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Private Equity

China: Trends & Developments

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Trends and Developments

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COVID-19's Impact on the Market
The outbreak of COVID-19 has had a significant impact on the private equity market in China. Particularly, in the three months following the Lunar New Year in late January, which featured a large-scale decline in both the deal numbers and capital raised compared to the same period last year.

Due to travel restrictions and compulsory quarantine measures, most business trips in the private equity (PE) and venture capital (VC) sectors had to be postponed, and video calls, though useful, result in the execution of deals becoming significantly more time consuming. Further issues included uncertainties of valuation of target assets; equity buyers expected a lower price, while sellers hoped for a rebound in market and a better financial report.

Despite the slow start to the year, China's economy is shifting into recovery mode, and there are signs of optimism. During the past few months, the Chinese stock markets performed beyond expectation, which has encouraged investors and fund managers to look for opportunities in the PE/VC market. In addition, the COVID-19 outbreak has strengthened the focus on certain sectors, eg, healthcare, pharmaceutical, e-commerce, online education, semi-conductor and high technology, which will benefit from the societal shift of a post-COVID-19 era.

Role of State-Owned Capital
In the first quarter of 2020, the state-owned capital played a dominant role in rejuvenating the PE/VC market of China. According to Zero2IPO Research, the average capital raised from state-owned limited partners was 7.53 times of that from private limited partners. In addition, state-owned general partners raised 65.7% of the total capital in the domestic fundraising market.

The trend is unlikely to fade as the Chinese government expects the state-owned capital to continue to play an important role in developing the capital market and implementing industrial policies. However, state-owned capital is facing more red tape over its business activities.

Among others, the government promulgated certain provisions on the registration of state-owned equity of limited partnership enterprises, which will lead to a more stringent regulatory framework. If a state-owned investor is to be involved in fundraising or PE/VC acquisition, the fund managers are advised to draw-out decision-making processes and consider the special requirements for protection of state-owned assets.

Merger Clearance Review in PE/VC Deals
In the first half of 2020, the State Administration for Market Administration (SAMR) publicly announced two penalty cases involving the acquisition of minority stake for the relevant transacting parties' failure to submit declaration for merger clearance review in accordance with law. The SAMR took the view that the acquiring parties aimed to gain control (whether alone or in concert with others) over the target companies. It is expected a number of similar transactions will invite increasing attention or challenge from the regulatory authorities.

Acquisition of a minority stake in a target by investors (financial or strategic) may still trigger the acquiring party's obligation of declaring to SAMR for merger clearance review, if the acquiring party gains control over through the transaction and any statutory threshold is satisfied. The test for "control" should take into account various legal and factual factors, including, among others, voting mechanism of shareholders' or board meetings. Thus, if an investor who acquired minority interest is granted, under the shareholders' agreement and/or articles of associations of the target, a right to veto on certain significant operational matters of the target (eg, business plan, budget, appointment and removal of CEO and CFO, branch/subsidiary setup and close-down), it may be viewed as acquiring de facto control over the target, alone or in concert with others.

To manage the risk of triggering merger clearance, the acquiring party should think carefully to narrow down the scope of "veto" matters so as to avoid being regarded as taking control of the target's daily operation. Where substantial risk of failure to obtain merger clearance exists with a particular transaction, an acquiring party may consider:

- making the receipt of merger clearance a condition precedent for it to close the deal and asking for a breakup fee from the selling party/target; and
- requiring the selling party/target to redeem the purchased shares of the acquiring party with agreed annual return if the transaction is invalidated or unwound by order of SAMR after the closing.

The VIE structure

In the past, the legality of the variable interest entity (VIE) structure was a grey area. Before the SAMR took on the responsibility for merger clearance review, it was under the jurisdiction of the Ministry of Commerce (MOFCOM), which also reviews and approves foreign investment. As MOFCOM would not validate a VIE structure, it refused to officially accept such declarations.

