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China Law Update BLOG
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China Law Update

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Return to Direct, Onshore PRC Investments

It is always dangerous to try to make long-term forecasts during volatile times – and there hasn't been a more volatile time in the Chinese private equity and venture capital market since it began opening to foreign investment in the last decades than that of the last several months.

Of course, this is not to say that one should discount lessons learned from recent experience even in times as unique as these. The current global financial crisis will certainly lead to substantial changes in markets worldwide, and the Chinese PE/VC market will be no exception. Investors and entrepreneurs alike are busily examining every industry and business model in front of them, testing for resilience in the face of widespread financial distress, looking for counter-cyclical performance indicators, etc.

On the level of individual industries and business models, because current market conditions have been authored by the financial crisis, the ultimate lessons to be drawn will depend on how the crisis resolves itself. Currently there is much discussion of counter-cyclical industries such as low-cost foods and consumer goods, the demise of luxury brands and products, and the opportunities for infrastructure investments driven by China's (and other countries') plans for massive government stimulous spending. But does this mean that a PE/VC fund investing in fast food and bridge-building, but which shuns high-end consumer goods, will be a top performer in 3- or 5-years' time? Will returns from investments in these industries exceed those of the technology, software and other industries that have receive the lion's share of investments during the past decade? None of us – well, certainly none of we lawyers – can be sure that these industries will continue to be favored in the years to come, and certainly cannot know which companies within them may or may not find success.

Investors and entrepreneurs will look to answer those questions and manage the opportunities and challenges at that industry and individual business level. As a lawyer, though, my view is that a more fundamental change in the Chinese PE/VC market – one that will have a dramatic impact on what the market will look like in 3- to 5-years -- is one that has been developing for several years already, which is almost entirely independent of the current economic crisis, but which is being accelerated because of the crisis. This is the movement towards structuring investments as onshore, RMB-denominated transactions rather than as offshore foreign currency investments – a trend which involves not only vastly different corporate and transaction structures at the time of PE/VC investment, but also dramatically different goals for the types of exits that target companies and their investors will seek.

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Until Recently, Offshore Structures Have Dominated

During the last decade, since the "WFOE" became a feasible alternative to joint venture investments, foreign investors have typically structured their PE/VC investments in China through indirect investments in non-PRC holding companies: rather than investing directly in the PRC operating company that was the ultimate target of an investment (the "**PRC Target**"), foreign investors would invest in an offshore, non-PRC entity (the "**Offshore SPV**") which owned the PRC Target (or controlled the PRC Target through a series of contractual relationships if the PRC Target's business activities rendered it restricted or prohibited to direct foreign investment). A condition to the foreign investor's investment would be that the original owners of the PRC Target would create the Offshore SPV and transfer ownership/control of the PRC Target so that when the foreign investor did invest funds it would become a shareholder side-by-side with the original owners of the PRC Target.

This model for foreign investment – which became known as the "Red Chip" structure – brought many advantages (particularly to the foreign investors): notably, the rights and preferences foreign investors could incorporate in the equity securities they purchased could be more extensive and more easily enforced then their equivalents in direct PRC investments, and because ownership was offshore, there would be no future need for PRC government approval of the sale of the shares owned by foreign investors. Offshore SPVs were generally established in the Cayman Islands, British Virgin Islands or Hong Kong – all jurisdictions in which investments could be denominated in foreign currencies, "preferred shares" carrying extensive rights and privileges could be issued to investors, and documentation (and any disputes arising from such documentation) could be controlled by non-PRC laws and courts.

Recent Laws & Regulations Changed the Dynamic

Without question, the Red Chip structure was the most commonly used model for foreign private equity and venture capital investments in China during the bulk of the past decade. In the years prior to 2005, in fact, it had a virtual monopoly on the market. However, beginning in 2005 a series of regulatory changes in the PRC began the trend we are seeing accelerate today.

The first changes were the promulgation of a series of Circulars by the State Administration of Foreign Exchange ("**SAFE**") – there have been several iterations of the requirements set forth in the various SAFE Circulars, but the ultimate effect has been to require that PRC residents who wish to establish or become owners of Offshore SPVs are required to seek a discretionary registration with SAFE, and many individual transactions (including receipt of investment by an Offshore SPV to fund a PRC Target Company) also require registration. These registrations, while generally obtainable, can be time consuming and add to the complexity of establishing a typical Red Chip structure.

Later, additional regulations were promulgated with even greater impact. In 2006 the *Rules on the Merger and Acquisition of Domestic Enterprises by Foreign Investors* (关于外国投资者并购境内企业的规定) (the "**M&A Rules**") and the *Guidelines on Domestic Enterprises Indirectly Issuing Securities Overseas or Listing and Trading their Securities on*

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Overseas Stock Exchanges (境内企业间接到境外发行证卷或者将其证卷在境外上市交易) (the "**CSRC Guidelines**") were promulgated. Under the M&A Rules, the restructuring of PRC Targets under Offshore SPVs requires Ministry of Commerce approval – approval that to date has been virtually impossible to obtain. Under the CSRC Guidelines, the listings of Offshore SPVs that are owned or controlled by PRC persons (including both PRC individuals and companies) requires prior CSRC approval, also difficult to obtain.

