EQUITY AND DEBT FINANCING OF BUSINESS OPERATIONS FOR PRC COMPANIES

By

PETER S K KOH*

Types of PRC Companies

Under the Company Law, there are two types of companies: limited liability company and joint stock limited company.

For a **limited liability company**, a shareholder will be liable to the company to the extent of his paid capital contribution. The shareholders of a limited liability company can be no more than 50.

For a **joint stock limited company**, a shareholder will be liable to the company to the extent of the shares he has subscribed and paid. A joint stock limited company may be established by the way of promotion (where promoters subscribe all the shares to be issued) or stock floatation (where promoters subscribe only a part of the shares to be issued).

A joint stock limited company can either be an unlisted company or a listed company. In China, the stocks of a listed company are listed and traded on either Shanghai Stock Exchange or Shenzhen Stock Exchange.

Another classification method is based on whether there is foreign investment involved. A foreign invested company ("FIC") refers to a company with foreign investment and shareholding. A domestic company has no foreign investment or shareholding. The Company Law is applicable to both a domestic company and an FIC. However, an FIC is also subjected to special laws or regulations for foreign investment.

An FIC is classified either as a wholly foreign –owned enterprise ("WFOE"), a contractual joint venture ("CJV") or an equity joint venture ("EJV").

A **WFOE** is a limited liability company with only foreign shareholding. A WFOE is mainly governed by *Law of the People's Republic of China on Foreign-invested Enterprises* as well as many other relevant regulations and rules, which make it clear that its structure will be the limited liability company. Only by approval, it can be structured otherwise.

A **CJV** is a joint venture with both foreign and domestic investors. The CJV contract will be the basis for such joint investment. The contract will include contents such as the investment criteria or conditions for cooperation, distribution of earnings or products, sharing of risks and losses, style of operation and management and ownership of the property at the time of the termination of the contractual joint venture. The establishment and operation of a CJV will be based on the CJV contract as well as the Articles of Association.

Like a CJV, an **EJV** is also jointly invested by Chinese Party and Foreign Party. The parties to the venture share the profits, risks and losses in proportion to their respective contributions to the registered capital of the EJV.

Under *Law of People's Republic of China on Chinese-Foreign Equity Joint Ventures* as well as many other relevant rules and regulations, an EJV, like a WFOE or a CJV is structured as a limited liability company.

When foreign investment is involved in a joint stock limited company, it can be deemed as a special type of EJV or may be classified simply as "**foreign-invested joint stock limited company**".

Foreign shareholdings in a foreign-invested joint stock limited company must be no less than 25% of the company's total registered capital and the total registered capital at its minimum level must be RMB 30 million.

In the case that a foreign-invested joint stock limited company is listed, the foreign shareholdings are allowed to be less than 25% of the total shareholding, but must not be less than 10%. The Certificate of Approval for FIC will be revoked as the foreign shareholding is less than 25%, which means that the company is no longer treated as a FIC under PRC law.

Onshore Equity Financing

Equity financing refers to raising funds from existing or new shareholders by increasing the registered capital in respect of limited liability companies and issuance of new shares in respect of joint stock limited companies.

For shareholders that do not want to increase their shareholdings, the registered capital increase or the issuance of new shares will be carried out among the existing shareholders on a pre-emptive basis. If new shareholders are invited to make contributions, the percentage of the existing shareholding will inevitably be diluted.

A joint stock limited company can increase its registered capital with new shareholders. The **Private Equity Investment ("PE investment")** and **Initial Public Offering ("IPO")** are the most common methods of equity financing.

PE investment refers to an equity investment in non-public listed companies by investing institutions (usually set up as limited partnerships in overseas financial centres). It is not unusual for a company that aims at IPO to consider attracting PE investment as a pre-requisite. PE investment will result in an increase of capital for the invested company.

Example 1: China Mengniu Dairy Company Limited [1]

In November 2002, Morgan Stanley China, Actis Investment China, and CDH Investment China jointly invested US$26 million in China Mengniu Dairy Company Limited. It is now the biggest and most famous milk products manufacturer in China. That was the first round investment, followed by the second round in May 2004 where the same three PE investors injected another US$35.23 million.

Example 2: Alibaba Group[2]

Founded in 1999 as a small company, Alibaba Group is now a global name in consumer e-commerce, business-to-business marketplace, on-line payment, and other Internet-related business. In 1999 and 2000, Alibaba Group raised US$5 million mainly from Goldman Sachs China and then another US$20 million from Softbank China and other institutions. It was then at the nadir of its business operations.

IPO means the initial sale of a company's common shares to public investors. The main purpose of an IPO is to raise capital for the company.

