Eye on China: Private Equity Investments in China

"Private Equity Investments in China" was the topic of discussion during the May 7, 2008 presentation of the Foley Executive Briefing Series. Foley & Lardner LLP partner David W. Kantaros led the discussion, joined by Foley attorney X. Linda Ji and Celsius Capital managing partner Carlos M. Bhola. The panelists discussed solutions for navigating and understanding the investment opportunities within China's burgeoning marketplace, with a focus on both practical and legal concerns. This brief discusses and provides a follow-up to some of the points raised in the discussion.

China's business landscape offers enormous opportunity for both private equity (PE) and venture capital (VC) investment. But the country's almost explosive market growth also presents tremendous challenge, as international investors must navigate a unique culture as well as an evolving legal and regulatory environment. Before capitalizing on the Chinese economy, U.S. investors must give careful consideration to business structures and strategies, regulatory landscaping and asset protection.

Current Landscape of Private Equity and Venture Capital Investments in China

China's economy has grown at an annual rate of nearly nine percent for 25 consecutive years and its growth is forecasted to continue at an annual rate of eight percent. PE and VC funds both domestic and foreign are continuing to flow into China. In 2007, foreign investments in China reached a record high:

- PE and VC investments in China totaled $12.82 billion and $3.25 billion, respectively;
- 64 new PE funds raised $35.58 billion dedicated for investment in China;
- 58 new VC funds raised $5.48 billion dedicated for investment in China;
- 94 VC/PE backed IPOs and 30 merger and acquisition transactions took place in 2007

N.B.: All dollar amounts are U.S. dollars
Source: The Zero2IPO Research Center

Showing no signs of slow down, the first quarter of 2008 saw continued growth:

- 16 PE funds raised $20 billion for targeted investment in Asia (including China)
- 36 Chinese enterprises received $2.68 billion in investment from over 30 PE firms (both foreign and U.S. based)
- In a reflection of the current Initial Public Offering (IPO) market slowdown, only 8 exits occurred during Q1, including 3 PE-backed IPO events.
- 23 VC funds form to raise $2.26 billion of capital for investment in China

FOLEY
FOLEY & LARDNER LLP

- 116 Chinese start-up enterprises received $940.73 million investment from VC firms

  N.B.: All dollar amounts are U.S. dollars
  Source: The Zero2IPO Research Center "China Private Equity Report Q1 2008"

But where exactly are the dollars going?

PE and VC funds typically focus on four primary investment candidates:

- Foreign Invested Enterprises (FIEs)
- Private start-ups by Chinese nationals returning to China from overseas after studying or working in foreign countries, so-called "Sea Turtles"
- Private start-ups by domestic Chinese nationals
- State-owned enterprises

Private start-ups by domestic Chinese nationals and state-owned enterprises offer the greatest potential for return on investment since they have the strongest direct ties to the mainland. However, investments in FIEs or "Sea Turtle" start-ups might be more appealing for U.S.-based investors, as these China-based partners will have had more experience with international investors.

Industry Focus
Investments in Q1 2008 have focused largely on traditional industries as well as broad information technology (IT) industries:

- Traditional industries represent 52.9% of PE investments and 16.5% of VC investments
- Broad IT represents 33.5% of PE investments and 39.5% of VC investments
- Other Hi-Tech represents 3.6% of PE investments and 6.6% of VC investments
- Services represent 7% of PE investments and 15.5% of VC investments
- Biotech/Healthcare represents 3% of PE investments and 9.5% of VC investments

  Source: The Zero2IPO Research Center

The expected hot areas of investment for 2008 are clean technology, education, healthcare and life science, as well as TMT (telecom, media and technology).

Products and Technology
It is important to note here that investments in China's product or technology sectors require special consideration of Chinese foreign investment and import and export laws.

The Chinese government has classified all products and technologies in terms of how foreign investments in those products and technologies must be structured.

