Venture Capital and Private Equity Investing In China

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Today’s eLunch Presenters

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Introduction

- Capital reallocation from developed countries to China via venture capital, private equity, and cross-border mergers and acquisitions
- Is China’s role as one of the factories and R&D centres of the world fading?
- Political and social stability, strong domestic and foreign investment
- More than 7% growth in China’s GDP annually, less than the central target of 8%
- Recent SEC investigations, delistings, securities law class actions, privatizations of Chinese companies listed in the U.S.
Total Foreign Direct Investment

- Capital contributors: Hong Kong, Taiwan, United States
- Industrial Sectors: manufacturing, telecom
- Recent examples
Hong Kong Experience

- Lessons from Hong Kong and Taiwan
  - Since 1980, Chinese from HK and Taiwan moved their manufacturing base across the border because of cheaper labor, land, etc.
  - Operated mostly through contractual or equity joint ventures or subcontracting

- Examples of transactions
Direct Investment from the U.S.

■ Between 1990-2011 income of U.S. foreign affiliates has grown
■ Considerable earnings
■ Foreign capital reallocation to China (control value chain across production operations by acquiring local strategic assets and talents) in:
  ■ Telecom
  ■ Semi-conductors
  ■ Healthcare
  ■ Financial services
World Trade Organization

- Officially joined WTO in December 2003:
  - Opened vast opportunities in venture capital and private equity; retail opportunities under CEPA
  - Especially in the growing sectors
  - Particular interest in capital-intensive industries such as chip manufacturing and telecom equipment
Financial Issues

- Lack of predictability and transparency in Chinese business environment:
  - Inconsistent interpretation and application of laws and regulations
- Chinese Government: over-protecting local firms
- Centrally planned economy lacks free competition
- Foreign enterprises too enthusiastic
- Unreliability of information disclosed and faked financial reporting
Funding of VC or PE

Huge returns to early Facebook and Chinese game company VC or PE investors

Types of private funding:

- Seed financing
- Family and friends
- Angels
- Incubators
- Strategic investors and venture capital
Funding of VC or PE

“Seed” Financing

- Investment by founders
- Often invest in common stock in an off-shore company
- Investment size
- Shareholders' agreement
Funding of VC or PE

"Family and friends" investors, mostly "Accredited Investors"

- Closest allies, fast
- Usually invest in common stock with few preferential rights, investment size
- Disadvantages:
  - Small amount, not available for additional capital needs
  - Few contacts or valuable business input
  - Compliance with U.S. federal and state securities laws
Funding of VC or PE

“Angel” Investors:

- Not well defined
- Investment amount, use of non-disclosure agreement
- Usually invest in common stock and involves certain rights
- More aggressive “angel” investors will seek additional rights
- May provide contacts and expertise
Funding of VC or PE

“Angel” Investors:

- Key issues: restructure of Chinese companies, redomicile and special arrangements. Change of PRC M&A rules involving acquisition of Chinese companies by foreign capital in 2006 and 2009

- Subscription agreement and/or purchase agreement, shareholders’ agreement, and registration rights agreement
Funding of VC or PE

Incubator funds:

- Provide money and services to portfolio companies
- Generally invest in preferred stock
- Subscription agreement and purchase agreement, shareholders' agreement, and registration rights agreement
Funding of VC or PE

Strategic investors definition

- Use of non-disclosure agreements

- Advantages:
  - Expand brand
  - Validate business idea
  - Terms of business relationship
  - Can boost valuation significantly
Funding of VC or PE

- Disadvantages:
  - Issues for start-ups with significant strategic investor
  - Competition, conflicts, confidentiality issues
  - Need approval for any expansion, inability to operate joint venture efficiently
  - Chilling effect on potential acquisition by others
  - Possible delays in further funding
Funding of VC or PE

- Venture capital investors – current characteristics:
  - Revenue generation
  - Scalability of business
  - Quicker timing to profitability
  - More critical review of projection

- Advantages:
  - Possible source of significant funding
  - Provide expertise and experience
  - Provide valuable network of professionals, etc.
Funding of VC or PE

