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Private Equity 2023

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China: Law & Practice
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Han Kun Law Offices

CHINA

Law and Practice

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Han Kun Law Offices

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Han Kun Law Offices is a leading full-service law firm in China. Over the years, Han Kun has been widely recognised as a leader in complex cross-border and domestic transactions and compliance matters. Its main practice areas include private equity, mergers and acquisitions, international and domestic capital markets, investment funds, asset management, compliance, banking and finance, aviation finance, foreign direct investment, antitrust/competition, data protection, private client/wealth management, intellectual property and dispute resolution. Han Kun has nearly 800 professionals located in its seven offices in Beijing, Shanghai, Shenzhen, Hong Kong, Haikou, Wuhan, as well as Singapore, a leading financial center in the Asia-Pacific. All of its lawyers are graduates of top universities and have extensive experience in complex cross-border transactions and dispute resolution as counsel to both Chinese and foreign clients.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

Private equity transactions and M&A deals in mainland China and the PRC are expected to pick up in 2023 as the Chinese market starts recovering from strict pandemic policies and economic downturn.

Major market research agencies appear unanimous in their analysis of the transaction activity in China in 2022 – both the total number and total value of private equity transactions decreased notably in 2022, roughly in the range of 10% to 30%, depending on the different methodologies used by different sources to calculate the volume and value of private equity and M&A activities in China in the past twelve months.

According to CV Source (an online database maintained by the Chinese research and consulting firm ChinaVenture Group), private equity activities and M&A deals generally saw a decline in 2022. The number of M&A deals completed in China declined to 4,535 in 2022, representing a decrease of 4,49% from 4,748 in 2021. A total of 2,303 deals disclosed their deal value, encompassing an aggregate invested amount of USD167.09 billion, representing a decrease of 27,62% from USD230.86 billion in 2021.

PwC also finds that M&A activity in China fell in 2022 to its lowest level since 2014 at USD486 billion. This is down 20% compared to 2021, while announced deals (excluding VC) fell by 11% in terms of deal volume. Likewise, in 2022 the value of PE investment declined by 23%, whereas the announced deal volume showed a slighter decline from 2,269 in 2021 to 2,020 in 2022.

Although transaction activities in China showed a downward trajectory overall in 2022, domestic private equity and M&A transactions increased significantly, while cross-border transactions involving China declined.

In the first half of 2023, approximately USD71.3 billion was invested in PE/VC market. The figure remains relatively flat compared with the one in 2022. Furthermore, investments at the start-up and early stages are starting to re-gain popularity.

China's market is expected to see a recovery and rebound in the rest of 2023 as the central government is issuing new policies to encourage economic development and deal-makers are leveraging declining valuations to develop deal opportunities. In addition, the fact that private equity funds have a lot of dry powder on hand, putting pressure on fund managers to start making use of it is also expected to facilitate the investment activities in China in 2023.

1.2 Market Activity and Impact of Macro-Economic Factors

Investments in certain sectors such as semiconductor, electric vehicles, information technology and life sciences remain active in 2023, and growth equity investments remain the dominant type of transactions. It is noteworthy that in March 2023, the Stock Exchange of Hong Kong introduced a new chapter 18C to the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited to permit the listing of companies operating in specified specialist technology sectors, including, amongst others, next-generation information, advanced hardware and software, advanced materials, new energy and environmental protection and new food and agriculture technologies. It is expected that the new listing rule will encourage more growth equity investments in such sectors.

Rising interest rates, macro-economic uncertainty and geopolitical tensions slowed down cross-border transactions involving China in the past twelve months, but deal makers anticipate a return of M&A activity in 2023 as buyers and sellers agree on valuation and pricing.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

Due to the geopolitical volatilities and disruptions caused by the COVID-19 pandemic, the PE/VC market seemed to have ups and downs in the past three years. Five main features of domestic PE/VC markets have appeared in recent years.

Firstly, state-guided funds (SGFs) and government-guided funds (GGFs) are major sources of capital for PE/VC funds.

Secondly, fundraising periods have become relatively longer. For example, around 2016, a PE/VC fund took about three months on average to complete its first closing (in fact, a number of PE/VC funds completed their first closings within one month) and took an additional three to nine months to reach its final closing. However, in the past three years, it has been quite common for PE/VC funds' first closings to take six to twelve months and an additional twelve months to reach the final closings.

Thirdly, fund structures have become more complicated to accommodate fundraising needs. PE/VC funds have commonly utilised the parallel fund structure, the multi-parallel fund structure, the connecting fund structure, the umbrella fund structure and combinations of these structures.

Fourthly, it is obvious that only certain "top-quartile performance" funds have successfully launched with smooth fundraising. Many PE/VC firms at "middle waist" are still under great pressure in their fundraising activities.

Fifthly, there are fewer new PE/VC firms coming to the market compared to previous years. Due to the internal and external environment, there is a significant decrease of the size of the generation of the new market players in the Chinese PE/VC market.

It is a primary trend that investment fund practice will continue to maintain its blue ocean status. However, laws and regulations governing the investment fund sector will be strengthened which will cause the PE/VC industry to develop in a more standardised and robust way. This is expected particularly due to the Regulations on the Supervision and Administration of Private Investment Funds, which were published on 9 July 2023 and came into effect on 1 September 2023.

