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Private Equity 2021

China: Trends & Developments
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Trends and Developments

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COVID-19's Impact Continues

China's economy made a good start in the first quarter of 2021. However, the situation soon changed with the arrival of the pandemic, and the private equity (PE) market in China is still far from recovered. To keep any outbreaks of the virus under control, China has taken a "zero tolerance" approach to COVID-19. In the past months, China has continued to use aggressive measures, including strict lockdowns, mass testing, travel controls and quarantine, which could hold back the country's economic growth and disrupt the investment markets.

Investment in Manufacturing Industries Increases

Over the years, China has made efforts to promote the transformation and upgrading of the country's manufacturing industry. Mega-funds have been set up and a huge amount of capital has flooded into this area. This trend strengthened in 2021. In April, both the China Securities Regulatory Commission (CSRC) and the Shanghai Stock Exchange released guidelines and regulations to emphasise their interest in attracting and supporting companies with "hard technology" and helping them go public. Hard technologies mainly include areas like new materials, new energy, aerospace, biotechnology, advanced manufacturing, and integrated circuits. On the other hand, the companies in the areas of non-manufacturing, especially a significant number of companies listed in the US, have fallen under heavy scrutiny and been more restricted recently. In July, the government banned private companies from teaching the school syllabus, along with a list of other restrictions on the whole private education sector and for educational phases from kindergarten through to high school (also known as K-12 under the UK or US system). Meanwhile, the cybersecurity reviews and anti-monopoly scrutiny of Chinese internet giants continues. Amid guidance and pressure from the government, it is apparent that more investors will choose to invest in the manufacturing industry value chain.

Impact of "Life Cycle Administration" on PE Investments

Along with other increasingly stringent regulatory enforcement policies in China, a unique regulatory requirement known as "life cycle administration" has emerged in the real estate industry in the past few years. It has been a requirement that any change to the shareholding structure or de facto controlling party of a PRC company (that has acquired the land use right with respect to certain land parcel(s)) will be subject to the prior written consent of a relevant government authority (usually being the grantor of the underlying land use right or the relevant local administrative committee). Such requirement has become more and more widely seen in various subsectors (warehouse, industrial park, commercial, office, etc) in the real estate industry in various cities in China.

Such "life cycle administration" is usually documented in the relevant land grant contract with the land grantor or in a separate investment agreement with the relevant local administrative committee.

One of the key considerations for a PE investor that wishes to conclude an investment opportunity is to ensure a "clean" entry into and a free and clear exit path for such investment opportunity. Whether as a buyer or as a future seller, a PE investor needs to have some assurance from the relevant government authority that there is no regulatory hurdle when it purchases an interest in a real estate project and sells the same after holding it for a period of time. With such "life cycle administration" requirement being seen more frequently in the market, PE investors have become increasingly hesitant about relevant investment projects, as, on the one hand, they encounter difficulties in obtaining such written consent before closing and, on the other hand, they are concerned as to whether they will be able to obtain such consent in their future exit.

PE investors would usually make such consent from the relevant government authority a condition precedent to closing. Unfortunately, however, there is not yet an established set of procedures in legislation as to:

- how to apply for such consent;
- on what condition such consent will (or will not) be granted; and
- in what form such consent will be granted.

Therefore, the parties (especially the sell-side) to a proposed acquisition may not agree to (or may not be able to) obtain such written consent prior to closing (in most cases they may only have informal communication with the relevant government authority) or may even be delayed or suspended in a proposed acquisition due to failure to get through the relevant registration/filing with the local administration for market regulation. In the absence of such written consent, PE investors need to build a complicated mechanism into the acquisition documents to ensure their losses are fully indemnified in case of a challenge from the government or failure to close. Such "life cycle administration" requirement and the lack of established procedures in legislation also result in uncertainty in future exit by PE investors. Given such consent may be granted or withheld by the relevant government authority at its discretion, PE investors are concerned about not being able to obtain such consent in the future, or about unacceptable conditions being attached to such consent. This results in a tougher internal approval and clearance procedure for PE investors on investment projects carrying such life cycle administration requirement.

Uncertainty about the Government's Actions Increases

Recently, the Chinese government has taken various actions to manage the economy, including placing restrictions on certain industries like private education, conducting cybersecurity reviews of China-based offshore companies, and launching antitrust scrutiny of investments made by internet giants. Common practice and market consensus have been greatly challenged. When making the decision to close a deal, both investors and portfolio companies need to consider the uncertainty about future actions by the Chinese government that could significantly affect the performance of the transaction documents.

New policies make K-12 online private education sector almost "not investable" for PE/VC investors

In 2020, due to the impact of the COVID-19 pandemic, the offline private education business suffered business loss while the online private education sector rose rapidly in revenue and market share. China's online private education sector had grown to a USD100 billion market and billions of dollars of capital had rushed into this sector. The astonishing amount of investment in Yuanfudao and Zuoyebang in 2020 drew a great deal of attention in the market and from the Chinese government.

