WEIL GOTSHAL

Private Equity Alert

June 2008

Weil News

- Chambers recommended 11 of our private equity partners in its 2008 Chambers USA Guide to Leading Business Lawyers, including David Duffell, Doug Warner, Glenn West and James Westra, who were ranked nationally in the category of Private Equity Buyouts, Jonathon Soler, Jeffrey Tabak and Barry Wolf, who were ranked nationally in the category of Private Equity Fund Formation, Marilyn French, Steve Peck and Kevin Sullivan, who were ranked in Massachusetts in the category of Private Equity Buyouts and David Kreisler, who was ranked in Massachusetts in the category of Private Equity Fund Formation
- Weil Gotshal advised Blue Ridge Capital as lead investor in the acquisition of a significant minority interest in Jiangxi Tian Ren Ecological Industry Co., a leading Chinese bio-pesticides company
- Weil Gotshal advised Beijing-based Legend Capital in the formation and closing of its fourth China-focused investment fund
- Weil Gotshal advised NuCom Online Corp., a leading Chinese internet sports portal, in its issuance of Series A Preferred Shares to a group of investors
- Weil Gotshal advised Tower Three Partners in connection with its participation with Catterton Partners in the public-to-private acquisition of Restoration Hardware
- Weil Gotshal advised The Brock Group (a portfolio company of Lindsay Goldberg) in connection with its $250 million acquisition of Atlantic Industrial Inc. and its acquisition of Miken Specialties, Ltd.

China's Private Equity Landscape

By Peter Feist (peter.feist@weil.com), Anthony Wang (anthony.wang@weil.com) and Sidney Qin (sidney.qin@weil.com)

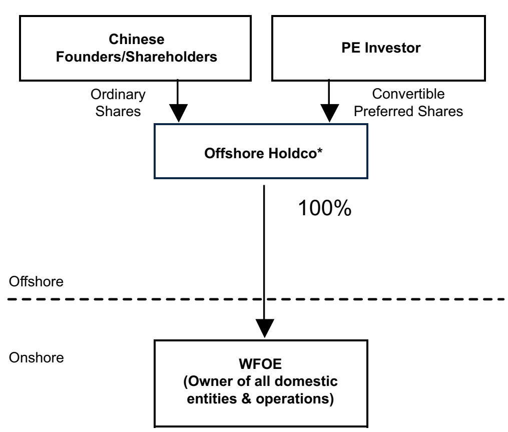
Private equity investments in China continue to attract significant attention across the private equity spectrum from global buyout funds, VC funds, regional funds and other investors. Unlike more developed markets where control transactions are often the focus of many investors, private equity investing in China generally takes the form of minority growth capital or pre-IPO investments in businesses where the Chinese founders or management have controlling or significant stakes.

In September 2006 the Chinese government adopted what are known as the "New M&A Rules."[1] These rules significantly affected how private equity investments could be made in China. Below we take a look at how these rules changed investing in China and offer some thoughts on the current private equity landscape.

The "Red Chip" Structure

Before the New M&A Rules came into effect, foreign private equity investors typically used a structure similar to **Structure 1** to complete a minority investment into China.

Structure 1
"Red Chip" Structure



* There may be an intermediate holdco (*e.g.*, a Hong Kong entity) between the offshore holdco and WFOE (wholly foreign-owned enterprise)

In this structure, commonly called the "red chip" structure, the Chinese founding shareholders would reorganize the target business offshore by establishing an offshore holding company, often in the Cayman Islands, that would then acquire the onshore business that they owned. The Chinese founders would acquire ordinary shares in the offshore holding company, and the private equity investor would invest in the holding company in exchange for convertible preferred shares.

This form of investment was known as a "round trip" acquisition or investment because its central component was the Chinese founders going offshore to acquire, or reinvest in, their existing business onshore (in other words, making a "round trip"). This structure appealed to foreign private equity investors in part because the offshore jurisdiction provided an established and familiar framework for investor protection in the form of preferred shares, corporate governance protection, and transfer/exit rights at the holding company level. In addition, this structure allowed for a future offshore IPO listing of the offshore holding company.