Meanwhile, with those "first generation" PE/VC funds set up around 2010 entering their exit period, it is a significant task to arrange an orderly liquidation of such funds. The value of secondary funds and secondary transactions to the liquidity and continuity of the PE/VC market is becoming more notable. Additionally, the investment fund sector will enter a new era of cross-border capital allocation with the liberalisation of QFII, QFLP, QDLP, QDIE and QDII policies and quotas and with the growing importance of allocating capital to the Chinese market.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Formation and Operation of PE Funds

On 9 July 2023, the Regulations on the Supervision and Administration of Private Investment Funds were officially released to the public by the State Council. They were formally implemented on 1 September 2023. These new regulations will facilitate the improvement of the basic legal framework for the supervision of private equity funds in China. As such, they represent a milestone for the private equity industry.

Prior to these new regulations, the Asset Management Association of China also issued new Private Investment Fund Registration and Filing Measures. The updated self-regulation rules set the principle of “Favour top students and reject underachievers.” At the same time, new requirements were also put forward for private equity funds, especially reiterating that private equity funds should focus on equity investment, instead of investing in non-equity interests such as creditor’s rights and income rights, and should not invest in conflicting businesses such as factoring businesses and P2Ps.

Merger Control Filing

The anti-monopoly authority in China is the State Anti-Monopoly Bureau, a deputy ministerial-level authority. Under applicable PRC merger control filing rules, a transaction is subject to a merger control filing where it results in a change of control of the target company and where the turnover of the target company and the buyer has reached the PRC antitrust filing thresholds. The State Anti-Monopoly Bureau determines whether the transaction can proceed as contemplated and whether conditions are to be imposed, taking into account not only the transaction’s impact on competition but also public interest, industry policy and other factors. For PRC antitrust analysis purposes, turnover analysis of private equity-backed buyers has more nuances since the calculation of turnover of portfolio companies or affiliates of private equity funds varies from fund to fund.

National Security Review

National security review, if triggered, affects the completion of a transaction in China. The Foreign Investment Law of the PRC and Measures for the Security Review of Foreign Investment came into force on 1 January 2020 and 18 January 2021 respectively, and established a systematic regime of national security review of foreign acquisition transactions. A foreign investment falling into the following scope is subject to national security review: (i) investment in the military industry, the supporting industries of the military industry and other fields relating to national defence, and investment in areas surrounding military facilities and military industry; (ii) investment in other important fields relating to national security (eg, important agricultural products, important energy and resources, important equipment manufacturing, important infrastructure, important transport services, important cultural products and services, important information technology and internet products and services, important financial services, key technologies), where the foreign investors obtain the actual controlling stake in the investee enterprise.

The foreign investment subject to the national security review shall be filed with the National Security Review Working Mechanism Office (“NSR Office”), set up under and led by the National Development and Reform Commission. The NSR Office can also take initiative to demand the parties to make a filing if it considers the transaction falls within the national security review scope. Parties cannot close a transaction during the review procedure. In the event that the transaction has been closed before a review decision is made, the NSR Office has authority to unwind the transaction or order divestment.

Foreign Investment Negative List and Information Report

China maintains a foreign investment negative list, which sets out industries where foreign investors are "prohibited" or "restricted" from investing. Foreign investors are permitted to invest in industries not on the negative list. Foreign investors in most "restricted" sectors are required to team up with a Chinese partner and, in some cases, the Chinese partner must maintain a controlling stake. Foreign investments in a "prohibited" sector are prohibited regardless of what percentage of the target is acquired.

To invest in those "restricted" or even "prohibited" sectors, some foreign investors use a "variable interest entity" (VIE) structure, under which the foreign investor may obtain control and economic interest in a Chinese company through contractual arrangements rather than shareholding. Many Chinese companies adopting the VIE structure are successfully listed in Hong Kong, the United States or other stock exchanges abroad. The China Securities Regulation Commission (CSRC) released new regulations for filing-based administration of overseas offering and listing by domestic companies on 17 February 2023, formally integrating "red chip" companies into the scope of these regulations and clarifying that companies operating through a VIE structure in China can legally be listed abroad, after satisfying certain regulatory requirements.

According to the Measures on Reporting of Foreign Investment Information, effective from 1 January 2020, key information on an acquisition by foreign investors must be reported to the local bureaux of the Ministry of Commerce through an online system. Prior approval by or filing with the Ministry of Commerce is no longer required except in special circumstances such as cross-border share swaps and related-party mergers.

Anti-bribery and ESG

China has seen a significant uptake of ESG investment in the last couple of years. Like other emerging markets, a major driver has been ESG integration demand from international investors. Regulatory requirements have also been a major driver. With China's ambitious carbon goals and its determination to transition to a green, low-carbon and circular economy, ESG has grown to be a positive indicator for the long-term revenue growth of businesses in the country. ESG-related due diligence of the target company is gaining popularity among conscious private equity buyers and it is expected that more private equity transactions will be ESG-motivated.