This practice has not changed much since the SAMR took over merger review responsibility. However, in April 2020, the SAMR released public notice of a case (the "SMZ Case") in which one of the transacting parties has a VIE structure. Whether this means that the SAMR is now completely open to VIE declaration remains unseen, but the SMZ Case may signal that VIE arrangements can obtain formal recognition from PRC regulatory authorities (or at least from SAMR) and will no longer constitute an obstacle to the making of merger clearance review.

Impact of Foreign Investment Law

On 1 January 2019, the Foreign Investment Law of the People's Republic of China ("Foreign Investment Law"), together with its implementation regulations, took effect and replaced the "Sino-foreign Joint Venture Enterprise Law", the "Sino-foreign Cooperative Enterprise Law" and the "Foreign Enterprise Law" (collectively the "Three Foreign Enterprise Laws").

The Foreign Investment Law has an impact on share acquisition of Chinese targets by foreign PE/VC firms in China ("foreign acquisition") in the following major aspects:

Foreign acquisition and the "negative list"

Foreign acquisition not falling under the scope of the "Negative List" for foreign investment will only follow a mechanism of information reporting to MOFCOM through SAMR instead of a long-standing separate filing procedure with MOFCOM. This shift shows great improvement on the efficiency of administration of foreign invested enterprises (FIEs) throughout the process from its incorporation to subsequent changes (if any).

PRC Company Law governance requirements

As the Foreign Investment Law calls on an FIE to adopt a corporate governance structure compliant with PRC Company Law within the five-year transitional period starting 1 January 2020, many Chinese companies, after becoming an FIE by foreign acquisition, can retain its existing governance structure, which may bring some favorable changes to forging PE/VC firms. For instance, under the Three Foreign Enterprise Laws, the board of directors is the highest decision-making authority of a Sino-foreign joint venture (JV); this is now the shareholders' meeting, thereby making it feasible for foreign PE/VC firms to have a say or even veto at the shareholder level.

Another good example is that, under the Three Foreign Enterprise Laws, any equity transfer in a JV is subject to unanimous consent of all other parties to the JV which cannot be circumvented by private agreement; such restriction is lifted with the implementation of Foreign Investment Law and more flexibility could be available to foreign PE/VC firms for their planning of investment exit.

VIE arrangements

The Foreign Investment Law does not address the VIE issue as anticipated by most of the market practitioners; the legislative and regulatory authorities are reluctant to clearly regulate foreign investment through a VIE structure. That means a VIE arrangement typically employed by foreign PE/VC firms for their indirect investment in China in those restricted industrial sectors is safe for the time being.

However, it is still worth noting the definition of "foreign investment" under the Foreign Investment Law shall mean any investment activity "directly or indirectly" carried out by foreign investors within the PRC territory, including foreign investors acquiring shares, equity interests, shares of property or "other similar interest" in a Chinese target. According to this definition, China will adopt a "penetrating administration" system, regulating various kinds of foreign investments. Therefore, VIE arrangements can, theoretically, be covered under the scope of "foreign investment", and there might be a possibility that the Chinese authorities may bring the VIE issue into the regulatory net under the Foreign Investment Law and take an active role in supervising it when they see fit.

Investment and capital

Although it remains unseen whether or not the concept of "total investment amount" and the compulsory ratio of "total investment" to "registered capital" of an FIE in the context of Three Foreign Enterprise Law will be abolished, in practice, FIEs are treated equally with purely Chinese enterprises in terms of receiving capital from investors in their equity financings and are no longer subject to the cap of "total investment amount" when receiving capital from abroad. However, as China is yet a country of foreign exchange control, capital inflow and injection into a Chinese target by foreign PE/VC firms based on a valuation of PE multiples, especially where the valuation is well above the net assets of the target, may still be subject to a case-by-case scrutiny by the compete State Administration of Foreign Exchange.

Emerging S Funds in China's PE/VC Market

The secondary fund, also known as the S fund, provides an alternative exit approach to the LPs besides IPO and M&A exits. The S Fund is not a new species in the PE/VC world, but it just draws attention of the PE/VC market of China in recent years.

The Chinese PE/VC market grows rapidly after 2010 but it is still a relatively young industry in China.

