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Foreign Private Equity in China: Challenges and Opportunities Under Chinese Legal Environment

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Abstract: As the world's second largest economy, China's private market is attractive to investors around the world. The legal environment in China can be one of the major concerns for foreign investors who are interested in investing in the Chinese capital market. With enough knowledge on how foreign private equity firms operate in China, unnecessary loss can be easily avoided. This article analyzes opportunities and challenges that foreign private equity investors would face by looking over structures of PE and the legal environment in China. From a historical perspective, the restrictions on foreign equity investors are gradually removed by the Chinese government, so investing in the Chinese private market overseas is now much more viable. Since 2020, foreign-owned private equity funds can be freely established in mainland China after a series of applications. Under this trend, the Chinese private market is expected to encourage more foreign investors to enter which also brings international investors more potential opportunities.

Keywords: China, private equity, foreign private equity, venture capital

1. Introduction

With China's rapid economic growth in the past two decades, the capital market in China has become the second largest and is essential to investors around the world. As a major component to the capital market, the area of venture capital was only explored in China since the 1980s [1]. Thus, compared to most developed eastern countries, the Chinese venture capital market has a relatively short history. Under this background, provisions regarding private equity are strict and can be an obstacle for foreign investors. Since the revision of the partnership enterprise law in 2006, limited partnership has become a popular choice among investors as the most effective structure for private equity [2]. Just like every other industry, only few firms can remain successful in the area of private equity. In December, 2021, Bridgewater's subsidiary in China reached the 10 billion yuan ($1.57 billion) mark and became the largest wholly-foreign owned enterprise (WFOE) in the country, which showcases the potential of Chinese foreign PE (Private Equity) market [3]. Among over 35 WFOEs that were registered under Asset Management Association of China (AMAC) by 2021, only two of them have an Asset Under Management (AUM) over 5 billion Yuan. Unlike Bridgewater, most WFOEs are struggling in the Chinese market. One essential contributing factor to failures of cross-border PE investment is lack of understanding of PE structures and their corresponding regulations. Although

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the Chinese PE market attracts many foreign investors with its huge potential, facing changing policies and pressure from local firms, there are challenges as well as opportunities which should be taken into consideration before investing.

2. Industry Overview

This section specifies reasons of why should investors care about private equity and the market in China.

2.1. Private Equity

To clarify the main subject of the discussion in this article, it is vital to define the term "private equity". The term "private equity" is generally used to describe the type of fund that is managed by firms invested by individuals with high net worth or institutions. They inject capital into private companies in the hope of selling their stakes at a higher price by gaining control over the company and actively influence its business. This type of funds often exits through initial public offering (IPO) or trade sales. Because of the techniques that PE firms use, including leveraged buyouts, usually contain higher risks, investors of private equity funds typically expect higher profits. Thus, investors in private equity funds are mainly high-net-worth clients with strong risks tolerance. The minimum investment limit in China is 1 million yuan. This limit protects investors by filtering out those who are more risk averse. The number of investors in each fund cannot exceed 200, and the information disclosure requirements are correspondingly low. The relatively loose regulations in PE industry can provide fund managers with more flexibility, which is beneficial to fund earnings growth in the long run.

2.2. China's Capital Market

On the macro level, the expanding financial management needs of Chinese residents due to the rapid growth of national GDP is bringing a huge potential to China's financial industries. Currently, the ratio of an average Chinese residents' financial assets is still not yet optimized, and this room of improvement gives companies that provide financial services a higher chance to succeed.

According to the results of the China's seventh national census in 2021, China had a total population of 1.44 billion, an increase of 5.38% compared with the population of 1.34 billion in the sixth national census in 2010. With the co-growth of GDP and population, China's per capita GDP and per capita disposable income of residents have also increased steadily. From 2013 to 2020, the disposable income of Chinese residents has gradually increased from 18,300 yuan to 32,200 yuan, with a compound annual growth rate of 8.41%. It is worth mentioning that the average household savings rate in China is nearly 30%. Based on the compound annual growth rate, the annual savings of Chinese residents in 2022 and 2023 is predicted to reach 1.14 trillion yuan and 1.23 trillion yuan respectively, which can bring a significant demand for financial services [4].

