Getting Money Out of Mainland China

A presentation for
The International Insolvency Institute
New York

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Agenda

• Getting a Piece of the China Pie
• Investing in China
• Remember the Seven Deadly Sins of Investing
• Exiting...
  – Debt
  – Private Equity
  – Listed Offshore Equity
• Investors be Aware
Getting a Piece of the China Pie

• It is a common perception that there is money to be made by investing in China:

“China has replaced the US to become the world's second largest luxury goods consumer, only second to Japan, according to a report by World Luxury Association... Chinese people consume about 27.5% of the world's luxury products.”
(Source: China Daily, 10 Feb 2010)

“A decade ago, there were essentially no private jets in China and only a handful in Hong Kong... At the end of April this year, there were 90 registered in China and 10 of those - worth about $500 million in total - were delivered since the start of January...”.
(Source: Forbes.com, 25 May 2011)
# Getting a Piece of the China Pie

Where the Chinese luxury consumer lives:

<table>
<thead>
<tr>
<th>Region</th>
<th>No. of millionaires*</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Beijing</td>
<td>170,000</td>
</tr>
<tr>
<td>2</td>
<td>Guangdong</td>
<td>157,000</td>
</tr>
<tr>
<td>3</td>
<td>Shanghai</td>
<td>132,000</td>
</tr>
<tr>
<td>4</td>
<td>Zhejiang</td>
<td>126,000</td>
</tr>
<tr>
<td>5</td>
<td>Jiangsu</td>
<td>68,000</td>
</tr>
<tr>
<td>6</td>
<td>Others</td>
<td>307,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>960,000</strong></td>
<td><strong>100.0%</strong></td>
</tr>
</tbody>
</table>

*Individuals in China with personal wealth of RMB10M (Source: Hurun Report)

Out of 1,011 people on Forbes list of the world's richest billionaires, the US ranks number one with 403 people, followed by China with 64 people and Russia is in third place with 62 people. Of the 64 Chinese on the list, 27 are first-timers.
Investing in China

- Investment in China can follow various paths:
  - Debt Instruments
  - Private Equity (either onshore or offshore)
  - Listed Offshore Equity
- Each method of investment and subsequent exit has its own issues
But...

Do you recall? We did warn you...

Seven Deadly Sins of Investing in China
Exiting Debt

• Repayment of offshore loans
  – Easiest way to exit
  – SAFE registration required
  – Total foreign debt amount cannot exceed the difference between total investment and the registered capital

• Case study 1
Case study 1: Asia Aluminum

- Asia Aluminum Holdings ("AA"), a company headquartered in Hong Kong and listed on the HKEx in 1998, was the largest aluminum extrusion facility in Asia.
- AA had significant assets/subsidiaries in the PRC.
- With the global economic downturn in 2008, AA’s business was adversely affected, resulting in a deterioration of its financial position, forcing the company to be declared insolvent.
- AA offered a debt buyback which was rejected.
- The local authorities favoured a management buyout and a successful bidder needed to have the support of the local government and local stakeholders.
Case study 1: Asia Aluminum

- Foreign parties were not allowed to inspect the business or review books and records
- The Liquidator sold the equity in AA’s PRC operating assets to a company said to be associated with the former management
- Offshore creditors only received a few cents in the dollar depending on their level of entry
Exitting Private Equity

- Issues to Note:
  - Foreign Investment Catalogue
    - Encouraged Foreign Investment Industries
    - Restricted Foreign Investment Industries
    - Prohibited Foreign Investment Industries

(For a detailed list: www.fdi.gov.cn/pub/FDI_EN/Laws/law_en_info.jsp?docid=87372)

- Structural Issues:
  - Wholly Foreign Owned Enterprise ("WFOE")/Equity Joint Venture ("EJV")/Co-operative Joint Venture ("CJV")/Foreign Invested Company Limited by Shares ("FICLS")/Sina Structure (by contractual arrangements)
  - Injection of funds: shareholder loan v. registered capital
Exiting Private Equity

- Private Equity includes:
  
