

Fortress China – Venture Capital Environment in 2004

Dr. Martin Haemmig (Version September/2005)



The author, Adj. Prof. Dr. Martin Haemmig has done extensive research over the last 5 years on over 100 international venture capital firms in Asia, Europe, Israel and the United States. He expanded since his research scope to international investors and startup companies with joint projects between CeTIM (Centre of Technology & Innovation Management at their university sites in Munich/G and Leiden/NL) and with Stanford University (Business School), as well as the University of California. In addition, he also lectures on Entrepreneurship & Venture Capital at the ETH in Zurich and at China's top Universities (Tsinghua, Peking, Renmin, Fudan). Martin Haemmig is an advisor to the World Economic Forum working group on "Nurturing early-stage venture investments in China", and is a consultant to governments and venture capital associations with regard to professionalizing the venture capital industry and to venture capital firms on their internationalization processes. His book on "The Globalization of Venture Capital" (ISBN 3-258-06565-9), captured over 20 sponsors and global supporters to finance the research. The 600-page work has been translated into Chinese by Fudan University in Shanghai and sponsored by Intel Capital, IBM Global VC, 3i, Apax, Ernst&Young, Partners Group, Silicon Valley Bank, and NASDAQ.

Adj. Prof. Dr. Martin Haemmig, Neuackerstrasse 25A, 5408 Ennetbaden, Switzerland

Phone: ++41-(0)79-746 76 11, Email: Martin.Haemmig@CeTIM.org Website: www.MartinHaemmig.com

Copyright © Martin Haemmig 2005

China's booming economy has revitalized Asia's venture capital community, with vast sums pouring into the PRC from around the globe. Major risks remain, however, not only legal, regulatory and fiscal issues but also around the areas of corporate governance and intellectual property protection. Nevertheless, a number of factors favor collaboration and/or investment efforts, being it to provide access to foreign portfolio companies to the world's largest populated market or to tap into innovative companies for investment purposes and help exit them in international markets.

China is Asian's Titan

While Asia is increasingly being viewed as a hotbed of investment opportunities for a growing number of private equity houses, the potential in backing even just the top-tier of fast growing companies in China is theoretically phenomenal. China is the world's giant in terms of population size and it is precisely the potential demand in the country that is the root cause for many investors moving in, to secure a share of annual growth rates topping 100% or even 150% at some companies.

The Chinese economy began its opening to a market economy in 1978 and is going through big changes, which make them ripe for venture capital and buyout opportunities. The buyout sector may offer the largest opportunity in history for at least the next 10 years, since China needs to privatized its state owned companies and spinning off numerous of their divisions.

The management experience of entrepreneurs is still limited, however, the entrepreneurial drive of these people and their hard working attitude will expand the talent base very rapidly in China. Business increasingly operates on a global basis and thus the defining lines have become a little blurred. What constitutes a US or a Chinese company is not always clear.

China is the world's largest centrally-controlled state. But this seemingly clear statement does not mean that economic development necessarily is driven by the central government. It is the provincial governments and the mindset of the millions of entrepreneurs that produce the current boom at large. Federal legislations are often trying to catch up what people and local governments already practice in one way or another.

Many Asian investors and longtime experts are very bullish on China both from a macro economic but more from a deal perspective. Many Western investors are scared to deal with China, while others try to oversimplify it. The facts are clear: China's economy offers itself as hub for the international supply chain and the coming years will see innovation and new business popping up all over the country.

China has 1552 universities with 19 million students, of which 72 universities are considered world class. As of today, 17% of the nation's population has completed a higher education. A total of 220 million children/students go to school every day (92% complete 9 years of schooling). The future talent pool is enormous and China's government needs this educated workforce, since 20 million jobs must be created annually to sustain the long-term economic growth targets, in order to spread economic wealth more evenly across the nation.