According to the "National Residents' Balance Sheet" released by the Chinese Academy of Social Sciences, the total wealth of the Chinese household has risen from 179 trillion yuan in 2011 to 574.9 trillion yuan in 2020, and the compound annual growth rate of the total household wealth is about 12.38%. Moreover, the proportion of residents' financial assets has also risen rapidly from 51% in 2010 to 57% in 2020. It is notable that the PE market is growing dramatically with the proportion of Chinese residents' financial assets flourishing.

3. Structures of PE in China

It is difficult to understand how private equities operate without knowing the structures of PE in China. PEs that fall into different categories of structures can be regulated separately accordingly.

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Depending on types of currency raised and locations of legal entities, PE firms in China generally fall into two categories: offshore funds and onshore funds.

3.1. Onshore Funds

Onshore funds invest in domestic Chinese corporate entities with firms based in China. This type of PE firm is under the supervision of China Securities Regulatory Commission (CSRC) and is registered under the Asset Management Association of China (AMAC). To start up a Wholly Foreign Owned Enterprise (WFOE) in China, investors should follow a series of guidelines from AMAC, Municipal Administration and other government agencies. Fund itself can be contractual type, partnership type or corporate type (see Figure 1) [4].

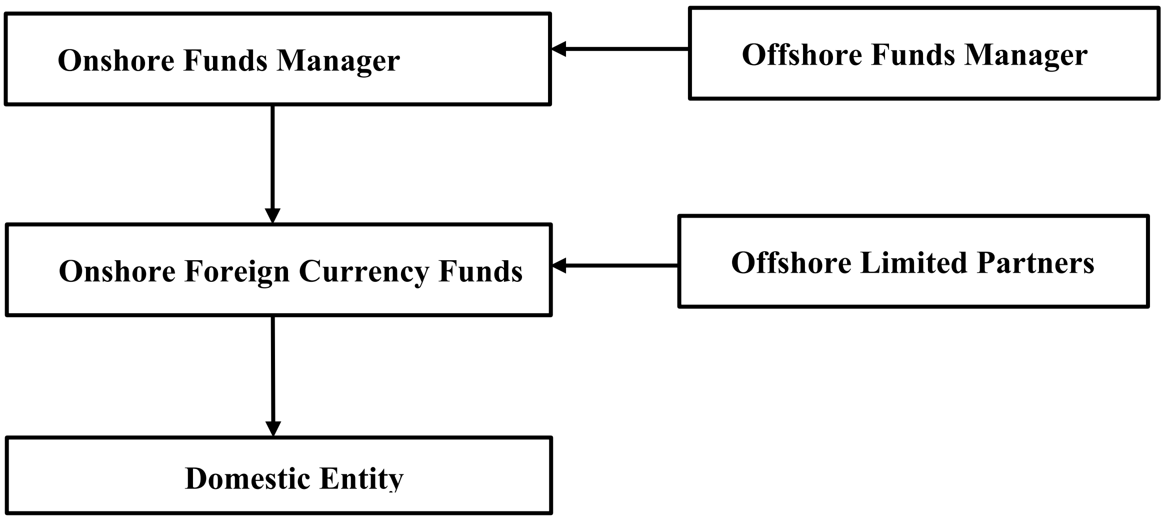

Figure 1: Example structure of onshore funds.