On 24 July 2021, the Opinions on Further Easing the Burden of Excessive Homework and Off-campus Tutoring for Students Undergoing Compulsory Education ("Double Down New Policies") issued by the State Council and the Party's central committee were released and shocked the market, especially the US and Hong Kong stock markets. Even though the Double Down New Policies are not "law" or "regulation" under the Chinese legal system, it is widely anticipated that laws or regulations will be modified or put in place to echo the spirit of the Double Down New Policies.

The new policies are much tougher than previously experienced by the private education industry. Under the Double Down New Policies:

- curriculum-based tutoring is prohibited from raising capital through public listing or other channels;
- all institutions offering tutoring on the school curriculum will be registered as non-profit institutions, and no new approvals will be granted;
- listed companies will be prohibited from issuing stock or raising money in capital markets to invest in school-subject tutoring institutions, or acquiring their assets via stock or cash;
- foreign firms are banned from acquiring or holding shares in school curriculum tutoring institutions, or using variable interest entities (VIEs) to do so;
- curriculum-related tutoring during vacations is banned;
- online tutoring and tutoring on the school curriculum for children below six years of age is forbidden; and
- institutions cannot teach foreign curriculums or hire foreigners from outside of China to provide remote teaching to Chinese students.

The Double Down New Policies basically remove the K-12 online private education enterprise from the investment map for PE/VC investors. It is also anticipated that dispute among investors and target companies on the redemption clause of investment transaction documents will emerge in the near future.

Hong Kong might replace the US as the first listing choice for technology enterprises due to the coming restrictions of Chinese cybersecurity regulations

On 2 July 2021, two days after the listing of Didi Group on the New York Stock Exchange, the Cyberspace Administration of China (CAC) required Didi to stop accepting new user registrations. Two days after the administration order, the CAC further announced Didi's app "has serious violations of laws and regulations pertaining to the collection of personal information". Affected by the harsh administration measures on Didi, it has been reported that several technology companies have decided to delay or abort their US listing plans.

On 10 July 2021, CAC released the Measures for Cybersecurity Reviews (revised draft for public comments) ("Draft Cybersecurity Measures") and sought comments from the public. Under the Draft Cybersecurity Measures, any operator of the critical information infrastructure who seeks to be listed overseas must obtain a cybersecurity review clearance from the Cybersecurity Review Office if it is in possession of the personal information of more than one million users. Obviously, national security concern is the real reason behind the regulations, and some insiders tend to believe that Hong Kong, as a special administration region of China, would probably not be deemed as an overseas listing destination under the Draft Cybersecurity Measures.

Traditionally, Hong Kong is not the first choice for technology companies planning their initial public offering. Ignoring the valuation factor, the Hong Kong Exchange has a higher standard and a relatively stricter compliance requirement than the US exchanges when reviewing listing applications. Under the listing rules of the US exchanges, even if the applicant is non-compliant in its business operation, a full disclosure of the deficiency would meet the requirements, which makes the US exchanges a better choice for technology companies that have legal deficiencies in their operations. However, under the Draft Cybersecurity Measures, technology companies with more than one million natural person users, which is not a high bar in China, must obtain clearance from the Cybersecurity Review Office before their overseas listing. It is expected that companies with highly sensitive personal data will face a higher standard of scrutiny if the listing destination is the US, especially against the background of increasing tension between the US and China. Hong Kong would of course gain an advantage over the US if the latter is excluded from the overseas listing destinations under the Draft Cybersecurity Measures.

Some uncertainty about overseas IPOs predicted under July 6 Opinion

On 6 July 2021, the CPC Central Committee and General Office of the State Council jointly promulgated the Opinions on Lawfully and Strictly Cracking Down on Illegal Securities Activities ("July 6 Opinion").

The July 6 Opinion mentions in a subheading "strengthening the regulations of China Concept Stock" and that "(China) will amend the State Council's special regulations governing the overseas share placement and listing of stock companies, and will define the respective functions and duties of the domestic industry-specific authorities and regulatory authorities". The above is widely interpreted by the market as an indication that the overseas listing of China-based offshore holding companies, especially for newcomers employing a VIE structure to consolidate entities operating in China, might face some scrutiny from the CSRC and/or other government authorities, in both substance and procedure aspects.

In April 2003, the CSRC officially repealed the procedural prerequisite called the "no-objection letter" for China-based foreign companies (red-chip companies) seeking overseas IPOs, which was viewed as an epoch-making milestone in China's process of capital market globalisation. Now, nearly two decades have passed and the July 6 Opinion leaves room to imagine that China may review its regulatory framework over the past years and take active remedial measures in this regard. If that is the case, the rules of the game for all market players, whether in China or globally, will also be changed accordingly.

