Financing a China Company

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The process of capitalizing and financing a China company is different from just about every other country in the world. You probably think that investing in your China company would be as easy as writing a check and depositing in your account as equity, or taking out a loan for working capital at a local China bank as long as you have qualified collateral. These would be reasonable expectations, but they would be wrong in China. These assumptions cause some companies with great potential in China to run into unanticipated problems such as running out of money or inadvertently violating specific Chinese investment regulations.

There are only three legal ways to get cash into a Chinese company and two of them are fixed by the provisions of the company's business license. Companies may revise these business license provisions, but legal filings must be made and regulatory approvals obtained in a process that are bureaucratic in nature. It is far better to spend the time up front to determine the best level of investment for the company and capitalize it correctly from the beginning.

The only three legal methods of funding a China company that are generally available to a foreign company are:

1. Registered Capital – defined and capped in the Company's business license;
2. Allowable Foreign Debt – determined and capped by metrics in the business license;
3. Funds internally generated from business operations.

Registered Capital

Think of Registered Capital as a sort of statutorily required equity investment in your new company in China. It is not a balance of cash you need to maintain. It is an investment used in the normal course of business to buy equipment, fund working capital and any other normal business needs. It gets absorbed across the balance sheet just as normal capital in the West.

The main difference is that Registered Capital is capital that you are legally required to contribute to the business in the beginning of the business start-up according to the terms of your business license. Registered Capital must be audited and "registered" by an approved government agent before it can be counted against a company's Registered Capital investment commitment defined in the business application process. Only when this "registration" process is complete are the funds contributed as Registered Capital actually available for use by the company in China.

The most common form of Registered Capital is cash in foreign (non-Chinese) currency. However, technically, your Registered Capital obligation may also be satisfied by contributing hard assets into the business (e.g. equipment or technology). There are various limitations to non-cash investment elements that can be used to satisfy Registered Capital. These non-cash investment elements do not directly put cash into the business, but in a sense they can reduce the need for cash. For example, you can either contribute cash and buy equipment or contribute equipment directly.

If you want to use either of these "non-cash" investment methods (contributing hard assets or technology), a valuation process – defined and controlled by the Chinese government – is required to validate the value of all non-cash contributions of Registered Capital. This is not a simple task and often takes considerable time and complication to execute. The reason is that some Western companies abused this opportunity in the past by placing excessive valuations on equipment and technology to satisfy their Registered Capital obligations. The Chinese investment authorities now scrutinize these valuations of "non-cash" Registered Capital contributions very closely. Consequently, they are more difficult to process.

Once you have your Registered Capital declared and approved in your business license, you are not legally allowed to invest additional equity (or increasing your Registered Capital) without obtaining separate approval. This is an odd limitation from a Western perspective, but China wants to maximize foreign investment and drive companies to identify all requirements up front and commit to the planned investment.

Changing your Registered Capital commitment is certainly possible as business conditions evolve and new investment needs arise. Increases to Registered Capital involve governmental filings before actual additional investment can be made. Depending on the circumstances, the necessary filings and approvals can take anywhere from a few weeks to as long as a few months. One last point on Registered Capital is that raising your commitment is much easier than reducing it.

Determining the right level of Registered Capital is extremely important. You need enough Registered Capital to fund the start-up, but too much Registered Capital is also bad. If your company contributes too much, it is very possible that cash balances may be trapped in China. Dividends may only be declared from positive retained earnings. Until net positive retained earnings are generated, cash contributed as “excess” gets trapped because without approval – which is difficult to obtain – return of capital is generally not allowed.

The solution is to conduct a comprehensive financial modeling of the proposed business, with detailed expense and revenue assumptions, that generates a detailed cash flow forecast on a monthly basis. Cash is spent monthly and annual modeling is simply too long a period for this purpose. The Total Investment needed by a business is the maximum negative accumulated cash flow that occurs on a monthly basis. That maximum almost never happens conveniently at the end of a year. Modeling monthly flow is the only way to assure that the right investment level is determined. It is also important to be sure that the modeling be done using a China cost structure where the relative costs of labor, capital and material are different. A sensitivity analysis of the model should be done to test various assumptions to understand the sensitivity of capital requirements of important business model considerations.

Allowable Foreign Debt

China investment regulations also cap the amount of allowable foreign debt that a company can bear, based on the size of the business. Technically there is no legal limit on a company’s local debt with a Chinese bank. However, as a practical matter, foreign companies generally must demonstrate three years of profitable history in China and qualified collateral before they can be considered for a China bank loan. Therefore, local debt is not a viable option for most foreign start-ups in China. Most foreign companies in China must rely on loans from their foreign parent company for debt financing to optimize the capital structure of the China entity.

To understand the allowable foreign debt metric, it is first necessary to understand another metric – Total Investment, which is also defined in a Company’s business license. Total Investment is equal to Registered Capital plus Allowable Debt. While it sounds like Arithmetic 101, you can also look at it as Registered Capital equals Total Investment Minus Allowable Debt. It is this last definition that better explains how these metrics are determined and we will explain this process a little later in this paper.

Once you have modeled your capital requirements (ignoring any debt component) and added sufficient cash cushion to cover the inevitable variability of actual cash needs, Total Investment will be equal to the maximum negative accumulated cash flow in the month totals, as indicated above. Due to the limits to putting cash into a China business, it is highly advisable to generate a monthly forecast of cash requirement for the first three years or until the business becomes cash flow positive and begins to self-fund capital requirements.

Once you have determined this maximum negative accumulated cash flow figure, you have defined the Total Investment metric that must be included in the business license application process. Pus, you are now able to determine the maximum legal amount of foreign debt your China Company may have from any source at any time, unless you file to change your Total Investment and Registered Capital.

China investment regulations allow for a higher percentage of debt in the capital structure for projects with greater total size (Total Investment):

Total Investment	Maximum Allowable Debt	Minimum Registered Capital
< $3M	30%	70%
$3M to <$10M	50%	50% (or no less than $2.1M)
$10M to <$30M	60%	40% (or no less than $5M)
$30M <	67%	33% (or no less than $12M)

These are national restrictions and applied against all companies regardless of business type or location. These capital structure restrictions apply to all forms of loans, including intercompany loans, bank loans, subordinated debt, preferred (non-convertible) stock, etc. There are situations where companies may encounter minimum Total Investment or Registered Capital requirements that differ from this profile, but this is the general model.

One last comment is that before any foreign debt can extended by a foreign parent company to a Chinese subsidiary or JV, the full amount of the Registered Capital contribution must be completed. The rationale is that China wants permanent capital (equity) to be contributed before temporary capital (debt) is contributed.

Funds Internally Generated from Business Operations

As soon as your China business becomes profitable and cash flow positive, any funds internally generated can be used to fund the business and make investments in the normal course of business according to your Scope of Business.

Financing a China Company is Critical First Step

Correctly capitalizing a China company from the start is a critically important foundation step is establishing a company. The regulations and processes are fundamentally different and have different effects on different companies. If a company approaches the issue with the same perspective and expectations as they have in the West, they will almost certainly sub-optimize their result. There is no short cut in the process to analyze all of the relevant issues and build the right capitalization plan. The downside of over-investing is trapping cash in China. The downside of underinvesting is risking running out of cash without the effective and timely options to add new resources as in the West.