Trends and Attitudes Toward Exit Among Entrepreneurs in China
US-Asia Technology Management Center
Stanford University

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K&L Gates Law Practice

- We have offices across the globe, including 6 offices and 100 lawyers in Asia
- Mandarin and Cantonese speaking attorneys throughout the firm
- We serve start-up and established technology businesses and other enterprises around the world
- We work with global and U.S. venture capitalists and private equity investors
- Cross border M&A and IPO exits in the U.S., Hong Kong, Taipei and AIM in London
Overview

- China venture capital investments and exits slowed in Q1 2012
- Key drivers on exit location are market focus, availability of seed and early stage funding and nature of founders and investors-local government funding an important factor
- Exit positioning should be considered at the time of formation
- Exit alternatives will be restricted by where the company is formed particularly if in China
- Current investor skepticism continues at least in the U.S. about China stocks
- M&A exits should increase in China given investors desires for exits and lower amounts raised in IPOs
Q1 2012 Activity in China (I)

- VC funding in China slowed in Q1* which makes local governments an even more important source of early stage funding.
- China Securities Regulatory Commission (CSRC) decides on number and timing of IPOs not market demand
  - CSRC also must approve any offshore listings
- IPOs/M&A exits distribution about 80/20%*
  - Fewer IPOs and smaller amounts raised quarter over quarter. About 80% of IPOs were on domestic exchanges
  - ChiNext - primarily high tech (Senzhen Stock Exchange) – busiest exchange for domestic offerings
  - Small and Medium Enterprise Board (SMBE) of the Shenzhen Stock Exchange
  - Shanghai Stock Exchange
  - Hong Kong Stock Exchange (HKMB) – primary exchange for offshore IPOs

*Source: Zero2IPO Research Reports
Q1 2012 Activity in China (II)

- M&A transactions*
  - Most transactions were domestic rather than cross border
  - Number and value down quarter over quarter
  - Cross border transactions have higher valuations but are more complex, take more time and are more likely to fail

*Source: Zero2IPO Research Reports
Exit Strategy Formation Considerations (I)

- Geographical market focus
  - China or global
- Nature of founders/investors
  - Domestic, foreign or both
  - Local government funding
- Global investor preference or requirement
  - China or offshore
- Restricted or prohibited industry status under Chinese law
  - Media, telecom, internet,…*

*Catalogue of Industries for Guiding Foreign Investment (2011 Amendment)
Exit Strategy Formation Considerations (II)

- Variable Interest Equity (VIE) model risk
  - Do you have any alternative?
  - Enforceability of control contracts
  - Chinese government action
  - Predictability at time of exit
- Foreign exchange restrictions on moving money out of China
- Listing eligibility on stock exchanges
  - Caymans early on for HK exchange eligibility
- Availability of M&A suitors
Offshore Strategy (I)

- Test the waters for the business before building infrastructure
  - Start with U.S. or China domestic company
- Start offshore from the U.S. and China
- In general around the world, there is a tax consequence of reincorporating a company offshore. Usually treated as a sale of the company.
- Under IRC 7874, the tax consequences of reincorporation offshore is either a sale of the company or it remains a U.S. corporation for tax purposes.
  - Sale with no cash if former shareholders own 60-80% of new foreign company
  - Treated as U.S. corporation if former shareholders own 80%+ of new foreign company
Offshore Strategy (II)

- China government approval (Ministry of Commerce) is required for reincorporation outside of China
  - No “Round Trip” approvals under Circulars 75/106
- M&A rules in China, US and elsewhere (MOFCOM, SAFE, etc.)
  - China approvals not required if offshore entity
- CSRC approval required for offshore IPOs
  - Not required if offshore entity
- Caymans company treated like a Chinese domestic company for Chinese tax purposes if managed from China
<table>
<thead>
<tr>
<th>Type of Company</th>
<th>China</th>
<th>Cayman Islands</th>
<th>British Virgin Islands</th>
<th>Delaware</th>
<th>Hong Kong</th>
</tr>
</thead>
<tbody>
<tr>
<td>IPO on China Stock Exchange</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
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<tr>
<td>IPO in Hong Kong</td>
<td>Yes</td>
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<tr>
<td>IPO in U.S.</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>IPO on AIM (UK)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Availability of Government Funds for startups</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
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</tr>
<tr>
<td>Government Approval for Foreign Listings</td>
<td>CSRC approval for offerings outside China</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>
Examples (I)

- Smartphone game application for the Chinese market
  - Team could not raise money in the U.S.
  - Formed China domestic company
  - Provincial government financing at a reasonable valuation
  - Exit strategy

- Semiconductor company
  - U.S. corporation
  - Targets global markets not just China
  - Prototype product developed
  - Could not raise money in the U.S.
  - China provincial government wants a China JV
  - Leverage to use offshore Caymans because of competition for funding among Chinese local governments?
  - Exit strategy
Examples (II)

- Telecommunications company
  - China market focused
  - Raised initial funds in the U.S. as a U.S. corporation
  - First VC financing round was from an offshore China VC
  - Moved to Caymans in the VIE structure as part of the financing
  - Exit strategy
Examples (III)

- Value Added outsourcing company
  - Not a restricted industry
  - Serial founder who sold a previous Caymans company based in Suzhou
  - Street wise about Suzhou government funding so used a Chinese domestic company for current company
  - Positioning for another acquisition

- Thin film solar technology company
  - Caymans company
  - Could not raise money in the U.S.
  - Formed China JV with strategic investor in Hangzhou
  - Local government provided land, etc.
  - Exit strategy: JV IPO and creeping liquidity
Summary

- China provincial and county governments are a source of capital that cause more startups to be China domestic companies.
- China domestic companies are more likely to go IPO in China or be acquired by another Chinese domestic company.
- IPOs are still the primary exit strategy in China but M&A should increase.
- Current investor skepticism continues at least in the U.S. about China stocks – CSRC likely to remain cautious to try to restore investor confidence.