How can the PE of China take the advantage of Shanghai Free Trade Zone(FTZ) to go abroad?

-A case study of Hony Capital

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Abstract—the traditional way of cross-border investment has been complained by investors because of the complexity of approval process, the limited investment range of industries, and the potential high cost of capital. However, Since China (Shanghai) Pilot Free Trade Zone had been set up, China open wider to the outside in the area of trade and investment, encouraging enterprises to go out. This paper analyses the policy advantages of overseas investment in FTZ by the case study of Hony Capital, and put up an improved plan. To speed up the process of domestic capital going abroad, both the financial service and the policy in FTZ need to be improved: On the one hand, the bank should actively explore the way to service the enterprises, helping them expand financing channels. On the other hand, the FTZ could be built into the center of cross-border investment funds, where enterprises can get help when they plan to overseas merge and acquisition.

Keywords- Overseas investment;offshore finance; FTZ; system of filing; M &A lending

I. ENTERPRISES CROSS-BORDER INVESTMENT DIFFICULTY

Before the setup of FTZ, the road for RMB sponsor behind the border (limited partnership) to invest overseas enterprises' equity is not very smooth. Complicated policies and regulations make domestic enterprises stranded. Traditionally, there are mainly two investment ways.

1) Wait for the approval of cross-border investment, exchange and then invest abroad. This follows the steps -- approval step by step, foreign exchange registration, exchange and invest abroad. Details are as follows. First, cross-border investors need to prepare related materials and send them to commerce department. Then they need to submit materials to the NDRC for approval after they get submission instructions. After the regulatory approval, they need to do foreign exchange registration in the SAFE. Finally, they should hold the approval of SAFE to do foreign currency exchange in the bank.

2) Parallel Fund Model, that is, dual currency investment. When raising fund, enterprises use RMB and USD at the same time. When investing, they use dollars to do project investment first and then subscribe responding stock rights of overseas enterprises after exchanging equivalent amount of RMB.

3) Although the procedures of the above two traditional ways are clear, the operation efficiency problem will always affect the carrying-out investment. For example, the first way is such a complicated and long-term approach so that most companies will lose the best timing for investment. Crossing-board investment follows the approval system. According to this system, one time investment needs the approval of Department of economy, Department of development and reformation and etc. And all the system may take 3 to 6 months to operate, which will increase the uncertainty of approval results. Some foreign companies may even ask 10% to 20% compensation just due to the delay of the investment which will also cause extra cost. What's more, because of the rigid process during the approval period, invest company may be required to hand in detail information about the whole investment, which may even cause the economy secret put on the street. And for the second way, even though it can promise investing on time, but it might also cause the profits distribution discrepancy between RMB sponsors and foreign sponsors.

As a result, traditional cross-border investment will to some extend keep Chinese companies from "Going abroad".

II. SHANGHAI FTZ ENCOURAGE DOMESTIC CAPITAL TO GO ABROAD

The government makes effort to provide convenience for overseas investment. From then on, the processes of project approval and currency swap have been simplified in FTZ. Therefore, enterprises could apply for overseas investment approval by one sheet, and foreign exchange registration and currency swap can be done in the same place in FTZ.

A. Putting on file of overseas investment in FTZ

On the date of September 29 of 2013, when Shanghai FTZ was formally established, the Shanghai Municipal People's Government issued < Measures for the administration of overseas investment projects in China (Shanghai) free trade zone > and < The regulation of applying the record system to foreign investment to start a business in China (Shanghai) free trade zone >, which applied to FTZ. According to < Measures for the administration of overseas investment projects in China (Shanghai) free trade zone >, overseas investment projects took by local enterprises, which registered in FTZ, should be submitted with the administrative committee of FTZ for filing. The Record-filing Authority should provide opinion in 5 working days since they received the application. Besides, < The regulation of applying the record system to foreign investment to start a business in China (Shanghai) free trade zone > explicitly pointed out that, overseas investment in sensitive country, area or industries should be approved by the State Council, other than that, projects should be filed by the administrative committee of FTZ. The enforcement of those two regulations means that the complex and time-consuming approval system of enterprise overseas investment is replaced by registration system, where eligible overseas investment projects can be realized after filing to administrative committee of FTZ. During the process, all the information need to be given only once in one form, which greatly simplify the work and increase the working efficiency. In addition, the provision of replying in 5 working days significantly shortens the wait times. A project which can be implementation after 3-month approval, now can be carried out in 5 days .This saves enterprises a lot of precious time, and significantly improve the efficiency of investment.

