blackpeak

KEEPING A COOL HEAD AS CHINA'S INTERNET SECTOR HEATS UP

6.57B

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China's Internet sector continued to grow robustly in the first half of 2015: there were 518 investment deals in the Internet sector in the first half of the year with a total value of USD 6.57 billion, the highest point since 2012. Entrepreneurs backed by venture capitalists and private equity funds experimented with new business models in traditional industries such as education, finance, health and logistics.

Facilitating the investment boom was China's effort to diversify exit channels for investors. China's Internet firms can now list on the National Equities Exchange and Quotations. Also known as the "new third board," this over-the-counter market has no profitability requirements and simpler listing procedures. Listing on the new third board remained attractive for entrepreneurs and investors, after IPOs on China's main board were suspended in July 2015 to stabilize stock prices. Meanwhile, the Chinese government is planning to lower the main board's listing thresholds to benefit fast-growing Internet companies, including dropping the requirement that companies be profitable for three years before listing.

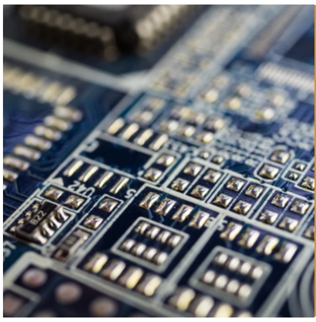
Capital market liberalization has not only spurred the emergence of domestic Internet startups, but also tempted many overseas-listed Chinese Internet companies to list domestically. By July 2015, over a dozen overseas-listed Chinese Internet companies had finalized plans or received bids to go private, including Momo, Renren, Qihoo 360 and 21 Vianet, aiming to be relisted in mainland China. The companies believe their business models would be better understood by Chinese investors and thus enjoy higher valuations. They could also avoid potential regulatory issues by dismantling their current variable interest entity (VIE) structures that could be deemed problematic by the newly proposed Foreign Investment Law in China.

The privatization trend reverses the tide of Chinese Internet companies listing overseas, represented by Alibaba's record-breaking USD 25 billion IPO on the New York Stock Exchange in 2014, as well as the listings of JD.com, Weibo and Jumei. The recent losses in China's stock market do not seem to have unnerved firms planning to relist domestically.

However, fears of an Internet bubble have been on the rise, and investors are ever more cautious in choosing investment targets in China's Internet sector. Looking forward, a significant number of Chinese Internet firms will still be involved in high-profile transactions – whether receiving significant funding, privatizing or (re)listing – but prudence is required for good decision making. Given the significant size and public attention of these future transactions, it is also particularly important for investors and other advisors to better understand the regulatory, reputational and operational risks of China's Internet industry.

Regulatory Risks

Based on our research experience in China's Internet sector, Chinese firms are particularly exposed to two categories of regulatory issues: reliance on VIE structures and industry-specific regulations on the business.



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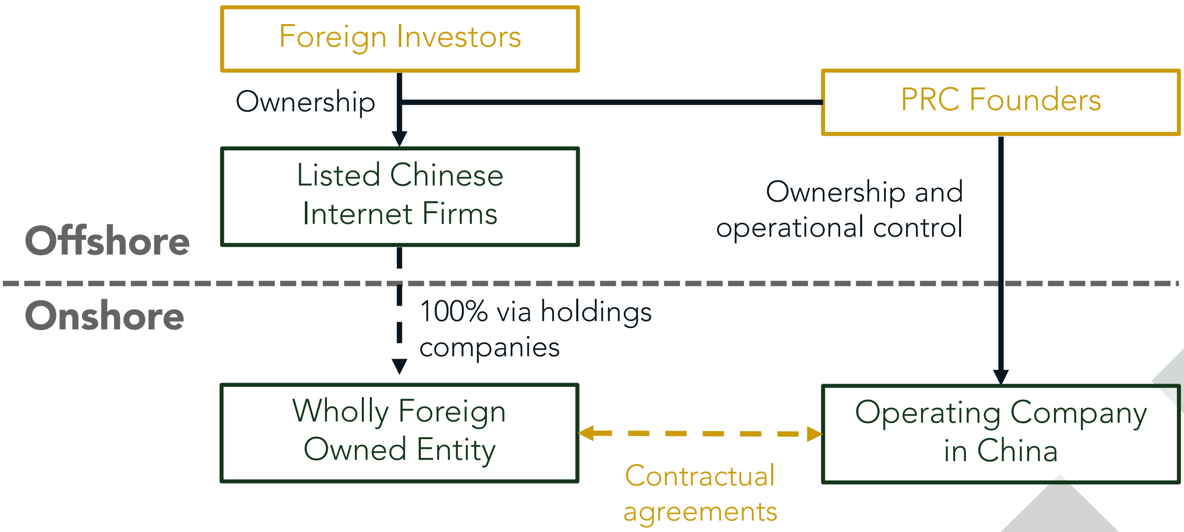
Variable Interest Entity Structures

