

China's Venture Capital System and Investment Decision-making

Dr. Wei Zhang (张炜)

School of Economics & Management, Tsinghua Univ.

Visiting Fellow, Stanford GSB

zhangw3@em.tsinghua.edu.cn

zhang_wei@gsb.stanford.edu

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VC industry in China: heating up

- **9 VC-backed firms from China IPO in NASDAQ and NYSE in the past 11 months.**
- **Impressive M&A in China: Joyo(Amazon), eachnet(eBay), 3721(Yahoo!)**
- **Carlyle Asia Venture Partners' \$8m investment in online travel company Ctrip.com ballooned to \$100m when the company went public in Dec. 2003. (\$48.33/share, Nov.30, 2004; nearly 3 times of IPO price)**
- **IDGVC made 1,900% profit on its stake in online auction company EachNet when it was bought by eBay Inc. for \$200m last year.**
- **More active VC investment, more international willing to join.**

<i>Company</i>	<i>Stock code</i>	<i>IPO time</i>	<i>Core business</i>
Ctrip	CTRP	2003/12/09	Travel service
Linktone	LTON	2004/03/04	Wireless service
Tom Online	TOMO	2004/03/10	Wireless service
SMICS*	SMIC	2004/03/17	Chip manufacturing
Shanda	SNDA	2004/05/13	Networking Game
Kongzhong	KONG	2004/07/09	Wireless content and application
51job.com	JOBS	2004/09/28	Website of recruitment
Financial street	JRJC	2004/10/15	Financial information services
elong	LONG	2004/10/29	Online travel business

** IPO in NYSE and Hong Kong*

Key topics

- **What is the evolving structure and system of VC industry in China?**
- **What is the investment process and how do international VC firms make decisions when investing in China?**
- **Why have several VC firms outperformed others? Why lose money?**
- **What challenges lie ahead?**

General framework of VC system

- **Configuration of actors**
- **Rules and practices**
 - ✓ investment funds pooled
 - ✓ investment targets identified
 - ✓ funds invested and monitored
 - ✓ returns appropriated
- *Specific to China's national context*

Evolving structure and system of China VC

- **Relatively recent phenomenon**
- **Emerging from decades of government-led technology policy.**
- **A still-transitioning business system.**

China: Key events

- **1985: Central govt. notes that VC is/should be part of overall reforms of China's S&T system. Est. 1st govt-backed VC firm.**
- **1988: Torch Program to promote engineering and commercialization of S&T outputs.**
- **1991: Central govt issues high-tech zone policies. Some VC firms started by local govts.**
- **1998: No.1 Proposal: Watershed event.**
- **2003: Rules on Administration of Foreign-Invested Venture Capital Investment Enterprises implemented.**
- **2004: SME board opened in Shenzhen Stock Exchange.**

Antecedents: transition-era reforms and practices

- **Chinese government:**
Science & Tech(S&T): critical part for searching economic development.
- **VC in the Chinese context:**
 - Promoted (by government)**
 - ✓ not as a means to private gain
 - ✓ but as a critical mechanism of linking S&T capabilities and
 - outputs
 - Economic and social development
- **Institutionalization of China's VC system:**
Result of preceding and on-going changes in China's national innovation system and business system during the transition era.

The problem of centrally planned system: by late 1970s

- **Inefficiencies and lower effectiveness of a centrally planned economy**
- **R&D system in China:**
 - ✓ a large number of organizations specialized in particular industries and in specific stages in the value chain.
 - ✓ little or no horizontal linkages and information flows between these functionally specialized actors.
 - ✓ Innovation was primarily initiated by central government ministries and bureaus, within the guidelines of national plans.

- **Three primary institutional actors**
 - ✓ **R&D institutes and universities:**
 - Primary role at start-up stage: original technology and seed capital.**
 - ✓ **Banks:**
 - Primary source of financing: investment in spin-off projects under Torch Program.**
 - ✓ **Technology zones:**
 - Incubator functions**

VC: potential solution??

