ACORE

CREIA

US-CHINA
QUARTERLY MARKET REVIEW

SUMMER 2011

US-CHINA
QUARTERLY MARKET REVIEW

SUMMER 2011

A COLLABORATIVE REPORT BY:

American Council On Renewable Energy (ACORE)
www.acore.org

Lesley Hunter, Primary Editor & Contributor
Tom Weirich, Contributor

Chinese Renewable Energy Industries Association (CREIA)
www.creia.net

Ma Lingjuan, Editor & Contributor
Li Junfeng, Contributor

SECTION AUTHORS:

U.S. Market Focus
Sungevity
Danny Kennedy
dkennedy@sungevity.com

U.S. Policy
David Gardiner & Associates, LLC
Bill White and Jeff Stein
bill@dgardiner.com

U.S. Finance
Citigroup, Inc.
Michael Eckhart
michael.eckhart@citi.com

China Market Focus
Covington & Burling LLP
George Frampton
gframpton@cov.com

China Policy
Pillsbury Winthrop Shaw Pittman LLP
Judy Deng and Sylvia Burks
judy.deng@pillsburylaw.com

China Finance
Troutman Sanders LLP
Edward Epstein
edward.epstein@troutmansanders.com

OFFICIAL RESEARCH PARTNER:

Bloomberg New Energy Finance
Dave Poritzky
dporitzky1@bloomberg.net

CHINA FINANCE: VENTURE CAPITAL AND PRIVATE EQUITY CLEANTECH FUND STRUCTURES FOR CHINA INVESTMENTS

China's economy is a rare silver lining in the world today, and policies to promote China as a world leader in the cleantech and renewable energy industry are attracting even more foreign investment in China.

Venture capital/private equity (VC/PE) firms are riding this new wave of foreign investment by establishing funds that are specifically dedicated to cleantech and renewable energy investments in China. This section will discuss some of the fund structures generally used and/or considered by VC/PE funds investing in Chinese cleantech and renewable energy companies.

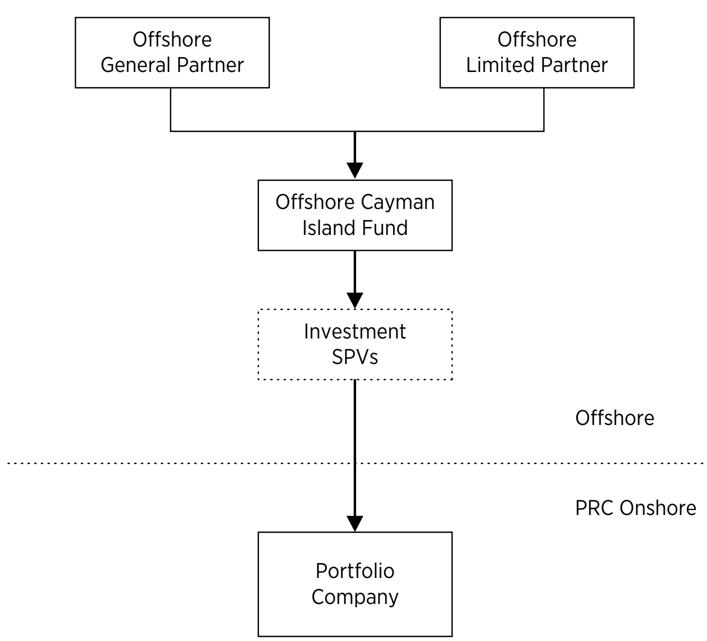
OFFSHORE FUNDS

All foreign investments in China, including investments by foreign VC/PEs, are subject to approval according to investment policies set out in the *Catalogue for the Guidance of Foreign Investment Industries* ("Catalogue"). As described in the previous section, the Catalogue categorizes industries as either encouraged, permitted, restricted or prohibited to foreign investment. Encouraged industries are industries in which the Chinese government would like to attract more foreign capital, technology and experience.

Cleantech and renewable energy have, in general, been encouraged under the Catalogue, and this policy has recently been reinforced by the "Catalogue of Guidance for Industrial Restructuring," promulgated and put under effect on June 1st, 2011 by the Chinese National Development and Reform Commission (NDRC). The "Catalogue of Guidance for Industrial Restructuring" states that "new energy" investments are "encouraged." Therefore, the door is currently wide open for foreign VC/PE investments in the cleantech/renewable energy in China.

Foreign VC/PEs have historically invested in Chinese companies through an offshore foreign currency denominated fund using offshore structures. A simple example of an offshore fund's direct investment into a Chinese company is illustrated in Chart 1.