The demand for S funds originates from the need for the exit of portfolio of the funds. According to the statistic of the Asset Management Association of China, as of 31 March 2020, there are 85,058 existing funds with a total asset management amount of RMB14,312.3 billion. For the funds established before 2015, most are facing the pressure of exits of their portfolios.

The capital market of China is big enough to support a secondary market; however, there are still not many S funds in the market. According to a report of the FOF Research Center, as of 8 December 2019, there are approximately 17 S funds with a total asset management amount of about RMB31 billion.

S funds are still in the early stages in China. In 2020, TR capital, with a group of buyers, closed an S fund transaction with Kinzon Capital, a well-known Chinese VC firm, with a first-stage closing amount of about USD100 million. The transaction draws lots of attention and discussion in the practitioners of the PE/VC market. Greater numbers of S fund transactions are forseen, and such transactions would be considered an important way to exit to the GPs and LPs in the PE/VC market of China.

Latest Update on Validity of the VAM Clause in China

The Valuation Adjustment Mechanism ("VAM Clause") is commonly adopted in equity financing agreements between an investor and a financing raiser. The VAM Clause is introduced to mitigate the uncertainty of the future development of the target company. The adjustment mechanism normally would be share compensation, share repurchase and cash compensation or both in a combined manner for the benefit of investors to cover the potential loss resulting from the adjustment to the valuation of the target company in the future.

In terms of the parties to VAM agreements, there are agreements between, among others, investors and existing shareholders, between investors and target companies, and between investors on one side and both the existing shareholders of target companies and the target companies on the other side.

The Haifu case and subsequent examples

In Haifu Investment Co, Ltd vs Gansu Shiheng Non-ferrous Resources Recycle Limited (the "Haifu Case"), the Supreme People's Court (SPC) hheld that the VAM clause among shareholders is valid and enforceable, but VAM clause between the investors and the target company invalid and unenforceable. The Haifu Case has profound impact on the investment practice and also provokes long discussion in the PE/VC industry. After the Haifu Case, most of the VAM Clauses adopted by the investor have been structured as the arrangement between the shareholders to enhance their enforceability.

After the Haifu Case, there are following judgements that ruled on other aspects of the validity of the VAM Clause. In Qiang Jingyan vs Cao Wubo and Shandong Hanlin Biotech Limited (the "Qiang Jingyan Case"), and Tonglian Capital Management Limited vs Chengdu New Direction Technology Limited and Sichuan Jiuyuan New Direction Intelligence Technology Limited (the "Tonglian Case"), the SPC held the opinion that if all necessary internal approvals are duly obtained, the guarantee provided by the target company against the obligation of the controlling shareholder under the VAM Clause could be deemed to be valid and enforceable.

Ninth Minutes of Trial Work Conference

In Jiangsu Huagong Venture Capital Co Ltd vs Yangzhou Metalforming Machine Tool Co Ltd (the "Huagong Case"), the court changed the position on the validity of the VAM Clause between the investors and the target company, and opined that VAM Clause between the investors and the target company is not necessarily invalid.

On 11 November 2019, the SPC released Notice by the Supreme People's Court of Issuing the Minutes of the National Courts' Civil and Commercial Trial Work Conference ("Ninth Minutes of Trial Work Conference"). This further developed the reasoning in the Huagong Case. The VAM Clause between the target company and the investor was not deemed to be completely invalid if the investor requests the target company to repurchase its shares and does not completed the capital reduction procedures properly, the request will not be supported by the court. In other words, the VAM Clause might be deemed to be valid, but remain unenforceable.

It should be noted that the PRC judicial system is not a case law system; the judgements of the SPC and the high people's counts at provincial level ("High Courts") are not legally binding upon the lower courts, but would highly likely to be adopted or referenced by the lower courts in their trials of similar cases considering the status of the SPC and the High courts in the judicial system. Similarly, Ninth Minutes of Trial Work Conference is not a legally binding judicial interpretation, but SPC explicitly stipulates in this guiding document that courts may reason according to its provisions when specifically analysing the reasons for the application of law in adjudicative instruments, which means in practice it would still have strong guidance effect on the lower courts.

