

'If you want to make money in China, you cannot take the short-term, fly-by-commando approach and try to manage remotely. If you do, you will get burned and lose your money.' – David Zhang, WI Harper Group

China Strapped for VC Cash

China's young, innovative companies desperately need early-stage funding. But there have to be some ground rules first.

September 12, 2005 Issue

In China, precious little venture capital goes into seeding startup companies and that, say VC experts on the ground, is what's holding the country back from beginning its ascent to becoming an innovation powerhouse. Total VC investment in China reached \$1.27 billion in 2004, only 14.62 percent of that at the initial startup stage, according to Ernst & Young.

"It is really at the early stage where venture capital has its greatest value for China," says Jeremy Xue, managing director of Beijing-based Tsinghua Science Park Venture Capital, an affiliate of China's famous university of the same name. But when it comes to facilitating needed funding, "there is a lot of talk but no action," says Mr. Xue.

That could change, if the World Economic Forum gets its way. Over the past year, the Geneva-based WEF held a series of workshops—with Chinese and Silicon Valley universities, venture capitalists, and global consultancy Ernst & Young in California and China—all aimed at pinpointing problems and remedies for nurturing early-stage companies. Now, the plan is to present findings and recommendations arising from those deliberations to China's central government agency in September, including the State Administration of Foreign Exchange, Ministry of Science and Technology, China Securities Regulatory Commission, State Council Research Office, Shenzhen Stock Exchange, State Development and Reform Commission, State Administration of Taxation, and National People's Congress.

The group will likely recommend improving entrepreneurship education and creating a national venture capital association that would set transparent valuation guidelines and corporate governance standards, identify methods to improve technology transfer, and propose new laws governing limited partnership and incorporation. According to Anand Sunderji, the WEF's Geneva-based community manager for private equity, venture capital and hedge funds, these are the actions experts zeroed in on.

The country's investment ecosystem definitely needs attention. "China's legal system is inadequate, inconsistent, and inequitable," says Fernando Bensuaski, an advisor to the WEF's working group on nurturing early-stage companies, and managing director of Sinolinks Financial Services in Shanghai. "The management skills of entrepreneurs and proposed entrepreneurs are poor, [and] business ethics are nonexistent by U.S. and European standards—and the ability to exit is limited."

Other WEF advisors blame the dearth of seed capital on little or wrongheaded government funding, a lack of tax incentives to encourage investment, a risk-averse domestic venture capital industry, outdated laws, intellectual property issues—and misconceptions and missteps by foreign venture capitalists.

Crucial for China, not just for VCs

"We view any acceleration in creating a robust early-stage investment climate as something fundamentally important not just for the sector, but for China," says Kevin Steinberg, the senior director of the World Economic Forum's membership and partnership program.

In the United States, venture-backed companies account for about 10 percent of GDP and about 10 million jobs, according to Mr. Steinberg. And innovation in the technology sector has created many more jobs. To push back chronic unemployment brought on by the ongoing collapse of its state sector and fulfill its goal of becoming a global innovation center, China needs to create 20 million jobs a year and it needs to keep its economy growing at 7 to 8 percent to do that.

In 2002, total VC investment in China was only \$418 million, split among 226 companies. According to Chinese market research firm Zero2IPO and Ernst & Young, last year's record \$1.27 billion, which funded 253 Chinese ventures, put China in third place as a VC market—behind the U.S. (\$21 billion) and three countries tied for second place, Canada, the United Kingdom, and Israel (about \$1.4 billion each).

In just two years, the average deal size grew from \$1.8 million to \$5 million, according to an Ernst & Young report. Out of the 253 VC deals made in China in 2004, 14.62 percent went to startups, 34.78 percent to growth companies, 14 percent to help companies expand, 13.04 percent to mature companies, and 1.98 percent to pre-IPO companies, according to Ernst & Young. It is unknown where 18.58 percent of the investments went. What is clear is that foreign investors—who do most of the deals in China—tend to favor advanced-stage companies because of their perceived lower risk and prospects for quick returns, so they aren't much help at the beginning of the chain.

But there are always exceptions. VC firm WI Harper Group invested in Shanghai-based Focus Media, which developed a market-disruptive business model—distributing television commercials on flat screens placed in building lobbies. Valued at \$750 million when the two-year-old venture went public on July 13, it delivered the San Francisco-based investors a tenfold return in just over a year. “We don't care if there is no component of high technology, as long as we make money,” says David Zhang, an executive vice president in WI Harper's Beijing office.

Many China startups, in fact, focus on disruptive business service models for the domestic market, or copying successful U.S. companies rather than inventing disruptive technologies. And when they gain enough traction domestically, WI Harper introduces them to U.S. investors and looks for an exit. “Early stage is the way to go,” says Mr. Zhang.