China's average per capita income in 2003 surpassed US\$1,000 (compared with \$100 in 1990) and reached as high as \$5,000 in the Shanghai region. Although only 4% of the population had a \$20,000+ income in 2004, which translates into a rapidly growing 50 million affluent population with high purchasing power.

The Land of Diversity and Complexity

Unlike the United States, China has many different spoken dialects and various ethnic groups, making it a culturally diverse nation, more than anticipated by most Westerners. Although China has a central government defining a national approach for every aspect of life, it would be naïve to think Beijing and its many provinces take a unilateral approach to politics, economics and finance. The best way to look at China is to compare it to the European Union. Brussels might say one thing, but if Tony Blair or Jacques Chirac don't like it, then it does not happen in the UK or in France. China is very similar. You really have to take into account of what is happening at each provincial level and you have to be aware of the cultural differences in each one.

Authorities in China realize that they need inward investment to help develop its economy. The Chinese are, according to a majority view on investors, proactive at providing a framework for this investment. Given historical precedents in other nations, the Chinese understand that widening the wealth and employment gap between the coastal areas and the hinterland may increase the chance of a potential turmoil.

On an annual basis, China accounts for around US\$60bn in foreign direct investment, making it the single largest recipient of inward investment in the world. There are macro risks in investing in China and there is always going to be strains on the system, yet, growth and market reforms are likely sustainable but certainly irreversible. The risks of drastic domestic policy changes in China are minimal, since the positions of the Government is fairly predictable. In other words, many foreigners feel comfortable investing in a country, which has that political comfort. China has coordinated this approach at a central level but the motivation to attract outside investors has filtered down to the provincial governments. The local councils in China all understand the principles of job creation. Believe it or not, there is much less red tape in China today than in other emerging countries in Asia. These local officials seem to take a similar approach used by Singapore in the 1970s and 1980s. For their careers to go well, they have to promote job creation, eradicate corruption and grow local GDP levels. To keep up with the planned economic growth of 7-8 percent in the next 10-20 years, they need to create 20 million new jobs annually.

Around four years ago some investors were just about becoming comfortable with the idea of investing in the more developed nations in the region such as Hong Kong, Japan and South Korea, in the re-awakening of the markets recovering from the Asian Financial Crisis of the late 1990s. In China there's no legacy to deal with. They simply jump into new technologies without having to disband old industries. They are not willing to buy or to invest in products or technologies that near the end of their life cycle.

Sometimes it is difficult for investors to keep up with deregulation that constantly changes the business landscape in China. What might have been a no-go sector a year ago, suddenly opens up a myriad of opportunities, as the following examples show. Five years ago in the media industry, it would have been unheard of for everyday Chinese, to listen to commercial advertising on radio or be bombarded with billboard advertising all over town. Furthermore, until very recently, education was completely state-controlled, but now the sector has been released to such an extent that some people even call it a partial privatization of the education system. Another example is the power-generation industry, where the Chinese are actively courting outside investment.

China has demonstrated real zeal in its quest for deregulation and attracting overseas investors. What has happened to the country with literally millions of private companies in the space of 25 years is quite staggering by the standards of any other emerging market. Around 15 years ago, when the Chinese private sector started to develop, around 90% of enterprises were in state hands. Today, already 60% of enterprises are in the private sector.

Experiences of those investors active in the Chinese market reflect that success stories are now happening. However, some investors are left with the memories of bad experiences of participating in deals featuring former state-owned companies in China, where many of them performed poorly. It would not surprise, if most US investor and many of their Europeans and Asians counterpart will be giving money to investments in China in three to five years. Many more recent investors feel comfortable, because they did not get burned from investments and currency fluctuations in the 1990s.

China's Appeal to the Global Private Equity Industry

China requires the right timing and the private equity asset class is about ripe for it. To provide the right context, following are the three recent eras of doing business in China: The first from 1993-1996 with Sino-Foreign joint ventures and government incentives, with lots of failures in the venture capital and buyout community. The second from 1996-2003 with Wholly Owned Foreign Enterprises (WOFE), where VC/PE-backed companies were registered in Cayman Islands. Finally the third era from 2004 onward with a less-regulated regime, based on a more maturing regulatory and legal environment. Given this premise, the outlook for the venture capital industry is promising.

