

# [Venture capital in china: past, present, and future](https://assignbuster.com/venture-capital-in-china-past-present-and-future/)

Ruohong Zhao Economic Development in East Asia, Term paper Dr. Yifan Zhang May 1, 2006 Venture Capital in China, Past, Present, and Future Introduction China’s stifled economy has experienced an unprecedented period of growth since the introduction of new economic policies at the Third Plenum of the 11th Congress of the Chinese Communist Party in 1978. The long-suppressed entrepreneurial zeal of the Chinese people was rekindled with the lifting of restriction on private business ownership. Later, the advent of Western-style venture capital funds provided budding Chinese entrepreneurs with sources of hitherto unavailable capital.

Western investments, advice, and discipline, combined with Chinese entrepreneurialism, knowledge, and circumstances, have produced a blossoming venture capital industry that has produced some spectacular results. Both the Chinese government and international investors have focused on the potential of this industry: the former hoping to foster the industry into an steady driver of future economic growth, while the latter eyeing the potential for outsized returns. It would, however, be simplistic to assume that Western venture capital and the Chinese entrepreneurs it funds are the creation of the last two decades.

In fact, today’s proliferation of venture capital investments and boom in entrepreneurial drive are similar in many ways to the economic transformation that took place in China during the early part of the 20th century, when local entrepreneurs and investments in new technologies and manufacturing flourished. This paper seeks to offer a brief examination of the rise, current status, and future potential of the Western-style venture capital industry in China (and the modern entrepreneurs in whom it invests).

Part one of the paper will lay out the historical context for the rise of modern entrepreneurialism and venture capital investing in China, focusing on the social, economic, and political environments that led to the rise of entrepreneurs who flourished by adapting Western technologies and manufacturing processes in the early part of the 20th century. Part two aims to give a quantitative economic overview of the venture capital industry in China today. Part three will explore the operating and regulatory environments which the industry faces today.

Finally, part four will attempt to explore some of the challenges and opportunities facing the industry in the future. Part I: The Historical Context for Entrepreneurialism in China In the most basic sense, venture capitalists represent investors who give entrepreneurs relatively small amounts of money to finance the transformation of their ideas into business realities. As such, the emergence of a flourishing entrepreneurial class is a necessary pre-condition to the advent and existence of venture capitalists.

In today’s China, the term “ venture capital” immediately conjures up images of hot technology companies, founded by foreign-educated Chinese engineers and MBA’s, that are listed on American and European stock exchanges. Such perceptions unsurprisingly foster a belief that entrepreneurialism in China constitutes a relatively modern phenomenon. This belief, however, stands far from the truth. The rise of the modern Chinese entrepreneur could, in fact, be traced to the early 20th century, when the last imperial dynasty neared its end and a new republic was emerging.

In order to better understand venture capital in China today, it would be beneficial to first examine and compare the historical context to the current one for entrepreneurs and those who invest in them. This exercise will help shed light on the current state of the venture capital industry in China. The modern entrepreneur, for the purpose of this paper, is defined as one who utilizes new technologies and ideas (typically Western in origin) to found business enterprises that create economic value.

According to historians like Parks Coble and Marie-Claire Bergere, the rise of the modern Chinese entrepreneur could arguably be traced to the first decade of the 20th century. During this period of great turmoil and transition, the imperial Qing dynasty that had ruled China for almost three centuries struggled to maintain the last semblance of control, while leading political figures like Sun Zhongshan contemplated the formation of a democratic republic (Spence, 1991). The relatively chaotic and transitional nature of the country, however, did not at all diminish the demand for manufactured consumer products.

Instead, the gradual opening up of the country (at least the coastal regions) created new demand that could not be entirely satisfied by the Western firms that rushed to enter China. The imbalance between supply and demand gave opportunities to local entrepreneurs to create new business enterprises that would help fill the new demand. Many new, Chinese-controlled firms grew up in the foreign-dominated enclaves (mainly in and around the city of Shanghai) that provided relatively stable business environments during those turbulent times (Bergere 1989).

It was during a similar period of transition when the first of the entrepreneurs of the new China re-appeared. After the founding of the People’s Republic, the communist government abolished private ownership of businesses and nationalized all industrial and commercial concerns in 1956 (Bergere 1989). The subsequent two decades proved to be tumultuous as the Great Leap Forward, the Three-year Natural Disaster, and the Great Proletariat Cultural Revolution wrought one catastrophe after another upon the Chinese economy (Spence, 1991).

After the death of Mao Zedong in 1976, Deng Xiaoping emerged at the top of the political order and introduced a new economic system that restored the concepts of responsibility and profit, reawakened individual initiative, and called upon the entrepreneurs to again play an important role in the development of China (Bergere 1989). The government began to create “ Special Economic Zones” (the most notable of which was Shenzhen, just north of Hong Kong) along the coast.