In the past, Chinese Internet firms listing overseas used VIE structures to address regulatory restrictions on foreign ownership in certain sensitive industries such as in the technology sector. The VIE structure effectively circumvented foreign ownership restrictions by separating equity ownership from economic and operational control. By using certain nominee or other contractual arrangements between the holding entity's onshore subsidiary and the operating company in China, the VIE structure allows foreign investors to invest indirectly in the restricted industry, have control of the investment and enjoy economic returns without having direct ownership of the structure. Chinese Internet giants Alibaba, Baidu and Tencent are all listed using VIE structures.

The reliance on VIE structures presents inherent commercial risks for investors. Foreign investors do not have direct ownership rights over the VIE entity and are only bound to it by contractual agreements. This presents certain commercial risks, especially if disputes arise between the foreign investors and the domestic Chinese entity.

Moreover, the release of the draft version of China's Foreign Investment Law in January 2015 might have an even greater impact on VIE structures. Under the draft law, "foreign ownership" which is currently strictly prohibited in certain sub-sectors of China's Internet industry, would be defined by control rather than ownership of the company. The proposed regulation could potentially challenge the legality of companies' corporate structure if domestic Chinese control is not clearly established. As the draft law is subject to revisions, regulatory uncertainties remain a key risk issue for many in the Internet industry.



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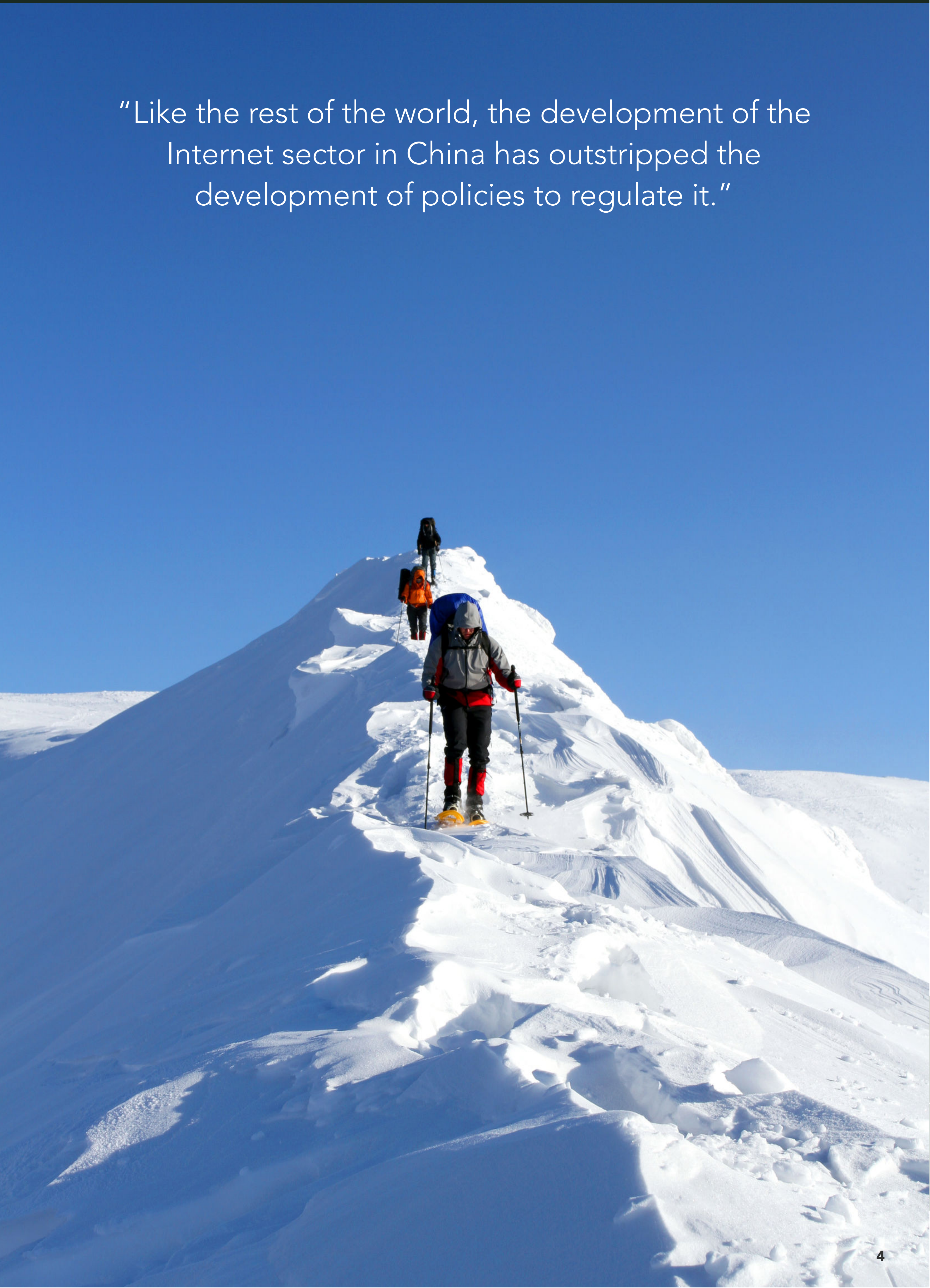

