Venture Capital in China

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Company Financing

How Do Companies Get Capital?

• Informal Financing
  • Founder savings, Loans from friends, Credit card debt

• Private Equity or Bank Loan
  • Company funded from professional financier

• Public Stock Markets
  • Company funded from widespread public

More legal and regulatory hurdles but capital available in larger amounts
Bank Loans vs Private Equity

Bank loans are easy method of financing companies.

Private equity can substitute when bank loans are not available

- Capital demanded is too much for bank (buy-out, restructuring, etc.)
- Investment is too risky for bank because company is new, growing very fast and/or lacks assets which can secure a loan (venture capital, growth capital)

In China, bank loans are relatively less available; private equity can step in as an alternate source of financing.
Venture Capital Defined

Venture capital is a method of financing companies where the investment involves a substantial element of risk, often because the company is new, fast-growing and/or lacks tangible assets.
Characteristics of Venture Capital Investing

- **Very Risky**
  - Expect 70% of venture investments to fail

- **High Returns**
  - In order to be profitable on a net basis, returns from successful investments must outweigh losses on failed investments

- **Illiquid/Long-term**
  - Legal restrictions prevent investor from easily selling its investment (compare to stock market)
  - Investors must be willing to hold onto investment for long periods until the company can be publicly listed or acquired

- **Active Involvement of Investor**
  - Investor can often add value to the investment by hands-on participation
Characteristics of Venture Capital Investing (cont)

- Not all companies are suitable targets for venture capital
  - E.g. a restaurant cannot generate the investment returns needed to support a venture capital investment
  - Typically, a company must be part of a growing market, or have a disruptive business/technology to quickly grow its revenues in the market
- In the United States, only technology and life sciences sectors can support the growth needed to support a venture capital investment.
- In China, the economy is both (a) more disorganized, and (b) growing more rapidly overall. More room for non-technology venture capital in conventional sectors.
Venture Capital Funds

A managed pool of capital for making venture capital investments
Characteristics of Venture Fund Investor

- Able to make large investments
  - Regulatory hurdles and “too much hassle” to seek capital from numerous, small investors
- Able to tolerate risk
  - Portfolio construction theory implies diversified investments outside venture capital
- Long-term
  - Must have long time horizon to accommodate illiquid nature of investments
- No better “own use” for capital
  - If capital can be profitably invested in own business, why invest in a fund?
    Most “operating” businesses do not invest

Most common Fund Investors: Pension Plans, Insurance Companies, University/Charity Endowments, and Aggregators for other Investors
Pension plans, Insurance companies, and Endowments have their own tax, regulatory and “good governance” requirements which are “pushed down” on the fund and the portfolio companies.
Strategic Venture Fund Investor

Exception to the rule: Strategic investor

- Small minority of venture fund investors don’t invest for financial returns
- Invest for introductions to portfolio companies and insight into evolving markets
- Very different characteristics than most fund investors
Venture Capital In China

Venture Capital has many opportunities in China
  - Relative lack of bank financing
  - Disorganized state of Chinese economy
  - Need for small-scale business expertise

Market is back to 2008 levels of financing

Source: Dow Jones VentureSource, 2012
Venture Capital In China: Domestic vs Int’l

- Historically, Chinese domestic venture capital has been underdeveloped
  - Relatively few sources of capital which met the requirements for venture fund investors and were willing or legally authorized to make venture capital investments
- Most Chinese venture capital has been sourced from international sources
- International investors face a variety of legal/regulatory challenges
  - Investments in certain sectors prohibited or restricted
  - Foreign exchange controls impose delay and uncertainty
Venture Capital In China: Convergence of Domestic and Int’l

- Recently, Chinese government has taken steps to “domesticate” the venture capital industry and harmonize domestic and international investing
  - Encourage domestic funds with Chinese investors (“RMB Funds”)
  - Pilot program to ease foreign exchange controls for international investors using domestic vehicles (“Qualified Foreign Limited Partnerships”)
  - Discourage use of offshore holding companies (“Circular 75” and “M&A Rules”)
  - Ensure that international investments are subject to Chinese tax (“Circular 601 and 698”)
Venture Capital In Hong Kong

• It is not practical to form a new venture capital firm in Hong Kong in compliance with the law
  • Securities and Futures Ordinance requires licensing for “advising on securities” and “managing a portfolio of securities … for another person”
  • Licensing is too burdensome for typical, small scale venture capital funds
  • Licensing requirements designed for hedge funds and similar investors (compliance manuals, risk analysis, custodian requirements, etc.)
• Almost all venture capital activity in Hong Kong are local offices of large, international firms
• Hong Kong is missing an opportunity for small-scale and homegrown venture capitalists
This presentation is intended only as a general discussion, and should not be regarded as legal advice.