Four of the top 10 global technology offerings in 2004 were venture-backed Chinese companies. Ten of the 93 IPOs in the U.S. were China-based venture companies, in fact. The top performers—companies like Shanda, Sohu, Sina, and 51Job—were market rather than technology plays. Only Shanghai-based foundry Semiconductor Manufacturing International Corporation (SMIC) was a “real Chinese-flavored” technology play, says Tsinghua University's Mr. Xue.

SMIC is the kind of company that will be crucial to China's future, he says. “If we really want to play the Silicon Valley game, which is about real technology, China still needs time before it is ready,” he contends.

Start with the Universities

But where to begin? In the university research labs, says WEF advisor Martin Kenney, a professor in the department of human and community development at the University of California, Davis. Most Chinese universities only do contract work, he says. Government funding should instead be targeting breakthroughs in global class technologies—honing skills that could one day go on to create China's Intels. Some of the most successful U.S. tech companies, such as Intel, were created by engineers who did cutting-edge work at universities, then joined big companies to learn about business and later set off on their own, says Mr. Kenney.

China should also focus on a few core tech strengths and become world class, says Forum working group advisor **Martin Haemmig**, a widely traveled university speaker and specialist in the globalization of venture capital. China has the chance to become a serious player in areas like wireless technology, semiconductors, telecommunications infrastructure, and consumer electronics. Achieving that would help China shift up from being a manufacturing-based economy to an innovation-based one. But to do that, China's central government has to identify development priorities and then do a better job helping young companies and seeding cutting-edge research.

That's certainly the view of former venture capitalist Frederick Chang, the Chinese-American vice president of operations for Shanghai-based semiconductor company Apexone Microelectronics who is also a WEF advisor.

Acknowledging the government's success attracting the big fabs, Mr. Chang says, "If they would take the same amount and put it into fabless design houses and support a grassroots flourishing of creativity, then companies like ours will drive demand and bring in the rest of the pieces of the industry."

If government funding and seed money were available, engineers could get their start in targeted research at universities and go on from there to create their own startups with the help of experienced managers and VCs, assert **Mr. Haemmig** and other members of the WEF's working group.

Tending the Ecosystem

China's technology ecosystem would then start to look a little more like Silicon Valley's, except much bigger. Universities in Zhongguancun, Beijing's tech zone, churn out 50,000 engineers a year—compared to 70,000 for the entire U.S.

The WEF's Mr. Steinberg recounts a tale that brings these numbers home: a Western software company sets up development centers in China and around the world, and the Chinese center emerges as the most productive. Why? "If you find someone who is one in a million in China, it means there are a thousand more people like them."

But China still has a long way to go. "We are still learning from Silicon Valley," says Tsinghua's Mr. Xue. "But no matter how much we learn, we have to combine their experience with local experience. No matter how similar it looks, it just isn't the same."

How the Chinese government interacts with business and how it approaches funding are crucial differences. Indeed, how it changes that approach could determine whether young companies with innovative technology can get some wind in their sails.

China's municipal governments have tried to fill the early-stage funding void with funds managed by government officials. The problem with that, says Mr. Xue, is that these investment funds report to the local state-owned assets commission, which often demands fixed annual returns. "The only thing to do is to put [the money] in a bank to try and meet those obligations, so after two years it accomplishes nothing," he says. "Everyone is trying simply to cover their assets."

The selection process for government research grants is another issue. The people hired to evaluate projects are technical experts, not businessmen, so evaluations tend to glide over business models instead of properly sizing them up. "The macro environment is still unfriendly, or more accurately, it's unready to play at Western-style VC," says Mr. Xue.

The government has had more success channeling innovation funds through university organizations like Tsinghua Science Park, which are run more like a business. But the parks are overwhelmed: "We don't have the manpower," says Mr. Xue, who sits on the board of five companies, as three other colleagues do—for a total of 20 out of the 100 startups in the Tsinghua Science Park incubator.

"If we don't help, who can possibly help them? Do we take more, or do more for the good ones?" he wonders. Mr. Xue thinks teaming up with international partners is the answer.

Another possible approach is copying the Israeli government YOZMA fund model (which gave the Israeli venture capital industry a jump-start) and teaming these funds with large international VC firms.

Government money in early-stage companies can serve as a catalyst, says Mr. Xue. "But it can't play the main role. It is not their business."

So what can the Chinese government do to clear the way for local and foreign investors to invest more readily in early-stage companies? Creating tax incentives would be a good start, says **Mr. Haemmig**.

Outdated company laws also need to be changed, he says, arguing that they constrain China's domestic VC players and make it difficult for them to create effective business structures for VC funds. For example, the limited partnership model should be adapted to include the commitment and drawdown concepts used by most VC funds in the world, says **Mr. Haemmig**.

