

## **TRENDS AND CHALLENGES IN CHINA'S VENTURE CAPITAL MARKETS**

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### **ABSTRACT**

Despite being the world's second largest economy, China accounted for only 7% of global Venture Capital (VC) activities in 2013. In further expanding the industry, China can unleash an engine of creativity and investment. This matters to business and political leaders today because entrepreneurs are critical to China's growth, yet face severe difficulties raising capital. Given China's immature capital markets, a healthy VC industry is particularly essential to the SMEs that drive the economy. VC is currently experiencing a boom in China, but it goes regularly through boom and bust cycles. In this way the industry is failing to achieve its potential. The regulators of China's financial industry should act to improve the stability and dependability of VC investment. From the perspective of the VC firms, there is currently a lot of money on the sidelines. Deploying those funds will make them productive, and allow the general partners to practice their craft and the limited partners to profit from their investments.

*Keywords:* China, Venture Capital, Financial Markets, SMEs

### **INTRODUCTION**

This paper investigates the current state of the Venture Capital (VC) industry in China, highlighting the opportunities and challenges it faces. It identifies changes that are needed to improve the industry's health and outlook, and who should make those changes. It also explores strategies that individual Entrepreneurs and VCs can use to maximize their chances of success.

The issues we examine are important since Chinese VC has huge growth potential. Despite being the world's second largest economy, in 2013 China represented only 7% of global VC activity (EY, 2014). By understanding the constraints on the industry, and by addressing them, China can unleash an engine of creativity and investment. This matters to business and political leaders today because entrepreneurs are critical to China's growth, yet face severe difficulties raising capital.

Small and Medium Enterprises (SMEs) provide over 80% of China's urban jobs. The Ministry of Industry and Information Technology calls them "irreplaceable in boosting economic growth" (Xinhuanet, 2014). Yet they face severe difficulties in raising capital. Most banks in China are state-owned, and 70% of their loans are made to State Owned Enterprises (SOEs). Some have gone unrepaid, and the banking system is "fragile" (Lin, 2012, p. 193). Since the government relies on this system to fund SOEs, the banks offer little support to SMEs.

The market for corporate junk bonds, established in 2012, is still immature. High-profile defaults have dampened enthusiasm for such investments, and borrowing costs are "soaring" (Bloomberg, 2017a). Given the deficiencies in the capital markets, a healthy Venture Capital environment is crucial to the SMEs and the whole economy.

In addition, the sector is prone to boom and bust cycles. Chinese VC is experiencing a boom: Q2 2014 investments were the highest since VentureSource began collecting data in 2006 (Venture Capital Dispatch, 2014). The trend continued into 2016, with PE and VC fundraising reaching an all-time high of \$73Bn. But fundraising and investment are sporadic. It's important to understand and address this instability.

Further, there are gaps in our understanding of the system. As our literature review highlights, there is a limited amount of available research on the VC sector in China. Market data is also limited, with many firms reluctant to share or pool information.

Finally, the business and regulatory environment is changing fast. China's growth trajectory is changing, and so is the China model of economic development. Entrepreneurs can no longer count on 10% GDP growth every year to support their business plans. But some sectors are doing extremely well and producing home runs for investors. VCs should understand those sectors, and how the changing economic and regulatory environment is likely to impact their chances of success.

## **INDUSTRY OVERVIEW**

China's first VC firm, China New Technology Venture Capital Company, was established with government funding in 1985. The industry remained small until legislation in 1998 designed to promote its development was passed (Xiao & Zhou, 2013, p. 75). This was followed in 2005 by central government guidelines directing local governments to support VC with favorable tax treatment, financing assistance, and direct investment (Linton, 2006). VC fundraising took off with those reforms. Growth was further boosted by the establishment of a NASDAQ-like "venture board", known as ChiNext on the Shenzhen stock exchange in 2009. This facilitated local IPOs for Venture-backed firms, and stimulated the development of RMB-based funds (RMB refers to renminbi, the local Chinese currency). Fundraising in the years to 2008 was substantially US dollar based; in subsequent years most funds raised have been in RMB. By 2016, as shown in Figure 1 below, fully 76% of funds raised by VC and PE for Chinese investment were denominated in RMB.

### **Industry Size and Growth: Investments**

VC investment grew steadily until 2011 then declined substantially in 2012. Reasons for the decline include a "policy adjustment storm" warning by CSRC, the China Securities Regulatory Commission (CNSTOCK.com, 2012). This was followed by a sharp reduction in IPO volume and a general decline in share prices (zero2ipo.com.cn, 2012). The market continued to be difficult in 2013, with a complete freeze on domestic IPOs. Given that fundraising and investments declined in lockstep, the funds available for investment changed little during this period and set the stage for the resurgence of activity seen in 2015 and 2016. (See Figure 2 below.)