China, long a global leader in manufacturing, is also gearing up to provide high-quality, low-cost IT services to anyone who will come. Already a US\$ 4billion-per-year business, the Chinese software industry is forecast by the Gartner Group to be as big as India's by 2007. Other markets undergo similar progress.

Seen by some as a barometer for measuring the level of private equity interest in Asia is the California Public Employees' Retirement System's (CalPERS) Board of Administration decision in April 2004, to add for now India to its list of permissible emerging equity markets. CalPERS said India had moved to new global standards for trade settlement to settle trades one day after the trade date. The move into Asia by the largest pension funds in the US is sending signals to a market that is expecting other funds to follow suit. However, CalPERS has not given the green light to investments in China yet. Nevertheless, with further international IPOs and trade sales expected in 2005, providing handsome returns to their investors, China is likely to become a private equity target even for foreign public pension funds and life insurance companies.

In 2003, London's Almeida Research unit conducted a survey among the most active 50 European and 50 American institutional investors and asked them to score various countries in Asia, in terms of attractiveness to their investment strategies. While Japan topped the table with 32% of respondents, India returned 23% and China is appealing to 19% of those surveyed. The same ranking remained in the 2004 survey. The reason people are going further afield is that returns from some of the very best GPs are anticipated to be as good as those achieved by their colleagues in the US and Europe.

China's Shortcoming in the Venture Capital Industry

Although global institutional investors into Chinese private equity are becoming as bullish as foreign venture capital firms, there is still a myriad of problems for local and foreign VC firms that already operate or plan to do so in the near future.

China's VC industry is still young and was initially driven by government entities. Most investment managers are short-term result driven and thus prefer later-stage investments. The bigger investment funds and their hands-on approach permit foreign VC firms to garner the best deals, most of them in the high-tech sector.

China's local VC firms are not only confronted with less experience but are also hampered by structural issues such as: inappropriate corporate forms for VC firms, inadequate operating setups by VC firms, as well as qualified and ethical talents (investment managers and entrepreneurs). The nation poses different challenges for VC firms. While foreign VCs find solutions around barriers through offshore vehicles and by hiring returnees, local VC firms are plagued with difficult issues. The gap between the two camps widens even further and many foreign VCs start picking deals without including a local partner. The latter find it therefore difficult to improve their skills without co-investment opportunities, which would provide the best on-the-job training with their seasoned foreign colleagues.

Here is how the challenges in China between foreign VCs and local VC firms differ.

- Foreign VCs face “operational challenges”:
The disintegration of offshore and onshore activities pose special challenges for foreign VCs operating in China, but these operational challenges can be overcome by VCs.
 - 1) Offshore: fund raising, portfolio investment and divestment
 - 2) Onshore: deal flow sourcing and portfolio management
- Local VCs face “institutional & structural challenges”:
Difficulties on fund-raising, divestment and portfolio management are of legal, regulatory and structural issues, which cannot be overcome by the VCs community.

To better understand the reasons for the up-hill battle of local Venture Capital firms with structural problems, following are some more detailed explanations.

- Lack of a complete VC law and regulation system in China: current corporate and tax laws have no VC-supporting mechanism; e.g. GP/LP structure, staged drawdown, double tax avoidance, and preferred stock or stock option.
- Limited exit routes in China: no stock market for start-ups; under-developed M&A market.
- No GP/LP mechanism and mindset exist in China: PE/VC funds are long-term equity investments. However, local investors look for short-term financial gains, which in turn drive GPs into non-VC investment activities.
- Challenges for portfolio management teams in China: lack of corporate management training, observing the board, operation transparency, disintegration of shareholder and management, CEO change, strong VC fund mindset, expectations.

Local Venture Capital firms are also struggling with operational problems when compared with their more seasoned foreign counterparts.