On 10 June 2021, the Standing Committee of the National People's Congress of China enacted the Anti-foreign Sanctions Law (AFSL). According to this law, the relevant departments of the State Council may decide to include in the Countermeasures List ("List") individuals and organisations that have directly or indirectly participated in the formulation, decision on or implementation of discriminatory restrictive measures of foreign governments. The persons and their related parties in the List may endure countermeasures imposed by the Chinese government. Private equity funds may be prohibited from dealing with individuals and entities in China, if they or their senior executives were added to the List.

There have been no substantial changes to PRC regulations and practice of anti-bribery in recent years.

4. Due Diligence

4.1 General Information

Private equity investors often engage counsels to conduct comprehensive legal due diligence in transactions involving Chinese target companies or businesses. The key areas of focus for legal due diligence usually include corporate and regulatory matters, litigation and contingencies, property, material contracts, management and employee matters, insurance, intellectual property, environment and compliance. Compared to strategic investors, private equity investors focus more on issues that may affect their exit, eg, non-compliance issues that can be a hurdle for the target's IPO.

Customary legal due diligence review often involves: (i) conducting publicly available searches on target companies; (ii) review of legal due diligence materials provided by target companies; and (iii) management interviews. The deliverable of legal due diligence review for private equity transactions is often a red-flag issue report summarising key issues and mitigants. A detailed descriptive report summarising all legal aspects of target companies has become increasingly uncommon in private equity transactions.

4.2 Vendor Due Diligence

Vendor due diligence is less common for private equity transactions in the PRC, and buyers typically engage their own counsels to conduct independent due diligence. However, where a sale transaction involves a competitive auction process, a private equity seller may provide a vendor due diligence report, summarising key information or findings about the target company and its business for the purpose of streamlining the sale process.

Vendor due diligence reports are often provided on a non-reliance basis to potential bidders initially, and reliance will eventually be granted to the one single winning bidder.

5. Structure of Transactions

5.1 Structure of the Acquisition

Acquisitions by private equity funds in China are typically designed and executed by private sale and purchase agreement. Auction sales are not as common as private sale, except for distressed acquisition transactions which are executed through a judicial auction procedure. If a transaction involves the sale of state-owned shares or assets, the transaction is required to go through an open bidding procedure through the Property Rights Exchanges. The structures of acquisition of shares in PRC listed companies include acquisitions by agreement, private placements, block trading, tender offers, as well as indirect acquisitions (ie, acquisitions of the shareholder of a listed company by agreement).

In a privately negotiated sale, the parties typically negotiate and sign a term sheet setting out key commercial and legal terms at the very beginning, followed by due diligence and documentation preparation and negotiation. Other than a few clauses (such as exclusivity, confidentiality, legal effect), most of the terms documented in a term sheet for a private transaction are not legally binding, and the parties may renegotiate or supplement the terms included in a term sheet at the documentation stage. However, in an auction sale, sellers have more leverage in determining the terms of transactions and buyers tend to focus on key terms and issues in order to stay competitive in the auction process. In addition, the terms of a judicial auction should follow the applicable judicial auction rules, and buyers have less flexibility of negotiating the terms for judicial auction sales. Moreover, in case of a public companies, transaction procedures and terms are required to comply with applicable securities rules and disclosure requirements, which limit the parties' flexibility to negotiate a deal.

5.2 Structure of the Buyer

In transactions in China, a private equity buyer is typically structured as a limited liability partnership formed under PRC law or foreign law, and is managed and controlled by a general partner entity, which is usually a limited liability company. While structuring an acquisition transaction, a private equity buyer, taking into account tax, accounting and legal issues, often sets up a chain of wholly-owned subsidiaries or SPVs to hold and own the acquired target company or business.

However, the private equity fund itself rarely becomes a contracting party to the acquisition or sale in order to protect it from liability. In certain exceptional cases where a private equity-backed buyer is required to provide certain guarantees to counterparties, it often also designates a specific affiliate entity or SPV with sufficient assets to be a party in the acquisition documentation.

5.3 Funding Structure of Private Equity Transactions

Private equity growth investment deals are normally financed by equity in China. Private equity activity is usually categorised into two types of transactions – (i) offshore transactions where acquisition targets are China-based holding companies established under foreign laws (such as the laws of Cayman Island or the British Virgin Islands) and (ii) onshore transactions where acquisition targets are Chinese companies.

Sizable offshore transactions are arranged with acquisition financing provided by offshore financing sources from time to time, but onshore transactions are seldom financed with offshore acquisition financing given China's foreign exchange restrictions on Chinese borrowers' ability to provide onshore collateral assets for cross-border debt financing arrangements. It is possible to arrange onshore acquisition financing to meet the financing needs of onshore acquisitions.

As for the equity-funded portion of the purchase price, an equity commitment letter is used to provide contractual certainty of funds from a private equity-backed buyer in sizable offshore transactions, but it is not often used in onshore transactions. This depends on the private equity-backed buyer's bargaining position. With respect to offshore transactions involving acquisition financing, debt commitment letters provided by financing sources are often delivered at signing to provide more certainty.