These regions provided both economic benefits (e. g. favorable tax treatments) and stability (e. g. local governments that encouraged and protected capitalistic behaviors in the world’s largest communist country) to both entrepreneurs and investors alike (Spence, 1991). Having been ruled by a highly-centralized imperial bureaucracy for almost three centuries, the initial stages of economic modernization in China (at the turn of the 20th century) exhibited a pattern of continued government dominance.

Some of the earliest modern Chinese business enterprises grew out of self-strengthening projects of the late 19th century, led by senior government officials such as Li Hongzhang and Zhang Zhidong, which aimed to revitalized the Chinese economy by adopting and utilizing advanced Western industrial technologies. Due to the poor financial state of the imperial government, however, these government-sponsored projects sought the participation of rivate individuals who could provide the necessary capital to create new business enterprises (Coble 1986). Already, one could see the incipient shadows of venture capital investments, as new ideas and the adoption of Western technology, coupled with private investments (where the investors arguably took significant risk in exchange for the promise of future profitability) combined to create the first generation of modern industrial and commercial enterprises in China.

One of the first groups to take up the opportunity to invest in new industrial and commercial ventures, in association with the government, were the compradors (Chinese who had learned both Western languages and business skills while working for foreign firms in major ports like Shanghai). Many compradors leveraged their unique skill sets, combining a knowledge of the Chinese business world with an understanding of Western commercial practices, to develop sizable business operations. However, the partnerships between the compradors and the government did not necessarily endure.

While the government often insisted upon having a leadership role in the new enterprises, it failed to establish the necessary institutional infrastructures that serve as the pre-conditions to the establishment of a viable, modern business system (Krug 2004). In addition, the government’s leadership often proved to be inadequate. Doubtful of the potential for success, the private investors hesitated to sink in more capital, and many of the new enterprises failed through inefficiency, waste, and the unavailability of the necessary funding for maintenance and growth (Coble 1986).

As China gradually opened up in the late 1970s and early 1980s, the central government once again attempted to capture the positive economic benefits of advanced Western technologies and industrial practices. However, just as the late Qing government lacked adequate financial resources, so too did Beijing’s coffers fall short of having enough hard currency to make all the necessary capital investments (Spence 1991). This time, however, no wealthy compradors existed within China.

As a result, the government turned its attention outside the country and sought funding from foreign investors in Hong Kong, America and Europe (Clissold 2004). As time went on, the government also began to encourage the development of China’s own science and technology capabilities through the establishment of government-sponsored investment funds with mandates to invest in new startup companies focused on technology (Wei 2002). This arguably harbingered the establishment of the first modern venture capital firms in China (though Western-style venture capital firms would not arrive until the early 1990s).

The successful implementation of economic transformation, however, involves more than simply importing technology, capital, and management competency. In order for the new entrepreneurs and their enterprises to succeed, “ new individual and organizational agents…must learn to interact and search for means to facilitate such interaction…. [T]he formation of firms (entrepreneurship) and the establishment of widely acceptable institutions that co-ordinate individual behavior in and between different sectors [together] add up to a business system (Krug 2004). Without the necessary institutions in place to facilitate the survival and prosperity of the newly established startups or newly-capitalized enterprises (previously state-owned enterprises that transformed to partially foreign-owned enterprises through the incorporation of foreign capital), many of the new ventures failed. Many of the largest of the foreign investors who began to invest in VC-like deals in China during this period incurred significant osses as the new investors and the government’s representatives clashed, attempting to gain control over each other (Clissold 2004). In fact, the most visible of the governmentsponsored venture capital firms, the China New Technology Start-up Investment Company, eventually went bankrupt when most of its investments became financial failures due to mismanagement (Wei 2002). The manner in which these entrepreneurial enterprises failed recall the early failures of the collaborations between the Qing government and the compradors.

As imperial power waned at the dawn of the 20th century, the relationship between government and businesses changed, and a new generation of entrepreneurial enterprises, independent of government control, sprang up in areas such as Shanghai (Coble 1986). Some members of this new entrepreneurial class—small merchants and craftsmen who acquired new knowledge and skills while in the employment of Western firms—focused their efforts on the production of relatively simple manufactured products that required neither significant investment of capital nor access to technology, ut were labor-intensive in nature. Nevertheless, the availability of capital was an important determinant of any entrepreneur’s ability to expand his business. In this respect, the local Chinese entrepreneurs competed on an unequal footing against Western businessmen and industrialists, since they usually had better access to capital through their international contacts. Therefore, the Chinese entrepreneurs “ increasingly perceived the foreigners as an obstacle to their own expansion…(Coble 1986). The arrival of the First World War, however, led to the withdraw of a substantial number of Western companies from China, giving the local entrepreneurs a ripe opportunity to compete with the foreign firms that had hitherto so dominated the local markets. As Coble observes, “[g]rowth was especially great during and immediately after the First World War when the temporary lessening of Western competition created especially favorable conditions for expansion [for local firms] (Coble 1986). This window of opportunity helped to spawn a dynamic local entrepreneurial class and capital began to accumulate and become available for additional investments. As the new entrepreneurs sought to invest in more advanced technologies and methods of production, one key challenge arose. No longer lacking the necessary capital, the problem became one of how to acquire technological expertise (Bergere 1989). Against this backdrop, some entrepreneurs who had received their technical education from abroad began to try their luck, sometimes with financial assistance from other newly-successful entrepreneurs.