  A. Sale of equity interests – onshore
  
  B. Repatriation of capital of Foreign Investment Enterprise ("FIE")
    
    i. Reduction of capital
    
    ii. Dissolution

Approval from original approving authorities required
Exiting Private Equity

Offshore

Hong Kong ListCo → 100% → PRC WOFE

Onshore

PRC WOFE → Nominee PRC (Restricted Industry)

Nominee PRC → 100% → OpCo (Restricted Industry)
Exiting Private Equity

c. Sale of equity interests - offshore
   – Need to consider anti-avoidance rule (GAAR) and Circular 698

Pros:
   ▪ Generally not subject to PRC regulatory approval so allows disposal of the offshore share interest without onshore notification requirements
   ▪ More relaxed and favourable legal and tax environment depending on the choice of domicile of the offshore vehicle

Cons:
   ▪ Price may be reduced as purchaser may argue it will not be able to "cherry pick" the assets and liabilities of the target but to assume all existing/contingent liabilities/hidden liability issues

• Case studies 2 & 3
Case study 2: Jiangsu Case

Holding structure:

- Offshore
  - US Group
    - Offshore Intermediate Company
      - Hong Kong Company ("HK Co")
        - Jiangsu Company
          - Onshore

Jiangsu Company

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Case study 2: Jiangsu Case

Disposal (early 2010):

1. **US Group**
   - 100% owned by **Offshore Intermediate Company**

2. **Offshore Intermediate Company**
   - 100% owned by **Hong Kong Company (“HK Co”)**

3. **Hong Kong Company (“HK Co”)**
   - 100% owned by **Jiangsu Company**

   - **49% owned by** **Jiangsu Company**

   - **100% owned by** **Offshore Group**

   - **Cap gain US$254M (RMB 1,730M)**

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Case study 2: Jiangsu Case

- The relevant tax authority ("TA") learned about the disposal through discussions with the Jiangsu Company management.
- US Buyer announced acquisition of 49% of the Jiangsu Company when the actual transaction was acquisition of 100% of the HK Company.
- TA treated the transaction as direct disposal by the US Group of the Jiangsu Company – the entire capital gain was treated as PRC sourced income and taxable.
- US buyer’s announcement indicated that the HK Company had no other business, so the HK Company was ignored by the TA.
Case study 2: Jiangsu Case

• Circular 698
  – For multi-jurisdiction deals, allocation of consideration to the different jurisdictions is allowed
  – Retained earnings of a Chinese investee cannot be excluded from the equity transfer price

• The TA followed Circular 698 and:
  – Adopted substance over form, ignoring the HK Company
  – Did not look into whether the Jiangsu Company had pre-2008 retained earnings leading to the possibility of double taxation
Case study 3: DriveSol

- DriveSol was an FIE which produced pedal assemblies for motor manufacturers including Ford.
- US private equity fund had 82% interest in DriveSol, the balance was held by a PRC national who provided factory space in Chongqing.
- Assistance on the sell side was provided by a HK firm who:
  - Identified and contacted potential buyers.
  - Prepared an information memorandum, valuations and financial forecasts.
  - Supervised site visits from potential buyers.
  - Responded to enquiries.
Case study 3: DriveSol

Holding structure:

- **US Private Equity Group**
  - Offshore Intermediate Company
    - Minority Shareholder
    - **Hong Kong Company (“HKCo”)**
      - WOFE
        - PRC Facilities

- **Minority Shareholder**
  - 82%
  - 18%

Offshore

Onshore

**JOHN LEES ASSOCIATES**
Case study 3: DriveSol

Disposal (2009 to 2010):

- US Private Equity Group: 100%
- Offshore Intermediate Company: 82%
- Minority Shareholder: 18%

Acquired the remaining shares in HKCo for cash.
Case study 3: DriveSol

• Formal bids were received from 2 third parties and the minority shareholder who has pre-emption rights

• There were negotiations with third parties and the minority shareholder leading to a MOU with the minority shareholder

• The minority shareholder, being a PRC resident, had to obtain SAFE approval to transfer money out of the PRC in settlement of the transaction

• It took nine months to complete final negotiations

• US Seller was able to obtain a satisfactory price on disposal of their investment
Exiting Private Equity

• Points to Note
  – It’s important to have a good understanding of Chinese business customs and language
  – Negotiations can be long and frustrating – good humour and perseverance required!
Listing Offshore

