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PERSPECTIVE

VENTURE CAPITAL CORNER

Chinese interest high despite uncertainty

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President Xi Jinping of China speaks after touring Boeing's manufacturing facility in Everett, Wash., Sept. 23, 2015.

How does China view the U.S. as an investment market under the new administration? President Donald Trump has withdrawn the U.S. from the Trans-Pacific Partnership (TPP), and rumblings continue in Congress and the new administration about tightening the Committee on Foreign Investment in the United States (CFIUS) regulatory review on inbound investment and M&A from China. But based on meetings I had with venture capital, private equity, sovereign wealth and strategic investors in Beijing and Shanghai just before the Lunar New Year, the interest from China to invest/acquire in the U.S. in general — and California in particular — has never been higher.

What gives? Several factors are driving this perhaps nonintuitive trend. First, in our meeting discussions, Chinese funds and strategics repeatedly mentioned the relatively poor quality and overpriced nature of deals currently in the Chinese market. As a result, these players find themselves with large pools of capital still looking for a home. Investing to bring leading-edge technology and services from the U.S. to the still-burgeoning consumer market in China (as Alibaba's latest quarterly results attest) is the natural strategy.

Additionally, a strengthening "risk-on" feeling about the Chinese currency renminbi and China's macroeconomic prospects generally has only heightened Chinese investor interest in the U.S. So as the pace of U.S. venture investment continues to slow, for properly positioned companies in California looking for alternate investment sources, the timing couldn't be better.

Chinese policy may follow an increasingly nationalist line, but President Xi Jinping knows he can ill afford to disengage from foreign investment.

Here's a checklist to help founders, investors and directors of venture companies with cross-border aspirations (including China) to navigate cross-currents in today's unsettling environment:

Keep Perspective

Foreign companies correctly criticize measures like China's newly announced draft law to tighten regulation of cloud services, and Beijing's adoption late last year of a vaguely worded cybersecurity law that requires storage of personal information and business data in China and "technical support" to Chinese security authorities.

But the news from China isn't all bad. For example, in a little-noticed development last month, Beijing announced plans to loosen foreign investment controls in banking and related financial sectors (good news for FinTech), and to make it easier for foreign invested entities in China to raise equity and debt financing. Chinese policy may follow an increasingly nationalist line, but President Xi Jinping knows he can ill afford to disengage from foreign investment. Foreign companies that have done well in China in the past have planned for the long term, not the quick buck. That strategy remains valid today.

Plan the Right Structure

Depending on the level of a company's ultimate beneficial U.S. ownership and plans to drive revenues in China, simply dropping a wholly foreign-owned enterprise below the recently formed Delaware C corp. may not be the most tax-efficient or IPO-friendly approach. Using alternative holding structures, it may be possible (at least under current tax rules) to keep China-based revenues out of the U.S. tax net while in the process avoiding imputed taxable income on deemed cross-border royalties. The holding company's charter can still include those economic and governance preferred terms that venture investors demand. Such structures can also preserve flexibility for founders and boards looking to eventually exit via dual-listings or alternative capital markets, while not ruling out a U.S. IPO.

File your IP Early in China

The typical patent strategy of filing first in the U.S. with a Patent Cooperation Treaty filing to cover the rest of the world may not ensure the best protection for your patentable IP in China. If the nature of the technology allows, consider parallel utility model and invention patents in China. Utility model patents are available in China to protect products with new shapes or structural (physical) features and are issued much more quickly (typically, within months of the initial filing) than invention patents. Once the invention patent is issued, the utility model version can be abandoned. The company should use seasoned bilingual patent counsel who can ensure

Chinese claims are as robust and accurate as those in the U.S. filings.

Show Me the Money

Capital flight from China accelerated dramatically during 2016 and shows no sign of abating. Problematically, however, a tightening of Chinese banks' review of foreign exchange remittances first announced last November to "strictly control" deals falling into six categories of outbound investment is now affecting even non-targeted categories. The company should verify that the potential investors from China have the money in U.S. dollars offshore now, and ask to see their funded bank account statement as proof. If the investment funds are still sitting in Shanghai in renminbi, double the closing timetable and think about assured U.S. dollars sources of bridge financing.

Board Seat? Government Contracts?

Is the Chinese investor seeking a board seat? Does the company have government contracts? Classified activities? Does the business involve collection or storage of individually identifiable customer information? Will the company license any technology to China as part of the deal? If the answer to any of these questions is "yes," the company may need to consider making a CFIUS notification filing or focus on export controls compliance.

Do I Need a Partner?

Management may not want or feel like the company needs one (I understand), but the reality in most cases (unless the team already has a Chinese background) is that the company will need a strategic ally in China. Joint venture and licensing partnerships can help growth companies bridge gaps in local market knowledge, and investment capital (cash) that Chinese rules require (no, in most cases the company can't license its IP for equity in the Chinese entity), while also — if appropriately structured — discouraging local partner breach/IP misappropriation. If management or current investors aren't sure they can educate the candidate partner effectively, get an advisor who can.

Only time will tell where rising populism, Xi's "Strong China Dream" and Trump's "America-first" agenda ultimately lead. In the meantime, emerging companies with an eye on China are well advised to keep the above issues in mind as they seek to manage risks and reap rewards.

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