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Viability of Red-Chip Model: Exit Through Offshore Listings Reconsidered

by Joseph Chan

Nine months after the new M&A rules became effective; approvals for Chinese enterprises to list overseas remain frozen. VCs active in China have been re-evaluating the way they carry out their investment activities in China and, most importantly, their exit strategies.

Historically, foreign-denominated funds contribute about 80% of venture funding in China and offshore-based US dollars are the currency of choice. An offshore structure affords the type and level of protection that venture investors are accustomed to receiving overseas. More importantly, such offshore structure makes exit easier, bypassing the cumbersome and oftentimes unpredictable regulatory landscape in China. Listing their Chinese portfolio companies abroad, for example, provide foreign venture investors with a freely convertible currency and made it possible to avoid China's strict capital controls, regulatory monitoring and various hurdles that confront Chinese enterprises if they were to directly list overseas. This is accomplished through an offshore listing vehicle under the so-called red-chip model.

Red-Chip

Under the red-chip model, foreign investors who came upon a company owned by domestic PRC shareholders would set up and fund an offshore holding company in a jurisdiction like the Cayman Island or the British Virgin Islands. The shareholders of the PRC company would become shareholders of the offshore holding company as well. After the offshore company is set up, it would purchase the PRC company and made it its wholly-owned subsidiary. This is sometimes described as a round-trip affiliate purchase. The majority or all of these enterprises' operations and assets are in China. The primary reason for this structure is that it facilitates exit by foreign venture investors, either through a trade sale or an IPO. It is very challenging to take a pure PRC company public in an offshore market. Getting approval from the China Securities Regulatory Commission ("CSRC") is one of the main challenges. There are other legal shortcomings as well.

The new M&A rules put a limitation on the round-tripping transaction described above. Under the new rules, the establishment and listing of an offshore holding company now require approvals by the Ministry of Commerce ("MOFCOM") at the central level and the CSRC. Moreover, companies that successfully list abroad must now repatriate proceeds within a pre-determined time frame to

China. Even if a company obtains listing approval, failure to complete the overseas listing within 12 months of such approval would result in the company reverting to its original share structure. This is an unrealistic time frame which for all practical purposes renders the listing approval of limited usefulness.

The new rules translate into delay in deal execution and exit uncertainty. The new rules have made it more difficult for foreign venture investors to utilize the “tried-and-true” method of investing in PRC enterprises via an offshore structure. The net effect is that foreign investors may pause before committing to a deal. This may be a consequence not intended by the regulators. One cannot help but reflect on Circular No. 11 and No. 29 issued by the State Administration of Foreign Exchange (“SAFE”) in the early months of 2005. These regulations practically shut down the venture industry in China. To SAFE’s credit, the most troubling aspects of the regulations were reversed or modified by Circular No. 75 later that year. Only then did the door to foreign venture investments in China re-open.

The new M&A rules can be seen as an attempt by the Chinese regulators to foster the domestic stock markets by encouraging listing of promising enterprises domestically. Based on data gathered by Zero2IPO, of the 151 Chinese companies that listed in 2006, 86 chose an offshore listing. Among these 86 companies, 29 were venture-backed. China seeks to encourage the development of its domestic capital markets. Offshore listed blue-chip companies have been encouraged to make secondary listings onshore. This is consistent with the recent trend of IPOs of major SOEs. Contrary to common practice in the past, major Chinese enterprises such as the Industrial and Commercial Bank of China and the Bank of Communications have opted for a listing on the HKSE, followed by an A-shares listing on the Shanghai Stock Exchange. In contrast, common practice previously entailed dual-listings on the Hong Kong Stock Exchange and the New York Stock Exchange. It has been suggested that encouraging venture-backed companies to list domestically may be the next logical step of development.

To our knowledge no overseas listing approvals have been granted by the CSRC since the new M&A rules came into effect. This has created uncertainty in the venture world and put a damper on venture deal-making. Of course, it is possible that the bottle-neck in listing approvals thus far is less the product of a deliberate policy to discourage offshore listings than the out-working of differences among the six agencies which jointly issued the new M&A rules. There are rumors in the market that the regulators are still ironing out their differences over the future direction of offshore vis-à-vis onshore listings.

On the other hand, it could be that the new M&A rules are aimed more at preventing money-laundering and unfair tax savings obtained through round-tripping. With the unified tax scheme between domestic enterprises and foreign invested enterprises becoming effective in 2008, the incentive for round-tripping as a means to reap preferential tax benefits may decrease in any event.

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For foreign venture investors, the challenge posed by an onshore listing is the ability or rather, the inability, to repatriate proceeds overseas from an onshore IPO in a reasonable timeframe. The current regulatory landscape may increasingly distinguish foreign venture investors who are investing in China for the long haul vis-à-vis those who may have a shorter time frame in view. For the former, the prospect of immediate repatriation may be less of a concern.

Onshore Structure

The question increasingly being asked by foreign venture investors is whether it now becomes necessary to consider an onshore exit strategy via the domestic stock exchanges. There has not been an exit by a foreign dollar-denominated venture fund in the Shanghai or Shenzhen exchanges to date. Of course, overseas listings remain important and attractive for a number of reasons, some of which are already discussed above. Any listing of true international scale would probably still dictate an overseas listing. Chinese regulators likely recognize that.