3.2. Offshore Funds

To prepare for going public overseas in the future, many companies adopted the offshore fund structure. Offshore holding companies generally have legal entities established overseas with funds raised in foreign currencies. They can hold assets indirectly or directly in China by investing in target company's offshore holding companies. Specifically, there are three ways for offshore funds to enter the Chinese capital market, QFII/RQFII, QDLP and Shanghai/Shenzhen-Hong Kong Stock Connect. QFII refers to Qualified Foreign Institutional Investors, qualified foreign investors can only invest in China using a special account with the approval for currency exchange. Similar to QFII, RQFII refers to RMB Qualified Foreign Institutional Investor, which allows qualified foreign investors to invest in China using a regulated amount of RMB raised overseas. QDLP (Qualified Domestic Limited Partner) enables firms that are registered overseas to invest in foreign markets with domestic limited partners and domestically raised funds. Unlike previous methods, Shanghai/Shenzhen-Hong Kong Stock Connect is a system which allows stock trading between mainland and Hong Kong. Hong Kong based PE firms can therefore enter the market by trading stocks that are listed in mainland China through local exchanges or brokers (see Figure 2) [4].

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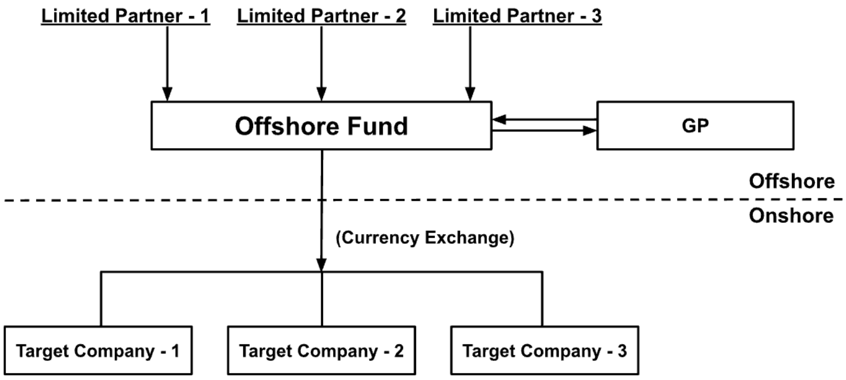

Figure 2: QFII structure example.

4. Legal Environment in China

It is crucial for investors to have a general idea of the legal environment in China by knowing the development of relevant provisions at each stage and understanding the regulatory trend. Before the implementation of “Interim Provisions on the Establishment of Foreign-invested Venture Capital Enterprises” in 2001, there were no existing regulations related to foreign equity investment. Under such a legal environment, one popular method foreign PEs used to enter the Chinese market is known as the “red chip structure”. “Red chip" was originally a casino jargon, and then securities investors used it to refer to specific types of stocks. Since the 1990s, many companies in mainland China have been listed in overseas capital markets, they are known as "red chips" among investors. Most of these companies have registered their entities in foreign countries (mostly in Cayman Islands). However, they own assets directly or indirectly in China through business restructuring to gain control from offshore entities. This type of companies with overseas controlling stakes and major assets in mainland China are called "red chip structures" (see Figure 3) [5].

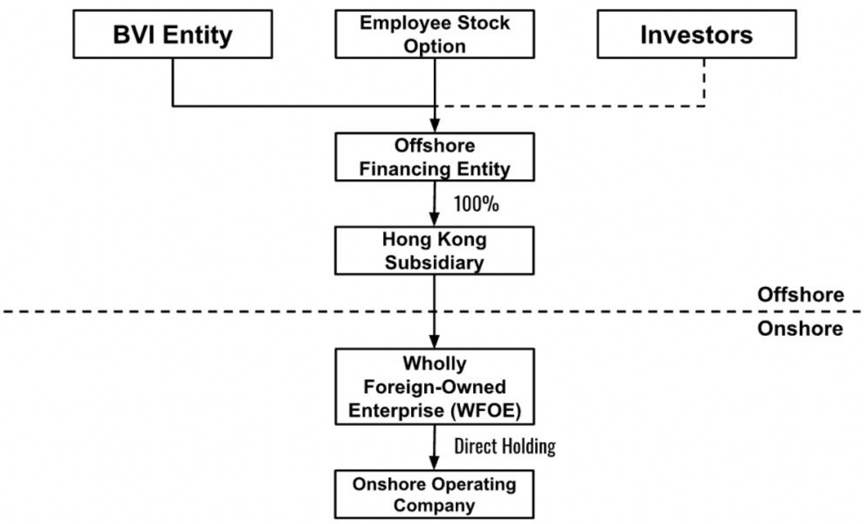

Figure 3: Red chip structure example.