Not satisfied with simply putting their skills to work for established firms, these engineers founded their own companies that manufactured products with more advanced technical content. Though they faced a plethora of operational challenges and financial difficulties, some of them eventually found success and competed directly with Western products during the 1920’s (Bergere 1989). Unlike the early 1910’s, the power of the government did not wane as the 1980’s progressed.

While struggling to increase the wealth level of the entire population, Deng Xiaoping famously intoned that it would be acceptable to allow some people to become rich first. This permissiveness (even encouragement) from above contributed to the government’s active encouragement of entrepreneurialism and investment in entrepreneurial enterprises (Spence 1991). New entrepreneurs sprang up and, taking advantage of the low labor cost, focused on manufacturing labor-intensive products like toys and clothes, much like the entrepreneurs during the late 1910’s and early 1920’s had one. Instead of focusing solely on the local markets, however, the new entrepreneurs exported most of their products, leveraging their low costs to gain market share internationally. During the process, they earned valuable foreign currency for the state and themselves (Lin et al. 1996). More technologically-savvy entrepreneurs created firms like Legend Computers to explore opportunities in industries like information technology, where brain capital took precedence over physical capital (Lenovo 2006).

Later on during the 1990s, overseas returnees also began to play an important role and helped to create a new class of high-tech entrepreneurs. Companies such as AsiaInfo Holdings (which built most of the internet backbone in China during the 1990s) were built by entrepreneurs who had received their technical training abroad, and having lost interest working overseas, brought their know-how back to China to build new companies (Hai Chen 2005). These returnees played an important part in bringing advanced technology to China, and in the process helped ameliorate one of the biggest challenges facing the country’s modernization (Lin et al. 996). The last point of interest lies in the differing treatments entrepreneurs received at the hands of the Nationalist and the Communist governments. Traditionally, many believed that the early entrepreneurs, many of whom went on to became successful capitalists, exerted enormous influence on the Nanking-based Nationalist government since 1927. Akira Nagano, writing for the Council of the Institute of Pacific Relations in 1931, observes that, “[t]he influence of capitalists in Shanghai and other big cities has increased remarkably in recent times.

The Central Government cannot exist without enlisting this influence. And…the capitalists…control the Government’s policy (Nagano 1931). ” Similarly, Robert Barnett writes in his 1941 book that “[a]fter 1927…a progressive but anti-revolutionary Chinese bourgeoisie provided the ruling KMT (Nationalists) with its principal source of inspiration and support (Barnett, 1941). ” However, later scholars examining this period arrived at a rather different conclusion about the relationship between the Nationalist government and the capitalists.

As Coble points out, “ Nanking did not represent the interests of the capitalists, nor was that group able to exercise significant political influence on government decision making (Coble 1986). ” Indeed, the relationship between the capitalist entrepreneurs and the Nanking government was far from harmonious. First, during the turbulent times, the KMT government viewed the entrepreneurs and their successful companies more as sources of potential tax revenue that could be tapped to support Nanking’s military efforts, and not as potential engines that could power future economic growth.

As Coble observes, “[c]oncern with revenue, not the welfare of the capitalists or the possibility of economic development, dominated the Nanking government’s policies (Coble 1986). ” Second, due to the Western firms’ better access to capital and pre-established competitive position, the Chinese entrepreneurs who were building up China’s own industry-champions attempted time and again to gain favorable tax breaks from the Nanking government. However, Jiang Jieshi’s (Chiang Kai-shek) demand for revenue was paramount as continuous military operations drained the government’s coffers, and therefore the entrepreneurs’ pleas remained ignored.

Third, not only did the Nanking government not assist the entrepreneurs through tax breaks, it utilized “ the powerful criminal underworld in Shanghai…[who] used a variety of methods, including kidnapping and coercion, to control the capitalists,” thereby ensuring the extraction of the maximum amount of tax revenue possible (Coble 1986). Indeed, one could argue that the Communist government treats the modern entrepreneur with more respect and enthusiasm than the Nationalist government did.