- Foreign VCs outperform local VCs and dominate the VC industry. Foreign VCs with global operations, come with higher profile, professionalism, and adhere to global practice.
- For mitigating risk, foreign VCs opt for co-investment with other VCs. Local VCs go for higher equity share and more management control.
- Local VCs exit their investments mainly through domestic trade sales. This path generates much lower returns when compared with international IPOs or M&As by foreign VC firms.

China's government has recognized that innovation through venture capital is vital to sustain the nation's planned economic growth. A task force formed by 10 ministries/commissions starts to draft a special Venture Capital code to bypass many legal and regulatory constraints under the current legal environment. This task force addresses the following key points:

1. A VC fund company can do private fund raising
2. Capital fundraising by commitment with draw-downs (not one-time payment)
3. Allow full capital for investment (not only 50%)
4. Provisions for preferred shares
5. A fund company can be managed by another company (GP/LP structure)
6. Management fee mechanism
7. Carried interests arrangement
8. Consider life-cycle concept for VC-backed startup firms
9. A company could get loans to enlarge investment scale

Three Reasons to Participate in the China Race: opportunity, opportunity, opportunity

China is now the only country outside the United States, which enables the creation of multiple billion dollar market-cap companies with a pure domestic market. Chinese firms not only benefit from low-cost labor but from their economies of scale. When expanding internationally, they have a cost-advantage from day one.

Lots of American venture-backed portfolio companies started to set up operations in China. Especially Silicon Valley venture capitalist are bullish on it and so are their Taiwanese counterpart. Israeli VCs are preparing to ride the next wave, while European VCs and their portfolio companies have only started to test the waters.

Some Californian venture capital firms are banding together and have moved into China to take advantage of the natural shifts in the global economy, since not only production of high-tech, IT and wireless technologies has shifted to Asia, but the markets have also been localized there. In the last two to three years, people realized they could not just push an American product in a local market. In addition, foreign vendors have to be prepared to provide a stripped-down version of their initial product and accept lower prices. The key to success is to localize a product, not just offer a manual or an interface in a different language. The world really has changed and so has global innovation and its commercialization. You can't follow the American model and stay at home. American startups have to go to Asia as well as Europe and vice versa, which puts a lot of additional stress on these young companies and their financial backers.

Stage definitions are different in Asia. Early-stage companies there are at later stages of development than companies in Silicon Valley. Generally, they are generating initial revenue and have a customer base. The connecting lines of investment are coming from all countries in the world, with European-based investment slowly picking up pace. Some experienced private equity investors have a strategy to buy a number of platform companies and do add-on acquisitions to those platforms. New legislation in China make it possible and much easier to invest directly in companies in China.

The majority of investors in China have tended to concentrate around the main commercial centers of Beijing, Shanghai Shenzhen and Guangzhou. Collectively, the greater areas surrounding these cities have an urban population larger than the whole of the United States. Nevertheless, some investors are looking at opportunities in the second-tier cities, whose authorities are keen to develop their local economies like the big three Chinese cities. In some of the second-tier cities, there are less than a hand full financial players and thus the quality of the deals and the pricing are much better than if competing with 20 other investors in the bigger cities. Many experienced foreign VCs argue that valuations in the trendy cities have become too high lately, which will hamper future returns. Needless to say that local VCs cannot compete at these prices.

Foreign VC firms in China, see the main drivers for a booming venture industry as follows:

- **China is a huge market.** Many business models, even focusing on small niche markets, can be successful. Even just emulating a well proven and successful business model from the States can be feasible.
- **Low labor costs provide an advantage for local startups.** Lower investments and potential exits in foreign markets at high valuation should yield higher returns.
- **US companies will need to focus on their own huge local market first.** Even for going abroad, they will often go to Europe and Japan first. This provides a golden time window for Chinese startups to grow.
- **The market leader in a particular segment may go public.** The 2nd & 3rd placed companies in their market could become potential M&A targets for MNC, which planning to enter the Chinese market in the same sector.