Industry-Specific Regulations

Like the rest of the world, the development of the Internet sector in China has outstripped the development of policies to regulate it. The disruptive innovation technology firms bring is often constrained by existing regulations within their industries. For instance, car-hailing apps such as Didi Kuaidi have faced crackdowns by authorities due to the questionable legality of their private car services. Didi Kuaidi operated in a legal grey area for several years before finally receiving an unprecedented permit for private car hailing services from the city of Shanghai on 8 October 2015. However, such policy innovation has not been adopted nationwide.

In the Internet finance industry, many peer-to-peer (P2P) lending firms have operated under regulatory uncertainty due to the absence of clear regulations concerning their operations. This policy vacuum was partially filled in July 2015, when the Chinese government issued guidelines to better regulate the Internet finance industry, clarifying the supervisory responsibilities among the central bank, securities and banking regulators.

Other Internet firms, particularly search engines and social media platforms, have also previously faced fines and penalties by authorities in China for not abiding by state censorship requirements. Meanwhile, as the online drug market continues to expand in China, regulations and guidelines set forth by the China Food and Drug Administration will determine the future size and direction of the market. All of these regulatory uncertainties and challenges present unique risks that greatly impact the operations and even viability of companies in the technology sector.

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Reputational and Operational Risks

In addition to regulatory risks, there are some common reputational and operational risks for companies in the Chinese Internet space.

Questionable Metrics

There have been past allegations that Chinese Internet companies have overstated their user bases or revenue numbers in an attempt to attract investors and higher valuations. One typical issue involves companies falsifying user data, including the creation of fake accounts to boost the number of reported users.

Moreover, some online retailers have allegedly inflated sales figures via undisclosed related party transactions. Undisclosed related party transactions can be particularly costly to investors, not only as a way for a company to falsely embellish its performance but also potentially as a mechanism to funnel corporate resources into the pockets of selected individuals.

Short seller attacks on reported figures can cause big troubles for Chinese Internet companies and their investors. For example, Vipshop, a Chinese e-commerce platform, was attacked in early 2015 by short sellers for suspected misrepresentation or overstating of total revenues. This led to falling stock prices and potentially costly class action lawsuits being filed in the United States.

Reputational Issues and Disputes

Investors should be aware of reputational issues associated with high profile Internet companies. For instance, claims of selling fake goods on online retail platforms or other intellectual property rights disputes can impact the reputation of a company. For instance, in January 2015, Alibaba was criticized by China's State Administration for Industry and Commerce for poor control of counterfeits, causing its market capitalization to drop significantly. Alibaba was also sued by Kering SA in May 2015 for selling counterfeits.