Today, both the national and local governments view entrepreneurship and venture capital favorably as sources of future economic growth and job creation (Wei 200). Rather than using any means necessary to maximize tax revenue, national, provincial and local governments offer entrepreneurs and venture investors everything from favorable tax breaks (such as three-years of loss, three-years of half tax policy) to direct financial support and startup capital (which come from government-backed investment funds, such as the Shandong High Tech Investment Corporation), oping to facilitate the formation of new entrepreneurial ventures (York Chen 2005). For example, in cities like Beijing and Shanghai, where entrepreneurs and venture capitalists tend to gather, the local governments have established “ High-Tech Parks” (in areas like Zhong Guan Chun in Beijing and Zhang Jiang in Shanghai) that offer investment tax credits, expedited approval processes for new business ventures, extensive physical infrastructures, and other favorable treatments to attract the formation of new startups (Wei 2002).

Part II: An Economic Snapshot of Venture Capital in China Having examined some of the key similarities and differences between the environments during the early and late 20th century that gave rise to two different waves of entrepreneurialism, and having glimpsed at the importance the current government places upon entrepreneurship and venture capital, it would be helpful now to gain a better understanding of the economic importance of venture capital and the entrepreneurs it supports in China today. For all the enthusiastic attention given to and the excitement urrounding the venture capital industry in China, it would appear that investing in startups in a country with more than 1. 3 billion people could represent the best profitgenerating idea since someone gave two Stanford Ph. D. students $100, 000 to start something called “ Google. ” However, upon closer examination, the economic importance of the venture capital industry in China, as well as the entrepreneurial companies they finance, appears to be rather less significant than all the hype would suggest.

This section will provide a brief overview of the size and relative economic importance of the venture capital industry in China’s rapidly ascending economy. After registering years or high-single digit growth in its economy, it is estimated that China’s gross domestic product for 2005 topped $1. 8 trillion, having grown 9. 2% from 2004. After adjusting for the relative difference in purchasing power, the PPPadjusted (purchasing power parity) GDP for China amounted to more than $8. 1 trillion, making China the second largest economy in the world (in PPP-terms) after the United States (CIA 2006).

Within this enormous economic engine, the venture capital industry in China, as a whole, invested just $934 million in 183 companies during 2005. At the same time, venture capitalists extracted $736 million from existing investments over the same period, either through initial public offerings or via private sales (Kang 2005). Due to the private corporate status of most startups (they are not required to disclose financial information publicly), no exact figure of how much revenue VC-funded startup companies actually generate in China exists.

Most experts agree, however, that many of these startups make little or no profit, regardless of the amount of revenue they generate, since startup companies tend to invest more money to grow than they earn back in revenues. The most successful of China’s startup companies, those that manage to generate substantial revenue and net income, are listed on the US stock markets (mostly on the NASDAQ). According to industry insiders, the US stock market remains the most efficient intermediary of financial capital in the world.

As such, they collectively represent the most desirable place to list a successful startup company’s stock (Zhao 2006). If one examines the financial records of the 16 of the most successful publiclytraded Chinese startup companies listed on the NASDAQ (for the complete list please refer to Exhibit 3), it can be seen that during 2005 they generated a combined revenue of less than $2 billion, and profits of less than $430 million. (This list includes only VC-funded startup companies founded over the last decade, and excludes large companies also listed in the US, but are partially- or majority-owned by the state).

In other words, the economic power of the most successful Chinese startups combined generated only about one tenth of one percent of China’s annual GDP. As this data suggest, the relative economic weight of VC-backed companies in China may leave spectators wondering what all the excitement and hype surrounding the venture capital industry is about. However, despite this apparent lack of economic power, the venture capital industry in China continues to attract significant amounts of foreign investment.

For instance, China-based or China-focused venture capital funds raised a total of $4 billion in new capital during 2005, an almost six-fold increase from 2004. To put this figure in perspective, it is equivalent to 6. 7% of the $60. 3 billion in total foreign direct investment in China during 2005 (Ministry of Commerce). It would appear that although the actual economic impact of VC-funded companies in China remains relatively slight, international investors continue to believe that the venture capital industry will generate significant economic returns in the future.

As one venture capitalist from a prominent US VC firm puts it, “ no one could afford to sit on the sidelines and wait. Many [US-based venture capitalists] are saying, we need to get in now (Zhao 2006). ” Indeed, other venture capitalists the author interviewed agreed with this view, believing that China represents an golden opportunity which venture capitalists would neglect it at their own peril (Zhao 2006). From a micro-level, industry data appear to show that VC investments in China follow no particular trends.

Exhibit 1 shows the total amount of VC investments in China-based startup companies for the last four years, in half year increments. The total amount of VC investments in China increased dramatically from 2002 to 2004, then cooled in 2005 (mainly due to certain changes in regulation the government made, which will be discussed in part 3). As Exhibit 2 shows, venture capitalists in China today favor high-tech industries (internet, telecommunication, integrated circuits) over more traditional ones such as services.