Figure 1. China PE/VC Fundraising 2012-2016 (PWC, 2017)

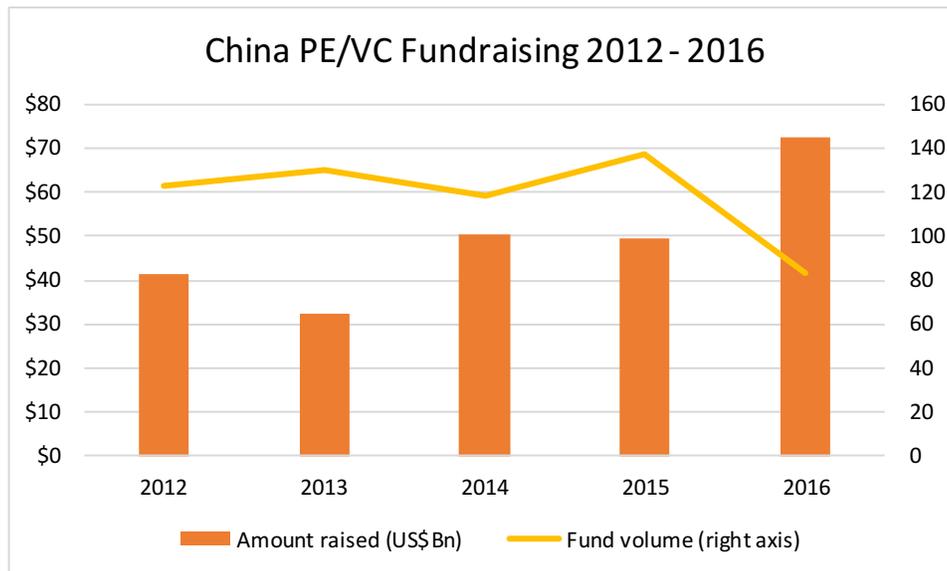
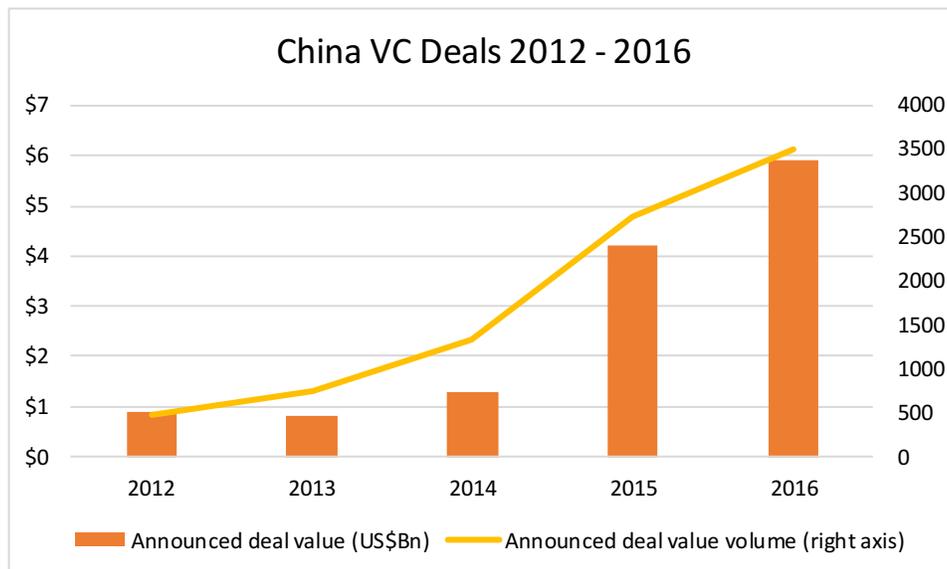


Figure 2. China VC Investments 2012-2016 (PWC, 2017)



### Venture Capital with Chinese Characteristics

Observers familiar with US or European Venture Capital will notice some peculiarities of the Chinese industry. These are summarized below, as they influence the subsequent analysis:

**Fast paced and uneven regulatory change.** The 2012 “policy adjustment storm” and 2013 IPO moratorium are just two examples of the rate of change in regulations as the industry continues to develop.