Until 2001, the implementation of “Interim Provisions” gave foreign investors a legitimate way to set up foreign invested limited liability companies for the purpose of venture capital through the QFII system [6]. With more specific guidelines, “Provisions Concerning the Administration of Foreign-funded Business-starting Investment Enterprises” was soon issued in 2003. Compared to previous

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interim provisions, the new provisions allow foreign-invested venture capital enterprises to be formed in a structure of unincorporated organizations. However, as the most common form of private equity, foreign-invested partnership business was not allowed and regulated until 2009 with issuance of "Partnership Business Law of the People's Republic of China", "Administrative Measures for the Establishment of Partnership Enterprises within China by Foreign Enterprises or Individuals" and "Provisions on the Registration of Foreign-funded Partnership Enterprises". These provisions indicate specific guidelines regarding registration and establishment of foreign-funded partnership enterprises which further set up the foundation of the PE regulatory environment in China [7].

With the release of "Notice of the General Affairs Department of the State Administration of Foreign Exchange on the Relevant Operating Issues concerning the Improvement of the Administration of Payment and Settlement of Foreign Currency Capital of Foreign-funded Enterprises" (expired) in 2008, foreign-invested enterprises are specifically required to request approvals from the government before each transaction that involves CNY funds obtained from foreign exchange. This notice undoubtedly made offshore funds and WFOE in China harder to operate. In 2014, the State Administration of Foreign Exchange (SAFE) gave foreign-invested enterprises an opportunity to transact freely with target company using exchanged CNY according to "Notice of the State Administration of Foreign Exchange on Reforming the Mode of Management of Settlement of Foreign Exchange Capital of Foreign-Funded Enterprises" (partially invalid as of 2022). However, this notice was only implemented in certain provinces and regions including Shenzhen, Dalian, Qingdao, Xiamen and Ningbo.

At this stage, the most essential issue that foreign PE firms would face when entering the Chinese private market is the foreign exchange control policy. In 2008, SAFE introduced a series of provisions which strictly restricted the conversion from foreign currencies to RMB for the purpose of capital investments. This provision was gradually lifted from 2008 to 2019 with few revisions and supplementary guidelines. Through this period, foreign funds can only invest in China using certain structures. The Qualified foreign limited partner (QFLP) was therefore born as the solution to the foreign exchange control policy [8]. The QFLP pilot program allowed flexible currency conversions for the purpose of capital investing in several major cities while keeping foreign limited partners participating. This structure soon became popular as it was the only legitimate investing method under foreign exchange controls [9].

The Measures for the Administration of Foreign-Funded Securities Companies published by China Securities Regulatory Commission in 2018 allows a shareholding ratio up to 51% by foreign institutions. This is also effective in the area of security, funds and futures investments. It enables foreign-invested institutions to control business activities of joint-venture in China. This shareholding ratio limit was soon removed in March 2020 by China Securities Regulatory Commission and foreign-invested firms can freely establish in China since then.

5. Challenges and Opportunities

Although the PE industry has flourished swiftly in the last 20 years, uncertainties which are brought by frequently adjusted regulations are raising the risks for investors. Given the current legal environment of China, there are opportunities as well as challenges which investors should notice before entering the market.