In addition, VCs tend to concentrate their investments geographically, in Beijing and Shanghai (Exhibit 4). Together, these two cities constitute the hotbeds of VC-backed entrepreneurial activities in China. During 2005, 70% of all VC investments (by the number of investments) were targeted at Beijing- or Shanghaibased startups. As several VC’s pointed out during their interviews, this result is not surprising.

Both cities combine a large number of returnees with considerable technical skill and startup capital; enormous pools of local-trained (and relatively cheap) engineering and computer-programming talent; and local governments friendly toward high-tech entrepreneurs and VC investors—all important factors that drive the creation of startups. Finally, it is interesting to note that 66% of all VC investments were targeted at the early stages of a startup company’s corporate life (the start-up, growth, and expansion stages). Several VCs believe this results from increased investor confidence (hence nvesting at the riskier early states) and a growing appetite for higher return (investing early to receive more equity for less cash investment) (Zhao 2006). Part III: The Current Environment for Venture Capital in China Having gained a basic understanding of the economic significance and scale of the venture capital industry in China, we now begin a general examination of the current environment faced by venture capitalists in China. First, a brief history of the development of modern Western-style venture capital firms in China may be helpful.

A Western-style VC firm is typically organized as a partnership, comprising of general partners (GPs) and limited partners (LPs). Both classes contribute capital to the firm, with the LPs typically contributing more than the GPs. The GPs (typically experienced entrepreneurs or executives turned venture capitalists) make all investment decisions, while the LPs (often high net-worth individuals, pension funds, and university endowments) share in the profit, but do not normally have the ability to make operating decisions regarding how or where to invest the fund.

At the end of the investment fund’s life (typically 7-10 years, or as otherwise stipulated by contract), all investments are sold and the proceeds divided among the GPs and LPs on a pro rata basis (York Chen 2005). In the mid-1980s, the Chinese government established the China New Technology Start-up Investment Company (CNTSIC) in order to promote the adoption of new technology and the establishment of new companies in the high-tech industry. However, as a government-sponsored entity whose primary task was to serve policy directives rather than make a profit, the CNTSIC differed from a Western-styled VC firm (Wei 2002).

It was not until the early 1990s when the first Western venture capital firms, such as IDG Technology Venture Investment, set up operation in China. During the first part of the decade, these firms invested mainly in mature industries with relatively stable and predictable revenue and earnings, such as retailing and real estate. Beginning around 1998, the advent of the internet boom in the US prompted these firms to shift their investment focus to startup companies in the information technology and internet sectors.

Consequently, the investments became riskier in nature, but also generated higher returns. The bursting of the “ dot. com” bubble in 2001 once again shifted the VCs investment focus. Startups in the wireless communication, enterprise software, and semiconductor sectors moved center stage. The combination of substantial technology content, demonstrated revenue-generating capability, and ever-rising demand, particularly for mobile phones in China, made venture capitalists more confident investing in these industries (York Chen 2005).

After three years of relatively cautious investing, VCs in China regained their appetite for risk in 2004, riding a global wave of resurrection in confidence in high-tech. In addition to the traditional “ trinity of VC investment in China,” namely internet, IT, and wireless technology and services, sectors such as media and services have also begun to attract investor interest. Finally, 2005 marked an important milestone, as global interest in Chinese venture capital reached a feverish pitch. As mentioned earlier, venture capital firms targeting China raised $4 billion that year.

Some in the industry argue that “ there are too much money chasing too few good deals. ” Indeed, as one experienced venture capitalist puts it, “ the environment is very challenging…the good companies never need investment, the ones looking for investment often do not deserve it (Zhao 2006). ” The phenomenon of multiple VC firms “ fighting” for the right to invest in a particularly attractive startup has become more common than ever, resulting in a toughening of the competitive environment for venture capitalists in China (Zhao 2006).

As the Chinese government gradually embraced the concept of the “ knowledge economy” during the 1990s, a series of policies were adopted to promote the development of the venture capital industry. In 1999, the State Council adopted the Decision to Develop High Technology through Innovation and Industrialization, which called for the cultivation of the capital markets and a venture capital infrastructure for the development of high-tech industries (State Council 1999). Later that year, the State Council further codified its views on the importance of a venture capital industry in the Opinions on Establishing a Venture Capital Regime.