**A heavy reliance on IPOs:** Most VC exits in China are IPOs. 70% of technology sector exits are through IPOs. By comparison, 90% of US technology exits are M&A (Blank, 2013). With the 2013 IPO moratorium, China M&A exits doubled, but only from 11 to 20 deals (EY, 2014, p. 20).

**Blurring of VC and Private Equity:** In rapidly developing economies, investment opportunities are found in firms at all stages of development. The distinction between VC and PE is blurred, and funds compete in both (Ahlstrom, Bruton, & Yeh, 2007, p. 249).

### Returns: Comparing China and the US

Cambridge Associates supplies the National Venture Capital Association with data on US VC performance. While returns vary widely with time frame and fund, they show that the annualized return over the last 20 years for VC investments was 30% per annum. That figure is a peak, not an average, as seen in Figure 3. But 20 years is an interesting period for comparison, since that's how long the China industry has really been active.

Figure 3. US Venture Capital returns over 1 to 30 Years (Cambridge Associates LLC, 2013).

CA Index	1-Year	3-Year	5-Year	10-Year	15-Year	20-Year	25-Year	30-Year
Cambridge Associates LLC U.S Venture Capital Index®1	8.89	13.52	5.68	7.80	22.79	30.07	19.77	17.06

Comprehensive data is unavailable for China, where disclosure and secrecy standards are very different. But Cambridge Associates does track 45 China VC firms reporting over the last 20 years; this data is available through Thomson One. The reported return for those 20 years is 19.32% (Thomson One, 2014). So while returns in China are lower than in the United States, the industry has generated healthy returns over the last 20 years.

Unfortunately, the China data is less rich and less dependable (small sample size, less certain reporting quality) and it provides limited insight into the performance of the industry.

### Major Players

Table 1 below lists the most active VC industry players in China in 2013 by number of deals. Data is from the Asia Venture Capital Journal (AVCJ, 2014). The table was filtered to exclude those which are not VC firms (e.g. hedge funds). Notes are added to clarify the firms' origins and focus.

Table 1. Major Players in China VC 2013

Name	Nationality	Number of 2013 deals	Notes
Shenzhen Capital Group China	PRC	44	One of the first Chinese PE funds; established by the Shenzhen government to fund innovation
Sequoia Capital	US	26	Founded in 1972, "one of Silicon Valley's most influential VC firms" (Buckman, 2008)

IDG Ventures	US	22	One of the first foreign VCs to enter China in 1992, now manages over \$2.5Bn there.
Matrix Partners	US	18	Chinese arm of the established Palo Alto VC firm with \$350M raised (crunchbase.com, 2014)
Morningside Technologies	HK	16	Established by the Chan HK real-estate family. Active in technology startups.
GGV Capital	US	15	Menlo Park based Expansion Stage VC firm with investments across US and China
CDH Investments Management	PRC	13	VC established in 2002 by the former private equity group of China International Capital Corporation
Qiming Venture Partners	US	12	US invested VC founded by Gary Rieschel, focused on technology investments in early to growth stage
Tencent Collaboration Fund	PRC	10	VC fund established by Tencent, developer of China's QQ IM platform
Gobi Partners	PRC	10	Early stage VC focused on IT; took Tuniu Travel public on NASDAQ in 2014
Temasek Holdings	Sing	10	The Singapore sovereign wealth fund involved in a whole range of VC and PE activities
DCM	US	10	US based fund managing over \$2.5Bn Co-founded by Dixon Doll in 1996.
CBC Capital	PRC	9	Beijing based firm focused on Media and Communications. Manages \$500M and RMB1.4Bn
China Renaissance K2 Ventures	PRC	9	Seed, Early Stage, and Later Stage VC in E-Commerce and mobile applications

## LITERATURE REVIEW

While VC is a global phenomenon, the Chinese industry clearly has Chinese characteristics, which are highlighted in the literature.

### Entrepreneurship in the “China Model” of Economic Development

In their paper, Jiang et al point out the importance of SMEs to China’s economy. They highlight the difficulties that SMEs face raising capital in system dominated by state controlled banks, and find VC’s play “a critical role” in financing SMEs (Jiang, Cai, Keasey, Wright, & Zhang, 2014). Ahlstrom and Ding’s history of entrepreneurship exposes other challenges that China’s institutions pose to entrepreneurs (Ahlstrom & Ding, 2014). Li and Zahra call those institutions “a set of political, economic and contractual rules” that can collectively promote VC investment (Li &

Zahra, 2012, p. 97). Gu and Lu relate those institutions' weakness to the Corporate Governance of SOEs which are owned, regulated, *and* financed by the state (Gu & Lu, 2014).