Whenever manufacturing and labor intensive work is involved, it is hard to ignore China in the value chain. A 2004 survey by the American Bureau of Statistics compared that average cost for factory workers between US and Chinese companies. While the hourly cost in the States accounts for \$21.11, the average Chinese factory worker costs \$0.65, measured across 70 million employees in rural areas and 30 million in coastal regions. The average cost in the hinterland is at \$0.44 per hour, while the more expensive coastal region sees rates at \$1.04 per worker.

China's labor rates are not only remarkably low in factories. Programmers earn about \$500 per month and few experts expect the kind of wage inflation that is already plaguing the Indian IT sector. However, slower delivery times, higher costs and lower quality than expected is still the case for now, especially in first projects. Despite high-quality programmers, the Chinese don't have the project management experience of the Indians. English skills are generally poor – though improving, while piracy is still a major problem. Despite of this, it still makes China a required stop in the global IT highway. After all, it is

only a matter of time. Chinese work hard, learn fast and are driven by Maslow's hierarchy of needs to move up to the next level.

Entering China as Venture Capital / Private Equity Investor

The potential entry strategies for recently landed foreign VC firms can be grouped in three approaches and depend largely on their former investment experience in Asia:

- Without former Asian experience, it is recommended to collaborate with an international VC firm, which has investments and market expertise in China (Taiwanese, Americans, etc.) or work through a larger corporation that possesses a venture unit with China activities.
- If setting up a VC-office in China, staff it with local talents (ideally with US/Europe experience) and limit foreign staff to the interim GP/CEO. Finding a Chinese returnee, who could be trained at headquarters and then transferred, has proven successful in many cases. Have your CFO double check the portfolio's accounting books.
- Start setting up corporate relationships in China to help open doors for your portfolio companies' customers. A few firms have now specialized in providing these services to foreign VC-firms and their portfolio companies.

On the other hand, foreign late-stage financiers generally invest in established companies with a sophisticated management and a proven product. These companies are considered pre-IPO candidates in Western markets. Generally speaking, one of the main reasons why foreigners are brought in to invest in a company, is to assist it on the IPO path to an overseas exchange. Normally the investment goes towards restructuring the company and then gearing up to the IPO process.

China's venture and investment opportunities, as well as market access for foreign portfolio companies can be summarized as follows:

- The huge local market represents the opportunities in consumer products and services.
Opportunities: Mobile value added services, broadband contents, Internet applications, media, advertising, digital contents, lifestyle products & services, health & amusement.
- The world factory status represents the opportunities in 'import substitution' business
Opportunities: IC design, component design & manufacturing
- The abundant cost effective resources represents the opportunities in outsourcing services.
Opportunities: Hardware OEM/ODM services, SW outsourcing, BPO & Call Center, IC design & outsourcing services

Personal Relationships and Business Relations

In China, much is made of personal relationships called "guanxi" as the basis for business development. Nevertheless, the ongoing importance of this concept is splitting opinions. One of the most important aspects of doing business in China is business relations. Personal relationships drive things in China. Culturally everyone works in line with guanxi – their own personal networks. Until recently, too much gets made of political connections and connections in general. However, today the key question is how to become a long-term, value-added financial partner working with talented entrepreneurs to create and grow strong and durable businesses. To execute this professionally and successfully, local people are needed to know how the business culture in China works. There is a lot of leg-work, lots of hand-holding, but it's not impossible. In summary, the importance of relationships has declined as the importance of the free market has increased.