- **Disadvantages:**
  - Expensive money
  - Seek more control of company
  - Time-consuming process

- **Factors considered by VC investors**
Funding of VC or PE

- Documents and information required:
  - Executive summary
  - Business description
  - Management team
  - Growing market description
  - Revenue sources
  - Specify proposed investment amount
  - Use of investment proceeds

- Advantages, time or path to profitability, etc.
Funding of VC or PE

- Business plan
- Private placement memorandum to contain:
  - Business summary and description
  - Description of target market
  - Explanation of revenue sources and timing of revenue generation
  - Scalability of products and services
  - Capitalization table
Funding of VC or PE

- Financial statements and projections, reasonable but conservative
- Risk factors
- Description of competition
- Management profiles
- Strategic parties’ beneficial ownership table
- Path to profitability
- Use of proceeds and projected marketing/operating costs, cash burn
- Exit timing/exit format
Differences between Business Plan and PPM:

- Business plan primarily a selling tool
- PPM explains the business and protects the founders by highlighting risk factors
- PPM contains securities law disclaimers
- More detailed projections
- When to use which document
VC or PE Due Diligence

Confidentiality Agreement

- Protects confidential nature of target's information
- Sets rules for due diligence
  - Who may receive the confidential information, e.g., only employees/agents who "need to know" and who have agreed to be bound by the confidentiality agreement
  - Limits investor's contact with target, avoids business disruption, employee panic, and customer/vendor defections
  - Return of confidential information
  - No solicitation or hiring of target's employees
Due Diligence

- **Letter of Intent/Term Sheet:**
  - Memorializes parties' general agreement – helps avoid misunderstandings or "changes of heart"
  - May reveal irreconcilable disagreements
  - May make transaction cheaper in the long run, but could become so time-consuming that the deal becomes stalled
  - Often contains target's exclusivity covenant, no shop
  - May contain investor covenant not to solicit employees or customers of target
Due Diligence

DD Purposes

- Gather general industry, market, competition, management information
- Better understand the target, its business, assets/liabilities
- Identify risks, potential issues impacting investment cost
- Guidance for drafting and negotiation of investment agreement
  - Verify disclosure schedules
  - Identify closing conditions
  - Identify matters for indemnification
Due Diligence

■ Types of DD
  ● Legal: contract review, litigation, lien, judgment searches
  ● Environmental; accounting/tax
  ● Employee benefits; insurance, coverage and claims history
  ● Real property, title and surveys; intellectual property: patent, trademark and copyright searches
  ● FCPA review

■ Due diligence request list
  ● Define target to include all subsidiaries, including predecessors
  ● Open-ended, all-encompassing diligence requests vs. more focused, target-specific diligence requests
Due Diligence – Legal & Compliance

- Target's corporate structure? How long has it been structured this way? Proper PRC governmental approvals?
- Is target's business subject to any contingent liabilities?
  - Litigation claims; governmental investigations, FCPA issues, audits or claims for labor & employment; environmental; health & safety; antitrust; securities; criminal investigations
  - Tax audits or disputes; intellectual property claims (Apple vs. Samsung)
  - Insurance coverage disputes
  - Shareholder, employee, customer, or supplier disputes
Due Diligence – Legal & Compliance

- Is target subject to any change of control payments to management, creditors or any other party?
- Is target subject to any contractual restrictions affected by the transaction?
  - Any non-assignability or change of control restrictions in target's major contracts with customers and suppliers; labor agreements; debt instruments; joint venture agreements; governmental authorizations; retirement plans; non-compete provisions with suppliers, customers, equity holders, or partners; debt incurrence or other structuring limitations in material agreements
Is target or investor required to gain approvals to enter into a transaction? Estimated time needed for approval

Approvals from:
- Governmental agencies
- Right of first refusal or similar provisions in shareholders' agreement
- Shareholders and percentage required

Employee matters
- Employment agreements
- Are there standard confidentiality, non-compete, or non-compliance agreements in place?
VC or PE Investor Rights