- **How did this pre-institutionalized system work?**

- ✓ **Benefit:**

- large number of new tech-ventures founded

- ✓ **Limitation:**

- Too small of supply of initial stage capital

- Not providing legal, regulatory and other institutional support

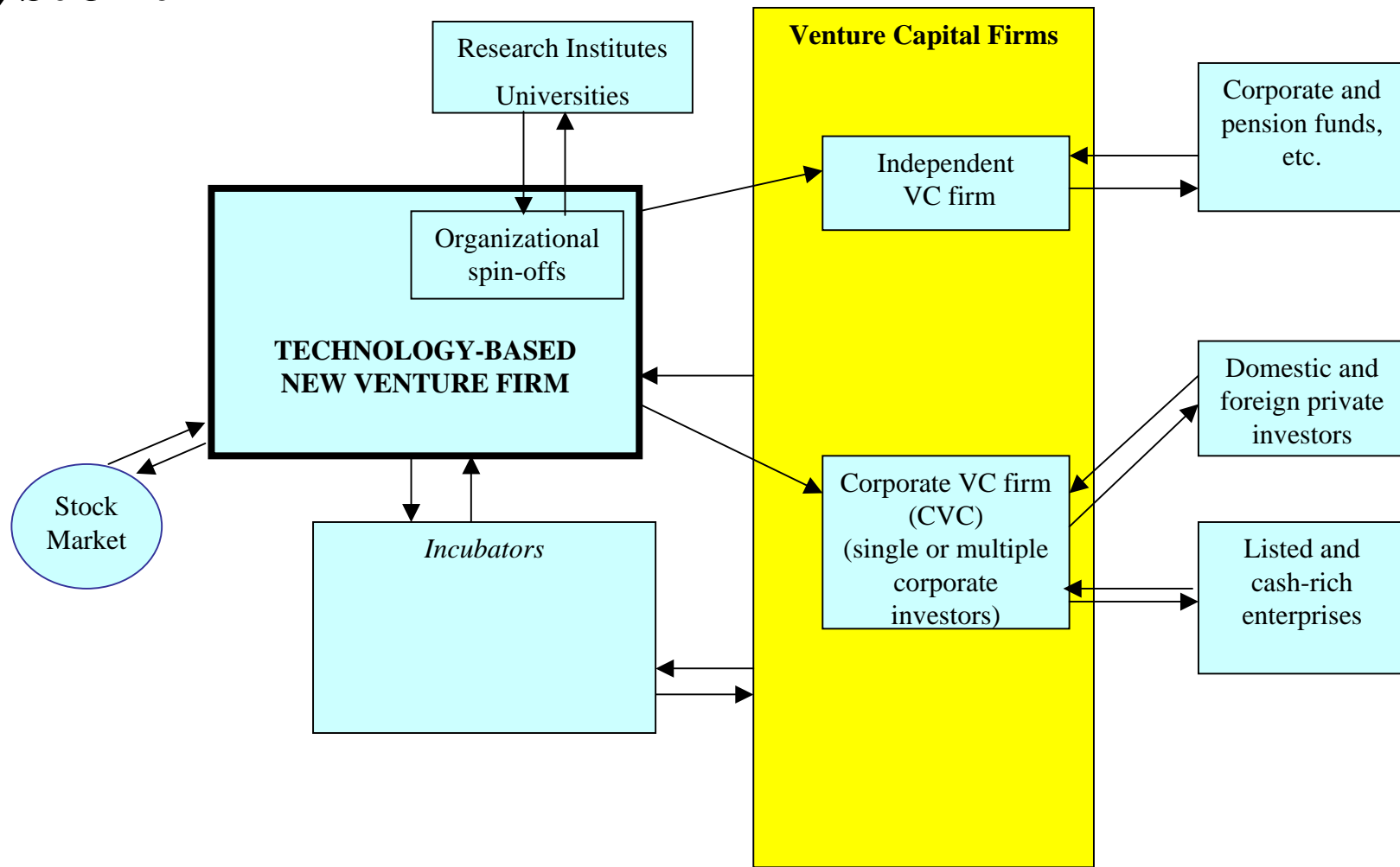
- Lack of a legal definition and protection of ownership over a new venture's assets: clearly inhibits the ability of actors to invest and channel funds to new ventures.*

- **Central government recognized the limitation of current system by mid-1990s.**