Companies in China may choose onshore IPO or offshore IPO. In the past years, Chinese domestic stock market was a big pool from which listed companies had no difficulty in raising capital. For example, in 2011, 281 companies listed on A stock market and a total of US$43.719 billion was

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[1] Source: "Investtide", official website of Dragon Brilliant Capital dated 15 July 2013:
http://www.investide.cn/db/event/eventDetail.do?enterpriseEventId=112301
http://www.investide.cn/db/event/eventDetail.do?enterpriseEventId=11849

[2] Source: "Company Overview", official website of Alibaba Group, dated 15 July 2013, website:
http://news.alibaba.com/specials/aboutalibaba/aligroup/index.html

raised. Each listed company raised US$156 million on an average from the A stock market in 2011. [3]

The IPO market in 2012 turned out to be sluggish due to some new and stringent rules and the backlog of applications for domestic share sales.

Onshore Debt Financing

Debt financing refers to loans from financial institutions such as commercial banks. Commercial banks rarely provide loans or credit facilities without provision of securities by corporate borrowers. Commercial banks require companies seeking loans to provide Letters of Guarantee or Promissory Bonds or Standby Letters of Credit together with acceptable collaterals such as mortgages or pledges. Credit worthiness or financial standing of the corporate borrower will be taken into consideration in their risk evaluation.

Letter of Guarantee or a Performance Bond can either be provided by a domestic financial institution (for example, a domestic bank) or a non-financial enterprise with credit worthiness (for example, the shareholder of the company). When the Letter of Guarantee is provided by a bank, the corporate borrower is usually required to deposit a substantial amount of cash as fixed deposit.

Properties such as real estate, land use rights, machines and equipments[4], transportation vehicles[5], either owned by the company itself or by a third party, can be used as collateral properties. **Mortgage** is always the most desirable security for a bank because of its safety and simple value appraisal.

The properties that can be used for **pledge** are mainly the movable properties, for example, inventory such as raw materials or goods in the warehouse, and instruments including bills of exchange, promissory notes/bank notes[6], cheques, bonds, bills of lading, negotiable shares or stocks. Other properties include negotiable rights to the exclusive use of trademarks, patents and copyrights can be pledged as well.

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3 National Business Daily dated 4 Jan 2012 (website: http://www.nbd.com.cn/articles/2012-01-04/626869.html)

4 A mortgage contract will be signed and shall be registered with the local AIC. The title documents attached to such machines and equipments will be marked "under charge".

5 A mortgage contract will be signed and shall be registered with the local transportation authority. The title documents attached to such vehicles will be marked "under charge".

6 Under Article 73 of the Negotiable Instrument Law of the PRC, a promissory note is an instrument written and issued by a drawer, promising to pay unconditionally a fixed amount of money to a payee or holder at the sight of the instrument. The term "promissory note" used in this law refers to the bank note.

Lately, small and bigger banks have more creative ways to raise funds by establishing private wealth management funds.

However, not all the commercial banks are privileged to establish wealth management. Only a few banks have been approved to do so.

The *Measures for the Pilot Management of Establishing Fund Management Companies by Commercial Banks* were promulgated by both China Banking Regulatory Commission ("CBRC") and China Securities Regulatory Commission ("CSRC") in 2005. These measures paved the way for the establishment of wealth management funds from 2005 onwards .

Bank of China, Construction Bank, Industrial and Commercial Bank of China, and Bank of Communications constituted the first group that were approved by CBRC and CSRC to establish subsidiaries dealing with wealth management funds.

The second group included Bank of China, Agricultural Bank of China, China Merchants Bank, Shanghai Pudong Development Bank and China Mingsheng Bank. The third group consisted of city banks, for example, the Beijing Bank.

Allowing commercial banks to establish wealth management funds helps them raise much needed capital during the prevailing credit crunch. However, in the short run, it is still not easy for companies, especially small and medium sized companies, to get loans from banks, mainly due to the credit crunch faced by the banks. As a result, many companies turn to debt financing from non -financial institutions and non-banks, such as private credit companies.

Private credit companies are legal entities in China. They can be either structured as limited liability companies or joint stock limited companies. No special license is required for the establishment of such companies, but there is a need for approval by local government and registration with People's Bank of China ("PBOC").

The permissible interest rate has to be no lower than 9/10 of the benchmark loan rate published by People's Bank of China, and the maximum is 4 times the benchmark loan rate.

Securities may be required. Private credit companies can grant loans with higher interest rates and shorter loan periods without the provision of securities by the borrowers. Companies have to be very careful when they raise funds from private credit companies as not every private credit

company carries its money lending business within the legal framework. Partly because of private credit companies not being allowed to raise funds from the public, a high interest rate may be charged in the guise of commission or other fees.

There are so many of such companies in Shenzhen and Wenzhou. These two cities are the examples in respect of private credit companies' administration.

Shenzhen has its own local rules regulating the qualification, establishment, operation, risk management and other aspects of private credit companies.