While none of these are absolute blocks on the use of the Red Chip structure in theory, and indeed there have been some signs that certain of these requirements may be significantly lightened in future, few doubt that the process of establishing a Red Chip structure will remain a difficult, time-consuming and costly regulatory gauntlet. As a result, while foreign investors will still generally first examine whether a typical Red Chip or other offshore structure is feasible in a given case, the industry has come more and more to recognize that alternate approaches must be looked at or investors will simply be unable to consider a very large number of potential investment opportunities.

The Return to Direct, Onshore Investments

What does all of this mean for PE/VC investments in China over the next several years? Well, the extent of impacts and changes going forward is of course impossible to predict, but one area that many expect to expand significantly is the dramatic increase in direct investments in PRC Targets, entirely bypassing the use of Offshore SPVs.

This can be done using the traditional model of a foreign investor investing directly from offshore in the PRC Target, thus converting the PRC Target into a Sino-Foreign joint venture – though the use of joint ventures waned dramatically in the early half of this decade, their numbers have increased significantly with the difficulty in using the Red Chip structure.

However, while a decade ago joint ventures were virtually the only option available to foreign investors wishing to make direct investments in PRC Targets, today another option exists: the use of so-called "RMB Funds" as investment vehicles allowing foreign investors not only to make direct investments more quickly and easily than joint venture regulations and procedures allow, but also to make investments that are denominated in RMB (a major selling point for many domestically-orienged PRC Targets that would prefer to avoid foreign currency issues).

RMB Funds are most commonly formed as "Foreign-Invested Venture Capital Enterprises", or "FIVCEs", a type of PRC legal entity designed to allow foreign investors to emulate a typical investment fund within China, but with the critical advantage of being treated as a PRC entity for purposes of the investment and thus the ability to invest in RMB. There are variations in the types of RMB Funds that can be formed, and there are restrictions in terms of formation (minimum investment amounts and timing of contributions, type and number of partners, etc.) – the details are beyond the scope of this article – but the key factor common to all of them is that, once formed, they allow foreign investors not only to bypass the risks and vagarities of the Red Chip structure, but also to move much more quickly and efficiently in closing investment transactions then would be possible in other situations. Though RMB Funds are ostensibly designed for investment in new- and high-technology ventures, the general feeling is that those

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terms can be defined quite broadly and so RMB Funds can be used to invest in a wide range of businesses.

RMB Funds have existed under Chinese laws and regulations for several years (the "*Administrative Provisions on Foreign-Invested Venture Capital Enterprises*" and the "*Provisional Measures for Management of Venture Capital Enterprises*" were issued in 2003 and 2005, respectively) but have only become well-known and commonly used in the last few years – today there are dozens of existing RMB Funds in China, with many more currently in the process of being formed. And the trend is not slowing – according to Zero2IPO Research Center, a well known research and consultation institution focused on the Chinese private equity and venture capital markets, while aggregate PE/VC fundraising has of course slowed dramatically in recent months, a telling statistic is that RMB-denominated funds represented approximately 90% of the total amount of new funds that were raised in the first three months of this year. Thus, while the global financial crisis is certainly severely depressing private equity and venture capital markets in China and worldwide, in relative terms the RMB Fund share of the Chinese PE/VC market is growing faster than ever.

The Demise of Offshore Structures?

Does all of this mean that the Red Chip structure, and offshore structures for PE/VC investments in Chinese companies are an endangered species, eventually to be extinct? Unlikely. For one thing, there are still many companies with offshore structures that were established prior to the effective date of the M&A Rules (August 8, 2006) and thus not subject to the M&A Rule restrictions. Another factor is that forming and operating RMB Funds can be time consuming and expensive – some investors, particularly those that are strategic rather than financial, are likely to continue to insist on only investing in offshore structures. And of course the longer the rules and regulations impacting offshore structures are around, the more sophisticated the market becomes at dealing with them – today an entrepreneur who knows her primary sources of funding will be foreign investors, and whose planned exit is an offshore listing or sale, may well simply establish an offshore holding structure from day one to avoid the need to possibly restructure in future. But most important is the simple fact that the hurdles blocking so many transactions are likely to be lowered in any case. There have been recent signs that the key bottleneck in most cases – the need for central MOFCOM approval – may be lightened or eliminated.

Conclusion

So what will the Chinese PE/VC market look like in 3- to 5- years? At the industry and individual business level, I wouldn't want to hazard a guess – some will be hot, others passé, some huge successes and some dismal failures. But of this I am sure: a far larger portion of transactions will be structured as onshore RMB investments, the first choice for future exit transactions will far more often be the onshore Chinese equity markets, and the most successful foreign players in the market will be those that have the knowledge and flexibility to asses and take advantage of these options.

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