Institutionalization of VC system: from mid-1990s

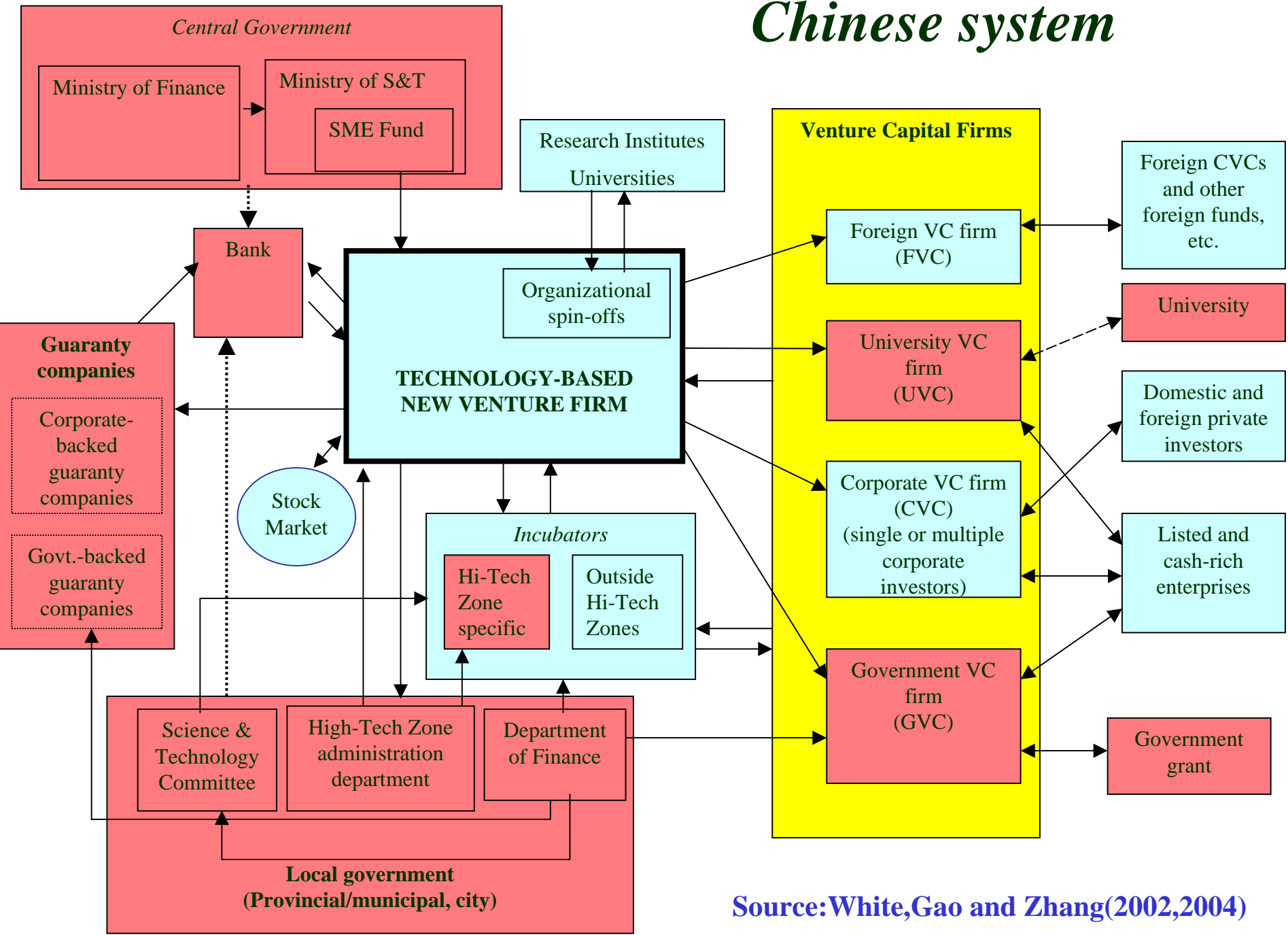
- **Perception change of VC by policymakers:**
From government funding to commercial activity to support the commercialization of new technology.
- **Changes in government involvement in VC activities**
 - ✓ **Central government more focus on:**
 - Policy of decentralization
 - Provide legitimacy to VC as well as private entrepreneurship
 - Create institutional environment conducive to investment in new ventures
 - ✓ **Local governments:**
much more direct role in development of new ventures and supporting infrastructure, including in basic activities of the VC system.

