

INVESTMENT FUNDS ALERT

RENMINBI (RMB) FUNDS – A NEW BRIGHT SPOT IN 2008



During the first 11 months of 2007, 170 Chinese enterprises received a total of USD 12.49 billion from 105 private equity (PE) and/or venture capital (VC) funds, according to data compiled by Zero2IPO, a VC research organization in China. Among other trends in China's super active PE/VC market, one thing is clear: RMB funds have come of age. These funds are private investment funds that are denominated in RMB, organized under Chinese law, and invest primarily in the People's Republic of China.

TYPES OF RMB FUNDS

Generally, there are two types of RMB funds: purely domestic RMB funds and foreign-invested RMB funds. Purely domestic RMB funds are funds denominated in RMB, organized under Chinese law, raised from domestic Chinese investors and investing in domestic Chinese companies. Foreign-invested RMB funds are also denominated in RMB, but are essentially foreign-invested enterprises (FIEs), funds with full or partial foreign ownership, organized under Chinese laws that govern foreign investments into China.

Domestic RMB funds experienced phenomenal growth during 2007 and are expected to continue the momentum in 2008.¹ Within this sector, national and local government-backed industrial investment funds and local government-backed incubator funds are the dominant players due to their sheer size, although private sector VC funds established under China's new limited partnership law have become a new force in the market.²

¹ At least six government-backed industrial investment funds have been established or approved. They include the Bohai Industrial Investment Fund established in late 2006 and a group of five industrial funds with a total capital subscription of RMB 56 billion, all approved in September 2007 (Guangdong Nuclear Power & New Energy Industrial Investment Fund, Shanghai Financial (Development) Fund, Shanxi Financial (Development) Fund, Sichuan Mianyang High-Tech Fund and Citic High-Tech Industrial Investment Fund).

² The revised "Law of the People's Republic of China on Partnership Enterprises" went into effect on June 1, 2007. One significant feature of the law is the introduction of the limited partnership as a valid form of business entity under Chinese law. The first fund organized as a limited partnership under the new law was reportedly Nanhai Growth Venture Capital Partnership Enterprise, which was registered in Shenzhen in June 2007 with an initial capital subscription of RMB 162 million yuan. Wenzhou Donghai Venture Capital Partnership Enterprise was reported to be China's second VC fund organized as a limited partnership. It initially raised RMB 500 million yuan. Currently, Dongfang Fuhai Venture Investment Partnership Enterprise, established in Shenzhen in November 2007 with a registered capital of RMB 900 million yuan, is believed to be the biggest limited partnership VC institution in China.

Foreign-invested RMB funds are generally established under the Measures on Administration of Foreign-Invested Venture Capital Enterprises (FIVCE Measures), which was promulgated on January 30, 2003, and became effective on March 1, 2003. The FIVCE Measures allow foreign investors to establish joint ventures and/or wholly foreign-owned enterprises (WFOEs) to engage in venture capital investments in China. A recent high-profile RMB fund is an IDG-funded FIVCE.³

In addition, it is expected that foreign fund managers/sponsors will be able to set up foreign-invested RMB funds in the future under the regulations governing foreign-invested limited partnerships.⁴ Finally, both foreign and Chinese sponsors and managers are exploring setting up domestic RMB funds in parallel with offshore foreign currency funds whereby the two funds will be invested side-by-side in Chinese portfolio companies. The Chinese government's restrictions on foreign investments and currency controls can present certain challenges to this parallel domestic RMB fund/offshore foreign currency fund structure. Nevertheless, some managers have already set up Sino-foreign joint venture management companies in China to manage RMB funds.

MARKET AND POLICY FORCES BEHIND RENEWED INTEREST IN RMB FUNDS

Market conditions and policy forces are the main drivers of the renewed interest shown by foreign fund managers/sponsors in establishing foreign-invested RMB funds four years after the FIVCE Measures were promulgated. First, a steady appreciation of the RMB may have given managers an incentive to convert their foreign currency into RMB earlier rather than later. Second, having a foreign-invested RMB fund can facilitate a manager's ability to raise capital from domestic RMB funds and other domestic investors. Third, policy and regulatory changes have made "round-trip" investment structures that offshore foreign currency funds have widely used for their China investments (i.e., foreign PE or VC funds investing in foreign holding companies set up by Chinese companies to make investments back into China) much more difficult. Fourth, the domestic IPO market has performed exceptionally well and a foreign-invested RMB fund may be able to exit from its China portfolio investments through a domestic listing with an attractive valuation.

REGULATORY HIGHLIGHTS

First, the FIVCE Measures permit a foreign-invested RMB fund to be organized as either a limited liability company (Incorporated FIVCE) or a non-legal person entity (Non-Legal Person FIVCE), similar to a limited partnership. Second, in an Incorporated FIVCE, each investor's liability is limited to its capital commitment, while in a Non-Legal Person FIVCE investors may stipulate in the fund's governing document that they bear only limited liability while the "indispensable investor" (similar to a general partner) bears the joint and several liability of the fund. Third, an Incorporated FIVCE pays taxes at the entity level while taxes on the income of a Non-Legal Person FIVCE may be paid by its investors or by the entity, subject to approval by the competent tax authority. Hence, structured properly, a Non-Legal Person FIVCE can achieve a tax pass through status.

One of the regulatory requirements for a foreign-invested RMB fund concerns minimum registered capital (similar to a fund's total capital commitments). For an Incorporated FIVCE, the minimum registered capital is USD 5 million, while it is USD 10 million for a Non-Legal Person FIVCE. All registered capital must be contributed within five years.

³ It was reported that IDG Technology Venture Investment won approval from the Chinese Ministry of Commerce in January 2008 to set up a foreign-invested RMB fund under the FIVCE Measures. The fund target size is USD 68 million. The fund will mainly invest in fast-growing companies in the chain store, high-technology and energy sectors.

⁴ The Chinese Ministry of Commerce has circulated a draft regulation governing foreign-invested partnership enterprises following the adoption of the new PRC Partnership Enterprise Law.

Another requirement is that an “indispensable investor” must meet certain prior experience, staffing and capital requirements. Its withdrawal is subject to rather stringent statutory restrictions. Finally, establishment of a foreign-invested RMB fund under the FIVCE Measures is subject to approval at the central government level regardless of the fund size.

One noteworthy feature of a foreign-invested RMB fund established pursuant to the FIVCE Measures is that the fund may invest only in unlisted high-technology companies (although such funds may continue to hold securities after the company has become listed). Additionally, there are borrowing and other investment restrictions prescribed in the regulation. Hence funds with a more flexible investment strategy may find it difficult to cope with the regulatory restrictions.

Despite some regulatory hurdles, foreign-invested RMB funds are expected to attract renewed interest from foreign fund sponsors and managers. Domestic RMB funds are expected to continue their growth momentum in 2008 and are looking for opportunities to cooperate with foreign-invested RMB funds.

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