- Principal Rights of Preferred Stock:
  - Types of investment: common stock, preferred stock, convertible preferred stock or convertible preferred debt
  - Valuation issues
  - Dividends may not exist and paid currently or accrue, typically 8% to 12%
  - Liquidation preference, typically, the preferred investors get their money back first
Investor Rights

- Conversion:
  - Converted at holder's option into common stock
  - The conversion ratio/price is generally subject to adjustment if the issuer later issues securities at a lower price, "price anti-dilution protection"
  - Preferred stock or convertible preferred debt automatically converts into common stock immediately prior to a "qualified" IPO
Investor Rights

- Voting Rights
  - Preferred stock or convertible preferred debt generally votes with the common stock as one class on an as-converted basis
  - Preferred stock or convertible preferred debt has special class voting rights with respect to certain matters

- Redemption
  - Preferred stock or convertible preferred debt will often be subject to mandatory redemption by the issuer if the issuer has not been sold or gone public within five years after the financing. Typical redemption terms.
Other preference rights:

- Preemptive right to purchase pro rata portion of new securities
- Right of first offer or refusal on sale of founders' shares
- Co-sale rights
- Right to have one or more representatives on the board of directors
- Information rights
- Demand rights
- Piggyback rights
Legal Issues – Employment Related Issues

- No employment contract
- Failure to pay overtime compensation
- Under-payment of social insurance and other employee benefits
Legal Issues – Anti-trust Filings

- The Ministry of Commerce is responsible for the anti-monopoly review
- Anti-monopoly review is required if an acquisition of a domestic enterprise by a foreign investor constitutes “industry concentration”
- Industry concentration:
  - The combined global turnover of the acquirer(s) and acquiree(s) in the previous fiscal year exceeds Rmb10 billion, and the respective turnover in China of at least two parties in the acquisition in the preceding fiscal year exceeds Rmb400 million
Industry concentration con’t:

- The combined turnover of the acquirer(s) and acquiree(s) in China in the previous year exceeds Rmb2 billion, and the respective turnover in China of at least two parties in the acquisition in the preceding fiscal year exceeds Rmb400 million.
Foreign Investors’ Strategic Investment in PRC Listed Companies

- A PRC listed company is not permitted to issue its shares to a foreign individual; however, it can issue shares to a foreign company pursuant to Administrative Rules on Foreign Investors’ Strategic Investment in PRC Public Companies jointly promulgated by several PRC government authorities in 2006.

- Such share issuance requires approvals from the Ministry of Commerce and China Securities and Regulatory Commission.
Foreign investors’ Strategic Investment in PRC Listed Companies con’t

- Requirements with respect to the foreign strategic investor (“FSI”)
  - FSI is duly established and validly existing with stable financial performance, good credit, and mature management experience
  - FSI has established healthy corporate governance and good internal control system
  - FSI shall own offshore assets of minimum US$100 million or manage offshore assets of minimum US$500 million
  - FSI has not been subject to any material penalties imposed by any PRC or foreign regulatory agencies
Transaction requirements

- The shares issued to the foreign strategic investor shall not be less than 10% of the PRC public company’s total outstanding shares.
- There is a three-year lockup period for the shares received from the PRC public company.
- FSI’s investment in the PRC public company shall comply with the PRC foreign investment catalogue.
Foreign Investors’ Strategic Investment in PRC Listed Companies con’t

Transaction requirements con’t

- When a PRC public company conducts an acquisition with its shares as consideration, it is required to enter into a compensation agreement with the acquiree, who is obligated to compensate the PRC public company for any difference between the projected earnings and the actual earnings in the three years after the completion of the acquisition.
State secrets are defined as information and matters relating to national security and interests and that are only permitted to be available to limited number of people within a limited period of time. The following shall be state secrets if the leakage or disclosure of such may damage Chinese national security and interests in the areas of politics, the economy, state defense and foreign affairs:

- Classified matters involving the key policy decisions on state affairs
- Classified matters involving the national defense construction and armed forces activities
PRC secret law *con’t*