US system



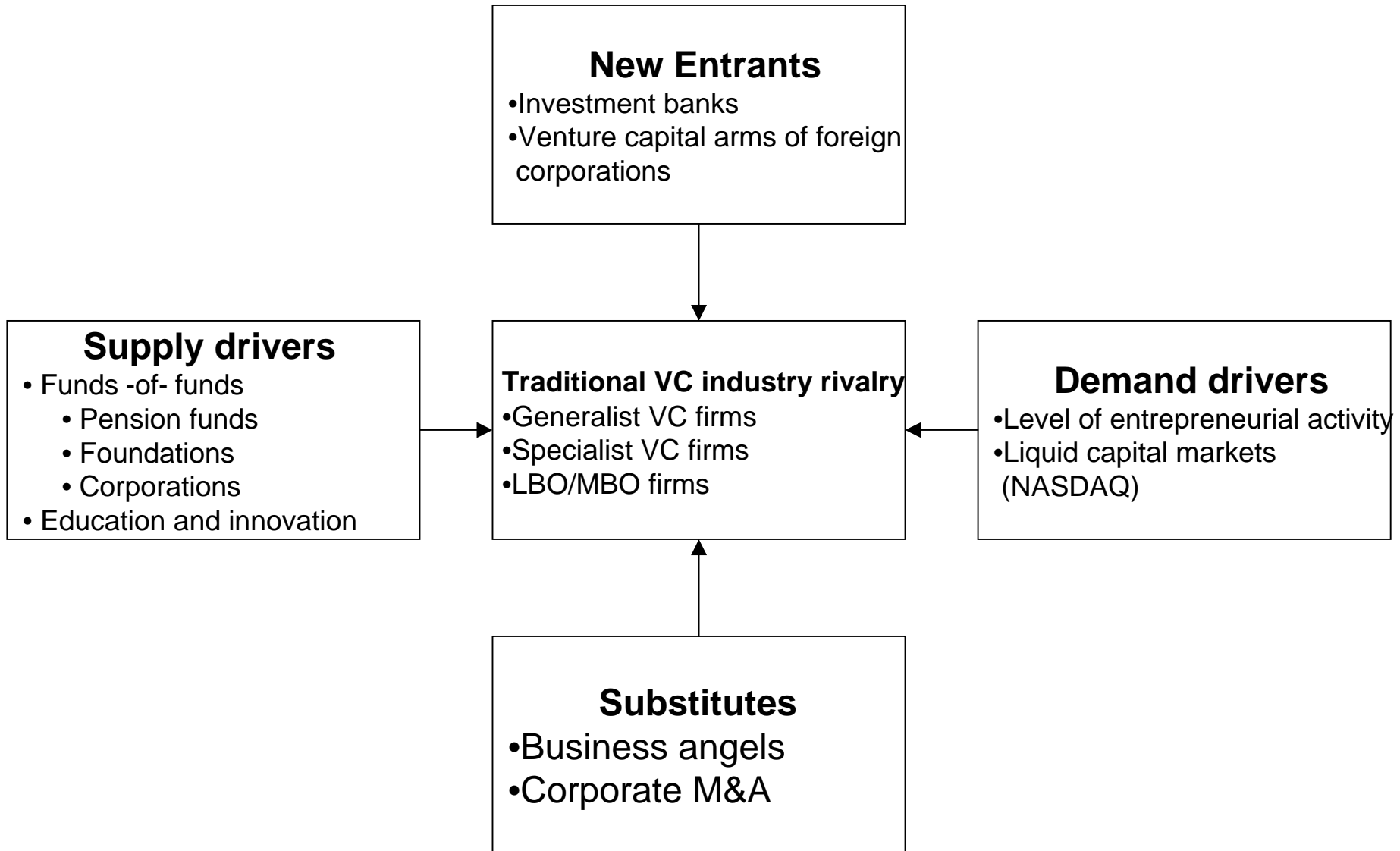
Source: White, Gao and Zhang (2002, 2004)