The New M&A Rules provided that, regardless of investment size, all "round trip" investments were subject to approval by the central Ministry of Commerce (MOFCOM) office in Beijing. In the almost two years since the effectiveness of these rules, central MOFCOM has yet to grant approval to any new "round trip" investments – *i.e.*, no new "red chip" structures have been approved.

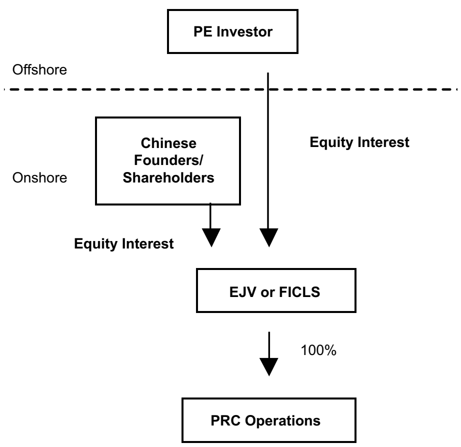
The requirement for central MOFCOM approval does not apply retroactively to "red chip" structures that were set up prior to the New M&A Rules. So private equity investors can still invest through these structures into Chinese businesses that were reorganized offshore before September 2006. Indeed, such investments have continued to occur with some regularity in the last two years, taking the form of a subsequent round (*e.g.*, series B, C, D, etc. round) of growth capital or pre-IPO investments.

However, private equity investors need to consider alternative structures if they wish to invest in Chinese businesses that did not restructure offshore before September 2006 or were otherwise established after that time (such businesses account for a lot of Chinese business activity). Below we highlight two possible investment structures for investments in Chinese businesses that do not constitute a "round trip" investment and therefore are not currently subject to central MOFCOM review under the New M&A Rules.[2]

Going Onshore

One option available to investors is to invest directly onshore (see **Structure 2**). There are two main forms of domestic Chinese entities into which a private equity investor could invest onshore. The first is what is referred to as a Sino-foreign equity joint venture (EJV), and the second, a foreign invested company limited by shares (FICLS).

Structure 2
Onshore Structure



Some factors that private equity investors need to consider when considering an onshore investment and choosing between an EJV or FICLS are:

Intended Exit – Only an FICLS can effect a domestic public offering in China. If an IPO in China is a consideration, either the investment must be made into an FICLS or, if an EJV is used, the EJV must eventually convert into an FICLS before it can go public in China. If a listing offshore is desirable, then the New M&A Rules do provide for a "swap" of the equity interests of a Chinese entity into shares of an offshore entity, but there are restrictions (for instance, the listing has to occur within one year of the approval of the "swap").

Timing – Establishing an FICLS takes longer than establishing an EJV (typically 8-12 weeks for an FICLS versus 2-6 weeks for an EJV). Closing a deal quickly is often important, so some private equity investors may prefer to use an EJV initially and then convert into an FICLS for purposes of an onshore IPO, if and when such time arises (although there are important considerations to the conversion process and how it affects the timing of an onshore IPO).

Investor Protection – From an investor protection perspective, the EJV and FICLS will be subject to different rules in some instances.[3] For example, under EJV law, amendments to organizational documents and transfers of equity interests require unanimous consent of equityholders, but FICLS has less stringent laws. In either case, due to lack of established precedent in China and other factors, there is some uncertainty regarding the availability and/or enforceability of some customary investor protections that are found in traditional offshore structures (*e.g.*, liquidation preferences and redemption rights).

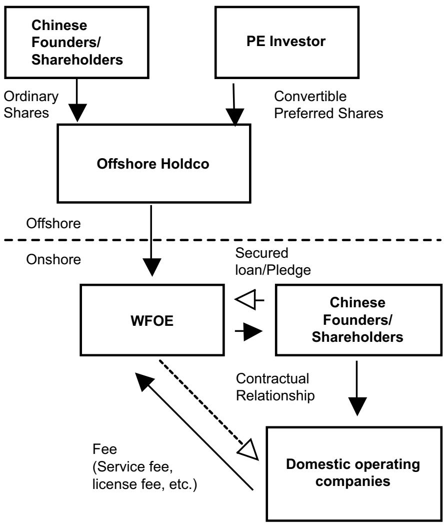
In the last two years we have seen a significant uptick in the use of the onshore structure for private equity investments, particularly in the use of EJVs.