The Foreign Investment Industry Guidance Catalogue & Encouraged Technology Catalogue divides industries, products and technologies into four categories:

- **Encouraged:** Foreign investments are welcomed and foreign parties may have an equity holding of more than 51% and up to 100%.
- **Restricted:** Foreign investments are limited in restricted industries and foreign ownership may not exceed 50%. Import and export of the technologies in this category must be approved by the relevant governmental authority prior to their import or export, and the relevant technology transfer agreement must be submitted to the relevant governmental authority
- **Prohibited:** Foreign investments are banned and technologies cannot be imported into or exported out of China
- **Permitted:** Industries, products and technologies that are not listed in the foregoing three categories fall under this "permitted" category. Foreign investments are allowed in this category.

In order to fully understand their rights and responsibilities, businesses and their investors must have an understanding of how these categories might be applied to their technology products. Certain approvals and registrations may be required before products or materials can cross the Chinese border.

Finally, like many regulations in China, these rules are evolving. The guidance of experienced counsel is advised.

The Demographics of China
Another factor to be considered when seeking a candidate for investment in China is its geographic and cultural significance.

These demographics, as well as the size of the investment, predict the potential national impact of an investment and therefore determine the level of government interest and involvement in that investment.

The culture and geography of a potential investment site is especially relevant in terms of what level of regulation can be expected from the Chinese government.

For example, provincially located investments may involve regulatory oversight of provincial rather than central government officials, while urban investments are more likely to receive a higher level of government scrutiny.

FOLEY

FOLEY & LARDNER LLP

The more populated the investment site, or the greater the potential demographic impact of the investment, the greater the level of involvement and the more regulatory requirements that can be expected from the Chinese government.

Similarly, the larger the amount of capital being invested, the greater the level of government involvement.

It is worth noting that the Chinese government remains the largest shareholder in most China-based enterprises. Some level of federal involvement should almost always be expected in any business or investment deal.

If agendas are aligned, the Chinese government can be relatively easy to work with. It is worth noting that the Chinese government has been known to make investment or business deals “on a handshake” or by verbal agreement and those deals are followed through.

As always, the regulatory climate is actively advancing and experienced counsel is recommended here.

Common Investment Structures

PE and VC funds can look to invest in China directly or indirectly.

A common direct investment strategy is the direct acquisition of equity interest in the expansion or late stage Chinese companies.

A common indirect strategy is the acquisition of equity interest in start-ups and early stage companies in China by PE and VC funds via offshore special purpose vehicles (SPVs).

The nature of the investment strategy—direct vs. indirect—typically reflects the level of commitment that investors are willing to dedicate. A direct investment may require more time on the ground and may be subject to more stringent government regulations, but may provide greater opportunity for continued investment.

An indirect investment offers easier repatriation and exit routes and flexible equity arrangements. The indirect investment also offers better transparency through the SPV. Whereas corporate structure in China can be sometimes murky, the structure of a Cayman Islands SPV, for example, is well understood.

Growth Drivers and Opportunities

Statistics demonstrate clearly that the Chinese market is a successful market, but where is the evidence that China's economy will continue to grow?

What are the market forces that are driving growth and providing opportunity?

China's economy is experiencing sustained macroeconomic growth through a rapidly growing private sector and continuing privatization of the state-owned sector. Chinese companies have an increasing desire to privatize and to go global.

Additionally, China's membership in the World Trade Organization (WTO) has allowed foreign investors to have access to additional sectors for investment.While the U.S. IPO and M&A markets are showing signs of slowdown, both the IPO and M&A activities of PE or VC-backed Chinese companies are active and present viable exit options.

Furthermore. both the 2008 Olympic games and the 2010 World Expo could provide fuel for market growth and opportunity in China.

Obstacles and Pitfalls

But amidst the booming opportunities in China are potential pitfalls and obstacles.

For example, investors might find a relative unavailability of reliable financial data, although the availability of data depends on the type and nature of the particular investment. Indeed, there is a need in China for greater legal protections for businesses and investors. For example:

- stronger enforcement of intellectual property rights;
- increased corporate governance; and
- greater clarity and stability on investment regulations and enforcement.