For example, Shenzhen government issued *Temporary Measures of Shenzhen for the Pilot Management on Small Credit Companies* in 2009. Under these *Measures*, the maximum registered capital will be RMB50 million in respect of a limited liability company and RMB 80 million in respect of a joint stock limited company. These *Measures* also have strict provisions regarding the investors/fund distributors to ensure the legality of their financial sources.

Wenzhou is the pilot city for the financial reform recently. Some private credit companies will be re-structured as small rural banks, and the remaining will be placed under stricter supervision. Previously a financing scandal regarding illegal fund raising was reported to take place in Wenzhou and its neighboring cities. Large amount of funds were raised by all kinds of companies including private credit companies from the public at exorbitant interest rates. In the end most of the lenders were not repaid.[7]

Another source of debt financing for companies is issuance of corporate bonds[8].

Compared with bank loans, issuance of corporate bonds allows a company to use the raised funds in a way not limited or interfered by creditors. Also, the company does not have to repay the debts in a shorter term and face cash liquidity. The company will be financially burdened with higher payments upon maturity of the bonds.

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[7] See the "Wu Ying" case. Wu Ying was given a suspended death sentence because of credit financing fraud. She established the Bense group and was its Legal Representative. In 2006, she was ranked No 68 in the Hurun Rich list with her total wealth of RMB 3.8bn. It was reported that she raised more than RMB 773m from the public of which around half was not repaid.

[8] In China, there also exists "enterprise bonds" that are different from corporate bonds, mainly in that enterprise bonds are issued by SOEs or state holding companies, the raised funds usually being invested in specific constructions of railway, highways or power station.

Other concerns that may impact a company's decision in issuing corporate bonds include the complicated and strict procedure in obtaining approval from authorities.

Issuance of corporate bonds must be approved by CSRC. Agents including underwriters and sponsors must be employed by the company. This is a heavy expenditure to be borne by the company. The company has to comply with conditions set by relevant laws, for example, the net assets shall not be less than RMB30 million in respect of a joint stock limited company or RMB60 million in respect of a limited liability company.[9]

Almost all the companies approved with issuance of corporate bonds during the past years were listed companies.

Off-shore Equity Financing

As a global economic engine, it is normal for companies in PRC to establish overseas subsidiary or associate companies. Such overseas companies require to raise capital for their business operations. The methods of obtain financing is the same as their holding or parent companies in the PRC. They can use equity and debt financing instruments to raise funds.

Raising capital directly from the Chinese holding company is sometimes not considered because of China's policy on foreign exchange control. A spate of financial scandals and auditing irregularities overseas have been daunting factors for overseas companies to engage in equity financing of their business operations.

Off-shore Debt Financing

The off-shore debt financing is more about "an overseas loan under domestic guarantee" than a direct overseas loan extended to Chinese overseas subsidiaries.

Debt financing can always be an avenue for Chinese overseas subsidiaries as they can also provide acceptable securities such as mortgages of real estate or commercial or industrial properties. Sometimes, directors and shareholders can also provide their residential properties overseas plus their personal guarantees to enable their companies to have lines of credit. However, they often face difficulties in raising funds directly from the overseas financial institutions, because of credit worthiness. In this context,

[9] Article 16 of Securities Law of the P.R.C.

“an overseas loan under domestic guarantee” was created and approved by the State Administration of Foreign Exchange (“SAFE”), for the purpose of giving support to Chinese overseas subsidiaries.

Such policy literally means overseas financial institutions granting loans or credit to overseas subsidiaries with the provision of security by its parent or holding company in PRC. This can be facilitated by an internal arrangement between the domestic bank and the overseas bank.

For example, XYZ is an overseas subsidiary or associate company established in Singapore by its Chinese holding company ABC. ABC provides security to a local Chinese bank, say, Bank D, such as pledging of shares, mortgage of real estate properties, fixed deposits and personal guarantees by substantial credit worthy shareholders. The Bank E in Singpore, will extend a line of credit to XYZ.

Between Bank D and Bank E, there will be an internal arrangement, usually by way of documentary standby letter of credit. The documentary standby letter of credit is issued by the Chinese domestic bank, Bank D, under which XYZ is the beneficiary. With the endorsement by a fully licensed bank in the PRC, the Singapore bank, Bank E, will extend a line of credit to XYZ.

In lieu of Bank E, it can also be the overseas branch of Bank D or the agent bank that has a regular business relationship with Bank D.

In conducting such arrangement, company ABC has to consider two important factors:

First, Bank D issues the documentary standby letter of credit to the extent not exceeding the amount associated with the line of credit given to XYZ.

Second, “an overseas loan under domestic guarantee” is under supervision of the SAFE and subjected to adjustment from time to time. For example, the SAFE suspended approving this kind of transactions in 2011, as some companies exploited this policy as a tool of making money by taking advantage of interest differentiation and currency fluctuation.

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