This policy paper specifically stated that ” [i]t is necessary to establish and develop a venture capital industry to support technological innovations of small and medium enterprises (SMEs)…[in] emerging industries and high-tech industries, [which] are the key drivers behind the growth of an information-based economy. ” Furthermore, the State Council indicated that “ IT, biotechnology, technologies on new materials, and advanced manufacturing technologies are the priorities of future government investment (State Council 1999). These directives endowed the venture capital industry with the blessing of the central government, and government agencies at various levels, including provincial and municipal governments, rushed to create new rules and regulations (such as Regulations of Zhongguancun Science Park, promulgated by the Beijing Municipal People’s Congress) to help establish a viable venture capital industry. The enthusiastic attitude the central and provincial governments adopted in promoting the development of a viable venture capital industry induced many Western

VC firms to establish operations in China. In fact, as Exhibit 6 shows, eight of the top ten venture capital firms in China are foreign in origin. However, despite the friendly and welcoming gestures, venture capital firms nevertheless face a challenging regulatory environment in China. As the regulators strive to stay abreast of the rapid pace of developments in and the evolution of the industry, the rules and regulations governing the operations of venture capital firms are also changing.

These changes often create real legal and operational risks for Western VC firms. Before delving into the details of these regulations and challenges, it would be helpful to briefly examine the typical operational model of a venture capital firm in China. Like their US and European counterparts, the overwhelming majority of Western VC firms in China are organized as partnerships (Kang 2005). The typical partnership and the fund(s) it manages, however, are registered overseas (either in the US or in offshore jurisdictions such as the Cayman Islands).

The partnership then sets up a representative office in China (which is registered in China as a wholly-owned subsidiary of the overseas partnership). The result of this arrangement is that the actual partnership (and the investment fund) is subject only to the jurisdiction of its place of registration, and only the representative office is subject to Chinese laws and regulations. When the VC firm makes an investment in a Chinese company, it will do so as a Wholly Owned Foreign Enterprise (WOFE), and the company it invests in will oftentimes also be converted into a WOFE.

In order to accomplish this transformation in corporate status, the founders of the startup (i. e. the founders) will establish their own investment company and register it overseas (e. g. Bermuda), thus giving it WOFE status. Then, this company, together with the investing VC firm, will form a new holding company, which will also be registered overseas. This holding company will then acquire the existing startup, and make it a wholly-owned subsidiary.

The founders and the VC firm will now split the ownership of the holding company, which in effect is nothing more than a shell company (York Chen 2005). Exhibit 7 provides a graphical representation of this investment structure. The reason for this complex structure lies in the fact that in order for a company in China to gain the right to list overseas (on the NASDAQ, for instance), it must be 100% foreign-funded. It is virtually impossible for a startup company with domesticsourced capital to list overseas.

It is limited to applying for a listing on the domestic stock exchanges in Shanghai or Shenzhen. These markets, however, do not constitute efficient financial intermediaries and do not possess the market depth that would allow a startup to achieve a successful initial public offering ( IPO). In addition, the listing requirements for these exchanges (such as three years of profitability and direct approval by the State Council) are often too stringent for startup companies to meet. Consequently, venture capitalists craft their investments such that an eventual overseas listing becomes a possibility.

Due to the gray areas and certain loopholes that existed in the regulations that had governed venture capital investments in China since 2003 (Rules on Administration of Foreign Invested Venture Capital Investment Enterprises; Interim Provisions on the Acquisition of Domestic Enterprises by Foreign Investors), such practices were mostly tolerated by the government (MFTEC 2003). Although this operational model functioned well for Western VC firms, criticism began to mount within China. Many believed this model resulted in significant “ leakage of national assets” and led to a “ decline in the number of successful China-based startups Shi 2005). ” The reason for the first claim is that some managers of state-owned enterprises (those in the process of capital-structure reform) would intentionally undervalue the enterprise’s assets, thus enabling them to purchase those assets at depressed price levels (often in cooperation with foreign investors). The purchase would be consummated using a overseas-registered partnership. Such practices resulted in what critics call “ corrupt wealth transfer from the state to the managers (Shi 2005). The cause for the second complaint lies in the fact that many of the most successful Chinese startup companies are in fact owned by overseas holding companies. Therefore, technically, companies such as Shanda Interactive and Baidu. com (both were structured as WOFEs) are not really Chinese companies at all. As such, critics have begun to question the real economic benefit these companies could actually bring to China, especially given the fact that the parent companies do not fall under Chinese jurisdiction (Shi 2005). In order to combat these deficiencies and close the loopholes, the government responded in 2005 through Order Nos. 1 and 29 of the State Administration for Foreign Exchange (SAFE), published in January and April, respectively. These two executive orders provided new regulations that, among other things, require Chinese nationals to seek SAFE’s approval prior to establishing offshore investment companies. In addition, offshore investment companies seeking to purchase China-based enterprises are required to receive the approvals of three government agencies before proceeding, namely the Ministry of Commerce, the National Development and Reform Commission, and SAFE (SAFE 2005).

Furthermore, the regulations did not specify a maximum time period for the approval process, leading many to wonder if the process would drag on indefinitely (Shi 2005). Although these new regulations were aimed at stopping the “ leakage of national assets” and encouraging the growth of more domestically-funded startup companies, in reality these requirements served to significantly dampened VC investments, since they made it very difficult for Western VC firms to employ the current WOFE structure to invest in China-based startups (Zhao 2006).

