire equity interest for a future IPO, trade sale – or yet another leveraged recapitalization as operating cash flow continues to increase.

Private equity funds are typically looking for a clean exit. But there are a variety of circumstances in which a leveraged recapitalization may be the best (or indeed the only) available alternative. The timing may not be right to do an IPO or to get good pricing in a trade sale, because of a cyclical capital markets or industry downturn. Or the investee company may have unresolved regulatory or tax issues that cannot be disclosed to the standard required in a public offering prospectus without causing undue damage, and that would seriously complicate any trade sale.

Leveraged recapitalizations work best in jurisdictions where there are minimal restrictions on payment of distributions to shareholders, and where lenders can lend on the basis of strong, enforceable security interests in the equity of the borrower and substantially all of the borrower's assets. In other words, they work best in jurisdictions other than China.

Under the registered capital system described in part one of this article, equity contributed to a Chinese-foreign equity joint venture company cannot be withdrawn at any time during the term of the venture without governmental approval that is difficult to obtain. Distributions are therefore generally limited to accumulated profits. Various legal and practical limitations on the effectiveness of security interests in the equity and assets of Chinese enterprises have retarded the development of debt financing for acquisitions and recapitalizations of FIEs. Moreover, borrowing money for the purpose of making an equity distribution will raise issues under PRC law.

Nonetheless, there are cases in which FIEs have substantial undistributed profits accumulated over a number of years, but too little free cash to pay the full amount of those profits out as a dividend. In these circumstances, borrowing may free up cash for an equity distribution. Although a full-scale leveraged recapitalization would be difficult to implement in China, this kind of combination of borrowing and dividend payout is certainly something that could be considered.

Redemption

In their negotiations with Mr Mou prior to making their investment, the funds insisted on getting a right to have their shares redeemed by CaymanCo if the company did not have a *Qualified IPO* (defined in terms of the price a share and the market capitalization of the company) within three years after their investment. They recognized that their ability to effectively exercise such a right would be subject to the ability of CaymanCo to get the cash to make the redemption payment, which in turn would be subject to the constraints discussed above in connection with leveraged recapitalizations. So they built in various protections to try to strengthen the right, including an ability to cause the sale of MauritiusCo under certain circumstances.

No matter how strong it is, though, a redemption right negotiated as a back-up liquidity guarantee is one of the last things that a private equity investor will want to rely on. It is a useful way to create a strong negotiating position for the investor. But it will only become relevant in a situation where things have not gone as expected, and exercising it will create a highly adversarial situation with the other shareholders – who will probably have means at their disposal to frustrate or delay a redemption payment. Having with great pain negotiated some strong redemption provisions in their investment documents, the funds are hoping never to have to read those provisions again.

Choices

So what will become of our heroes? Placing your bets now, you would have to put your money on a Hong Kong IPO during some period when the market window is open, or a trade sale in which Mr Mou cashes out some of his shares and is richly rewarded to stay on as chief executive. But China continues to surprise, and maybe our story will end with a triumphant A Share IPO, or a sale to the PRC's own first name-brand buyout fund. If you are a foreign private equity investor, you will hope so. ■

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