5.4 Multiple Investors

There have been consortium deals in Chinese private equity transactions. For sizable offshore or onshore transactions, co-investment by other investors alongside the lead private equity fund is common in China. Taking real estate transactions as an example, existing LPs often negotiate co-investment rights to enable those LPs or their affiliates to co-invest alongside the general partner of the fund. For large technology deals, consortiums led by private equity sponsors often include external co-investors or strategic partners. Consortia comprising a private equity fund and a corporate investor are commonly seen in Chinese outbound transactions where financial and strategic investors play different roles and contribute their own value in making a deal. They are also commonly seen in large transactions in certain key sectors (eg, semiconductors) sponsored by state-owned entity-backed private equity sponsors where key corporate investors are invited to co-invest and create industry synergies.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Fixed price and completion accounts are the predominant forms of consideration structures used in private equity transactions in the PRC. Earn-outs and deferred consideration structures are also seen in growth equity investments in certain sectors such as life sciences. Roll-over structure is commonly used in cross-border private equity transactions involving the PRC where majority and minority owners get interest alignment at the level of offshore investment vehicles.

Valuation adjustment mechanism (VAM) is also commonly used in early-stage transactions in the PRC, where private equity or venture capital investors are compensated (such as adjustment of conversion price of preferred shares into common shares in offshore transactions and issuance of additional shares to investors at a nominal price) in the case that target companies fail to achieve the agreed performance within an agreed period of time after closing.

Like in other jurisdictions, private equity fund sellers prefer fixed price with or without locked box mechanisms to get speedy closings with more certainty; however private equity fund buyers often request completion accounts, escrow or deferred consideration structures to reduce pricing risks. Compared with private equity buyers, strategic purchasers may offer higher amounts of consideration if target companies bring more strategic value or synergies to purchaser groups.

6.2 Locked-Box Consideration Structures

The fixed price locked-box consideration structure is not commonly used in onshore private equity transactions involving a PRC target company. When it is used in offshore transactions involving a PRC target company, interest (ie, “ticking fee”) is sometimes charged on the equity price depending on the bargaining power of the parties. Interest is not often charged on leakage as the fixed price locked-box consideration structure is typically used where the seller has dominating bargaining power.

6.3 Dispute Resolution for Consideration Structures

Transactions structured with completion accounts adjustment often include an agreed dispute resolution mechanism to resolve any disagreement on closing account adjustment items. Typical dispute resolution mechanisms include (i) a procedure of delivering a written dispute notice and an agreed timeline of resolving any dispute items, (ii) a dedicated auditor or expert to resolve the disagreement, (iii) the scope of items and amounts that could be considered in solving the disagreement, and (iv) the allocation of fees and expenses between the parties.

As for transactions involving fixed price mechanisms, earn-outs or VAM, in case of any disputes, the parties usually resort to the general dispute resolution provisions provided in the transaction documentation, which typically include good faith discussions by the parties within a specified period and submission of any disagreement or dispute to a selected arbitration tribunal or a court with jurisdiction.

6.4 Conditionality in Acquisition Documentation

In the PRC market, private equity transactions often include substantive closing conditions, including among others, (i) corporate authorisations and due execution, (ii) receipt of governmental approvals or completion of governmental filings, (iii) bring-down of representations, warranties and covenants, (iv) no material adverse changes between signing and closing, and (v) other conditions in relation to key legal due diligence issues. Third-party consent conditions vary from deal to deal, mainly depending on whether such issue reaches the magnitude of conditionality that affects deal closing. Financing conditions are not customary in private equity or venture capital transactions in the PRC since transactions are largely funded by equity in China. Where the deals are funded by a hybrid of equity and debt, sellers typically require certain funds and do not accept a debt financing condition.

6.5 "Hell or High Water" Undertakings

"Hell or high water" undertakings are uncommon in transactions in China. Regulatory approvals or clearance (eg, merger control clearance, national security review, foreign investment approvals in certain sectors restricted to foreign investment) are often listed as closing conditions and the level of efforts for such undertakings varies from "best efforts," "reasonable best efforts," to "commercially reasonable efforts." If such conditions are not satisfied or are waived by an agreed completion timeline (the end of which is usually the termination date for a transaction), the parties may terminate the transaction with or without a break fee, depending on the allocation of risks and uncertainty of obtaining the approvals by the parties.

6.6 Break Fees

In conditional deals with a private equity-backed buyer, a break fee in favour of the seller is not common in transactions in China. In complex transactions governed by PRC law, sophisticated parties may negotiate termination fees or reverse termination fees in the form of "liquidated damages" to compensate a non-breaching party for its efforts, time and costs of facilitating a transaction. The pre-agreed amount of the liquidated damages usually does not exceed 130% of the actual losses incurred by a non-breaching party arising from the termination of a transaction, and excessively high amounts of liquidated damages could be challenged before a PRC court and may be adjusted and reduced by the court.

6.7 Termination Rights in Acquisition Documentation

In private equity transactions in China, the parties often negotiate and include termination events in the transaction documentation. Customary termination events include, among others, (i) mutual agreement by the parties, (ii) material breach that is not cured within an agreed period of time or is not curable, (iii) failure to close before an agreed long-stop date, and (iv) insolvency, liquidation or dissolution of a party. Termination rights could be reciprocal or unilateral, depending on the parties' bargaining position, and may or may not be designed with termination fee structures.

