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Trends and Attitudes Toward Exit Among Entrepreneurs in China

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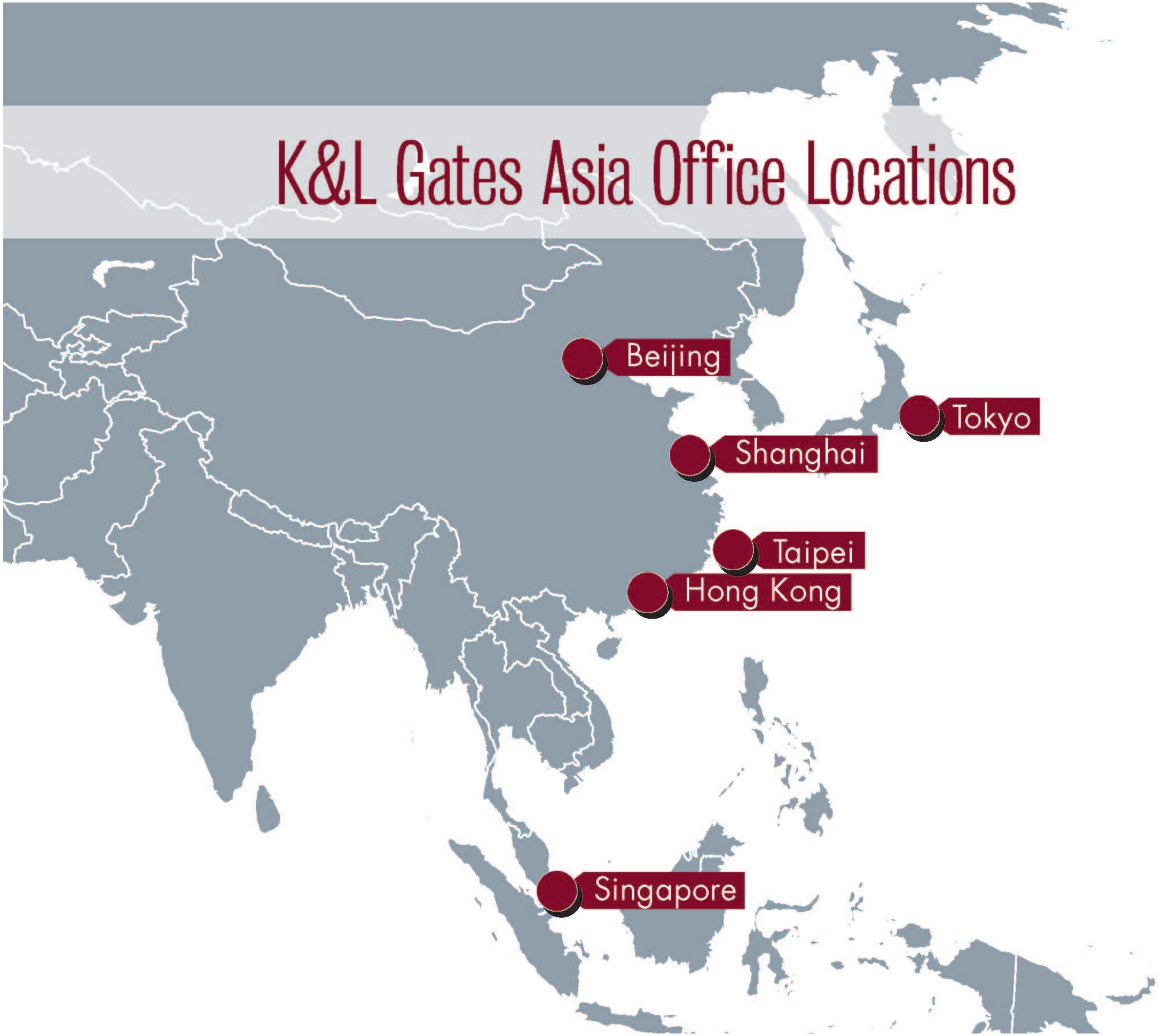

Overview

- 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 (Szenzhen Stock Exchange) – busiest exchange for domestic offerings
    - Small and Medium Enterprise Board (SMBE) of the Szenzhen 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

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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

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Exit Alternatives Chart

Type of Company	China	Cayman Islands	British Virgin Islands	Delaware	Hong Kong
IPO on China Stock Exchange	Yes	No	No	No	No
IPO in Hong Kong	Yes	Yes	Yes	No	Yes
IPO in U.S.	Yes	Yes	Yes	Yes	Yes
IPO on AIM (UK)	Yes	Yes	Yes	Yes	Yes
Availability of Government Funds for startups	Yes	No	No	No	No
Government Approval for Foreign Listings	**CSRC approval for offerings outside China**	No	No	No	No

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