Private equity in China – a public affair

Despite complex regulations, China’s private equity market is too good to pass up, writes Frank Hong

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nternational observers often deplore the complex and opaque barriers faced by private equity investors in China, but the country’s regulatory regime has its own logic and the ability to adapt to fast changing domestic and global market situations.

Thanks to a strict foreign exchange control regime, Chinese regulators can legally shut down international private equity deals with a stroke of their pen. But the Chinese government usually goes out of its way to accommodate and promote private equity investments in China.

This summer, the Shanghai Pudong New Area promulgated the “Provisional Measures on Establishing Foreign-Funded Equity Investment Management Enterprises,” the first legal rule in China to regulate the formation of foreign-funded private equity management companies. Although ground-breaking, this rule will expire in June 2010 and a national regulation on private equity is expected in the coming months.

Under China’s highly centralized government, no local authority can issue a precedent-setting rule ahead of a national regulation. However, Shanghai Pudong is a special jurisdiction empowered by the State Council to explore “comprehensive reform”; it is authorized by the Shanghai Municipal Government to experiment with ways to develop the private equity industry as part of the city’s ambitious drive to become a world financial centre.

Private equity, in this sense, is a public venture as it is directly linked to the national development agenda.

From venture capital to private equity

In so far as venture capital is a sub-category of private equity, China was already regulating such investments at the time the Ministry of Commerce issued “Provisions on Foreign-Funded Venture Capital Enterprises” in 2003 and the National Development and Reform Commission promulgated the “Provisional Measures on Venture Capital Enterprises” in 2005. Cao Wenlian, the NDRC’s deputy director of fiscal and financial department, however, said there was no standard Chinese term for “private equity fund” at the turn of the 21st century.

Shifting from venture capital to private equity is more than just a name change; it is linked to China’s desire to spur investment in innovation and high technology as set forth in a policy platform issued by the State Council in August 1999. The policy paper emphasized the fostering of a capital market, especially a venture capital investment and exit system, which would help high-tech development.

That same year, China’s securities law came into effect. A decade later, on the heels of the financial crisis, the State Council announced a resolution for Shanghai to become a world financial centre by 2020.

The Shanghai Financial Service Office issued in the summer of 2008
ChiNext, a long-awaited NASDAQ-style second board, attracted a slew of listing applications after it was launched in October. A vibrant China IPO market means private equity firms can easily exit their investments through stock listings in China.

a circular to relevant agencies on the licensing formalities of private equity companies. The circular, which paved the way for the Shanghai Pudong rule on foreign-invested private equity management companies, credited private equity but not venture capital with “improving corporate governance, creating value and facilitating realignment of industries.”

The last decade has seen the emergence of a new generation of so-called “modern enterprises” in many sectors other than technology, providing fertile ground for private equity participants. Private equity cannot, however, deliver its magic without a suitable legal infrastructure.

**Limited partnership, taxation and incentives**

At the time of the Ministry of Commerce’s 2003 provisions on foreign-funded venture capital companies, the 2007 amendment to China’s Partnership Law expressly allowing limited partnerships was still years away.

Undeterred, the regulators at MOFCOM created the concept of an “essential investor,” referring to someone with a solid track record in venture capital investments. Foreign-funded venture capital firms may adopt a corporate legal person form or a non-legal person form. In the latter case, the essential investor bears the joint and several liabilities for the venture capital firm and such liabilities will not cease even if the firm shuts down. Foreign investors cannot form limited partnerships and domestic investors are still unfamiliar with the balancing of the rights and responsibilities between general partners and limited partners. More importantly, only venture capital firms formed as corporate legal persons can potentially benefit from preferential tax rules. These reasons are why only seven of the 440 venture capital firms registered with the NDRC were partnerships by the end of the second quarter this year.

A foreign-funded, non-legal person venture capital firm, deemed as a Sino-foreign contractual joint venture for income tax purposes, can choose either “follow-through” tax treatment or tax payment at the enterprise level upon official approval.

In contrast, formally organized partnerships in China can only pay income tax on a follow-through basis. For natural person partners, their income is taxed under five progressive rates ranging from 5 percent to 35 percent, while the tax rate for legal person partners’ investment income is 25 percent under the 2008 Enterprise Income Tax Law.

The law states that only venture capital firms of legal person status registered with the NDRC may deduct up to 70 percent of the capital invested in certified small and medium, high or new tech companies from taxable income, provided that the venture capital firms have held the equity for at least two years.
The NDRC believes China's venture capital industry has so far failed to reach its full potential. In addition to offering tax incentives, the NDRC encourages local governments to establish “venture capital steering funds” as “fund of funds” to attract more private capital to form venture capital funds. At the national level, the NDRC has also approved a few equity investment funds – typically seeded with capital from state-controlled institutions – which do not limit themselves to investing in technology companies. Such funds are known as industry funds because they invest in specific industries.

**Yuan-denominated funds and GEM**

The growth potential in a broad spectrum of sectors including retail, media, education and entertainment has become so attractive that it has begun to overshadow the appeal of venture capital investments for technology companies.

In the broad arena of private equity, foreign capital is increasingly feeling the competition from Chinese home-grown newcomers.

Previously, foreign private equity and venture capital firms enjoyed the advantage of raising funds offshore and taking Chinese companies to IPO markets overseas. This model, dubbed as “both ends offshore,” has begun to crack under a series of regulatory changes since 2005.

Firstly, the State Administration of Foreign Exchange imposed registration and disclosure burdens on so-called “round-trip investments.” These investments involved mainland Chinese residents forming offshore special purpose vehicles. The SPVs, returning to China holding operational assets in Chinese companies, are taken to IPOs overseas.

Subsequently, the “Provisions on M&A of Domestic Companies by Foreign Investors” came into force in 2006, imposing a disciplined approval process on foreign investments in existing Chinese domestic companies. Delays owing to the application process for official approval have put foreign private equity firms at a disadvantage. Foreign private equity firms were further sidelined by SAFE Circular No. 142 in 2008, which required advance approval from the SAFE for each individual equity investment transaction by foreign-funded venture capital companies.

Foreign private equity firms are concerned but not deterred by these regulatory hurdles, as the growth potential in Chinese companies represents an opportunity too great to pass up. Indeed, they are now trying to form yuan-denominated funds to become more locally competitive.

Sequoia Capital, a U.S. venture capital firm, has registered a foreign-invested management company in Tianjin, which in turn formed a limited partnership and raised yuan funds from limited partners in China. DT Capital Partners, a China-based venture capital firm that has significant operations in the U.S., has formed contractual joint ventures with fund of funds backed by the Suzhou and Chengdu governments.

Private equity funds denominated in yuan are only one side of the new equation and the other side is the growing IPO markets in China.

The Shenzhen-based Growth Enterprise Market was launched in October. According to data compiled by private equity researcher Zero2IPO, among the 149 companies whose applications for listing have been accepted by GEM so far, 53 had venture capital and private equity investments.

A vibrant mainland IPO market means private equity firms can easily exit their investments through stock listings in China (an important channel for them) as opposed to going overseas. As such, yuan funds are more attractive because they face lighter regulatory burdens amid Beijing’s tight control on foreign exchange. Last year, 108 yuan funds raised US$23.7 billion. In the third quarter this year, 84.1 percent of the new funds raised are in yuan and not foreign currencies, according to Zero2IPO data.

All this is happening while the national regulation on the private equity industry in China has yet to make its debut. The show has just begun.

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