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Mergers & Money: After Didi, Will New Regulations Make VCs More Leary of Chinese Investments?

Editor's note: This is Mergers & Money, a monthly column by Senior Reporter Chris Metinko that covers dealmaking in the enterprise tech space.

On June 30, ride-hailing titan Didi went public to much hoopla and fanfare — raising $4.4 billion and the company's profile even higher. However, it was what happened two days later that could affect the venture capital market.

That was when the Cyberspace Administration of China announced it was launching an investigation of the company on suspicion it had violated data privacy and national security laws — causing shares to plummet 25 percent after the July 4 holiday weekend.

More importantly, it raised the possibility China may initiate new rules for "variable interest entities" — or VIEs — a model used by companies such as Didi and Alibaba for overseas listings. It was reported just after Didi's shares fell that Chinese regulators may make it necessary for companies seeking foreign listings to get approval.

Influencing a company's potential exit and investors' path to liquidity is something that is sure to catch investors' attention, and maybe give momentary pause concerning future investment even in a country with a burgeoning tech industry.

What is a VIE?

It's really complicated. VIEs are created by Chinese companies in regulated sectors — which include the tech and internet industries — to get around Chinese laws that prohibit foreign ownership. In essence, a company sets up a listed shell company offshore with no actual business dealings. While that shell company has no real business, it does have a claim to assets and profits from the actual Chinese company through a legal framework.

That means when the company goes public and foreign investors — such as those in the U.S. — buy in, they are not buying actual ownership stakes in the company, just claims to its assets.

The arrangement also would seemingly be against Chinese regulations.

“What’s interesting about VIEs is they bring a lot of capital into the country, but they are in direct contrast to Chinese law,” said Drew Bernstein, co-chairman of Marcum BP, an Asian-focused audit and advisory firm with offices in China and throughout Asia.

Nevertheless, the model has been used by a multitude of Chinese companies including Baidu and Weibo to access foreign money and list on the NYSE and Nasdaq.

However, as the Chinese market continues to emerge, the government is starting to look with more scrutiny on financial or operational dealings, and add more regulations for large tech companies looking to go public both in China and in foreign markets — as witnessed by the pulled $34.5 million Ant Group IPO in October of last year.

That should come as no surprise, Bernstein said.

“Having more regulations is a good thing — it promotes standards and lets people know what is going on,” Bernstein said. “Also, with (Chinese) companies being larger and more complex … you have to expect regulators will react.”

Impacts on venture funding

Still, the question remains how it may affect the growing venture capital market many large tech giants in China are tapping. Crunchbase data shows China saw $31 billion of funding in the first half of this year. That’s about a 5 percent increase from the $29.4 billion it saw in the second half last year and a more than 40 percent increase from the $22.1 billion it saw in the first half of 2020. It very likely could set the stage for the best year in funding China has seen since 2019.

While those numbers do not exactly measure up to the $155 billion North American startups saw in investment in the first half of the year, they show a large, maturing market with growing venture investor interest. Those investors eventually want to see a liquidity event and likely do not want it to be held up — or possibly blocked — by government regulations.

Winston Damarillo, CEO at Talino Venture Labs — which looks at investment opportunities in emerging markets in Southeast Asia and the Philippines — said a more regulated Chinese market could push investors to look elsewhere in the region. However, with China seeing more unicorns — think WeRide, Xingyun Group and others — he doubts it will affect how many VCs operate.

“It could have an effect of money migrating out of China,” he said. “PEs and VCs want liquidity options. But those big bets are still going to be made.”

Bernstein agrees it is unlikely venture money will stop flowing, as there is just too much venture capital out there in general, and many of these companies have an “aura of being too big to fail.” However, it could be wise for investors to add a level of scrutiny to the companies they are investing in just as the Chinese government is doing.

“I hope it changes how (investors) operate somewhat,” Bernstein said. “They better do their homework.”