Chinese system

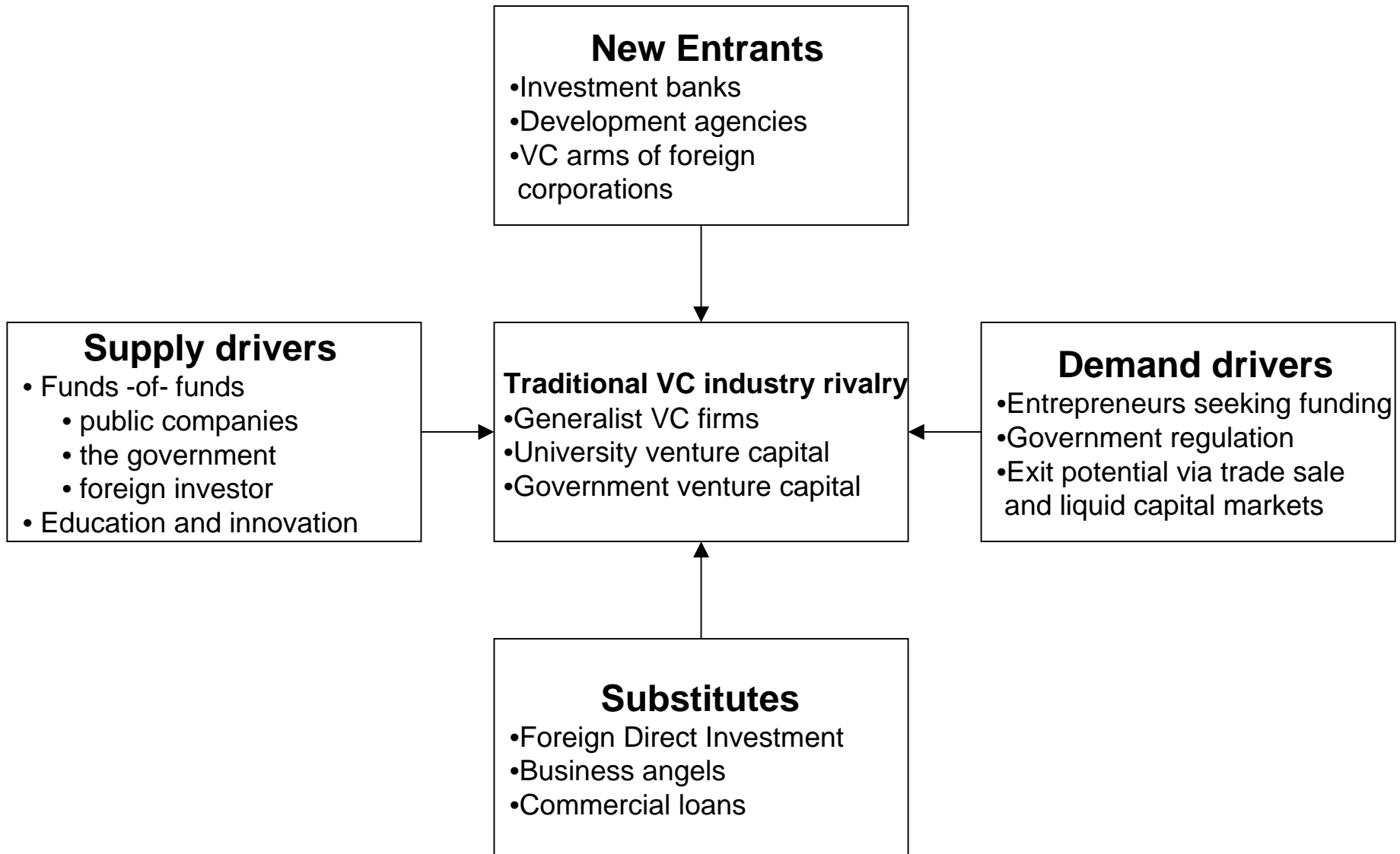


Source: White, Gao and Zhang (2002, 2004)

VC industry structure in U.S.



Market determinants of VC: a China perspective



Typical VC decision making process

Deal Origination

- Initiated deal through business plan sent or referral

Deal Due Diligence

- Analysis based on business plan
- LOI/MOU signed for due diligence
- Company valuation
- Key risks developed and evaluated

Deal Structure

- VC provides initial structure
- Negotiations
- Finalize structure
- Source co-investors where necessary
 - co-investors may perform own evaluation
- Money is funded

Venture Management

- VC participates on the board
- Operationally active on “as needed” basis
- Management contribution could include:
 - arrange financing
 - HRM
 - networking
 - later round investment
- outside expertise

Exit

- Exit via IPO, trade sale, merger

More uncertainty and higher risk in China, while with great opportunities

- **Higher information asymmetry:**
 - ✓ Potentially higher moral hazard of entrepreneur
- **Shortage of experienced entrepreneurs and investors:**
 - ✓ Lack of experience of managing growing enterprise
- **Quickly changing environment:**
 - ✓ Technology application, market, deregulation
- **Broad infrastructure:**
 - ✓ legal framework, the lack of liquid financial markets, et al.

