New Sources of Capital in China

By: Jack Perkowski | July 2, 2011

China's capital markets are at an inflection point, and foreign-invested enterprises (FIEs) are seeing more opportunities to raise capital to fund their China operations than ever before.

In terms of its capital markets, China finds itself in the same situation that the United States did at the beginning of the 1980s. During the 1970s, the Dow Jones Industrial Average (DJIA) barely budged; it ended the decade where it had begun 10 years previously — stuck at 840. With such weak equity markets, of course, raising capital for most companies was nearly impossible. As far as trying to do an initial public offering (IPO) of common stock, forget it.

With a much stronger economy in the 1980s, however, the equity markets came to life and the DJIA more than tripled to over 2800 during the decade. Stronger equity markets in turn gave rise to the dramatic development of the U.S. capital markets. IPOs became the rule, not the exception; the venture capital industry flourished; mezzanine securities, or junk bonds as they were called at the time, were invented; private equity was born and angel investing (affluent individuals providing capital for start-ups) became fashionable.

By the end of the 1980s, companies of all sizes and at all stages of development could obtain capital somewhere if they had a good business plan. Moreover, the remarkable development of the U.S. capital markets during this period set the stage for the economic prosperity and surge in technological innovation that occurred in the 1990s.

When I first came to China in 1992, China's capital markets were in the same place as the capital markets in the United States in the 1970s — it was impossible to raise capital of any kind to fund a China operation. A company simply had to obtain capital from the home office and bring it into China as equity. If a company did a joint venture, it couldn't count on its Chinese partner to inject cash as part of its capital contribution. The partner might contribute land use rights, buildings and some equipment — but never cash.

The only companies that had money back then were the large state-owned enterprises that were able to borrow all they wanted from the four large state-owned banks, or perhaps go public on one of the new stock exchanges in Shanghai and Shenzhen. For everyone else — FIEs, private companies, smaller state-owned companies — capital was nowhere to be had.

However, over the past few years there has been remarkable progress in the development of China's capital markets.

Their continued development in the years ahead will enable more FIEs and private companies to access funds, and will fuel a new round of growth in China, just like the development of the U.S. capital markets did in an earlier time.

How can FIEs access capital in China today? Here are a few of the methods we are working on with our clients at JFP Holdings.

Chinese Partner: Compared to just a few years ago, Chinese companies have cash today. They've been making money in their core businesses; they may have sold off valuable land in the cities and moved their operations to outlying areas where land is less expensive and pocketing the difference; and/or they may have done an IPO on the SME or ChiNext board in Shenzhen as MTD described in China's Equity Markets. However they may have obtained their cash, they are now focusing on developing their businesses and gaining access to world class management, good technologies and high-quality products. As a result, they are showing a strong interest in establishing joint ventures, entering into license agreements, and, increasingly, making equity investments or outright acquisitions. We are now linking up many of our overseas clients, who may not have the capital on hand to fund their China expansion strategies, with financially strong strategic partners in China.

Private Equity: Over the past several years, many domestic private equity (PE) firms have been formed and have raised large amounts of renminbi denominated capital. The domestic PE firms are focused on China, since they know the territory well and can act relatively quickly compared to international private equity firms, and many are interested in investing in FIEs, either joint ventures or wholly foreign owned enterprises (WFOEs), because of the higher levels of technology and management that foreign companies can bring to operations in China.

In fact, one domestic private equity firm we are working with is interested in purchasing 35 percent ownership interests in China WFOEs. Why? FIEs with at least 35 percent domestic ownership can list their shares.

Public Equity Markets: According to a little known rule, an FIE with at least 35 percent domestic ownership can list its shares in China, provided its parent company is private and its China operations are sufficiently independent. No Western companies have yet taken advantage of this rule because it requires a fair degree of

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political muscle to work through the process. However, we are working with a major domestic PE firm that has the clout and the ability to do so, and are now discussing this financing option with our clients.

In addition, large international companies may soon be able to list their shares in a new International Board in Shanghai, as I described in [Shanghai's International Board](). Coca-Cola, HSBC, the New York Stock Exchange, Volkswagen, Mercedes Benz, Siemens, Unilever and Standard Chartered are all big names that are lining up. Doing so will open up the large capital pools now available in China to foreign companies.

Another way for overseas companies to avail themselves of the high valuations in China's A share market is to consider merging with, or selling to, a publicly listed Chinese company and taking shares in exchange. This can be especially attractive to small- to mid-sized industrial companies that are shunned by Western capital markets but that are attractive to Chinese investors.

Dim Sum Bonds: This new financing alternative was discussed in [Dim Sum Anyone]()? First developed in 2010, dim sum bonds take advantage of the $75 billion of renminbi deposits that are sitting in Hong Kong by enabling international companies to borrow renminbi for their China operations at much lower interest rates than available in China. McDonalds, Caterpillar and Unilever are some of the big names that have already issued these bonds, but as we have learned from our extensive contacts in the securities industry, even relatively small companies are being considered for future issuance.

Medium-Term Bank Loans: Unless a company can benefit from government pressure, it is very difficult for the average FIE to obtain bank financing from traditional Chinese lenders. At ASIMCO, some of our larger joint venture operations were able to borrow, but they were all well established companies with long histories in China before ASIMCO came along. Typically, the loans were due at the end of one year, creating a constant need to rollover the financing. That's fine when times are good, but when the company hits a rough patch, as some of ours did, it can be a headache.

China changes constantly, however, and there are now financial institutions willing to extend three- to five-year loans that actually prefer lending to FIEs. This is yet another option we are discussing with our clients.

Long Term Leases: Purchasing land and constructing a factory and office building can take up a large part of the capital expenditure budget for a new project in China. While some companies prefer to own their land and buildings, others would much prefer to lease and reduce their capital commitment, particularly in a country where traditional bank financing is generally unavailable.

Lease financing is not nearly as prevalent in China as it is in developed countries, and when it is available, it's typically only available for a short term — three to four years in duration. However, companies that wish to lease would like to lease for as long a period as possible.

At JFP Holdings, we have identified financial institutions that are interested in writing long term — 15- to 20-year — leases for land and buildings in China, and we are structuring lease programs that will make such financing available to Western and Chinese companies alike. When I was running ASIMCO, I wish that I had had the option of entering into long term leases for the new factories that we were building.

As demonstrated by the above catalog of financing alternatives, the last few years have witnessed remarkable developments in China's capital markets. Even with these new ways to access capital, though, the country still has a long way to go before its capital markets can be considered fully developed. The good news is that they are already a far cry from where they were in the early 1990s and are headed in the right direction. Chances are that the pace of change will only accelerate from here.

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