As Exhibit 1 shows, total investment during the second half of 2005 declined by almost 40% compared to the second half of 2004. Industry experts believe most of this decline was attributable to the uncertainty and confusion among the venture capitalists generated by Order Nos. 11 and 29 (Kang 2005). After significant pressure from both venture capitalists and entrepreneurs, SAFE made a number of changes to the new regulations and published Order No. 75 on October 21, 2005, which superseded Order Nos. 11 and 29. Order No. 5 revised and clarified certain key provisions, with the net result being that Western VC firms could again invest in China-based startups by investing in the startup’s overseas-registered parent holding company. In addition, Chinese nationals could once again establish offshore investment companies for the purpose of “ various fund raising activities abroad (SAFE 2005). ” However, the new regulations require both the foreign investment firms looking to acquire companies in China and Chinese nationals interested in setting up overseas investment firms to follow a more comprehensive registration and approval process.

The net result of these regulatory changes, according to the practicing venture capitalists interviewed, is to increase both the complexity and the cost of making VC investments in Chinese startup companies. In the end, the operating environment for venture capitalists in China has become more challenging. Part IV: Outlook for the Venture Capital industry in China The previous three sections briefly surveyed the historical context of and the current environment for the venture capital industry in China.

In the last section, the paper will explore some of the challenges and opportunities facing venture capitalists in China as the industry moves into the future. Practicing venture capitalists see several challenges to the healthy development of the industry in China. First, the existence of information asymmetry could inject significant inefficiency into the investment process. This situation may arise when the entrepreneur and VC each holds (or suspects that the other side holds) superior information which is not being shared.

Such information asymmetry could give rise to mutual suspicion and uncertainty, leading, for instance, to the VC questioning the validity of the entrepreneur’s financial projections and the entrepreneur doubting the VC’s sincerity regarding post-investment shareholding arrangements (Zhao 2006). Furthermore, some parties may intentionally manipulate information to achieve a certain desired result. For example, according to public announcements made by Focus Media Holdings, one of the hottest Chinese startups that listed its shares on NASDAQ in 2005, the firm raised between $80 to $90 million (RMB 640 to 720 million! from VCs during two rounds of pre-IPO fund raising. However, according to industry insiders, the actual amount raised fell somewhere between $13 and $14 million. In other words, the company intentionally misstated a crucial piece of information to the press, and was able to successfully generated a significant amount of free publicity and hype for its IPO (York Chen, 2005). For the venture capitalist, such information asymmetry translates into longer (and more costly) due diligence investigations and potentially riskier investments.

The lack of exit channels constitutes another source of worry for China-based VCs. As previously mentioned, listing rules for China’s domestic stock exchanges typically require a company to demonstrate three years of profitability before an IPO could be filed. In addition, any public offering must be approved by the government, which has not allowed any public share offerings (both primary and secondary) since the middle of 2005 (Zhao 2006). As a result, venture capitalists must turn to foreign listings or M activities as means of exiting from existing investments.

However, the former option can be rather complicated and costly to execute, while the latter may result in a lower valuation compared to an IPO, thereby lowering the potential return to the VC. Although the April 17th edition of the Wall Street Journal reported that the China Securities Regulatory Commission plans to introduce more favorable rules aimed at improving the effectiveness of the domestic stock market as a capital-raising medium, it is uncertain how long it would take for these rules to transmit through the market place and what effects they would have on domestic initial public offerings (Areddy 2006).

The lack of effective exit channels could make it more difficult for VCs to turn existing investments into liquidity that would enable them to make new investments. This, in turn, may limit the flexibility, and thereby the return of the VC firm. In addition to information asymmetry and lack of exit channels, the venture capitalists interviewed also believe that the abundance of new capital pouring into China is creating an imbalance between the supply of good investment opportunities and the demand for them from VC funds. Some practitioners in China point to the emergence of he so called “ price-to-dream” ratio is some hotly-contested deals (where VCs make investments based not on concrete measures such as the price to earning ratio but rather on the “ size of the dream” touted by the entrepreneur) as proof that the VC industry may be overheating in China (York Chen 2005). One Shanghai-based venture capitalist pointed out during his interview that the current environment in China reminds him of the heydays of the dot. com bubble in the United States, when the pressure to invest an everlarger pool of capital induced VCs to invest in “ half-hatched business plans” (Zhao 2006).

While it may be difficult to point to any solid quantitative evidence that would indicate the advent of a “ bubble,” the fact remains that at the current rate of investment (~$900 million per year), it would take four and a half years to invest the $4 billion in new capital the industry raised during 2005. Some industry insiders suspect that the rate of investment will undoubtedly accelerate, and potentially contribute to the widening of the supply-demand imbalance (York Chen 2005).