In addition, the government also needs to rethink regulatory initiatives known as SAFE 11 & 29, introduced by the State Administration of Foreign Exchange (SAFE) in part to stop rampant asset stripping of privatizing state-owned companies. The proposals establish approval and registration requirements for Chinese residents setting up offshore companies or vehicles for onshore acquisitions and share or asset swaps with offshore companies.

The regulations were not aimed at venture-backed companies, says **Mr. Haemmig**, but they got caught in the crossfire. And they jeopardize the typical offshore holding investment model used by domestic founders of young tech companies in conjunction with foreign venture capital investments, permitting an overseas M&A or IPO. However, he is convinced that the government will make amendments within weeks to open the gate again for new investments by foreign VC firms.

Many VCs also worry about a lack of intellectual property protection in China and want the government to take steps to change this, although some in the industry argue that it is not an issue.

Opinion is divided over whether China needs its own Nasdaq—as a second board in Shenzhen, across the border from Hong Kong, was originally envisioned to be. Right now, foreigners, except for approved institutions, cannot own shares in traded companies. A reformed second board would open up both a market to young companies desperate for capital, and another exit for VCs now limited to either trade sales or offshore IPOs.

But a local Nasdaq appears to be a long way off. “Until there is a sound legal system, it will be a joke,” says WI Harper's Mr. Zhang.

Business ethics is another thorny issue. Cooking the books and other illegal practices are far more prevalent in China than in other countries, say WEF advisors. What to do? “If I knew the answer to that I wouldn't have so much trouble sleeping at night,” says Apexone's Mr. Chang.

Insufficient protection of investors' interests remains an issue the Chinese government will have to address, say WEF advisors.

Special Ks

But foreign venture capitalists can take some of the blame themselves, to hear Tsinghua's Mr. Xue tell it. He explains why foreign VCs miss out on opportunities with three words: *kanbujian* (they don't see the deals because they are difficult to find), *kanbuqi* (they don't take the deals seriously because they are too small), and *kanbudong* (they don't understand the deals because they are too Chinese).

In the first case, *kanbujian*, foreign VCs parachute in and expect to be flooded with deals. In the second, *kanbuqi*, foreign investors dismiss small deals because they don't justify the attorney fees. Mr. Xue cites the case of one of his own portfolio companies needing a small round of financing. Foreign VCs agreed it was a good company with good people that impressively went from concept to test prototype with carriers within nine months—but everyone passed on it.

Tsinghua University, in fact, can dole out that level of funding, says Mr. Xue, “[but] our objective is to line them up with a co-investor, an international investor that can give them exposure to international markets.”

The third excuse for not investing, *kanbudong*, comes down to fear of things foreign VCs don't understand, including the level of government influence in China. That is where collaboration with locals can help. “There are ways to manage these things, but these skills aren't transferable,” says Mr. Xue. Without local knowledge or help, the foreign VCs “are just scared off and they leave a good deal.”

WI Harper's Mr. Zhang has this advice for Western-based venture capitalists who want to invest in China: "If you want to make money in China, you cannot take the short-term, fly-by commando approach and try to manage remotely. If you do, you will get burned and lose your money."

Succeeding at venture capital in China takes commitment, patience, and passion, plus involvement in the local environment, he says. "The more committed you are, the better the deals you will find."

The WEF's Mr. Sunderji says the working group looked at best practice at U.S. business schools to identify courses and programs likely to benefit Chinese universities. The Forum has also been talking with nongovernmental agencies, such as the (U.S.) National Foundation for Teaching Entrepreneurship, about offering training courses in rural areas outside China's three main innovation clusters in Beijing, Shanghai, and Shenzhen.

Mr. Sunderji also makes the point that university contract work has some plusses. For one thing, it can help Chinese researchers work more closely with U.S. and European companies. Indeed, venture capitalists not yet investing in China should contract out software development for their portfolio companies to China's universities, he says.

The WEF is also looking at consolidating work done by U.S. and European venture capital associations with the aim of localizing it to fit the China market.

There is reason for optimism, says Mr. Sunderji. "Silicon Valley has shown us that for innovation clusters to work you need global-class universities, global-class research and development, high-quality entrepreneurs, availability of management teams, and the ecosystem surrounding it, including accountants, lawyers, venture capitalists, and an intersection amongst all of these," he says. "We are starting to see all of this happening in China."

Tsinghua's Mr. Xue predicts China will someday catch up with the U.S. in terms of VC funding. "It won't be 100 percent there, perhaps just 60 to 70 percent, but we will get there. The market size is big enough, the population size is big enough, the capacity for technological innovation is there, and the entrepreneurial spirit is there.

"It's a matter of when."

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