The CCF Structure

Another option for private equity investors to consider is the Chinese-Chinese-Foreign structure shown in **Structure 3** (which is sometimes referred to as the "Sina" structure, named after one of the China businesses that utilized this structure and has since gone public).

Structure 3

Chinese-Chinese Foreign Structure



Under this structure, the Chinese founders/shareholders and foreign private equity investor invest in an offshore holding company, which in turn owns a newly formed onshore entity in China, called a WFOE (a "wholly foreign-owned enterprise"). Like the "red chip" structure, the founders own ordinary shares in the offshore entity and the private equity investor typically acquires convertible preferred shares.

The main differentiating feature of this structure is that the WFOE does not actually acquire or own any equity interests in the actual business operations in China; the operations remain owned by the Chinese founders/shareholders. Rather, the WFOE enters into contractual arrangements with the existing domestic business entity(ies) and with the Chinese founders/shareholders, designed to provide the investors with the intended economics of the investment transaction, as well as some investor protection. These contractual arrangements typically involve profit arrangements, loan agreements, share pledges, a proxy and a unilateral call option for equity interests in the controlled domestic entity.

As with the onshore structure, no central MOFCOM approval is required under the New M&A Rules for this structure because there is not an actual acquisition of the onshore Chinese business or a "round trip" investment by the Chinese shareholders.

Historically, this structure has been used for foreign investment into specific regulated industries (*e.g.*, telecom, media and Internet portals) where direct foreign ownership of, or investment in, the operating entity or business is restricted and investment procedures are particularly stringent. The structure essentially allows for foreign investment indirectly into those industries. There have been a number of IPOs of Chinese businesses using this structure (*e.g.*, Sina and Focus Media).

In light of the New M&A Rules, some private equity investors are now considering this structure for non-regulated investments so that they can invest through a familiar offshore structure. However, because there is no actual equity control over the Chinese business operations in this structure, investors must carefully evaluate the investment risks posed by reliance on contractual rights as opposed to equity ownership.

Conclusion

Private equity investment into China continues to grow rapidly. Investments in traditional "red chip" companies have continued after the New M&A Rules in the form of follow-on investments. However, without further guidance or approval from central MOFCOM for new "round trip" investments, private equity investors need to consider onshore investments or other structures if they wish to invest in many Chinese businesses. As China's legal and economic framework continues to evolve, this increased attention on alternative and creative investment structures is set to continue.

1 "Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors," effective September 8, 2006.

2 An investment by a foreign private equity investor into China will be subject to various regulatory approvals. As a clarification, this article highlights only the additional approval brought about by the New M&A Rules with respect to "round trip" investments and several alternative investment structures that are available to investors that do not necessitate that approval.

3 Whereas all domestic companies and foreign invested entities (FIEs) are generally subject to the Chinese Company Law, each FIE (which includes the EJV and the FICLS) is further subject to its own rules.

New Office in Beijing

Weil Gotshal has received a license from the Chinese government to open an office in Beijing, the firm's third location in Asia. The firm's expansion in Asia highlights its ever greater participation in transactions involving both Asia-based clients and clients located elsewhere with significant business interests in the Asia-Pacific region.

The Beijing office will focus primarily on M&A and private equity matters. Steve Xiang, who leads the firm's China practice, will head up the Beijing office.

With the Beijing opening, Weil Gotshal now has 20 offices, half of which are located outside of the United States. The new Beijing office is located at 301 Office Tower C2, Oriental Plaza, No. 1 East Chang An Avenue, Dong Cheng District, Beijing, 100738, PR China (Tel: +86-10-8515-0558).

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