Chart 1: INVESTMENT BY OFFSHORE FUND



"the door is currently wide open to foreign VC/PE investments in cleantech/renewable energy in China."

A foreign fund investing in China is typically established in a foreign jurisdiction like the Cayman Islands in the form of a limited partnership. This fund may invest in the Chinese target company through various offshore single purpose investment vehicles (SPVs). In recent years, the offshore investment structure for an investment usually includes a few SPVs established in favorable offshore jurisdictions, with a Hong Kong holding company for the Chinese target company. Such a structure allows the investor to take advantage of, among other things, favorable tax treatment and easier offshore exits for the investment by either IPO or sale.

RMB FUNDS

Recently, new legislation has opened a crack in the door for foreign VC/PE firms and investors to establish onshore Renminbi (RMB) funds. The framework for RMB funds in China has developed piecemeal based on various regulations issued at different times, which has resulted in structures and practices that lack logical consistency. Given the variety and complexity of different RMB fund structures, we will only review two RMB Fund structures that are more applicable to the cleantech/renewable energy industry.

1. FOREIGN INVESTED VENTURE CAPITAL INVESTMENT ENTERPRISE (FIVCIE)

FIVCIEs are regulated by the Administrative Measures on Foreign Invested Venture Capital Investment Enterprise (effective March 1, 2003) and can take the form of either pure RMB funds or sino-foreign RMB funds under a corporate or partnership structure (for FIVCIEs, the regulation establishes a quasi-limited-partnership structure). Under the FIVCIE Measures, fund managers can raise funds from both offshore and onshore investors and establish onshore RMB-denominated funds. The management of FIVCIEs may be delegated to a Chinese domestic management company, a foreign invested enterprise or an offshore entity. Foreign fund managers appreciate this flexibility because it allows them to manage the funds from an offshore entity without incurring the additional time and cost to set up an onshore entity in China. Some qualified FIVCIEs can also enjoy certain incentive policies including tax benefits.

"Quam Ventures Ltd. is a FIVCIE fund recently launched in China using a limited partnership structure to invest in… Greentech / Cleantech and life science companies."

FIVCIEs are limited in that the legal structures of these funds are very inflexible and FIVCIEs can, in principle, only invest in high-tech or new-tech companies. This investment restriction sometimes precludes funds that invest in companies outside this scope from using this structure. However, this limitation may not affect cleantech/renewable energy investors since certain cleantech/renewable energy investments may qualify as high-tech or new-tech companies and fit within a fund's investment strategy. For example, Quam Ventures Ltd. is a FIVCIE fund recently set up in China by Quam Ventures (the private equity arm of Quam Limited, an HK listed financial services company), using a limited partnership structure to invest in, among other things, greentech/cleantech and life science companies.

2. SHANGHAI PILOT PROGRAM FOR FOREIGN VC/PE FIRMS

To promote foreign VC/PE investments, the Shanghai Municipal Government issued the Implementation Measures on the Pilot Program for Foreign-invested Equity Investment Enterprises in Shanghai (the "Shanghai PE Measures"), which became effective on February 1st, 2011. Shanghai is the first city in China to create such a pilot program, but it is anticipated that Beijing and Tianjin will issue similar measures in the near future. Shanghai has taken the lead on this pilot program because Shanghai is envisioned to be the financial center of China.

The Shanghai PE Measures allow foreign VC/PE firms to create VC/PE funds and manage investments in

China through the establishment of a foreign owned management company called a foreign-invested equity investment management enterprise (FEIMC). The FEIMC can be wholly owned by the foreign VC/PE and founded as a WFOE.

