China Hold 'em: the Bet-on Agreement in Chinese Venture Capital Market

What is Valuation Adjustment Mechanism?

China is one of the most important destination for venture capital in the world and has unicorn companies like Bytedance, Dji, and Shein. Those unicorn's growth is always nourished with the flow of venture capital. Nevertheless, the contractual relationship between investors and investees in China is distinct from that observed in other global markets.

Valuation adjustment mechanism, ("VAM") otherwise known as the "bet-on" contract, is one of the most prevalent investment contracts in China. A VAM affords the investor the right to adjust the original valuation of a target company and receive compensation in cash or equity upon the occurrence of certain events from founding shareholders from the company. For example, if a certain indicator (can be financial indicator or non-financial indicator) is not met at the date in the VAM between founding shareholder, then the founding shareholders shall pay compensation to the investors.
In some cases, the target company is also a party to the VAM contract.

Essentially, VAMs have the capacity to modify the valuation of a target company by establishing specific performance targets. The investor and founding shareholders are making a wager on whether the target company can achieve the requisite performance targets, thereby adjusting their financial return. The performance targets typically fall into three principal categories:

1. financial key performance indicators (KPIs) such as revenue, EBITDA, profit, sales growth rate, CAGR, NAV, sales volume or market share; [1]

2. non-financial KPIs, such as product quality, the acquisition of new patents, the successful industrialization of new technologies or skills/ processes, the formation of a new strategic alliance or the retention rate of technical personnel; and [2]

3. the occurrence or non-occurrence of certain events that may correlate to varying degrees with the performance of the target company, such as mergers and acquisitions ("M&A") and initial public offerings ("IPOs"). [3]

The common compensatory structures of VAM in China are listed below:

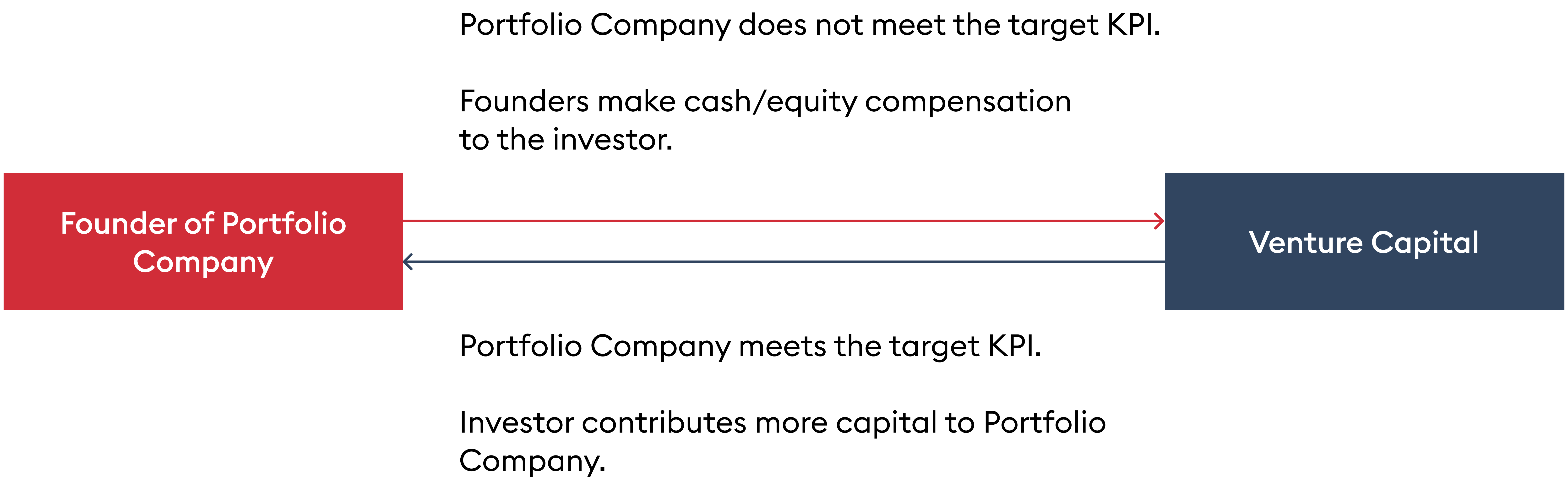
Compensation	Outcome when KPIs are met	Outcome when KPIs are not met
Cash-based	• second round of capital contribution based on pre-set price; • reduction of the accumulated dividend payable.	• no capital contribution; • cash compensation to the investor from the founding shareholders from the company.
Equity-based	• investors sell shares to the founders; • redeem shares on a reduced price.	• allotment of new shares at a reduced price; • equity transfer from the founding shareholders to the investors.
Board control	• bonus for management.	• management gives up board seats to the investors.

[1] Lin Lin, Contractual Innovation In China's Venture Capital Market, NUS Law Working Paper 2020/004. P. 10.

