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Emerging Trends in... China
Serving Silicon Valley via Shanghai

Finance

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A conversation with Joseph W. K. Chan, co-head of Greater China practice and managing partner, head of Shanghai, Pillsbury Winthrop Shaw Pittman LLP

Q: Pillsbury Winthrop Shaw Pittman recently opened an office in Shanghai. Why now? Why Shanghai?

Joseph W. K. Chan: This is an exciting time in China for private equity/venture capital investors.The U.S. venture capital community has been paying more attention to China, with many of the leading players in Silicon Valley, such as Sequoia Capital, Mayfield and Kleiner Perkins having set up offices in China or having begun the process of doing so in the last 12-18 months.

Given Pillsbury's strong venture capital practice in Silicon Valley, and the fact that not many U.S. firms versed in venture capital are established in China, we believe the establishment of our Shanghai office is well timed. Our initial focus in Shanghai is to serve our venture and technology company clients from both the U.S. and the PRC in financing and cross-border M&A transactions. However, as Pillsbury has core competencies in other areas including global energy and financial services, we will expand our offering as opportunities arise.

Q: What are indicators of the direction of the market heading into 2007?

JWKC: We have been involved with a number of cross-border mergers and acquisitions transactions and believe that the volume of those deals will only increase.

Regarding private equity, it is important to clarify that the term "private equity" when used in connection with China really means venture capital-type deals rather than buyouts. Given the current regulatory environment in China, including the recent newly promulgated M&A rules, buyouts are rather difficult to execute.

That said, generally, we are seeing a lot of new money flowing into China-focused venture funds. As much as $2 billion was raised as of the middle of 2006, largely on track to match and the $4 billion raised for China-focused investments last year. As many as 20 new funds were raised this year. Moreover, many firms already in China are allocating significant portions of their funds to China-specific investments. As much as $4 billion was raised for China-focused investments last year.

On the one hand, this is good news for Chinese entrepreneurs. On the other hand, there is the risk of having too much money chasing too few deals. Chinese entrepreneurs have been able to shop their term sheets, leading to a significant rise in valuation.

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The market right now may be too hot, particularly in the technology space. There has been talk of a bubble.The China market is showing symptoms similar to those associated with the pre-crash Internet boom.The large inflow of new money is one such symptom. High valuation and unrealistic expectation of entrepreneurs is another. Of course, the market is cyclical, and right now we're at high tide. Having said the foregoing, I am very bullish on the long-term prospects of the China venture market.

Q: Are there any particular industries that are likely to see more activity? Or less?

JWKC: Of course, China is a global manufacturing powerhouse, and the construction sector is very active. But much of the new money, especially the venture capital, is in TMT (telecom, media and technology). The majority of venture capital-backed China entities that have gone public have been in this space. Recent evidence suggests, however, that there is a slight shift in focus away from TMT to more traditional sectors, including retail, energy, materials and health care.

For a guide to areas of future growth it is important to look at the government's priorities. The government's 11th Five-Year Plan has two main goals.The first is to create a "harmonious society," that is, simply put, to reduce the tension due to the wide economic disparity between the haves and have-nots.

The second goal is to build an "innovative" economy. This is significant for foreign investors because although it is government rhetoric, it indicates that the Chinese government supports the economy's move up the value chain. It recognizes that the economy must move beyond its role as a manufacturing powerhouse to become a global innovator—to develop companies that can be pioneers in software, information technology, telecom, etc. As evidence of the government's support for this goal, it is possible to look at the recent stepping up of enforcement of intellectual property rights (IPR).The government realizes that IPR protection and enforcement are important to encourage domestic enterprises to innovate, invest in R&D and to develop indigenous technologies rather than just copy existing foreign technologies.

China has roughly 130 million Internet users, which is only 10 percent of the population.Thus the Internet space, including e-commerce, Internet portals, and to a lesser extent telecoms, have been popular in the past. But medical devices have been garnering more attention of late. China has an aging population so this area is likely to become active for some time to come.

Anything mobile-technology related is likely to be attractive, since China has more than 400 million mobile phone users (and only 350 million fixed-line subscribers).

Q: What are some of the biggest challenges facing investors generally, and private equity investors specifically, heading into next year?

JWKC: As mentioned, high valuation and easy money are of concern. On the regulatory fronts, one of the biggest challenges will be dealing with the effects of a July notice by China's telecom and Internet regulator, the Ministry of Information Industry.

Also as discussed, the vast majority of investment dollars and recent success stories in China have been in TMT. Under Chinese law, foreign investors may not hold directly any licenses to provide value-added telecom services, which includes most online commerce and Internet-related services. Foreign investors have been able to get around this prohibition by establishing a complicated contractual relationship with a Chinese license-holder who is controlled and owned by friendly parties.The MII notice basically says that circumventing the restriction by this type of contractual web is no longer permitted. The resolution of this issue is unclear at this point; but it will greatly affect how future deals in this arena are structured.

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