Strengthened Enforcement of a Merger Clearance Review in PE/VC Deals

Since 2020, the acquisition of a minority stake by an investor has stepped into the view of the State Administration for Market Regulation (SAMR) as a potential object of law enforcement in merger clearance reviews. In the first half of 2021, the SAMR publicly announced several penalty cases involving the acquisition of minority stakes and the relevant transacting parties' failure to file declaration for merger clearance review in accordance with the law and, in one penalty case, the acquired equity interest was approximately 10% when the SAMR determined that a "control" test was met. This shows that the SAMR is taking a more stringent view than before and has strengthened its law enforcement in practice. The trend of strengthened enforcement in merger clearance reviews gives rise to further concern for a PE/VC investor when making investment decisions.

"Control" tests developed along with the enforcement practice

Market players have observed that the following elements could lead to gaining "control" over the target company through the transaction if any of them exists in a minority interest investment or acquisition.

- A single veto right is granted any investor at the level of shareholder board or board of directors, as to the key operational matters of the target company, eg, determining the business plan and important investment scheme, approving the annual budget, appointing/removing the CEO or other senior management personnel, and even though two or more investors are granted a veto right by setting a threshold, such matters will require:
  (a) the approval of any two investor-nominated directors, given there are three investor-nominated directors in total; or
  (b) the approval of investors representing 80% of the preferred shares held by all investors given that two or three investors' collective shareholding has exceeded 20%, a possibility that joint "control" will be gained by two or more investors could not be excluded in the view of the SAMR.
- The shareholding structure of the target company is quite dispersive and it lacks a de facto controller, while an investor becomes the single biggest shareholder or holds at least one third of the shares of the target company, in which circumstances, such investors could have substantial influence on the decision-making of the company at the shareholder board level.
- One or more investors enter into a contractual arrangement in respect of voting proxy or acting in concert, as result of which, a single investor, or several investors, could jointly exert substantial influence on the decision-making of the target company at the level of both the shareholder board and the board of directors.
- One or more investors obtain the right to nominate and remove the majority of the board seats of the target company.
- Usually seen in a restructuring deal, one or more investors and the shareholder who is the de facto controller, enter into respect voting proxy or acting in concert, pursuant to which, a single investor could individually, or several investors could jointly, gain some control over the target company on a conditional basis, to help the target company overcome a financial or operational difficulty.
- In a strategic investment or acquisition, a minority investor undertakes to be a supplier (whether of raw material, core manufacturing assets or key technologies) or a client on whom the target company will have a high degree of reliance in its future operation.

To manage the risk of triggering merger clearance, the acquiring party should think carefully about minimising the triggering elements listed in the preceding paragraphs to avoid being regarded as taking control of the target company. Where substantial risk of failure to obtain merger clearance exists in a particular transaction, an acquiring party may consider:

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

The VIE structure is expressly brought into the regulatory net

In three penalty cases publicised by the SAMR in 2020, the reported transactions involve three scenarios:

- the acquiring party itself has a VIE structure;
- the target company already uses a VIE structure to consolidate the financial operating result of its entities operating in China; and
- the target company intends to enter the Chinese market restricted for foreign investment through a VIE arrangement.

On 7 February 2021, the State Council's Anti-Monopoly Committee released the Guidelines for Anti-monopoly in the Field of Platform Economy (the "Antitrust Guidelines for Platform Economy") which, for the first time, clarifies that concentration of business operators involving agreement control (VIE control) falls within the scope of concentration of business operators and needs antitrust clearance before implementation.

Although the Antitrust Guidelines for Platform Economy aim to regulate the activities of business operators in platform economies, such as e-commerce or other online 2C trading or service platforms, the rationale as to why operation income derived from VIEs should also be counted to determine whether the relevant statutory thresholds are met and whether the concentration could have the effect of restricting or eliminating competition, can be interpreted by the authorities to similarly apply in other industries and economic modes.

Draft amendment to Anti-Monopoly Law anticipated to enhance penalty

Under the Anti-Monopoly Law currently in effect, fines for merger-related violations, including failure to file, can be up to RMB500,000 which appears to be very low, as compared to the medium-to-high transaction size of a typical investment amount reaching hundreds of millions through to thousands of millions of renminbi. However, the revised draft of the Anti-Monopoly Law (the draft released for public comment in January 2020) will increase penalties for merger-related violations, such as failure to file, implementing the concentration before antitrust clearance or breaching merger commitments imposed by the authorities, to up to 10% of the sales revenue of the violator in the preceding year. If the draft is passed in its current form, the cost for a failure-to-file violation will be dramatically increased and will become a significant consideration for PE/VC investors in moving a deal forward.