[2] Ibid.

[3] Ibid.

Example: VAM based on financial KPI[4]:



Investor compensation examples:

$$\text{Cash compensation} = \text{investment amount} * \left(1 - \frac{\text{net profit realized of the financial year}}{\text{target profit of the financial year}}\right)$$

$$\text{Equity compensation} = \text{number of shares acquired} * \left(\frac{\text{target profit of the financial year}}{\text{net profit realized of the financial year}} - 1\right)$$

Why VAMs are Popular in China?

All venture capital investors in China are grappling with the challenge of information asymmetry. This can be attributed to several factors, including the developing valuation market in China, the lack of a unified national credit system akin to credit bureaus in the U.S., and the inefficient enforcement on default mechanism in China. Moreover, the valuations of Chinese start-up are frequently inflated. VAMs serve to deflate in valuation, mitigate the possibility of having unreal information in the early valuation.

[4] Ibid.

To illustrate, a VAM may stipulate that in the event that the target company attains the agreed performance targets, the company and its shareholders shall be entitled to adjust the valuation upwards in order to compensate for any losses incurred as a result of the initial undervaluation. Conversely, should the targets not be met, investors shall be entitled to adjust the company's valuation downwards in order to compensate for any losses incurred as a result of the initial overvaluation.

Another important reason is that lack of convertible securities for investors, such as convertible preferred stock and convertible debts in China. This is due to the developing Chinese law still does not fully has the convertible debts mechanism. So, the VAM, also act as a stop-gap measure for the market.

What VAMs Means for Russian Investors?

First of all, the VAM means a more secured way for Russian investors to enter the Chinese market. China, as a unique market in the east, is hard to bring the west experience from Russia to use in the Chinese investment. It is not only common but also necessary to hire local management. By using the VAM, the Russian investors can strike a balance between the freedom and entrepreneur sprit of the local management and the investor's control on the entity that is the subject of this analysis is the target company. Control may be achieved through the KPI or another target set out in the VAM. Furthermore, the VAM can act as an effective stimulus for local management to develop the business and foster shared interest with investors. A case in point is the investment made by Morgan Stanley in Inner Mongolia Mengniu Dairy Industry (Mengniu). As a result of this investment, Mengniu achieved its targeted 50% annual growth and successfully listed in Hong Kong. Furthermore, the management team received 60 million shares as a reward for meeting the KPI targets set out in the VAM signed with Morgan Stanley.

Nevertheless, it would be erroneous to assume that all VAMs are mutually beneficial. Furthermore, numerous unsuccessful VAMs are observed within the market. One of the most significant challenges arises from the fact that VAM does not align perfectly with Chinese legal frameworks. To ensure its enforceability under the evolving Chinese legal landscape, specific legal language is required. This is particularly the case following the enactment of the New Chinese Company Law. To illustrate, as previously outlined, Article 224, paragraph 3 of the new Chinese Company Law has restricted the disproportionate capital reduction to a unanimous agreement among all shareholders. Consequently, it is imperative that VAM investors establish a pre-arrangement within the VAM or the AoA of the target company to encompass an in-proportional capital reduction clause. It is also recommended that an acting in concert agreement be put in place.

However, there is a discrepancy in the way that Chinese courts have ruled on the enforcement of acting in concert agreements. Some Chinese courts view an acting in concert agreement as a binding component of an AoA and therefore enforceable (see 2018 Su 01 Min Zhong case No. 10492), whereas other Chinese courts consider the agreement to be a mere contractual relationship and hold that a breach of the agreement cannot be rectified by annulling the voting outcome.

It is therefore recommended that a liquidated damages clause be included, covering all potential damages resulting from non-performance of the compensation obligations. Furthermore, based on the observations of our China desk, it can be inferred that Chinese arbitrators are more inclined to support the enforcement of VAM (see 2014 CIETAC JinZhongZi No. 0779, see also 2014 CIETAC JinZhongZi No. 0556 awards).

Outlook

Chuck Peng, the head of China Desk of KKMP, has a comprehensive understanding of the investment tools in China, including VAM. He possesses both practical expertise and experience, which enables him to assist investors in selecting the optimal compensation model and drafting enforceable VAM agreements in accordance with Chinese law.

Furthermore, we are eager to explore the potential for a new VAM between Russia and China. Given the similarities between VAM and convertible securities, it would be beneficial to explore the potential for Russian companies to borrow at low interest rates (the 3Y LPR in China is currently 3.4%) in the form of Chinese investment in shares, with repayment in the form of cash compensation upon the fulfilment of certain conditions.

We look forward to receiving feedback and engaging in discussion on this topic in our channel. Should you wish to contact Chuck Peng, you may do so via email at: Please direct all correspondence to Chuck Peng at the following email address: Chuck.Peng@kkmp.legal.