Longstop dates vary from transaction to transaction, and are often in the range of three to six months depending on the timeline and complexity of the transaction.

6.8 Allocation of Risk

Overall, private equity buyers and strategic buyers apply similar strategies in allocating risks in transactions in China (such as price adjustment, representations and warranties, indemnity, termination). Compared with strategic buyers, who focus more on the strategic value of an acquired business (eg, business combination and integration), private equity buyers emphasise exit flexibility (such as put option, redemption rights, distribution and liquidation preferences). In addition, private equity sellers prefer clean exits in sale transactions and accept a limited scope of liability (eg, cap of indemnity liability, de minimis, basket, deductible, survival periods), especially where they are minority shareholders of disposed companies.

6.9 Warranty and Indemnity Protection

A private equity-backed seller normally provides a limited scope of warranties and indemnities to a buyer on exit, especially when the seller is a minority shareholder of the target company and the majority shareholder, who controls the management and operations of the target company provides more expansive warranties covering more business and operational aspects of the company, based on the management's knowledge. The scope of warranties provided by a private equity seller usually covers fundamental representations and warranties only, such as legal titles to sold shares, corporate power and authorisations. The management team is often not party to a sale transaction, and therefore does not provide separate warranties and indemnities to a buyer. The position does not differ when a buyer is also a private equity fund.

In private equity transactions in China, disclosure of the data room is typically not allowed against the warranties, and exceptions to the representations and warranties should be specified in the disclosure schedules attached to acquisition agreements.

Customary limits on liability for a private equity seller often include caps, basket or deductible, de minimis, survival periods of representations and warranties and so forth. Detailed terms on limitation of liability vary from transaction to transaction, mainly depending on transaction value, the parties' bargaining power and time pressure on negotiation and completion. Further, with respect to the survival periods of representations and warranties, parties usually apply different time limits by categorising representations and warranties into different categories such as fundamental representations, operational representations and other specifically negotiated representations (eg, tax representations and environmental representations), the customary time limits for which are up to five years, two or three years and the statute of limitations respectively.

6.10 Other Protections in Acquisition Documentation

While purchasing a Chinese business from a Chinese owner (especially a Chinese individual owner), it is not uncommon for a private equity buyer to request an escrow account or a holdback arrangement as additional protection in the acquisition documentation. However, private equity sellers rarely accept escrow or retention arrangements to back their obligations. In recent years, we have seen warranty and indemnity (W&I) insurance used in cross-border transactions involving Chinese target companies or businesses, but W&I insurance is not widely used in domestic deals.

6.11 Commonly Litigated Provisions

Litigation is not common in connection with PRC private equity transactions, as parties often select domestic or international arbitration as dispute resolution mechanisms. Since the PRC is a contracting state to the New York Convention, international arbitration awards are recognised and enforced by PRC courts in China except for certain reservations. The most commonly selected arbitration institutions include the Hong Kong International Arbitration Center, the Singapore International Arbitration Center, the China International Economic and Trade Arbitration Commission, the Shanghai International Arbitration Center and the Shenzhen Court of International Arbitration.

The most commonly disputed provisions in private equity transactions are representations and warranties, indemnities, earn-outs, valuation adjustments, redemptions, put options and shareholder or parent guarantees.

7. Takeovers

7.1 Public-to-Private

Though there are delisting rules under PRC laws, typical public-to-private transactions commonly led by PE investors, existing shareholders and/or management teams are rarely seen in the PRC market. This is mainly because the listing status of a public company is highly valuable due to China's unique IPO registration system. However, there has been a steady number of going-private transactions of US-listed companies based in China.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

Under PRC law, an investor of a listed company (whether an existing shareholder of a listed company or an investor who is going to be a shareholder of a listed company by acquiring the shares of such listed company) should generally comply with the following disclosure obligations.

Initial Disclosure

Once an investor (alone or together with others acting in concert with it) holds shares or voting rights of the listed company amounting to 5% or more, it is required to disclose such situation by way of filing a written report to CSRC and the stock exchange, notifying the listed company and making an announcement.

Subsequent Disclosure

Following the initial disclosure, the investor is subject to similar disclosure obligations every time the investor acquires or disposes of 5% or more shares of the listed company on an accumulative basis. With respect to a shareholder of a listed company whose shareholding percentage is no less than 5% (the "Major Shareholder"), any increase or decrease of its shareholding percentage by 1% or more on an accumulative basis must also be disclosed through a notification to the listed company.

In addition to these disclosure obligations, an investor is not allowed to trade securities of a listed company for a certain period when it initially holds 5% or more of shares or voting rights of a listed company or each time there is any change of the shareholding held by a Major Shareholder reaching 5%.

7.3 Mandatory Offer Thresholds

Under PRC law, if an investor intends to increase its shareholding in a listed company after such investor (alone or together with others acting in concert with it) has acquired 30% of the shares or voting rights of a listed company, such investor shall make a mandatory offer to all of the shareholders of the listed company for all or part of the shares held by the shareholders of the listed company. It should be noted that exemptions from the obligation of making a mandatory offer are available in certain circumstances, such as if buyers and sellers of the proposed acquisitions which will not lead to a change of control of the listed company are affiliates under common control, or if the proposed acquisitions are for the purposes of saving a listed company which is facing serious financial difficulties and the buyer is willing to make a commitment that it will not dispose its shares within three years after the acquisition.