5.1. Opportunities

In recent years, a series of policies was launched by the Chinese government to help the growth of small size enterprises. With supporting policies from the government, the venture capital market in China has topped $130.6B in 2022 and is 21.03% of the world total [10]. To investors, such a growing market generally contains more chances of gaining high profit. As mentioned above, the proportion of residents' financial assets has risen rapidly from 51% to 57% in the last 10 years, with per capital disposable income also growing steadily, this expanding demand means more potential profit to both foreign and domestic PE firms. Based on long-term data, the yield of private equity investment funds has always outperformed the stock market index in China. The success of private equity funds in China attracts more investments from high net-worth individuals and institutions to further snowball the scale of current private market. In terms of legal environment, one major takeaway from Chinese regulatory trends in the past two decades is that the Chinese government is steadily releasing the foreign capital control. Since 2020, access to the private market in China is easier than ever, with abundant demand for international partners from domestic enterprises, foreign investors are more desirable in many industries.

5.2. Challenges

Impacts of COVID-19. Due to China's recent zero-covid control policy, economy and employment are influenced respectively by lockdowns across the country. Numbers of enterprises are having trouble operating normally, and inventors are considering exiting the market. It is highly unlikely that the zero-covid is a sustainable policy regarding the economic pressure China is now facing, and before it ends, firms are expected to keep struggling in the Chinese capital market.

Legal Jurisdiction Risks. Compared to 2020 and 2021, China's economy in 2022 is in a relatively bad shape, PE firms in China are also affected in varying degrees. Considering China is also the only major economy which reported an economic growth in 2020, legal jurisdiction plays a dominant role in economic performance in China, especially under the current global pandemic. Just like how PE relevant provisions were evolved and adjusted in China through the past two decades, Investors should monitor China's regulatory trend constantly to minimize legal jurisdiction risks as much as possible.

Deal Evaluation. When it comes to deal evaluations, foreign investors with less experience in the Chinese market tend to have a hard time projecting profits because of the differences in economy between China and other western countries. Investing strategies that work well in western countries not necessarily can succeed in China without adjustments. Furthermore, completing an in-depth analysis in a new country can be costly for many firms.

Competitive Market. Although foreign investors can enter the Chinese private market much easier now, the domestic market has grown to nearly mature in recent years. As of July 2022, the number of operating privately offered investment funds has come to 24,304(Source from AMAC monthly report). To remain competitive in such a saturated market, firms must be clear with what differentiate them from other competitors and have the ability to sufficiently utilize their advantages.

Different Exit Routes. Compared to the UK and the U.S., PE in China is different in almost every aspect. Despite registration and operation procedures, exit routes are also required to be designed accordingly with respect to the differences between IPO policies in the U.S and China.

6. Conclusions and Future Outlook

Although the concept of "private equity" and "venture capital" was only introduced to China 40 years ago, under decades of development with support from the government, the domestic Chinese private market is already mature. Even though provisions on offshore funds had been strict and made it difficult for foreign investors to enter the market, in recent years, China gradually lifted restrictions to make overseas investment in the mainland more viable. Now that the era of foreign exchange control has passed, foreign funds are no longer forced to operate under the QFLP structure and have the opportunity to invest much more freely with less restrictions. Through the analysis of the regulatory trend in China, it is expected that China will keep encouraging the injection of foreign capital by

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introducing more supporting policies. Vast number of Chinese domestic businesses have the desire to partner with foreign firms for their expertise, this unfulfilled demand can translate into more potential profit for PE funds with the right strategy. Establishing a subsidiary in China is an efficient way to expand business for lots of PE funds as well. Regarding the intense competition in China due to the large quantity of domestic funds, foreign PE can only survive and succeed using flexible investing strategies with in-depth knowledge of the Chinese capital market. The founder of Bridgewater, Ray Dalio, was able to succeed in China mainly owing to his familiarity with the local market. Ray Dalio was first invited to China as a financial consultant in 1984 and had his first Chinese client in 1993. His long-term experience helped Bridgewater to become the first foreign fund that achieved the 10 billion yuan goal.

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