On February 20th of 2014, The National Development and Reform Commission passed < Measures for the administration of overseas investment projects in China (Shanghai) free trade zone >.According to it, overseas investment projects, where Chinese investment amount was under 1billion dollars, are applied to filing systems. Among which, projects above 0.3 billion dollars should be reported to NDRC; projects under 0.3 billion dollars should be reported to local competent authorities. Consider FTZ policies mentioned above, the overseas investment in FTZ under 0.3 billion should only be reported to the administrative committee of FTZ before putting into effort. The enforcement of filing system get through the bottlenecks of overseas investment policy, and the way is cleared for the overseas investment from then on.

B. Banks in FTZ were responsible for foreign exchange registration

On February 28th of 2014, the State Administration of Foreign Exchange passed< Implementation Regulations concerning Foreign Exchange Administration to Support the Construction of the China (Shanghai) Pilot Free Trade Zone >. Under the roles, banks in FTZ are responsible for recording foreign direct investment projects. This means that enterprises can file project and exchange currency in the same place, instead of filing to SAFE, exchanging in bank, which was necessary outside FTZ. Undoubtedly, this role saves enterprises a lot of time, and makes the process simpler and more efficient.

C. The construction of offshore financial markets

The offshore financial market is the special area of a country, which follows foreign financial laws and regulations, instead of local financial regulations. Therefore, non-resident enterprises in offshore financial market of Shanghai FTZ can arrange funds freely. Meanwhile, by using offshore account, they can hold foreign currencies as much as they like without exchange control. Before the setting up of FTZ, offshore banking services can only be provided by foreign banks or four Chinese banks' headquarters, including BOCOM, SPDB, CMBC, Ping An Bank. However, After FTZ was set up, the CBRC approved bank branch of the four Chinese banks in FTZ to provide offshore banking service. Thus, FTZ offshore financial center could provide divers financial service for overseas enterprises, including foreign exchange deposit, foreign exchange loan and foreign currency exchange and so on, so that they don't have to go through the complex foreign exchange process, and don't have to pay tax. Consequently, the construction of offshore financial market attracts more overseas firms to investment and trade here.

III. CASE ANALYSIS OF HONY CAPITAL

A. Brief introduction of Hony case

On February of 2014, by making full use of policy advantages of FTZ, Hony Capital, allied with Suning Appliance, purchased PPTV, which was registered in BVI, with 0.186 billion RMB (equals to 30 million dollars). The purchase was completed through following four steps:

1) On September of 2013, when FTZ was set up, Hony established a fund management in the form of general partnership, named Hony Shanghai co., LTD.

2) Hony Shanghai co., LTD. established a fund company in FTZ, as the purchaser, called Hony Chuangling equity investment partnership.

3) The Hony Chuangling equity investment partnership applied to the administrative committee of FTZ for overseas investment license after the administrative committee recording essential project information.

4) The Hony Chuangling equity investment partnership registered and exchange currencies in FTZ bank, and used the currencies exchanged to purchase target firm.

This is the first case of cross-border investment in FTZ. And it took only 5 working days from filing to finishing exchanging currencies, which was impossible outside the FTZ.As a result, its high efficiency attracts extensive attention..

B. Flexible application of FTZ achievement

The reason why Hony Capital is the first one is that, it dares to experiment, to pioneer with sharp and deep insight. Actually, the system of filing was imposed as early as when FTZ was set up, but as it was a totally new regulation, no one knows the process to get approval and foreign exchange. Thus overseas investment did not emerge until Hony took actions. Hony is different from other Capitals, for it actively studied and kept eyes on the policy development in FTZ. To make the policy advantages into full play, it took actions beforehand to become first capital established in FTZ.

In particular, following policies in FTZ enable Hony to purchase PPTV successfully (see Fig. 1, Fig. 2).