7.4 Consideration

Cash is used for consideration in most cases, partly because other forms of legally allowed consideration such as securities or a combination of cash and securities are subject to various requirements and restrictions. For example, where the acquisition consideration is to be paid by securities which are not listed and traded on a stock exchange, the acquirer must provide cash for the shareholders of the target listed company as an alternative at the same time, and make detailed disclosure on the custody of the relevant securities and the method and procedure of delivery of such relevant securities to the shareholders.

Where a public takeover is made by tender offers, the offer price for the target shares shall not be less than the highest price paid by the acquirer for such shares within a six-month period preceding the date of the indicative announcement of the public takeover. Furthermore, where the offer price is less than the mathematical average value of the daily weighted average prices for such shares over 30 trading days before the date of the indicative announcement, a financial consultant engaged by the acquirer is obliged to explain the reasonableness of the offer price. It is also mandatory that the independent financial consultant engaged by the board or independent directors of the listed company shall provide an explanation on whether the consideration matches the enterprise value of the listed company.

7.5 Conditions in Takeovers

PRC law does not restrict the use of offer conditions. In practice, however, most of the takeover offers are not conditional on the occurrence of certain circumstances, or are solely subject to regulatory conditions, such as regulatory approvals.

As mentioned above, in China, takeover offers rarely set out extra conditions. Obtaining of financing is unusual either as a closing condition or as an offer condition. Instead, the acquirer shall ensure that it is able to provide the consideration in full prior to the announcement of the intention to make the offer. For example, if the purchase price is paid in cash, the acquirer is required to provide at least one of the following guarantees: (i) deposit not less than 20% of the total purchase price as a performance bond in a bank designated by the securities registration and clearing institution to ensure its ability to perform the acquisition; (ii) provide a letter of guarantee issued by a bank for the purchase price to be paid by the acquirer; (iii) provide an undertaking letter issued by the financial consultant engaged by the acquirer that such consultant will be jointly and severally liable in case of the acquirer's failure to pay the purchase price. Furthermore, PRC laws stipulate that the financial consultant engaged by the acquirer shall conduct sufficient due diligence of the acquirer's ability to pay the consideration.

Other deal security measures such as break fees, match rights or force-the-vote provisions are rather uncommon in China.

7.6 Acquiring Less Than 100%

A public company generally should comply with the "one share, one vote" principle under PRC law. The special preferences and privileges of shareholders commonly seen in private companies are not applicable to public companies. Therefore, if a bidder does not seek or obtain 100% ownership of a target which will make the listed company into a private company, the bidder can't have additional governance rights except those rights naturally arising from its status as the controlling shareholder of the target company.

In China, it is rather uncommon that a bidder uses financing to raise the purchase price. Accordingly, there are no rules regarding the mechanism of debt push-down into the target following a successful offer.

There is no squeeze-out mechanism which is in favour of the bidder who does not seek or obtain 100% ownership of a target in China. Instead, only put option is available to the dissenting shareholders with respect to the proposed acquisition, according to which such dissenting shareholders can choose to sell all of their shares in the target to the bidder on the same terms as in the tender offer.

7.7 Irrevocable Commitments

As mentioned in **7.5 Conditions in Takeovers**, PRC laws have strict requirements with respect to the purchase price, which means the purchase price is more likely to be determined according to the mandatory requirements rather than the negotiations between the bidder and the sellers. Under PRC law, shareholders may agree to accept a tender offer and revoke the acceptance of the offer prior to three trading days before the expiry of the acquisition period specified in the acquisition report prepared by the acquirer. That said, the preliminary acceptance of the tender offer does not constitute an undertaking prior to three trading days before the expiry of thr acquisition period, but thereafter it will become a binding undertaking which cannot be revoked by the shareholders even if there is a competitive offer.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentivisation of the employees, including senior management and non-executive participants, is a common feature in the PRC. Incentivisation is normally structured through employee stock ownership plans, that might include restricted shares and stock options. As a company registered in PRC is not allowed to reserve an option pool directly, for purpose of tax planning, the shares reserved for incentive program are usually held by a nominee designated by the founder of the portfolio company through a limited partnership.

In a private equity transaction, the private equity investor usually requires that sufficient shares are reserved for equity incentivisation by the target company before the closing to avoid the dilution of its shareholding afterwards. In practice, prior to the first equity financing of a company, the shares reserved for employee incentive plans typically fall within a range of 10% to 15%, occasionally up to 20% or below 5% of the total shares of such company, whereas the shares reserved for the management team normally accounts for 50-70% of the total pool. Through the direct ownership of the management team in the portfolio company, management interests are automatically aligned with those of the private equity investor, which leads to high incentivisation.

8.2 Management Participation

For Chinese companies managed by founders, founders would typically roll over their shares when selling their companies to private equity buyers. Private equity buyers often offer ESOP, retention bonus or change of control bonus to founders and other management team members, but sweet equity is seldom used.

