Venture Capital Transactions In The United States And China

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Venture capital investment is on the rise in China, and many of the operative concepts are the same as they are in the United States.

ALTHOUGH AT ITS early stage, venture capital ("VC") in China, as an increasingly important means of financing, is developing rapidly. Many international VC firms are active in the vast Chinese market and played an important role in financing Chinese startup companies and bringing them public in overseas stock markets. Success stories include the 2004 NASDAQ listing of Shanda Networking (a leading online game operator) raising $151.8 million and Suntech Power's 2006 NYSE IPO, raising $400 million for the solar power equipment manufacturer. In these transactions, international VC firms all made handsome profits.

According to a recent research report released by Zero2IPO Group based on its survey on the Chinese private equity market, 58 newly raised funds targeting Asia, including the Chinese mainland, collectively raised $3.25 billion (U.S.) during 2007. Of this amount, over one-half ($1.8 billion) originated from U.S. funds. The total funds raised in 2007 that were allocated to investments in China increased by 83 percent over 2006. One hundred and seventy Chinese enterprises received $2.49 billion from 105 private equity ("PE") funds in 440 reported deals. These statistics and data show that China is the most active PE market in Asia. Zero2IPO Research Center estimates that

PE investment on Chinese market accounts for 1.5 percent of the 2007 global total. During 2007, the most active investments were made in the broadband information technology sector (46 percent) and a very high (by U.S. standards) 17 percent in what were categorized as traditional businesses.

According to another survey by Zero2IPO Group, VC investment was strong in mainland China during the first quarter of 2008. Eighteen foreign and domestic firms established 23 new funds during this period, representing $2.26 billion of committed capital, an increase of 57 percent from the last quarter of 2007 and 537 percent the first quarter of 2007! During the first quarter of 2008, investors put $941 million into 116 deals with broadband information technology, again accounting for the bulk of deal activity and investment. This upward trend continued into the second quarter of 2008, as VC investments reached $1.20 billion, a 73.5 percent increase from the second quarter of 2007. Similarly, the second quarter's 159 investment deals represented a 31.4 percent increase from the second quarter of 2007. However, no mega ($100 million or above) deals took place in August of 2008. As compared to July, August saw both the number of investment deals (down 27.3 percent) and the amount invested (down 72.4 percent) decline.

It is fair to say that international VC firms, especially those from the United States, are playing a leading role in the evolution and development of the VC industry in China. International VC firms, before making investment in a project in China, usually require the Chinese company to undergo a restructuring, in which one or a series of offshore holding companies are set up for holding the interests in the ultimate operating company in China. In such transactions, international and local advisors are required to work together to help the investors and the founders to close the transactions, both onshore and offshore. In such transactions, U.S. law firms have been playing an important role and in fact have exported a lot of U.S. VC concepts, models, and practices to the Chinese market.

In this article, we will first discuss five major structural components in virtually every VC transaction, whether it is in North America, Europe, or Asia. We will then briefly investigate the underlying concerns of VC investors. We hope that this deconstruction of the significant structural and motivational underpinnings of this major source of finance will help facilitate cross-border investments, provide fertile ground for critical self-examination and improvement, and offer insights to those seeking VC financing to appeal to the needs of their future partners.

We have made our discussions and observations in the context of the U.S. VC transactions. But with the international VC practice becoming increasingly universal, we believe such discussions and observations will be of equal reference value to the VC community in China.

FIVE MAJOR STRUCTURAL COMPONENTS OF VENTURE CAPITAL FINANCING • The basic structure of most VC transactions is quite complex and interwoven, with each feature being dependent on the other. For purposes of this article, we have identified five key components (in no particular order) of the structure of a venture capital deal and briefly discuss their relevance and interrelationship.

1. Liquidation Preferences

In the United States, virtually all VC transactions are structured with liquidation preferences in favor of the investor. In other words, the investor will receive its investment back first, before any return to prior investors. For example, assume the target portfolio company is valued at $10 million before the investment and the venture capitalist invests $10 million for 50 percent of the equity. Then, unfortunately, the company is sold for only $10 million. The proceeds would all be distributed to the venture capitalist, and the other owners would get nothing. That is a vast generalization and oversimplification, however, and many refinements abound.

First, if there have been other rounds of VC financing, you will occasionally see the other VC investors in the prior rounds share in the distributions. Using the prior example, if there had been \$10 million raised in the A round and then \$10 million raised in the subsequent B round, and the hapless company were liquidated for \$10 million, the B round investor would like to receive the entire \$10 million. The A round investor, however, may have been able to negotiate pari passu treatment, and therefore, the \$10 million would be distributed \$5 million each to the A and B round investors.