Based on the above, transacting parties should be more cautious as to whether previous transactions require merger filing, and should consider whether to voluntarily submit a remedial merger filing to reduce the risk of facing higher fines when the Anti-Monopoly Law is revised.

China Continues to Expand its QFLP Pilot Programmes throughout the Country

China launched its first qualified foreign limited partner (QFLP) pilot programme in Shanghai in 2010, followed by other major cities of China, eg, Beijing, Tianjin, Chongqing and Shenzhen. According to the incomplete figures reported, by the end of the first half of 2021, QFLP pilot programmes had been extended to 18 cities or administrative regions, which are Shanghai, Beijing, Tianjin, Chongqing, Shenzhen, Guizhou, Qingdao, Pingtan, Zhuhai, Guangdong, Xiaman, Suzhou, Hainan, Shenyang, Jiashan, Nanning, Xiongan and Jinan. Since 2020, pioneer cities such as Shanghai, Beijing and Shenzhen have actively amended the local regulations governing the QFLP regime to accommodate more flexibility under the Foreign Investment Law of the People's Republic of China ("Foreign Investment Law") which came into effect on 1 January 2020.

When it was first "invented" more than ten years ago, the QFLP regime was used as an innovative tool, in addition to the traditional FDI mode and foreign-invested VC mode, to attract foreign capital to make PE investments in China and seek return and exit from China's capital market (eg, the A-share market in the Shanghai and Shenzhen stock exchanges). Under the QFLP regime, a foreign-invested equity investment fund (FIE Fund) formed in China is allowed, although subject to some quota restriction, to directly convert the foreign capital contributed by overseas limited partners into RMB at the fund level for further onshore investment, which was seen as a breakthrough against the foreign exchange control regulation at that time. Another featured strength of the QFLP regime is that it allows sophisticated foreign PE houses to establish a foreign-invested equity fund management company (FIE FMC) in China to provide onshore management services for FIE Funds.

The local regulations governing QFLP pilot programmes vary from locale to locale in terms of specific threshold and compliance requirements. However, such regulations, modified or newly adopted in recent years, show great relaxation of those requirements in an effort to offer a more favourable regulatory environment for foreign participation in the domestic PE/VC market, including:

- besides the "FIE FMC to manage the FIE Fund" mode, the permitted operational modes have been expanded to allow "Domestic FMC to manage FIE Fund" mode and "FIE FMC to manage RMB-sourced Fund";
- the threshold requirements to establish a fund management company (FMC) have been lowered or even lifted, eg, no minimum registered capital requirement, no fund-management experience or other qualification requirement of shareholders of an FMC, and no special qualification required by the senior executives of an FMC other than those required by the Asset Management Association of China (AMAC);
- the threshold requirements to form a QFLP fund have been lowered, eg, no requirement relating to fund-raising scale or contribution schedule, no qualification required by limited partners of the fund (investment experience, financial net worth for individual investors; sound internal control system or net asset value for institutional investors);
- the permitted scope for QFLP funds to make an investment has largely been expanded from the PE market to almost all kinds of investment tools or target assets that are not forbidden by law, including without limitation, private placement by listed companies, privately raised bonds, convertible bonds, stocks or bonds in secondary markets, futures or other financial derivatives, mezzanine financial products, real estate or fund of funds (FOF); and
- QFLP funds are offered clear and optional exit paths, including equity transfer to other investors, equity repurchase by portfolios, dissolving and liquidating the portfolios, and going public in the domestic and international securities market.

Along with China's lightening of its foreign exchange control by allowing ordinary foreign-invested enterprises to convert their registered capital from foreign currency into RMB to make equity investments in China to expand their normal business, the advantage of QFLPs is gradually fading. However, compared with the traditional FDI mode and foreign-invested VC mode available to foreign investors, the QFLP regime is still a preferable and desired investment tool, with its strength concentrated in the following aspects:

- the foreign currency-to-RMB conversion by a QFLP fund can be done on a lump-sum basis rather than on a case-by-case basis;
- other than those listed in the nation's negative list for foreign investment, a QFLP fund is allowed to invest in various industrial sectors, while in practice an ordinary foreign-invested enterprise may be restricted from converting foreign currency into renminbi for investment in industrial sectors which are irrelevant to the current business of such foreign-invested enterprise; and

- a QFLP fund is allowed to invest in diversified financial tools or assets, subject to appropriate approval from the relevant authority.

We believe that the QFLP regime will exist for a long time and is not just a temporary tool to meet the current need to open up the domestic capital market. A nationwide and unified QFLP regulation is expected to be introduced in the near future after more than ten years of extensive pilot experiments in China.

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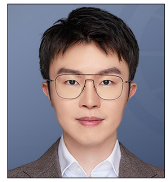

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