In China, if the management of a target company does not own equity in the company but wants to participate in the PE-backed buyout of the company, they typically will need to team up with a PE investor to purchase shares of the target company at the same or similar price, assuming they have sufficient funds, or through exercising ESOPs adopted by the target company post-closing if the management does not have sufficient funds or is unwilling to co-invest with PE investors.

8.3 Vesting/Leaver Provisions

Vesting provisions are very common with respect to incentive shares or options granted to the management or other employees, while vesting provisions with respect to shares initially held by the management are usually dependant on the negotiation between the private equity investor and the management. If the management shareholders accept such vesting provisions, it is common their equity or shares are subject to a four year vesting schedule, during which 25% of the total shares will vest at the end of the first year, with the remaining portions vesting monthly or annually in equal installments over the next three years.

During the above vesting schedule, if a management shareholder is a good leaver, all the unvested shares will be automatically cancelled or repurchased by the company at nil consideration and the vested shares will remain their shares. Furthermore, the company usually has the right to repurchase the vested shares of the leaving management shareholder at the fair market value if such shareholder leaves the company without cause (ie, good leaver) or at the price equal to the cost paid by such shareholder if they leave the company with cause (ie, bad leaver).

8.4 Restrictions on Manager Shareholders

It is customary that the management shareholders should make restrictive covenants to the private equity investors, such as full-time commitment, non-compete, non-solicitation and non-disparagement undertakings. Besides, given that management shareholders are always employees of the portfolio company, they are normally required to make the same or similar covenants to the company in their employment contracts.

In PRC, the non-compete obligation imposed on the employees under the employee contract requires corresponding compensation and may not extend beyond a period of 24 months post the termination of employment, whereas non-solicitation and confidentiality clauses are less strictly regulated. Though the non-compete covenant to the investors under the investment agreements is negotiable, in most cases the investor will not ask for a non-compete period more than two years because the investors may need to justify the rationality of the non-compete period that is longer than the one in PRC laws which is difficult.

8.5 Minority Protection for Manager Shareholders

In Chinese privately owned companies, the management shareholders (ie, the founders) normally hold the majority of shares in the company and accordingly have the right to appoint the majority of directors of the board. As such, the management shareholders naturally have the controlling power in the company and thus do not need minority protections, such as veto rights on certain matters or the anti-dilution right. Instead, they only have typical pre-emptive rights under which the management shareholder should raise funds to participate in the equity financing to make sure their shareholding will not be diluted. Normally, the investment agreements are crafted to protect the rights of the investors as the minority shareholders of the company.

If the shareholding of the management shareholders is diluted below 50% after several rounds of private equity financing, they may negotiate with the investor to keep their control power of the board and also ask for a veto right on certain important matters, such as amending articles and associations and increase or decrease of the registered share capital of the company.

In the PRC, it is commonly accepted that a private equity fund is totally free in the company. This includes its exit from the company, so in most cases the management team will not have the right to control or influence the exit of a private equity fund, except if the private equity fund plans to transfer its shares in the company to competitors of the company.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

In PRC, minority investment is still more common than buyout deals. Therefore, private equity investors as minority shareholders are typically not involved in daily operations of the portfolio companies and they will always seek various protections through the following arrangements.

Board Appointment Rights

As mentioned in **8.5 Minority Protection for Manager Shareholders**, the management team will typically nevertheless control the board of the company. In order to participate in the board decision-making, investors usually want to have the right to appoint a director. However, as investors grow in number, the company may want to limit the size of the board, so it may set a minimum shareholding threshold (5% is common in practice) for the investors to keep their board seats.

Protective Provisions

Protective provisions for the investors are typical in private equity transactions in PRC.

Protective provisions are reserved matters that require the approval of a specified number of shareholders or a specified number of directors. Reserved matters requiring shareholders' approval are usually matters that are very important to the company, such as any change of the share structure, shareholder rights, liquidation, dissolution and other major issues in the company. Reserved matters requiring board approval are usually those important matters relating to the daily business operations of the company.

The threshold for the requisite shareholders can be combined voting (eg, a percentage of preferred shareholders as a group where no one preferred shareholder has an individual veto), class voting (eg, a percentage of preferred shareholders in a certain group), or tied to an individual shareholder (eg, an individual shareholder has a veto). Accordingly, the threshold for the requisite directors can be combined voting (eg, only the approval of a portion of the directors appointed by the investors is required where no one director appointed by a preferred shareholder has an individual veto) or tied to an individual director appointed by a preferred shareholder (eg, an individual director has a veto). Individual veto rights are more common during early stage financings where there are few preferred shareholders. As the company matures and receives more financings, individual veto right evolve into class voting or combined voting in order to prevent the company from having to obtain required consents from many different shareholders.

Information Rights and Inspection Rights

Information right provides investors the right to receive information from the portfolio company that may be material to such investors, such as financial information, the annual business plan and budget. Inspection right allows investors to inspect the books and records of the company and inquire the management team about its operation. Information and inspection rights are common in PRC private equity transactions but the exact scope and parameters will depend on the circumstances of each transaction.