Drafting a VAM Clause

Based on the judicial practice and the contents of the Ninth Minutes of Trial Work Conference, the following is advisable for an investor in drafting VAM Clause:

- to structure the VAM Clause as an arrangement between shareholders as such clause would highly likely be hold valid and enforceable by the courts;
- if the investor would like to drag the target company into the VAM Clause, the guarantee arrangement made by the target company could be considered but the investor should ensure that all necessary internal approvals of the target company would be properly obtained; and
- the investor should still be cautious if the VAM Clause is structured as the arrangement between the investor and the target company (other than a guarantee arrangement), even though it might be deemed to be valid under certain circumstances, but still could be unenforceable.

Exit of PE/VC Firms under Registration-Based IPO System

When investing in an enterprise, the eventual aim of PE/VC firms is to exit from the enterprise and regain the capital. For most, the optimal choice of exit is through the IPO of invested enterprises, but in recent years, this has been increasingly harder, which constrains the exit of PE/VC firms in the Chinese market. Accordingly, the PE/VC market was in a slump, especially in 2018.

In 2019, the Sci-Tech Innovation Board (STAR) Market in Shanghai Stock Exchange (SSE) was launched with the adoption of registration-based IPO system, which is a positive signal to the exit of PE/VC firms. And in April 2020, following the STAR Market, ChiNext Board in Shenzhen Stock Exchange (SZSE) also embraced the reform of registration-based IPO system, offering more hope to PE/VC firms.

Registration-based approval

Different from the approval-based system, under which the China Securities Regulatory Commission (CSRC) vets each application and always spends months or even years to approve the IPO of a company, the registration-based system simplifies the lengthy of procedures and thus is more time-saving for companies that wish to float shares. Under the registration-based system, the timetable is no longer indefinite. In the STAR Market, the SSE issues opinions about whether the company is allowed to be listed within three months of receiving application files for listing, and the time for issuers, together with their underwriters, to respond to inquiries of the SSE shall not exceed three months.

After the CSRC receives application files and opinions from the SSE, the decision that whether the company can be listed shall be made within 20 working days, which means it only takes approximately six months for companies to know the final result. As for ChiNext Board, the SZSE adopts a similar policy, and the time span from the receipt of application files to the notice of whether getting through the process will not exceed six months.

The efficiency of IPO will largely promote the landing on the STAR Market and ChiNext Board among qualified companies. Despite the efficiency, the registration-based IPO system adopts looser requirements in listing standard and allows listing for unprofitable companies.

It is anticipated that, with the convenience of IPO in STAR Market and ChiNext Board, the dilemmas created by the strict approval-based system would get improved, accordingly, the efficiency of the use of funds in the PE/VC market would be enhanced.

Positive Impacts of New Refinancing Rules on Investors

Since the tightening of the refinancing rules in 2017 and the subsequent market decline, the CSRC promulgated the Decision on Revising the Administrative Measures for the Issuance of Securities by Listed Companies, Decision on Revising the Interim Measures for the Administration of the Offering of Securities by Companies Listed on ChiNext Board and Decision on Revising the Implementing Rules for Private Placement of Shares by Listed Companies (collectively, the "New Refinancing Rules") in February 2020.

The New Refinancing Rules establish a regulatory environment for refinancing that are more attractive for PE/VC investors, which has been reflected by the burgeoning of refinancing market after the promulgation. They have transformed the existing refinancing systems in favor of the PE/VC investors and promote the new round of easing cycles from four dimensions:

Streamlining

The New Refinancing Rules streamlines the issuance conditions by abolishing the requirement regarding the asset/liability ratio and profitability for the public offering on ChiNext Board, consequently, certain companies that are not previously qualified to offer may get access to the capital market and the PE/VC investors of these companies may directly benefit from exiting through the public offering and private placement of these companies.

Optimisation

The private placement system is further optimised by introducing more flexibility to the pricing benchmark date and base price of issuance. The New Refinancing rules allow the companies to choose either the first day of the issuance period or the announcement date of the resolution of the board or shareholder's meeting where all issuance objects are determined in advance, as strategic PE/VC investors. The base price of issuance is adjusted from 90% to 80% of the average share price during the 20 transaction days prior to the pricing benchmark date.