The writer observes that foreign venture investors are increasingly looking into direct investments in Chinese companies through onshore joint venture arrangements. The possibility of foreign-invested RMB-denominated venture funds are also emerging as a topic of discussion.

A number of factors give rise to the recent phenomenon of direct investments in Chinese companies.

First, as mentioned, there is the difficulty of investing through an offshore holding structure. Also, as discussed, there is the apparent preference by the Chinese government to bring Chinese companies onshore, subjecting them to the oversight of the Chinese regulatory authorities. This is consistent with the objective of the authorities in fostering the development of a strong domestic capital market.

The direct investment model effectively creates a joint venture between the foreign investors and the domestic company. In most of the 1980's and 1990's, most foreign investments took the form of joint ventures. However, as more foreign venture investors entered the market who needed a viable exit strategy, investing through an offshore structure became more prevalent. The main advantage of this direct investment approach is speed. If a transaction falls below a certain dollar threshold, only provincial approvals are required, thereby allowing a quick closing. Some of the foreign venture investors who adopt the onshore approach expect that as soon as the rules permit they would restructure their investment offshore and transfer ownership to the offshore level, making the PRC company a wholly-foreign owned enterprise. This is by no means uncertain, however. Such expectation may not be realized. An alternative to offshore restructuring is to convert the PRC company into a foreign-invested company limited by shares. The main advantage is that shares can be issued. In contrast, joint ventures usually do not issue shares. However, MOFCOM approval is required.

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Nevertheless, foreign venture investors face considerable difficulties in either a joint venture or a foreign-invested company limited by shares. First, foreign venture investors cannot obtain the minority shareholder protection that they typically expect and require, such as preferred shares. One important feature of an offshore holding company is its ability to issue different classes of shares. In contrast, Chinese companies are only permitted to issue a single class of shares, treating all shareholders equally. This poses significant challenge to the venture investors. To mitigate the risk they take on when investing in a new enterprise whose business model, in most cases, is as yet unproven, foreign venture investors require such protection mechanisms as liquidation preference and anti-dilution.

Furthermore, corporate governance under the PRC legal regime is very different from a common law jurisdiction. Foreign venture investors usually require certain shareholder rights, including management rights, voting rights, and preemptive rights like the right of first refusal. Chinese laws render many of these rights unenforceable. Also, other shareholders' consent and government approvals are required for practically all major corporate decisions, including issuance of additional stock. All these put the foreign venture investors in an unenviable position.

The strength of the A shares market is another reason why some of the foreign investors are contemplating a domestic exit strategy. This writer firmly believes in the continued rise of the A shares market over the long haul, although hiccups may be inevitable along the way. Domestic valuations have risen significantly as well, in part reducing the rationale of an overseas listing on account of higher valuation. A word of caution, however. A joint venture cannot be listed. And, under the current legal regime, the listing of a foreign-invested company limited by shares on a domestic exchange may not provide an exit for pre-IPO shares. While the trend initiated by the recent "G Share reforms" may eventually lead to the liberalization of the A shares market, making all shares tradable, this exit strategy is as yet unproven.

The recent enactment of the foreign invested venture capital enterprise regulations supplies an additional incentive for onshore direct investment. It is now possible to form domestic RMB-denominated venture capital funds with foreign investment. If structured appropriately, such enterprises can enjoy a lower tax rate because of the flow-through tax treatment allowed by the regulations. Investments from this type of funds can be quick as well, since no foreign investment approvals would be required if the target investments are in the encouraged or permitted categories. Often, in the frenzy of deal-making, especially in a competitive environment, the certainty, ease and speed of closing could give one investor the upper hand vis-à-vis the other. Foreign venture investors investing through this type of domestic RMB funds could tap into the domestic deal-flow which has been strong. Previously, the need to structure a transaction offshore would deter local VCs from inviting foreign VCs to co-invest with them. Moreover, unlike most foreign invested companies, this type of RMB funds can repatriate capital to investors upon disposition of their portfolio companies.

The fact that local venture funds are generating attractive returns has not gone unnoticed by their foreign counterparts. Local funds are able to take advantage of their ease with RMB investments and current Chinese regulations which disfavor offshore structure. The tide to more onshore investments through RMB funds is further helped by the new regulations which provide lower entry barriers and stronger legal foundations for foreign investments in RMB-denominated funds. At the same time, offshore funds face more challenges. For example, SAFE regulations now require a more complex registration process and complicated procedure designed to discourage offshore investment structure involving PRC shareholders. In the long run, the traditional offshore investment structure where the venture fund, portfolio investment and exit are all held or conducted offshore may be unsustainable. An improving domestic A shares market, higher valuation, and more facilitating regulations may make a domestic exit viable in the foreseeable future. The strength of the RMB and general expectation of its continued appreciation supplies yet another impetus to onshore investment. Given the current dynamic in the venture market and the growing maturity of the Chinese economy, this may well be a historic tide that will only grow stronger in the years to come.

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