Listing Offshore Equity:

- IPOs

  i. Offshore IPO by offshore vehicle
     
     **Pros:**
     - Expedited procedure
     - No PRC authorities' approval (or prescribed 1 year limit)
     - Negotiability of shares
     
     **Con:**
     - (Compare to private sale) listing procedures and pre-listing requirements: consecutive years of profitability/post listing lock-up period and potential higher income tax exposure

  ii. Offshore IPO by FIE
     
     - Subject to both PRC as well as foreign regulatory requirements
Entry / Exit via Listed Offshore Equity

• Reverse Take-Overs (“RTO”)
  – An RTO is accomplished when a privately-held operating company acquires a publicly-traded entity
  – After the takeover is completed, the managers of the acquiring firm take control over the newly merged entity and usually change its name to match that of the privately-held business
  – You now have a privately held business which is associated with tradeable US stock
Entry / Exit via Listed Offshore Equity

According to the US accountancy watchdog Public Company Accounting Oversight Board ("PCAOB"), from Jan 2007 to March 2010, of more than 600 companies that have entered US Stock Exchanges through RTOs, 26% were from the China region and their combined market cap is US$12.8B while assets/revenue stands at less than US$50M. Over the same period, 13% of all IPOs in the US were from China.

Pros:
- Savings on time and fees
- Reduced listing and filing requirements otherwise required for an IPO

Cons: Problems faced by US Regulators
- Lack of adequate supervision by US audit firms regarding the work outsourced to Chinese auditors
- Language barrier regarding working papers, books and records
Entry / Exit via Listed Offshore Equity

- Heavy reliance placed on Chinese auditors work such that US auditors sign off on the accounts of Chinese RTO companies without performing own independent work – breach of PCAOB guidelines

- PCAOB are finding it difficult to evaluate the quality of audits as Chinese authorities have refused PCAOB from inspecting the audit work of PCAOB registered accounting firms based in China

- Concerns about lax accounting and potential for fraud as China’s accounting regulatory body, China Securities Regulatory Commission (“CSRC”), shows interest only if the company concerned has dual listing in China, which is not the case with most companies

- SEC has also experienced lack of co-operation from the CSRC

- Case studies 4 & 5
Case study 4: Puda Coal

- Puda Coal, Inc (“Puda”) is a Chinese coal cleaning and processing company listed in New York.
- In 2009, to tide over industry consolidation and raise money in China, Chairman Ming Zhao transferred/pledged the ownership of Puda’s sole operating entity, Shanxi Puda Coal Group Co Ltd, without shareholder approval.
- Auditors failed to pick up on the transfer despite availability of official government filings.
- Money continued to be raised in the US.
- A US investor has already filed a lawsuit in a New York District Court against Puda and certain of its officers and executives alleging violations of Federal Securities Laws.
Case study 4: Puda Coal

- Puda USA
- Puda BVI
  - Puda WFOE
    - Shanxi Coal (Operating Sub)
      - Chairman Ming Zhao

John Lees Associates
Case study 4: Puda Coal

- **Puda USA**
- **Puda BVI**
- **Putai WFOE**
  - **Putai Mining**: 90%
  - **Chairman Ming Zhao** (Ming’s brother)** 2%**
  - **CITIC Trust**: 8%
- **51% pledged to CITIC Trust**
- **100% Common Level Capital Contributor**
- **Shanxi Coal (Operating Sub)**: 49%
- **CITIC Trust**: 51% pledged to CITIC Trust
Recently delisted companies and companies whose shares were suspended from trading