	Shanghai FTZ	The mainland of china except Shanghai FTZ
1.Overseas investment approval	Filing system （information need to be recorded once in one form, filing takes 5 working days）	Authorizing system （information should be submitted to different institutions, authorizing takes 3-6 months）
2.Checklist	Analyze whether the project is accord with relevant laws and regulations.	Detailed review of the project, including contract terms, investment structures,etc.
3.Foreign exchange purchase	Register and exchange can be done in banks	Register in SAFE, exchange in banks

Figure 1. The advantage of FTZ took by Hony case

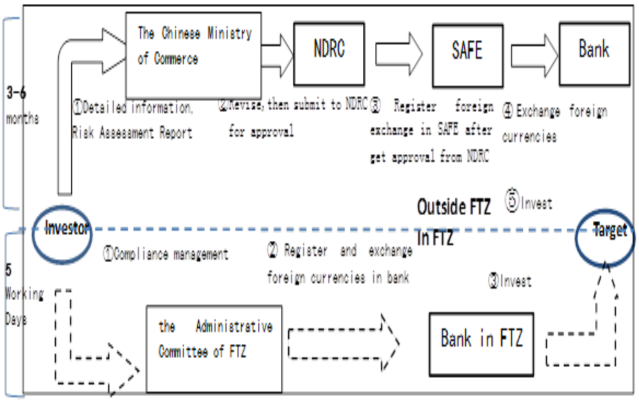

Figure 2. The route of overseas investment inside FTZ and outside FTZ

IV. ANALYSIS

Hony Capital's purchase defied inefficient precedent by using a new way. This new way not only saved precious time, but also reduced investment cost, which fully embodies the support from FTZ to Chinese Capital, and manifest Chinese capitals' strength.

However, Hony did not put the advantages into full play, which means Hony could probably earn a higher return on investment if it used leverage. Capital is of great importance for investment companies, the key to succeed for them is to get more return with lower costs. By using leverage, investors can not only use less their own funds, but also enjoy the benefits of tax deduction for interest paid. Hence, if Hony could get some loans from bank, then this case would be more perfect with higher returns. As Hony do have overseas subsidiary, we propose it could take following measures to get offshore loans:

1) Overseas subsidiary must open an offshore account in FTZ.

2) Hony Capital submit subsidiary's loan application to the bank in FTZ (According to regulations, credit lines should below 50% of purchase price), and at the same time supply guarantee and collateral to the bank.

3) The bank issues foreign currency loans after it finishing due diligence, risk valuation, and giving the loan amount, loan pattern;

4) Overseas subsidiary purchases the target firm with own funds and loans from bank.

V. EXPECTATIONS

As the experimental field of financial reform, FTZ promotes reform and innovation from it was set up. So far, capitals in FTZ can purchase overseas firm almost without any difficulties, but as Shanghai FTZ was built two years ago, there are still a small number of capital firms here, which offers limited help to firms. Consequently, many bricks-and-mortar companies cannot successfully go abroad with the limited help of capital firms, and this is absolutely violates the original intention of the government. To further help firms go abroad, we put up following suggestions:

A. Innovative finacial services should be deeply explored

Bank in FTZ should flexibly use the thought of" Negative list ", which means that except some prohibited services, the bank should actively explore creative services to meet the needs of enterprises, such as provide consulting service to make overseas acquisition plans for firms, or offer loans to reduce firms' heavy burdens of capital. In these ways, Which actively expand service for firms in FTZ. As more overseas investment projects emerge, and the qualification to apply M&A loan is lowered, banks in FTZ can cooperate with capital firm in FTZ to broaden financing channels for overseas investment, through cross-border loans, overseas bank loans with secured by SBLC(Stand By Letter of Credit)provided by domestic bank, cross-border asset management and cross-border wealth management. Besides, learning from QFLP experience, FTZ could offer convenience for foreign equity investments to fatherly cleared foreign investment channels.

B. Shanghai FTZ could be the center of cross-boarder funds

Just as Luxembourg is the center of global offshore funds, Shanghai FTZ could be built into the center of cross-border investment fund. Luxembourg rose from1985, when funds recognized by foreign country first emerged. By formulating favorable tax policy and perfecting legal protection for investment, Luxembourg attracts many funds. Now, it has the second largest number of funds. Learning from Luxembourg, Shanghai FTZ could work as an incubator for facilitating overseas investment projects by building into the center of cross-border investments. The establishment of the center of cross-border investment fund, can attract more investors coming to FTZ, generating industrial agglomeration effect, so as to promote domestic firms to go abroad, improving the international influence of Chinese firms. In addition, it can fully mobilize private foreign currencies (Yao Li, 2015).

VI. CONCLUSIONS

In conclusion, Now FTZ provides a favorable policy environment for investors, so that they could implement overseas acquisitions more freely and act more quickly with lower costs. However, the costs could be further lowered if better financial service be provided by banks in FTZ, such as offshore M&A lending and so on. Besides, to support and help more domestic firms "go abroad", FTZ could learn Luxembourg's experience of constructing global funds center, which means Shanghai FTZ should be built into the center of cross-border funds, just the Chinese version of the Luxembourg.

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