Venture capital infrastructure?

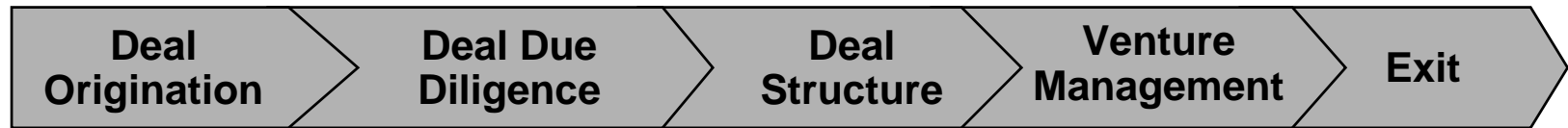
*More uncertainty and higher risk in China,
while with great opportunities*

VC investment in China:

- **More depend on the entrepreneurs than USA**
- **Need better interests aligned**
- **Need good guide, rather than just directly control.**

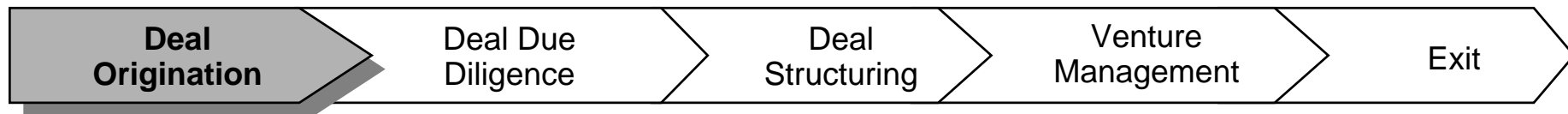
Foreign VC decision making process in China

(Preliminary findings based on the structured interview of 40 VC firms.)



- **From a high level perspective, VCs in China follow the same procedure as in the USA**
- **Chinese market environment poses very different challenges:**
 - Culture, business ethics, and business practices
 - Regulatory and socio-political frameworks
 - Access to and quality of information
 - The breadth/depth of the local networks and contacts
 - Exit paths / liquidity strategies

Deal sourcing and origination in China

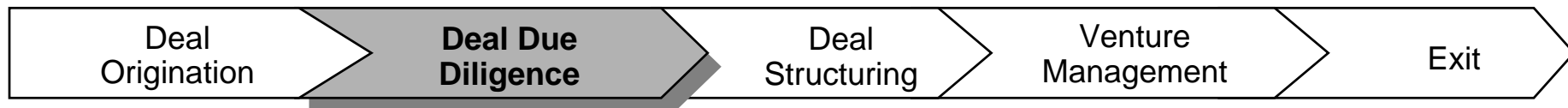


Foreign VCs find it more difficult to source quality dealflow in China

ISSUES AND CHALLENGES	STRATEGIES AND PROCESSES
<ul style="list-style-type: none"> • Network: New entrants in China – limited network of contacts • Reputation: not as strong as in home country > inbound vs outbound deal flow • Risk: Many opportunities too early-stage • Deal size: VC investment sweet spot -hard to find big enough deals • Insights: data and local market research not as good as back home • Trust: choosing intermediaries, agents, and service providers to work with 	<ul style="list-style-type: none"> • Learning by doing: sequential investing. • Team: mix local and foreign professionals • Risk-sharing: partner with a local VC • Network: Develop local network • Primary research: Do your own homework on market opportunities • Proactive targeting: Actively engage in <i>outbound</i> deal hunting. • Government: More important in deal sourcing than in the West, e.g. SOEs

Source: Vega, Chong and Zhang(2004)

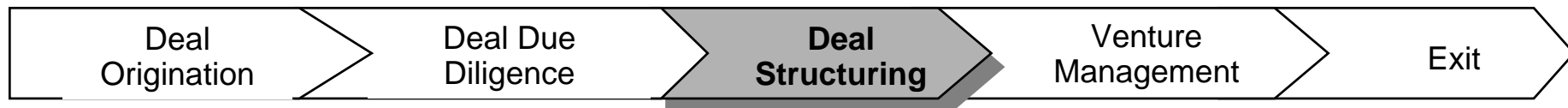
Deal evaluation and due diligence in China