A second significant consideration is whether the investment will participate or be directly convertible to common equity. The difference could be material and is often overlooked by less experienced founders. For example, assume the investor invests \$10 million in the A round for 50 percent of the company on a fully diluted basis. This company is then ultimately liquidated for \$40 million (much preferable to the prior examples). If the A round investment was a "participating preferred," then it would receive the first \$10 million of proceeds. The remaining \$30 million would be distributed on a 50-50 basis so that the investor would receive an additional \$15 million and thereby receive a total of \$25 million of the \$40 million proceeds, which in this example equates to 60 percent of the total. Another way to look at the participating feature is to treat it like debt. You would always pay a lender back on liquidation before paying back equity owners. In contrast, if the A round equity were treated as "convertible preferred," then the investor would have the option to either receive its investment back (which it would only do if the sale price was less than \$20 million) or convert to 50 percent of the common equity of the company. In this scenario, the investor would receive 50 percent of the \$40 million liquidation price, which is \$5 million less than the amount received in the case of a participating preferred investment.

A third area of debate in structuring preferences in VC transactions is whether the preference will be multiple. Although this is purely an economic valuation concept and a function of the leverage of the parties, the issue is hotly contested. For example, you will sometimes see the VC investor insist on a three-times liquidation preference. In the example of a participating preferred with a \$10 million investment for 50 percent of the fully diluted common and a liquidation of \$40 million, the investor would then receive the first \$30 million (i.e., three times its investment) and then 50 percent of the remaining \$10 million. A compromise is sometimes reached to limit the venture capitalist to the greater of its multiple return or what it would receive if there was no participating feature and just a straight convertible preferred. In the prior example, the investor would have to choose between \$30 million or 50 percent of \$40 million—and the choice is easy.

Other areas frequently debated are whether the unpaid coupon on the preferred will also be credited to the investor upon conversion to common or simply waived. Many founders and strong management teams will also try to insist that their common security will be reclassified as preferred so that their interests and the interests of the investor are perfectly aligned.

2. Dilution Protection

In the United States, a difficult issue in a VC financing transaction is how to protect the interests of the VC investor if additional rounds of financing are required. Venture capital investors typically demand protection against "dilutive" financings. Because any sale of additional ownership interests to a new investor group reduces the existing investors' claims to the company's assets and income stream, the broadest concept of dilution would render every financing dilutive. There are two types of anti-dilution protection: preemptive rights to subscribe to purchase shares in new offerings and anti-dilution protection in down rounds.

Preemptive rights afford the VC investor the right to subscribe to its pro rata share of the next round to maintain its pro rata ownership interest in the company. Although this is straightforward, two issues typically arise. First, should the VC investor have this right in perpetuity (or at least until the IPO)? Many argue affirmatively because the company is not harmed in allowing the VC investor to maintain its position. Oftentimes, however, companies desire to dilute the input of the VC investor and therefore ask that if it ever chooses not to participate in exercising its preemptive right, then those rights are forfeited not just for that round but for all future rounds. A second consideration concerns the exceptions in which preemptive rights are not applicable. These typically include the conversion of the preferred into common, a certain set-aside for an option pool for management, and sometimes "strategic alliances" and similar items. The VC investor needs to be careful in clearly delineating this often undefined phrase or at least have the alliances be approved by the board.

The other type of anti-dilution protection is to adjust the VC investor's conversion ratio if the price per share of the stock issued in any subsequent round of financing is less than the price per share that the VC investor paid for its stock (even if it is a different class of security).

Full-Ratchet Method

The full-ratchet method is the harshest and most punitive VC investor protection against a down round. The full-ratchet method reduces the VC investor's conversion price of its preferred stock from the purchase price paid by the VC investor to the purchase price paid by the new purchaser (or, if the VC investor has already converted its preferred, or has purchased common, the VC investor will be issued additional shares of common at that lower price). For example, if the VC investor purchased 1 million shares of convertible preferred stock at $1 per share, and new capital is raised at 50 cents per share, then the VC investor's conversion price will be reduced to 50 cents, and the VC investor thus will be entitled to convert its preferred stock into 2 million shares instead of 1 million shares. This method has extremely harsh consequences to the founders and existing shareholders because their shares are diluted not only by the down round but also by the change in the VC investor's conversion price. This dilution of the founders' interest is heightened, especially if the amount raised in the down round was an insignificant amount of money. Founders should strenuously resist the full-ratchet method (or any variation of it). It implies that the founders are guaranteeing that the VC investor's stock will never go down in price and that the founders are to blame for any such decline. This logic may be appropriate in the rare case in which the VC investor does not participate at all in decision-making or on the board of directors of the company. In most cases, however, the VC investor is active and also has the ability to veto the transactions causing significant price declines. Compromises include adopting the full-ratchet method for the first 12 months and using a fairer method thereafter, employing the full-ratchet method only if the amount raised exceeds a specified level (to avoid the absurd result of lowering the VC investor's price when only $1000 was raised in the down round), or using the full-ratchet method only if new financing is needed resulting from a breach of representations and warranties or covenants of the company.

Weighted-Average Method

A fairer approach to protect the VC investor against dilution is the weighted-average method. This method also reduces the VC investor's conversion price to a lower number, but that lower number depends on the number and price of new shares issued in the subsequent offering. For ex-