One of the key drivers in China is a whole new generation of management, which is a big driving force behind a growing pipeline of deals. Even in the last four years there have been demonstrable improvements. With the passage of time and economic development, the skills-base has naturally improved, which can be categorized roughly into three areas:

First, the engagement of multi-nationals has resulted in a new generation of local managers with skills and knowledge acquired from large international corporations. Second, Western-educated and trained

managers and entrepreneurs are returning to their home country or their parents' birthplaces to work in those economies. Third are the top-notch managers coming out of institutions like Beijing's Tsinghua University and budding entrepreneurs poised to spin-off specialist companies from some of China's large private IT companies. Each of the three management group is different in its own way and have their pros and cons. Training at multi-national companies has helped develop a mature management approach. The returnees have injected a Western outlook in the market. The home-grown management tend to be very cautious and focus most on costs but lacks solid management processes and marketing skills. Time will tell, but it could be a good bet to blend the three new manager generations in a high-growth technology company with international markets, to make it a global leader.

Venture Capital and Buyout Allocation for Asia – Driven by Healthy Exits

Should foreign venture and buyout investment firms have global funds, Asian regional funds or operate with dedicated funds for China only?

Some argue that they are more and more focused on a single global pool of capital. They don't want to get into the business of deciding in advance where they are going to invest. They want to have available capacity for opportunities on a real-time basis as political, economic and business conditions consistently evolve. After all, the life span of a typical Western VC/PE fund is about 10 years with 5-6 years for substantial initial investments.

Other houses have dedicated regional or country funds. One of the advantages of a regional fund is that one can allocate capital when it is required. There are no fixed conceptions of where the money should be allocated, since it depends on deal flow. Problem occur when the compensation schemes in the geographic locations don't provide a substantial cross-carry portion to incentivize both sides to collaborate on the same deal over the life-span of the company, especially when international expansion or exits are set on the agenda.

Foreign VC/PE fund managers who cashed in already with healthy returns don't ask the question any more if they should allocate Asia in a global portfolio. They argue that it is no longer about having an Asia allocation or not, it is about how you allocate in Asia by venture vs. buyout, geography and by stage. As each month goes by, there is more and more listing activity of Indian and Chinese companies on international exchanges such as Hong Kong, Singapore, New York and even signs of European activity. Although Israel lists the highest number of non-North American high-tech firms on American stock exchanges (over 150 firms), Nasdaq managers predict that the Israeli benchmark will be broken by Chinese firms within the next 2-3 years.

Structures like the Wholly-Owned Foreign Enterprise (WOFE) and foreign-owned joint venture have made it easier for listings out of China. But what China lacks in experience perhaps, it makes up for in volume. The public markets in India are more established than in China, where they are very nascent. However, over 280 Chinese companies have listed overseas totaling US\$110bn, while Indian companies don't provide that scale today.

Recent Chinese securities law changes have had a positive impact. In terms of exits, the capital markets have opened up. Although in terms of executing them, they are still challenging. Those investors bullish on China and India are very keen to highlight how the whole Asian region is re-establishing the economic power it enjoyed in the mid-1800s, when it held the lion's share of the global economy. Asia is less reliant on the West for trade, with 50% of all trade taking place between countries in the region. And this co-operation has led to diplomatic relations warming between countries like China, Japan, South Korea and India, which can only strengthen an already powerful region.

Buyouts driven by the new tier of management talents could attract many more investors to China in time. Although countries like Australia, Japan and South Korea have developed buyout markets, there is generally an overhang of capital in those markets. Nevertheless, it is still possible to get a four to six times multiple in the Asian buyout market, which is hardly any more possible in Western countries. Asia is not yet mature but it is quite safe, hence inefficiencies in the private equity market also means opportunities for many investors. For others, the growth approach is what makes China tick. Many new international investors are big believers in growth equity although historically this has been a much berated place to be. The reality of the landscape today is not a binary choice between VC and buyout.

Too Much Hype for Venture Capital in China? – Facts and Figures

According to Zero-2-IPO, Venture capital investments in China increased sharply from \$0.418 billion in 2002 to \$0.992bn in 2003 and topped the 1 billion dollar mark in 2004 with \$1.27bn into 253 portfolio companies. China's \$1.27bn pure venture capital investment in 2004 ranks 3rd behind the United States (\$21bn) and an equal group consisting of Canada, Great Britain and Israel (about \$1.4bn each).