Imperfect information and lack of transparency are challenges in due diligence

ISSUES AND CHALLENGES	STRATEGIES AND PROCESSES
<ul style="list-style-type: none"> • People: Management team risk • Imperfect information: Market potential difficult to quantify, no transparency • Regulatory: Border between legal and illegal not clear. Ownership/property rights issues. Company law. • Third party research: Consultant research output not that reliable / in-depth • Valuation: Existing asset valuation difficult • [...] 	<ul style="list-style-type: none"> • Network: Know the people in the target industry. Check the management teams. • In-house due diligence: <ul style="list-style-type: none"> – Do your own homework – Do not rely on desktop-based DD – Be thorough, triangulate, be rigorous • Be exhaustive: speak to clients, suppliers, colleagues, family, friends • Share risk: <ul style="list-style-type: none"> – Work/partner with a local VC partner – Co-invest to tap into local expertise

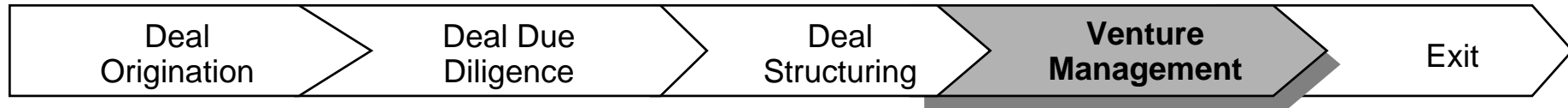
Deal structuring in China



Protecting shareholder interests without a strong legal enforcement regime

ISSUES AND CHALLENGES	STRATEGIES AND PROCESSES
<ul style="list-style-type: none"> • Legal: Cannot rely on the legal enforcement mechanism • Valuation: <ul style="list-style-type: none"> – Lack of public comparables – NPV/DCF not that reliable • Control: <ul style="list-style-type: none"> – Control capital and capex – Shareholder rights / veto rights – Liquidation preference – Maintain leverage post-investment 	<ul style="list-style-type: none"> • Align interests: Give management enough equity to remain interested and committed • Lock-ins and deterrents: <ul style="list-style-type: none"> – capital on tap – technology offshore – foreign domiciling and legal jurisdiction – performance based rewards/penalties – strong guanxi / reputational threats

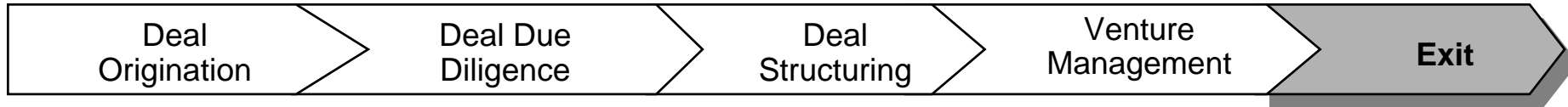
Managing the investment portfolio in China



Adding value and exercising control requires hands-on involvement

ISSUES AND CHALLENGES	STRATEGIES AND PROCESSES
<ul style="list-style-type: none"> • Value add: How to help the portfolio company? • Dispute resolution: How to manage disagreements with management? • Shareholder control: How to exercise influence and veto rights 	<ul style="list-style-type: none"> • Executional value add: Strong emphasis on doing not monitoring. Introduce partners, customers, professionalism • Active monitoring: Be there, be visible • Incentive: keep interests aligned • Operational leverage: <ul style="list-style-type: none"> – capital offshore / release in tranches – control technology transfer/access – legally enforce in foreign jurisdictions – equity / salary penalties – Reputational leverage

Investment exit strategies in China



The path to investment exit in China requires flexibility and patience

ISSUES AND CHALLENGES	STRATEGIES AND PROCESSES
<ul style="list-style-type: none"> • Investment exit unclear: <ul style="list-style-type: none"> – IPO common exit route in the West but not that easy in China – Listing procedure a long and difficult process – Lack of Liquidity, transparency, professionalism, valuation issues – No secondary stock market – No convertability on the capital account. <p>Source: Vega, Chong and Zhang(2004)</p>	<ul style="list-style-type: none"> • Trade sale: preferred option for many, but one must think of potential buyers early on • Foreign listing: <ul style="list-style-type: none"> – NASDAQ – GEMS – remains to be seen if viable – Buy into a HK listed company, backdoor IPO – Australia and Singapore listing • Deregulation: Listing procedures will improve • Professionalization: Foreign-trained experts now entering the managing stock exchanges • MBO: Conditions improving but management often cannot raise capital • Patience: Extended investment horizons

Why several VC firms outperformed others?

