Paul Hastings

CHINA MATTERS

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The Eight Essential Features of Private Equity in China

High-profile private equity success stories from China are attracting a growing number of US and European investors to the country. Structuring a deal in China, however, is complex. Investors should bear in mind the following eight key issues.

1. Multiple Layers of Companies in Different Jurisdictions

The customary vehicle for private equity investment in China is the offshore holding company (generally incorporated in the Cayman Islands or the British Virgin Islands), which does not operate in China. It is a distinct entity from its wholly-owned subsidiary in China – the wholly foreign owned enterprise (WFOE). In addition, Chinese founders may hold their interests in the offshore entity through their own offshore holding companies, creating multiple levels of ownership and control. It is therefore crucial that the legal documents bind the various parties and levels of control together into one overall structure.

2. Special Structure to Invest in Restricted Industries

Certain industries, such as telecom value-added services, the internet and media, offer attractive growth potential but are restricted from foreign ownership. To enable foreign investments in these sectors, a PRC operating company (a Chinese company held by Chinese citizens) is frequently established to hold the licence and operate and contain various aspects of the business. The offshore holding company and the WFOE in turn exercise both operational and financial control over the PRC operating company through a series of agreements, and the accounts of the three companies are consolidated. The internet companies Netease, Sina and Sohu are successful examples of this structure.

3. Foreign Exchange Control

Foreign exchange control can cast doubt over the enforceability of certain contracts involving cross-border currency flows. For example, without registration with the State Administration of Foreign Exchange (SAFE), a foreign currency bridge loan from the offshore holding company to the WFOE is not enforceable in China. If the PRC operating company, which is not foreign owned, wants to borrow from a foreign party (such as the offshore holding company), prior SAFE approval is required, yet this can be difficult for small and medium-sized companies to obtain. In practice, repatriating any money, for a purpose such as satisfying covenants made by the offshore holding company to redeem an investor's shares, will also trigger SAFE rules. In addition, when Chinese companies reorganize themselves into the customary offshore holding company-WFOE structure, Chinese resident founders may not establish or control a company outside China, nor give up assets within China in exchange for assets or equity outside China, without prior registration with SAFE.

4. Registered Capital Rather Than Shares

The equity of most foreign owned or invested Chinese companies is in the form of registered capital (expressed as an amount of money) rather than share capital (expressed as a number of shares). As a result, it is difficult to have different valuations of a company between different rounds of financing, or to document or implement anti-dilution provisions. In addition, increasing a company's registered capital requires

government approval, meaning follow-on investment is not at the absolute discretion of the shareholders.

5. Exit by IPO

To exit from the investment via an initial public offering (IPO) requires careful planning at the outset. For example, to list on the Hong Kong Stock Exchange (SEHK), a company generally must be incorporated in Hong Kong, the Cayman Islands, Bermuda or China. Further, to enter the SEHK Main Board, the company must have had the same owners for the full financial year immediately preceding the listing, and management must have been substantially the same for the past three years. These requirements mean private equity investors who want to take a substantial stake in a company followed by a quick IPO in Hong Kong should consider investing by way of convertible debt rather than shares.

6. Exit by Sale

The Cayman Islands, the British Virgin Islands and Hong Kong do not have merger laws. Two companies cannot, therefore, merge simply by a consent or vote of the shareholders. As a result, "drag-along" clauses are necessary to make sure that if the requisite percentage of shareholders decide to sell their shares, the minority shareholders will not hold up a sale of the company.

7. Multiple Layers of Decision Making for State-Owned Enterprises

If a transaction or restructure involves a state-owned enterprise, the investors must remember that every purchase or sale decision that an enterprise makes is subject to the review and approval of the State-Owned Assets Supervision and Administration Commission. As a result, an investor may find that a deal or valuation it has agreed with the management of a state-owned enterprise is later deemed invalid. When dealing with a state-owned enterprise, investors must remember that there are multiple layers of decision makers.

8. Fiscal Matters

Last but not least, all parties should establish whether any financial information (for example, representations and warranties, future performance warranties and financial reporting) is based on the PRC GAAP, US GAAP or IAS accounting systems, and whether it is on a consolidated or on an individual basis.

SUMMARY

Steps to Take

- Bind multiple layers of holding and operating companies
- Structure to invest in restricted industries
- Consider foreign exchange controls
- Plan the debt-equity structure early
- Know the rules of the potential listing venues (for exits via IPO)
- Put drag-along and voting provisions in initial contracts (for exits via sale)
- Know the multiple layers of decision-makers in state-owned enterprises
- Be clear about fiscal and accounting standards

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Bulletin Board

On October 21, 2005, SAFE issued Notice No. 75 to replace Notices Nos. 11 and 29, issued in January and April 2005 respectively. The new notice stipulates that Chinese residents will need only to register their investment with SAFE, rather than to seek approval from the regulator. In addition, Chinese residents must repatriate into China within 180 days any foreign currency they obtain following a liquidity event outside the country. Chinese residents with existing offshore holding companies must register them with SAFE pursuant to Notice No. 75 before March 31, 2006.

About Paul Hastings

Paul, Hastings, Janofsky & Walker LLP is a global law firm with 1,000 lawyers in 17 offices in Asia, Europe and the US. Paul Hastings provides a full service, multi-jurisdictional legal practices in China with over 85 lawyers in Beijing, Shanghai and Hong Kong, and 40 lawyers in Tokyo. For further information about private equity in China, please contact:

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