U.S. based PE and VC players will also face competition from Chinese domestic PE and VC funds.

Convertibility of the Chinese renminbi (RMB) might also be an issue for investors who want return of their capital gains in U.S. dollars rather than to reinvest. There are savvy financial strategies by which to avoid that particular issue, however.

Evaluate your Investments in China

In the wake of these and other potential obstacles, investors should approach potential deals with a careful and evaluative strategy that thoroughly analyzes areas of potential conflict prior to investment. For example:

Protecting and retaining control of intellectual property (IP)
The integrity and value of a company's IP assets depends upon an understanding of potential risks and possible recourse. The importance of IP protection is dependent on industry, but a general understanding of IP protection and enforcement in China is always paramount.

In China and on a global level, IP is becoming an increasingly powerful business tool, and China's aggressive market demands a thorough consideration of proactive strategies to manage IP risks for the protection of the technology and the business.

Issues such as counterfeiting and trademark abuse and benefits of entering into confidentiality agreements with suppliers, distributors, contractors and employees should be carefully considered.

Level of comfort and trust in local partners
The importance of an "on the ground" partner or counsel becomes clear here. As with any investment, comfort and trust in the investment partners is essential.

Recognition of differences in corporate culture and values
A recognition and appreciation of the differences between U.S. and Chinese culture can be key to a deal's success. Fluency in the language obviously helps, as does direct cultural experience.

Understanding the legal system, language, business and culture
Again, on the ground counsel is important here, particularly given the developing nature of China's legal and regulatory environment.

It is also important to understand how Chinese nationalism might influence attitudes towards foreign investment. A foreign investment is likely to be evaluated by Chinese nationals and the Chinese government in terms of its potential impact on the country.

For example, how significant is the capital investment? What is the potential demographic impact? It is true that some industries are considered more valuable to China and to China's national security than others, and those may be more tightly regulated.

In general, an understanding of Chinese legal, business and cultural principles will help investors navigate any potential challenges.

FOLEY
FOLEY & LARDNER LLP

Investment time horizon
The Chinese government once required investors to demonstrate long-term interests; but many of those restrictions have now relaxed. In general, the market has become more flexible to an investor's timeline, but the potential for long term presence should be considered.

Repatriation of investment capital
Some financial advisors might advise businesses to re-invest in China rather than attempt to convert RMB capital gains to U.S. currency.

The RMB is appreciating at a steady rate; and if an operation has proven profitable in China, it already has established a relationship with the world's largest customer base.

There are ways that investments can be structured to allow for repatriation. But in general, foreign exchange control regulations in China can limit repatriation. Experienced counsel should be consulted here.

Regulatory Framework

The current Chinese regulatory framework is an evolving set of regulations that vary with industry as well as level of foreign investment. The guidance of experienced counsel is imperative. Several key government-issued regulations must be considered by foreign PE and VC players, for example:

- Foreign Invested Venture Capital Enterprise Regulations (March 2003)
- SAFE Circular on Issues Concerning Foreign Exchange Control on Financing and Round-Trip Investment Through Overseas Special Purpose Companies by Domestic Residents (October 2005)
- Operating Procedures Regarding Circular No. 75, issued by SAIC (May 29, 2007)
- Amended M&A Regulation on Foreign Investors Acquiring Domestic Enterprises (September 2006)
- Anti-Monopoly Law (to take effect August 1, 2008)

China's challenging regulatory environment should not be taken as reason to avoid investments there; rather, the uncertainty should be mitigated by careful due diligence and competent legal counseling.

Summary

Although the Chinese market promises opportunities, it also may present serious hazards to the unprepared. U.S.-based investors must conduct careful due diligence before acquiring a target in China, and are advised to retain counsel to keep up with evolving legal requirements.

And while it is important to understand a potential investment target, it is also critical to understand the culture, values and management strategy of the China-based target. A recognition and appreciation of cultural differences is imperative.

With experienced counsel to provide essential foresight and assistance, success in China is very possible.

FOLEY

FOLEY & LARDNER LLP