Case1: IDGVC

- **Founded in 1992**
- **Mainly investing in China high-tech industries**
 - More 100 investees.
 - Near \$300M total investment.
- **Great success in China**
 - **IPO in Nasdaq:**
Sohu, CTRP, JRJC
 - **IPO in Hong Kong GEM:**
Kingdee, Superdata, hc360, Wu Mart
 - **Impressive M&A:**
eachnet(eBay), 3721(Yahoo!), Guangzhou Bonson(AsiaInfo)

Why several VC firms outperformed others?

Why IDGVC succeed?

- **IDG's long experience in China's emerging market**
- **Good management team**
 - Local knowledge and international experience**
- **Effective investment criteria**
 - **Emphasizing ownership of management team, et al.**
 - **IP Strategy**
 - **Other issues specific related to China market:**
 - effect protection of distribution channels**
- **Well balance between the guiding function and giving entrepreneurs enough operation freedom**
- **Persistence**

Why several VC firms outperformed others?

Case2: Intel Capital

- **Start VC investment in China from about 1998**
- **Mainly investing in IT related industries**
 - **More than 50 investees.**
- **“Great success in China”** (Claude Leglise, VP of *Intel Capital*)
 - **IPO in Nasdaq:**

UTStarcom, AsiaInfo, Sohu

Why several VC firms outperformed others?

Why Intel Capital succeed?

- **Intel's industrial experience in China's emerging market**
- **Good management team**
 - Mixed team of industrial expert and financial expert,**
Combining local knowledge and international experience.
- **Effective investment criteria**
 - **Combine strategic objective and financial objective**
- **Complementary of Intel's market development, China's high growth PC and related industry and manufacturing advantage.**
- **Value-added to the venture through management guiding, industrial network and channels providing, while not too much involving the daily operation.**

VC model with “Chinese characteristics”

- More emphasis on **technology application**, not invention.
- **Huge and growing local market**
 - More **focus on local market** than global markets (but variation by industry and firm)
 - **Distribution channels** becoming more valuable
 - More **cooperation between local and foreign** entrepreneurs and their firms.
- Undertake **sustainable projects**
 - Emphasis on time-to-market, time-to-revenue, time-to-profit.
 - Combination of experienced founders and cooperative management teams increasingly important.
- Even **more collaboration** within Greater China and between Silicon Valley and China.

Challenges ahead: overall challenges

- **Exit through IPO in China remains difficult, even after SME board opened in Shenzhen (May 04).**
- **Domestic VC firms need to improve **skills** and learn from (but not necessarily imitate) foreign VC firms to compete with foreign VCs.**
- **Need to shift **from “high-tech” to “high-growth”** (that’s where the bulk of opportunities are, and the foreign VCs know that).**
- **Other potential issues: IP, legal codes (appropriateness, transparency, enforcement)...**

Challenges by stage

- **Difficult for VCs to raise funds:improved Situation**
 - **Govt restrictions**
 - **Lack successful track record (esp. DVCs)**
- **Difficult to find promising projects**
 - **Small ventures: hard to get committed cash flow**
 - **Larger deals**
 - **If SOE, govt worried about losing state-owned assets (but getting better...)**
 - **If private companies, overestimated valuation**

(Challenges, cont.)

- **Difficulty in management after investment**
 - **Professional managers scarce.**
 - **Difficult to replace founder who is unfit for growing the venture.**

- **Difficult to exit**
 - **High barriers to listing (so far).**
 - **Low trading volume → low liquidity → not attractive to investors.**
 - **Undeveloped M&A market in China.**

China's VC industry has just passed its starting point.

Chang SUN, 2002

**Managing Director of Warburg Pincus Asia,
Founder and First Chairman of CVCA**

China's VC industry is entering the early mature stage, since there have been good cases and successful VC firm samples now.

Wei ZHANG, 2004

Main references

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