- Classified matters involving the diplomatic and foreign affair activities and classified matters involving the state’s international obligation of secrecy
- Classified matters involving the national economic and social development
- Classified matters involving science and technology
- Classified matters involving the activities of maintaining national security and investigating criminal offences
- Others classified matters as determined by the state secret administrative agency
Restructuring Legal Issues: SAFE Notices

- How do the various SAFE notices affect a typical redomicile?
  - Jan 24, 2005 SAFE circular (no. 11)
  - April 8, 2005 SAFE circular (no. 29)
  - October 21, 2005 SAFE circular (no. 75)
  - May 29, 2007 Operating Procedures to clarify no. 75

- Approval for overseas investment by Chinese residents

- Earlier halting of approval and examination by local SAFE
Foreign-funded Mergers and Acquisitions of Domestic Enterprises

- General Application – applies to domestic companies, enterprises and natural persons (round trip investment)
- Article 11 requires Ministry of Commerce examination and approval
- Article 29 permits use of equity of listed overseas company as consideration
Some current structures

- Creative options
  - Slow Walk structure
  - Variable Interest Entities, VIE structure, questioned in Shandong Province, China recently
  - Option to purchase employee stock option

- Uncertainties and Risks

- Current issues and creative thinking?
Other China VC or PE Issues

- State assets purchased in an auction?
  - Relevant regulations
  - Applicability of Provisional Regulations on Administration of Transfer of Enterprise State-Owned Property Rights
  - Effect of Chinese judicial procedures on validity of auctions not complying fully with Chinese regulations
  - Other irregularities in the auctions
Other Issues

- Formation of a WOFE using acquired assets:
  - Article 15 of the Pilot Rules on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors
  - Additional documents needed: Chinese seller's resolutions to sell assets, WOFE application letter, WOFE articles of association, asset sale agreement (translated), Chinese seller's articles of association, Chinese seller's notices to creditors, investor's documents, and Chinese seller's plan to lay off its employees, as applicable
Other Issues

- **Shareholder loans:**
  - Inter-company loans
  - Individual loans
  - Conversion of shareholder loans into registered capital

- **Land Issues**
  - All land belongs to the State
  - Allocated land v. granted land
Exit Strategies: Mergers and IPOs

- Exit by sale or merger:
  - Part of a larger organization
  - Tax considerations
  - Cash vs. stock
  - Stock vs. assets
  - Continuing role of management
Mergers and IPOs

IPO exit with follow on offerings

- Start planning in advance
- Decisions involving accounting matters
- Decisions relating to management retention
- Selection of professionals

Alternative fund raising: reverse takeover of a listed shell, not viable in the foreseeable future for Chinese companies

Universal shelf registration, registered direct, and follow-on offerings
Mergers and IPOs

■ Advantages

- Access to public equity markets will generally enable companies to secure:
  - Better valuations
  - Less dilution than private equity
  - Avoid interest costs, cash drain, and operating and current restrictions associated with debt financings
Mergers and IPOs

- Increased options for future financing
  - Currency for acquisitions
  - Enhanced reputation and visibility
  - Enhanced liquidity for investors
  - Incentives for management and employees
Mergers and IPOs

- Disadvantages of public offerings:
  - Loss of confidentiality
  - Increased expenses
  - Considerable management time associated with the IPO process and thereafter
  - Dilution of current ownership and potential loss of control
  - Registration process can be lengthy, and
  - Price volatility
Mergers and IPOs

Other Key Considerations re public offerings:

- Lock-up arrangements
- Company's profits must be shared with outside owners
- Continuous reporting obligations and regulatory requirements
- Legal liability, Rule 10b-5 federal liability for false or misleading statement of material facts in any offering memorandum or SEC filings
- Expenses
Successful Strategy

- China market remains to be tapped
- With the right people and structure, devise a winning strategy
- Accommodate different needs
- Not an easy task; delicacy of a diplomat and skill of a mathematician
Questions?
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Thank You.