Furthermore, reputational issues and disputes can have a more direct effect on a company's bottom line if it results in litigation. Other sorts of commercial disputes with business partners or competitors could also be damaging to the valuation of these firms and should be evaluated carefully.

Integrity and Track Record of Key Principals

Many Internet firms in China are founded and led by one or a small group of entrepreneurs. These companies are thus largely built on the founders' cult of personality. As such, understanding the personal track record, integrity and management style of these principals is especially relevant for investors seeking to better understand the operations and valuations of these companies.

We have seen principals with proven expertise and integrity who are trusted by investors to successfully navigate China's competitive Internet industry. We have also seen principals with histories of tangled related party transactions, dubious personal networks and poor industry reputations, who are a liability to their companies' valuations and prospects. Investors and advisors who fail to discover such landmines face significant risks and obstacles in their future cooperation with the entrepreneurs.

ABOUT OUR TEAM

Blackpeak's Team

Blackpeak has extensive experience advising clients in the TMT (Technology, Media and Telecommunication) sector across Asia. With the completion of more than 60 projects in the last three years, we have researched TMT companies operating in the Greater China region, Singapore, Indonesia, Malaysia, Australia, Japan and Korea.

Jack Clode, co-founder of Blackpeak, is one of Asia's most experienced risk advisory executives, having begun his career in 1995 handling front-line investigations. His expertise includes due diligence, business intelligence, fraud and intellectual property. His work covers many sectors, including energy, infrastructure, logistics and telecommunications.

Sean is Director of Strategy at Blackpeak and works with the founding partners on the development and execution of key strategic and operational initiatives at the firm. Currently based in Hong Kong, Sean has extensive experience managing complex business intelligence research and investigative due diligence projects for financial services, legal and corporate clients.

Typical Scope of Work

Blackpeak's due diligence investigations seek to accomplish the following:

- Understand the target company's background, including formation, ownership, corporate structure, history and business activity.
- Detect actual or alleged corruption, bribery, commercial disputes, significant litigation, labor disputes, safety issues or criminal activity.
- Search for indications of regulatory or compliance issues, undisclosed financial problems or detrimental information. This includes looking for regulatory penalty, bankruptcy or foreclosure.
- Develop profiles and understand the track records of key principals at the target company. Includes checking the principals against litigation, anti-money laundering and regulatory databases, as well as gathering industry knowledge on the individuals' reputation and standing within the business community.
- Understand the external business affiliations and past track records of the key principals to the extent that they relate to the proposed relationship with the client. Look for indications of undisclosed related-party transactions.
- Detect any undisclosed influences over the target company or its principals, including understanding extent of political exposure and government relations.
- Assess the business model of the target company and the veracity of its growth figures.

Standard Methodology

Blackpeak makes use of the following investigation methods:

- Analysis of legal and regulatory database materials, corporate and other records, local and international media, and global watch lists.
- Conduct discreet source inquiries with individuals familiar with the target company and principals. These sources should be qualified to comment on the target company and principals' reputation and business acumen, the dynamics of their government relations and any known incidents of business irregularities, fraudulent activities or corrupt dealings.
- Conduct discreet site visits to addresses related to the target company or principals.

Research and analysis of:

- Corporate filings
- Specialist databases
- Media and other desktop research involving subscription-based and special access databases

- Discreet human inquiries with relevant experts and other sources familiar with targets
- Site visit to target locations

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blackpeak

Blackpeak is a research and investigation firm dedicated to uncovering critical risk-related information for our financial and corporate clients.

We undertake pre-transaction due diligence, post-event corporate investigations and business intelligence research.

Each project is led by local nationals with unmatched in-country expertise, with a focus on accessing and analyzing hard-to-find information using investigative methodologies. Blackpeak also offers advisory services in corporate finance, from investment target identification to balance sheet restructuring, thus leveraging the management's solid background in investment and transactions.

Headquartered in Asia, the firm operates in every major market in the Asia–Pacific region.

In 2019, Blackpeak was acquired by Acuris, the BC Partners and GIC-backed provider of global data, intelligence, research and analysis.

To learn more about the Chinese Internet sector and how Blackpeak can help your company mitigate potential risks, please reach out to one of the TMT sector leaders listed above.

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