Of the about 300 VC firms the 187 more active investors disclose their data, of which 130 are domestic, 40 foreign, and are 17 Sino-Foreign joint ventures. The capital available by the 187 VC funds represents a \$12.8 billion pool, of which \$4.1bn are from domestic funds, \$8.1bn from foreign and \$0.6bn from Sino-Foreign joint ventures. Given the smaller number of foreign VC firms and their much larger fund size, foreign funds have much deeper pockets in China, averaging \$200,000 per fund or about seven times more than local VC funds. The 23 new funds raised in 2004 account for \$700 million, of which the 9 foreign funds obtained 53%.

Of the \$1.27 billion investments into 253 portfolio companies, only 25% of the amount invested came from domestic venture capitalists, while the balance was international capital. The foreign share in 2001 was only at 50%, hence foreign VC firms dominate the Chinese market now, with about 70-80% of the investments done in high-technology, while the local high-tech portion accounts for about 40-50%. The startup-stage received 6% of the capital, growth-stage 14%, expansion-stage 35%, mature-stage 24% and pre-IPO 6%, while 15% could not be allocated (unknown).

China's most active venture capitalists have been nominated in December 2004 during the Zero-to-IPO annual event. Among the top 10 investors are 4 Chinese VC fund managers (PRC), while most of the 6 foreign firms have a local office in Asia (China, Japan, Taiwan, Hong Kong).

• Softbank Asia Infrastructure Fund	Andy YAN	(Japan/HKG)
• IDG Technology Venture Inv.	Dongliang LIN	(USA/PRC)
• Doll Capital Management	David CHAO	(USA)
• CDH Investments	Shanghzi WU	(PRC)
• New Margin Ventures	Tao FENG	(PRC)
• Legend Capital Limited	Linan ZHU	(PRC)
• Acer Technology Ventures Asia	York CHEN	(Taiwan/PRC)
• Shandong High Technology Inv.	Luwei GUO	(PRC)
• Draper Fisher Jurvetson ePlanet	Fan ZHANG	(USA/PRC)
• JAFCO Investment HKG	Vincent CHAN	(Japan/HKG)

Exits are showing strong signs and help drive new investments, as investors see continuously healthy returns on their investments in the very recent years. China's 24 VC-backed IPOs raised \$4.3bn in the public market. The 4 largest Chinese overseas exits in the United States including SMIC (semiconductor), Shanda (Internet), Linktone (telecom), and 51Job.com (Internet), which account for the majority of China's IPO exit amount. A total of 60 exits returned \$0.82bn to their VC investors. The breakdown of all exits amounts include 69% for IPOs, 25% M&A/trade-sales, only 1% liquidation, while 6% remain unknown. The 24 Chinese IPOs in 2004 returned \$0.55bn to their VC investors. This compares with 34 IPOs in Europe returning \$0.92bn (vs. 172 IPOs with \$10bn in 2000), while the 93 American IPOs in 2004 returned \$11bn to their investors (vs. 264 IPOs returning \$25bn in 2000).

Investments by geography in 2004 sees the top 3 regions obtaining 80% of the total \$1.27bn venture amount. The Shanghai region was the hottest location, receiving 39%, Beijing got 28%, Shenzhen/Guangdong obtained 13%, followed by Helongjiang, Zhejiang and Jiangsu.

Outlook summary: The rapidly raising VC investments in China and the healthy returns in 2004 will trigger more foreign funds to invest in Chinese companies and international investors are likely to allocate more of their private equity portion to this nation. The long-standing and more recent investors are faced with high valuations and some of them argue that there is already too much money chasing too few quality deals. Time will tell, if China may become the next bubble or if there is sufficient innovation to be financed that generate returns above comparable deals in other parts of the world.

Source: China VC data was provided by Zero-2-IPO and some practitioner insights by York Chen of AcerVC. Other contributors remain unnamed unless stated in the article.