9.2 Shareholder Liability

It is very rare that the private equity fund backing the majority shareholder can be held liable for the actions of its portfolio company, whether under contract or under PRC laws.

Since the private equity fund is commonly a minority shareholder, it will not accept any contractual joint liabilities for the actions of its portfolio company. Instead, it is the management shareholders who are always required to assume joint liabilities for the actions of its portfolio company to third parties (including to the private equity fund under their investment agreements). Under PRC laws, shareholders of a portfolio company (whether the controlling shareholders or the minority shareholders) are generally not liable for the actions of the company, as the company is an independent legal person which should be liable for its actions with its own assets. Only in very special circumstances where shareholders abuse the independent legal person status of the company and limited liability of shareholders to evade debts and cause damage to the interests of the creditors of the company, the “piercing the corporate veil” rules shall be triggered under which the shareholders may be held liable for corporate actions directly.

10. Exits

10.1 Types of Exit

The main exit routes for private equity investors include IPOs, trade sales, private share transfers or sales and share repurchase or redemption. The most common form of private equity exit is through IPOs. Zero2IPO (a research agency) reports that IPO exits remain the dominant type of exits, accounting for 61.8% of the total number of exit deals in 2022. Share transfer and share repurchase or redemption also serve as important exit opportunities for some private equity investors, following with 21% and 10.9% respectively.

Although only 5.5% of the exits in 2022 were by way of trade sale, it is noteworthy that trade sale as an exit route is gaining popularity in recent years, as more and more industries gradually enter the stage of adjustment and integration. The dominance of IPO exits is in decline as policy changes make it more difficult for private companies to go public.

Though investors have the above exit alternatives, they are unlikely to choose other exit processes once they choose the IPO as their preferred exit route, because other exit processes such as share transfer, trade sale or redemption may bring uncertainties to the IPO process or affect the timeline of the IPO process. Thus, either dual track exits or triple track exits are unusual in China.

Whether or not a private equity fund will roll over or reinvest upon exit mainly depends on its own constitutional documents. In recent years, a private equity fund is usually not allowed to roll over or reinvest upon exit as most of the SGFs and GGFs have quite strict requirements for the return of funds. In rare cases where a private equity fund is allowed to roll over or reinvest upon exit, the amount of funds that can be used to roll over or reinvest will generally be capped at 10-20% of the total size of such private equity fund.

10.2 Drag and Tag Rights

Drag Rights

Drag-along rights are typical in equity arrangements and are commonly used in practice. A drag-along right provides a specified group of persons (typically preferred shareholders) with the right to require other shareholders (typically ordinary shareholders consisting of founders and management) to vote in favour of a sale of the company. The idea behind a drag-along right is to prevent a situation where minority shareholders or a group of shareholders, either by law or through procedural hurdles such as non-attainment of signatures, are able to block a sale of the company.

The conditions triggering a drag-along right vary, such as the identity of the drag-along holders (ie, those who may require the other shareholders to approve a sale of the company approved by such drag-along holders), a valuation floor, a time requirement whereby the right may only be exercised after a certain period, or a combination of the above.

The drag rights are originally designed only for the investors (subject to the above conditions), but now more and more management will require that a drag transaction initiated by certain investors must obtain its approval as well.

Tag Rights

Tag rights (or more known as co-sale rights) are typical in the equity arrangements and are commonly used in practice.

If a holder of right of first refusal (typically an investor) elects not to exercise its right of first refusal when a common shareholder (typically the management shareholders) proposes to sell their shares, the co-sale right allows the investor to participate in the sale of shares by the common shareholder at a pre-agreed ratio together with the common shareholder. The co-sale right is a common preferential right that allows investors to simultaneously exit with the founders, and it also functions to restrict the transfer of shares by the common shareholders.

There is no typical tag threshold in PRC. Tag rights are always granted to all investors together with the right of first refusal.

10.3 IPO

Under PRC law, all shareholders of a company going public have a mandatory lock-up obligation rather than a contractual obligation like in the US market. The lock-up period for a private equity seller is usually one year, but can also be longer and up to 36 months if such seller is an actual controller or controlling shareholder.

Where a company has no actual controller or has difficulty in identifying its actual controller, the company's shareholders, whose shareholdings in the company, ranking from high to low, are no less than 51%, are required to lock up their shares for 36 months, provided, however, that the 36-month lock-up period does not apply to the qualified venture capital funds which is not common for most market private equity funds.

Typically, relationship agreements between the private equity seller and the issuer are rarely seen in the PRC.

Following the expiration of the lock-up period, the private equity seller, whose shareholding is no less than 5%, may be subject to certain restrictions and disclosure obligations when transferring shares of the portfolio company acquired prior to an IPO. For example, the shares of the company transferred by it in 90 days in a row by way of block trading or a centralized bidding system may be no more than 1-2% of the total outstanding shares of the company. Furthermore, when a seller holding more than 5% of the total shares transfers shares via a centralised bidding system, its intent of share transfer and the number of shares to be transferred shall be announced in advance. Sometimes the underwriter may require the major shareholders to sign a commitment letter with respect to share transfers following an IPO.

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