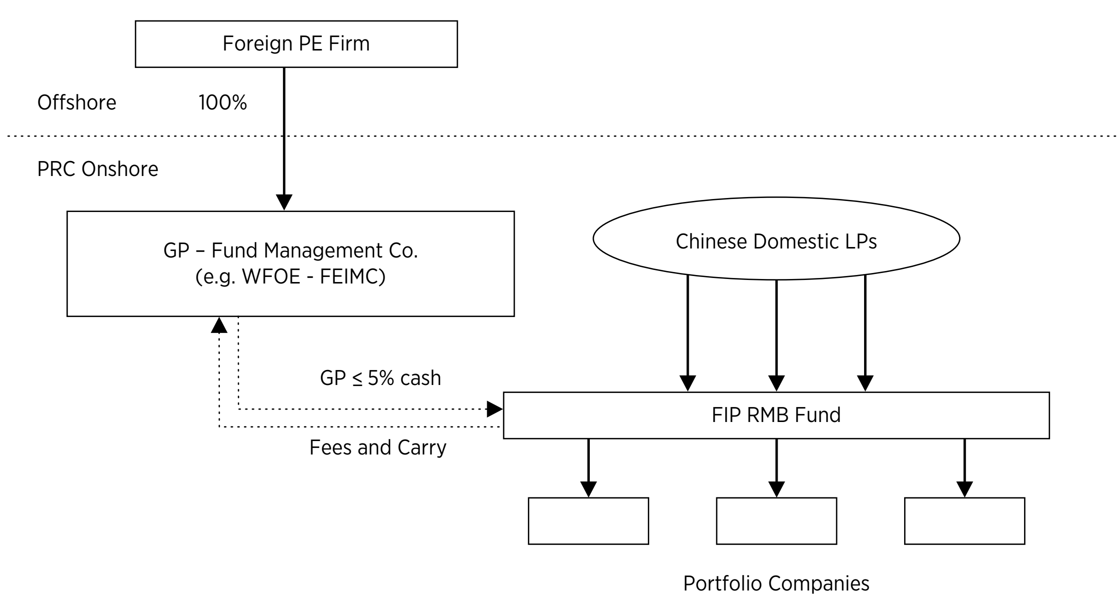
The fund established under the Shanghai PE Measures must have a minimum capital commitment of U.S.$15 million and can be established as a foreign invested partnership (FIP), which includes general partnerships and limited partnerships (a form typically used and desired by offshore VC/PEs). If the fund is established as an FIP, then the fund would only need to be registered with the local branch of the State Administration of Industry and Commerce (SAIC), and the longer and more complicated approval of the Ministry of Commerce (MOC) is not required.

Moreover, the fund established under the Shanghai PE Measures can either be: (1) a fund with only local Chinese investors or limited partners (other than the FEIMC which is foreign owned); or (2) a fund with both local Chinese and non-Chinese investors or limited partners. Thus, VC/PE firms can establish funds in China to raise both foreign and local capital for investments. However, to be qualified under the pilot program—to bring in foreign limited partners into the onshore RMB fund—may be challenging given that the requirements as to asset size and relevant investment experience and the Shanghai PE Measures are designed to attract qualified foreign institutional investors such as sovereign wealth funds, pension funds, endowment funds, charitable funds, funds of funds (FOFs),insurance companies, and banks.

> ***"a qualified FEIMC may invest into [a fund with only Chinese investors] which will not require MOC approval."***

With respect to a fund with only Chinese investors, a qualified FEIMC may invest into the fund and may convert foreign currency of up to 5% of the committed capital of the fund. More significantly, the fund will still be treated as a "pure" domestic RMB fund, which means that the fund's investments will not be subject to the foreign investment Catalogue, and will be treated like a Chinese domestic RMB fund, therefore not requiring MOC approval. The basic fund structure with only Chinese investors under the Shanghai PE Measures is illustrated in Chart 2.

Chart 2: BASIC SHANGHAI RMB FUND STRUCTURE



If a fund is established with both Chinese and non-Chinese investors, the fund will be subject to the Catalogue and require MOC approval and other applicable approvals for each investment, like an offshore fund.

PARALLEL FUNDS

Some VC/PE firms have considered and used the "parallel fund" structure to make investments in China. Unlike a U.S. parallel fund structure, which typically involves two funds that invest side by side on a pro rata basis, the China parallel fund structure involves two funds that invest together or in companies that are not available to the other fund. In general, one fund is formed outside China for foreign investors and one fund is formed in China for local Chinese investors, and these two funds in essence are managed by one foreign management company.

The China parallel fund structure is designed to offer foreign investors access to investments in China, which as a regulatory and/or practical matter are not accessible to foreign investors. For example, certain investments in China require greater speed to compete with Chinese funds. Investing through the RMB fund side of the parallel fund will provide the foreign investor with the needed speed by avoiding government approval and foreign exchange. Although this structure has been implemented in the past, this structure is complex and not without its problems. For one, inherent in this structure are the conflict of interest issues between the investors of the two funds that potentially cannot be resolved. Thus, VC/PE firms should seek the advice of counsel and carefully weigh the pros and cons of this structure before choosing this path.

CONCLUSION

Under China's current policies, foreign VC/PE investors are encouraged and welcomed to invest in China's cleantech/renewable energy industry. However, this may not always be the case. China's doors to foreign investment in various industries have been opened and then closed depending on political, economic and social factors. With this in mind, many VC/PE firms have already made and continue to make investments in Chinese cleantech/renewable companies.