Furthermore, the limit on the number of the maximum specified objects is uniformly relaxed and the scale of PE/VC investors is expanded to 35. The aforesaid measures respectively offered a discount rate and premium that are potentially more favorable for the PE/VC investors and considerably lowered the threshold of investment.

Shortened time period

The lock-up period for the issued shares was further shortened (eg, that period for the shares arising from competitive price offering be shortened to six months, compared to 12 months in previous practice) and the sales of shares obtained through private placement in accordance with the New Refinancing Rules shall not be subject to the relevant limitations on reducing the shareholdings. As a result, the financial liquidity in the refinancing market is significantly improved and the PE/VC investors are able to exit from the target company more easily and promptly.

Validity

The valid term of the approval was extended to 12 months (compared to six months in previous practice), which provides more extensive and flexible options for the listed companies pursuing refinancing and the PE/VC investors may avoid getting into the awkward situation where the approvals expire before proceeding the refinancing project.

More Convenience for Companies with a Red-Chip Structure

Based on long-term previous practice, for Chinese companies with red-chip structure that plan to be listed on A-share market, the only practicable way is to dismantle the red-chip structure. However, facing the recent trend that an increasing number of Chinese Concept Stock companies wish to return to A-share market, the policymakers have started to explore ways of attracting prime Chinese Concept Stock companies.

In 2018, the CSRC released several policies opening the gate for companies to return to A-share market without dismantling the red-chip structure. In 2019 and 2020, the STAR Market and the ChiNext Board respectively specified that companies can be listed with the red-chip structure. In April 2020, the CSRC issued the Announcement on Arrangements for the Domestic Listing of Innovative Red-Chip Enterprises under the Pilot Program, which further provides policy supporting the direct listing of red-chip enterprises.

Red-chip successes

Under the current laws and regulations, there are diverse criteria for red-chip enterprises to return to A-share market. Each company can select the most suitable route based on its market value, operating income, valuations, STI (science, technology and innovation) capacity and other factors. Since the related policy was recently implemented, in practice, there have been only two red-chip enterprises that successfully returned to A-share market yet.

The first one is CRM (China Resources Microelectronics Limited), which met the criterion that the estimated market value shall not be lower than RMB5 billion and the operating income of the latest period shall not be lower than RMB0.5 billion. And the second one is SMIC (Semiconductor Manufacturing International Corporation), which adopted the route that the market value shall exceed RMB20 billion and the company shall be equipped with independent research capacity, internationally leading technology as well as excellent scientific innovation capacity. With this trend, it is anticipated that more red-chip enterprises will seek landing on A-share market, which offers institutions investing in red-chip enterprises a new route to exit.

Exits

Speaking of exit, Special Provisions on Shareholding Reduction by Venture Capital Fund Shareholders of Listed Companies ("VC Fund Provisions") which was revised in March 2020, further loosens the requirements of fund investors' exit. According to the VC Fund Provisions, if PE/VC funds satisfy any one of the three requirements, respectively "investment at the early stage," "investment in small and medium-sized enterprises," and/or "investment in high-tech enterprise", the reverse connection policy would be applicable and PE/VC funds could reduce their shares in a more convenient way. And also it is noteworthy that considering the VC Fund Provisions do not rule out red-chip enterprises, the same policy should also be applicable for qualified red-chip enterprises.

Global Law Office (GLO) has more than 500 lawyers practising in the Beijing, Shanghai, Shenzhen and Chengdu offices, and is now known as one of the leading Chinese law firms, and continues to set the pace as one of the PRC's most innovative and progressive legal practitioners. GLO has been well recognised as one of the leading PRC firms in private equity and venture capital practice. Not only does the firm have a wealth of experience representing investors, but also extensive experience representing financing enterprises and founders. With an in-depth knowledge of the best legal practices and development trends of each investment term, the firm knows how to strike the best and most effective balance of interests in terms of negotiation in order to realise all-win results.

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