NEW YORK (Dow Jones Investment Banker) -- A spate of recent defaults by Chinese firms with foreign investors, including corn starch and ethanol producer China Sun Bio-chem Technology Group and yogurt drink maker Hunan Taizinai Group, highlights the legal risks inherent in the structures used by many mid-market Chinese companies to raise capital abroad.

It's long been known that investors in offshore entities often have only tenuous legal claims on the underlying business assets in China. But the viability of these structures, which exploit loopholes in Chinese law, looks more dubious now that entrepreneurs, rather than major, politically connected enterprises and individuals, are among the most active users.

Under M&A regulations known as Circular 10 that took effect in 2006, official approval is required before a Chinese citizen or company can form an offshore company, transfer an operating business to it, and raise money. Such vehicles had been in use for years to structure joint ventures between state-owned firms and foreign investors, but as private entrepreneurs began to use this technique, the government sought to rein in the trend. Because approval is almost never granted, Chinese entrepreneurs soon began devising end-runs around the restrictions.

One option, known as the “slow walk,” is to form an offshore company that is nominally independent of the owners of the onshore business, but in practice is owned by a friend or relative of the Chinese business’s owner. The onshore operating company is sold to that offshore entity, but ownership then shifts back over time to the original entrepreneur through an earn-in agreement. The loophole here is that the entrepreneur does not own the offshore business when the operating entity is sold to it. Examples include the Nasdaq-traded China Valves Technology Inc. and OTC-traded China BCT Pharmacy Group Inc.

Alternatively, an offshore entity can be set up with a Chinese subsidiary that enters a management contract with the operating business. Because technically the offshore investors don't own what they are investing in, this technique has been used to funnel foreign money into sectors where foreign ownership is forbidden. But it has also found much wider application. Orient Paper Inc., which trades on Amex, is an example, as is China Power Equipment Inc., which trades over the counter.

In many cases, however, valuations of Chinese companies don't reflect the risk that Chinese regulators might crack down on these work-arounds, or that contracts will prove unenforceable in Chinese courts.

"I do think investors somewhat overlook the structural issues," says Jon Salveson, head of global investment banking at Piper Jaffray.

Take Nasdaq-listed online media company SINA Corp., for example. It has a PEG ratio of 1.4, versus Yahoo!'s 1.6 and Google's 0.9.

SINA's Cayman Islands holding company long predates the regulations that put these offshore entities in a Chinese regulatory phantom zone. But even allowing for that, and for SINA's strong performance, the valuation doesn't seem to reflect the fact that investors in SINA don't actually own an operating business complete with assets. Instead, as SINA discloses in its SEC filings, they own shares in a Cayman holding company with a subsidiary in China that has a contract giving it a right to the economic benefits produced by operating companies that own the key business assets.

When everything works, investors get the economic rewards of owning a Chinese company without actually owning anything. Until they don't. Prior to its 2000 IPO in Hong Kong, China Unicom restructured over 40 such contracts, over objections of many counterparties, when the Ministry of Information Industries decided
they violated regulations.

Investment bankers refer to this contract-based structure as "VIE," for variable interest entity, and it has been used by Chinese businesses that are much more asset-intensive than SINA.

"We've done steel, copper clad wires, agriculture, fuels [and] food distribution," says John Borer, head of investment banking at Rodman & Renshaw LLP. "You don't really own the assets in the company ... You own a contract right to be able to get some economic benefit."

Some Chinese firms do trade at deep discounts to U.S. peers, and Borer says the discount reflects investor concerns about risk.

But Nicholas Howson, former managing partner of the China practice of Paul, Weiss, Rifkind, Wharton & Garrison LLP, now a professor at the University of Michigan Law School, warns that the middle-market companies come with extra risk.

"I would agree that most of these deals are not in conformity with regulations," he says. "When franchise holders are not [state-owned enterprises] or privileged people, watch who you're getting your assurances from and try to understand what ... protection they have for things that don't conform with law."

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