<table>
<thead>
<tr>
<th>Company</th>
<th>Delisted/Suspended</th>
<th>Company</th>
<th>Delisted/Suspended</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rino International</td>
<td>Delisted</td>
<td>China Electric Motor</td>
<td>31 March 2011</td>
</tr>
<tr>
<td>Duoyan Printing</td>
<td>Delisted</td>
<td>HQ Sustainable Maritime</td>
<td>1 April 2011</td>
</tr>
<tr>
<td>China INSOline</td>
<td>Delisted</td>
<td>Keyuan Petrochemicals</td>
<td>1 April 2011</td>
</tr>
<tr>
<td>Xinhua Sports &amp; Entertainment</td>
<td>Delisted</td>
<td>Subaye inc</td>
<td>7 April 2011</td>
</tr>
<tr>
<td>Tongxin International</td>
<td>Delisted</td>
<td><strong>Puda Coal</strong></td>
<td><strong>11 April 2011</strong></td>
</tr>
<tr>
<td>China MediaExpress Holdings</td>
<td>11 March 2011</td>
<td>Universal Travel Group</td>
<td>12 April 2011</td>
</tr>
<tr>
<td>China Agritech</td>
<td>14 March 2011</td>
<td>China Ritar Power</td>
<td>18 April 2011</td>
</tr>
<tr>
<td>ShengdaTech</td>
<td>15 March 2011</td>
<td>Duoyuan Global Water</td>
<td>20 April 2011</td>
</tr>
<tr>
<td>China Century Dragon Media</td>
<td>21 March 2011</td>
<td>China Integrated Energy</td>
<td>20 April 2011</td>
</tr>
<tr>
<td>NIVS IntelliMedia Tech</td>
<td>24 March 2011</td>
<td>Wonder Auto Tech</td>
<td>6 May 2011</td>
</tr>
<tr>
<td>China Intelligent Lighting</td>
<td>24 March 2011</td>
<td><strong>Longtop Financial Technologies Ltd</strong></td>
<td><strong>May 2011</strong></td>
</tr>
</tbody>
</table>
Case study 5: Longtop

Software maker accused of falsifying financial records is the latest foreign-listed mainland firm to be hit by accounting scandal.
Case study 5: Longtop

• Longtop Financial Technologies ("Longtop") is a Chinese software company listed in New York

• Its independent auditors resigned giving the reasons as, “...among other things, (1) the recently identified falsity of the Company's financial records in relation to cash at bank and loan balances (and possibly in sales revenue); (2) the deliberate interference by certain members of Longtop management in [the] audit process; and (3) the unlawful detention of [the] audit files.”

• Investment analysts Citron Research ("Citron") issued a report in April 2011 alleging that all of Longtop’s financial statements were fraudulent
Case study 5: Longtop

• CFO Derek Palaschuk also resigned from Longtop on 19 May 2011, following his resignation as head of the audit committee of Renren (China’s equivalent to Facebook).

• 7 hedge funds with the largest positions, have lost a total of US$447M after Longtop's share price fell by 25% following Citron's allegations

• Longtop is currently being investigated by the SEC

• It is useful to note that Longtop is a unique example; it didn't list via a RTO and it hired a reputable auditor to oversee its books which is not the case with many other troubled Chinese RTO companies
Investors be Aware

ACCOUNTING MYSTERY FOR MINING FIRM

Real Gold seems to have filed different sets of figures for 2009, one rosy version to HKEx and a loss-making version to the central government.
Investors be Aware

• Conduct adequate due diligence before investing. Various issues to keep in mind would include:
  
  – Companies often have at least 2 sets of books
  
  – There is a lack of the “separate legal entity” concept so major shareholders often make up the management. In particular, the corporate bank account is treated as personal resulting in the mixing of shareholders’ private funds with corporate money
  
  – Each province in China has different policies/rules
  
  – Majority of the board is controlled by one family
  
  – Sustainability, especially where business development relies heavily on 1-2 members of senior management with good guanxi
Investors be Aware

- Investment in China made through the Underground Banking System will present problems when trying to repatriate monies from sale of assets whose purchase was not approved by SAFE.
- Bad legal title to assets
  - Land Use Rights not issued – Collectively Owned Land (agricultural use only)
  - Land Use Rights not transferrable – Allocated Land Use Rights
  - Granted Land Use Rights not properly transferred and therefore transfer not registered
- Assets encumbered with third-party unpaid assets
Investors be Aware

- Difference in management culture
- Lost in translation? Many senior members of management in China do not speak English and sometimes the staff called on to assist in translation may add their own comments on issues when translating
- Degree of regulation
- Reluctance to disclose information and general lack of timely communication with investors
- US or HK auditors need to rely on PRC auditors as most of the assets are in the PRC
Investors be Aware

Professional advisers blame mainland firms

Bad IPOs not our fault, say auditors
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