A related challenge is the prevalence of fraud. Stuart and Wang studied 467 private technology companies and found that over half of them maintained two sets of books. They also found that companies with politically connected founders, and VC invested companies were "much more likely to commit fraud" (Stuart & Wang, 2014).

Unsurprisingly in a planned economy, much of Chinese VC is state-sponsored. Brander et al view government-sponsored venture capital (GVCs) as valuable, enabling enterprises to receive more funding than they would get from private VCs alone (Brander, Du, & Hellmann, 2014). However, the involvement of State-owned banks and institutions is contributing to an oversupply of Private Equity capital (Knowledge@Wharton, 2014).

### **The Challenge of Adding Value in a Chinese Context**

VCS normally add value to their firms through their "human capital". But this does not usually travel well; foreign VCs add little human capital value to Chinese firms (Wang & Wang, 2011). This may be due to the importance of *guanxi*, a network of personal and business relationships. Domestic VCs with political connections can ease the progress of firms to domestic IPOs (Wang, Anderson, & Chi, 2013). Nonetheless, foreign VCs add value in another way -- they are more likely to internationalize their invested firms (Humphery-Jenner & Suchard, 2013).

The value added by foreign *and* domestic VCs is debated: VC backed firms grew at an average of 35% in 2010, much faster than the broad economy (Xiao & Zhou, 2013). But the higher growth, profitability and labor productivity of VC backed firms may simply be evidence of VC selection criteria rather than value added (Guo & Jiang, 2013).

Working with a different dataset, Tan et al concluded that Chinese VCs do not add value in the IPO process, and do not improve operating performance (Tan, Huang, & Lu, 2013). In the most extreme view, Lu et al hold that Chinese VCs exist solely to capture rents from institutions like those described by Ahlstrom and Ding (Lu, Tan, & Huang, 2013).

Lu et al also show that Chinese VCs invest predominantly in "traditional sectors and late-stage deals". Due to the abundance of investment opportunities in emerging markets, the distinction between Venture Capital and Private Equity is blurred (Ahlstrom, Bruton, & Yeh, 2007).

Angel investors are increasing filling the early-stage gap. Li et al review their activities, and show that they also have "Chinese characteristics"; they are not all high net worth individuals, and they tend to spread their investments, taking a less hands-on role than their western counterparts (Li, Jiang, Long, Tang, & Wu, 2013).

### **The China Operations and Strategies of Foreign Firms**

Writing in 2006, Linton described the regulations regarding foreign venture capital investment as "chaotic and changing" (Linton, 2006). It is encouraging to note the progress that has been made

since then, with some easing of capital controls and ownership restrictions. Wei observes that Variable Interested Entities, designed to skirt foreign-ownership rules, represent a kind of “creative compliance” with the regulations (Wei, 2012).

In segmenting the industry, Ahlstrom et al studied foreign firms, government backed firms, Universities, and corporate VCs. With over 500 firms in the market, they felt that valuations had been driven up by “too much money chasing too few deals” (Ahlstrom, Bruton, & Yeh, 2007).

Fuller identifies three different VC profiles and investment strategies in China (Fuller, 2010): (1) “Service oriented, technology light” investment by foreign VC firms; (2) “Technology creation investment” by foreign firms founded by ethnic Chinese; (3) Investment in “state-directed projects” by local state-funded VC firms.

Another characteristic of the Chinese VC process is the preference for IPO exits rather than Strategic Sales. However Humphery-Jenner and Suchard show that foreign VCs tend to prefer M&A exits, possibly due to the extended lock-up periods enforced on VC backed IPO’s (Humphery-Jenner & Suchard, 2013). Restrictions on foreign ownership of companies in “sensitive” industries also inhibit M&A activity.