Despite these challenges, positive factors exist that could help the VC industry become more attractive in the future. First, China possesses a deep and ever-expanding talent pool comprised of well-educated and young workers, particularly in large cities. According to the China Ministry of Education, more than 3. 1 million young people graduated from Chinese colleges and universities during 2005. About 40% of these were trained as engineers. These newly minted engineers offer entrepreneurial companies an enormous and relatively affordable talent pool from which to choose workers.

Second, despite recent changes in regulations, the Chinese government remains friendly to the VC industry overall and continues to promote investment in entrepreneurial companies through favorable policies and tax benefits (Zhao 2006). Third, and perhaps most importantly, the same entrepreneurial enthusiasm that drove individuals to become successful industrialists during the early part of the 20th century is also drawing many talented and ambitious people, both locals and returnees, to try their hand at creating the lasting enterprises of the future (Hai Chen 2005).

As these entrepreneurs achieve success, so will the venture capitalists who invest in them. Concluding Remarks: Venture capitalists and the entrepreneurs in whom they invest have played important roles during two periods of significant economic growth in China’s contemporary history (1910s-1920s and 1980-present). Although today VC-backed companies do not yet play a very significant role in China’s overall economy, the venture capital industry is attracting an unprecedented amount of capital from sophisticated foreign investors, many of whom are convinced of the industry’s growth potential in the future.

Despite the positive expectation, the industry itself continues to face many risks, among which stand a changing regulatory environment, information asymmetry, and the threat of a possible investment bubble. Nevertheless, the author believes that as the government, the venture capitalists, and the entrepreneurs gain experience through action and practice, each will become more adept and efficient at working with the other constituents.

Together, they will be able to achieve the common goal of creating exciting new enterprises that will not only help fuel future economic growth, but also properly reward those who willingly undertake the risk to achieve this goal. Exhibit 1. Venture Capital Investment in China $900 $800 $700 $600 $500 $400 $300 $200 $100 2002H1 2002H2 2003H1 2003H2 2004H1 2004H2 2005H1 2005H2 Source: Zero2IPO. com Exhibit 2. USD Millions 2005 VC Investments in China, by Industry Traditional, 16% Services, 16% Internet, 24% Integrated Circuits, 21% Source: Zero2IPO. com

Telecommu nications, 23% Exhibit 3. Chinese Startup Companies Listed on NASDAQ (in USD Millions) 2005 2005 Net Name Symbol Revenue Income SHANDA INTERACTIVE SNDA $236. 0 $21. 0 BAIDU. COM, INC. Down BIDU $39. 8 $5. 9 51JOB, INC. JOBS $70. 0 $7. 7 SINA CORPORATION SINA $194. 0 $43. 0 ASIAINFO HLDGS INC ASIA $94. 0 $0. 0 CTRIP. COM INTL LTD CTRP $65. 0 $28. 0 LINKTONE LTD. LTON $71. 0 $12. 5 NETEASE. COM NTES $201. 0 $116. 0 QIAO XING UNIV TEL XING $251. 0 $2. 8 SOHU. COM INC SOHU $108. 0 $30. 0 TOM ONLINE INC. Up TOMO $172. 0 $45. 0 CHINA MEDICAL TECH CMED $41. $21. 1 CHINA TECHFAITH WIRELESS CNTF $90. 0 $41. 4 COMTECH GROUP COGO $108. 0 $10. 8 FOCUS MEDIA HOLDING FMCN $68. 2 $23. 6 HURRAY! HOLDING CO. , HRAY $62. 4 $18. 6 Total $1, 872. 1 $427. 4 Source: National Association of Securities Dealers, Yahoo Finance. Exhibit 4. 2005 VC Investments in China, by Geography Shandong, 10% Shenzhen, 11% Jiangsu, 8% Beijing, 44% Shanghai, 26% Source: Zero2IPO. com Exhibit 5. 2005 VC Investments in China, by Stage Unknown, 7% Pre-IPO, 15% Start-up, 13% Mature, 13% Growth, 32% Expansion, 21% Source: Zero2IPO. com Exhibit 6.

Top Venture Capital Firms in China (By Investment Activity), 2005 Rank 1 2 3 Name of Firm Softbank IDG Doll Capital Management Beijing DingHui (formerly CICC 4 5 6 7 Investments) New Margin Ventures Carlyle Warburg Pincus Local Foreign (US) Foreign (US) Foreign (US) Source of Capital Foreign (Japan) Foreign (US) Foreign (US) 8 9 10 Legend Capital Acer Technology Ventures, Asia Shandong High Tech Investment Corp. Corporate Foreign (Taiwan) Government Source: Zero2IPO 2005 Annual China Venture Capital Report. Exhibit 7. Typical Venture Capital Investment Structure in China VC Mgmt. Co. Rep. Office VC Mgmt. Co. VC Fund

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