## **DETERMINING VC MARKET ATTRACTIVENESS**

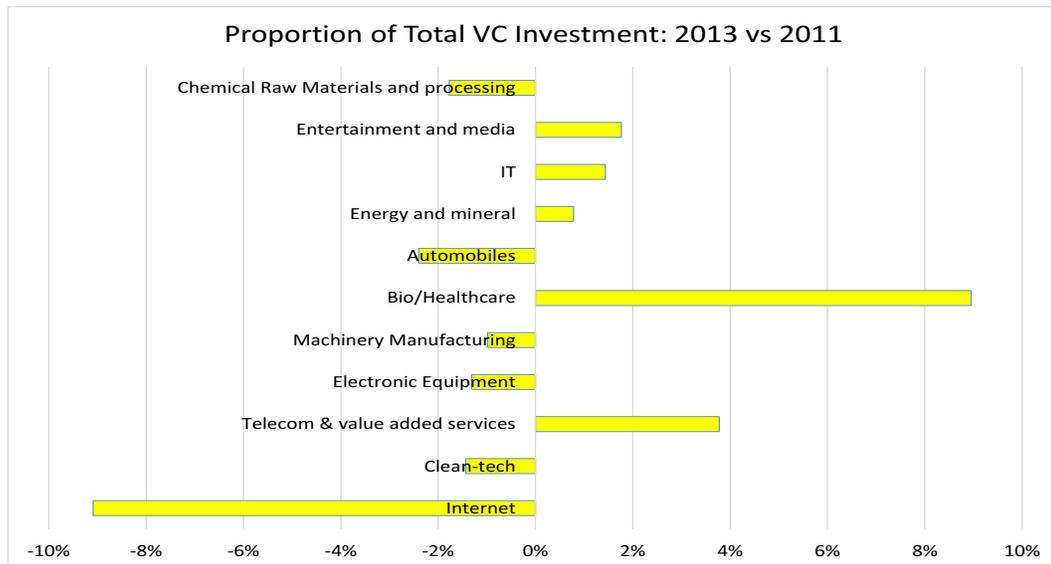
In this section, we use the IESE parameters for VC market attractiveness (Groh, Liechtenstein, & Lieser, 2013) to describe recent changes impacting VC activity in China. This section concludes with a summary of findings.

### **Economic Activity**

GDP growth is slowing from a thirty-year average of 10% to a projected 6.5% in 2017 (Bloomberg, 2017b). This could suggest a reduction of entrepreneurial activity with negative implications for VC. However, the authorities are also trying to rebalance China’s economy. Recognizing that they cannot continue to grow exports forever, the then China’s party Chairman Hu Jintao told the 18<sup>th</sup> Party Congress that “China’s economy must be driven more by domestic demand, especially consumer demand. We should unleash the potential of individual consumption” (Dollar, 2013, p. 3). If successful, this will create new markets for services like travel, healthcare, entertainment and education, all of which can provide VC deal opportunities.

Figure 4 below highlights how these changes are affecting VC investments. The industry segments that accounted for 70% of China VC investment in both 2011 and 2013 are shown in the figure. It shows how the proportion of total investment allocated to each industry changed over those two years. The increase in Biotech and Healthcare from 4% of total investment in 2011 to 13% in 2013 indicates its emerging importance. The decrease in Internet investment may reflect how overheated that market was in 2011 before the bubble burst (Mourdoukoutas, 2011). Smaller increases in Telecoms, value-added services, and Entertainment also reflect growing interest in these sectors as manufacturing declines in importance.

Figure 4. Changes in Proportion of Total VC Investment 2011 to 2013  
 Data: (zero2ipo.com.cn, 2012, 2014)



### Entrepreneurial Culture and Deal Opportunities

Entrepreneurs are crucial to China’s economy, and they have trouble raising capital. VCs are particularly interested in entrepreneurial firms involved in R&D. Such firms may develop Intellectual Property (IP) assets, but lack tangible collateral for raising bank loans.

Government has noted the need to support technology startups, and responded with initiatives including the Technical Innovation Fund for Small and Medium-sized Enterprises. By 2010 there were 720 VC enterprises in the country, and the average fund size was RMB330m (Shen, 2012).

While US R&D spending increased by just 5% from 2008 to 2013, China’s has almost doubled (The global innovation index, 2014, p. 6). The increase was accompanied by a boom in patent applications and Research publications. This created pressure to improve IP protection. The 2013 National IP Strategy is a comprehensive plan to improve the “IP culture”. If implemented fairly, it will enable real value creation through IP development. But the economic impact of all this activity appears limited: China’s Total Factor Productivity has “apparently flatlined” (Li, 2014).

Other indicators of entrepreneurship are also mixed: The relative ease of starting a business in China declined slightly in 2013 while access to credit improved slightly (World Bank, 2014).

A potential concern is the reliance of internet entrepreneurs on the “copy to China” model, imitating Western business models like Amazon, Google, Paypal, and YouTube. These startups have seen significant investment, but “the space is getting really crowded” (Blank, 2013). The attractiveness of Internet investments will improve when this sector becomes more innovative.

## Size and Depth of Capital Markets

The success of Venture Capital depends on robust markets, with healthy IPO and M&A activity.

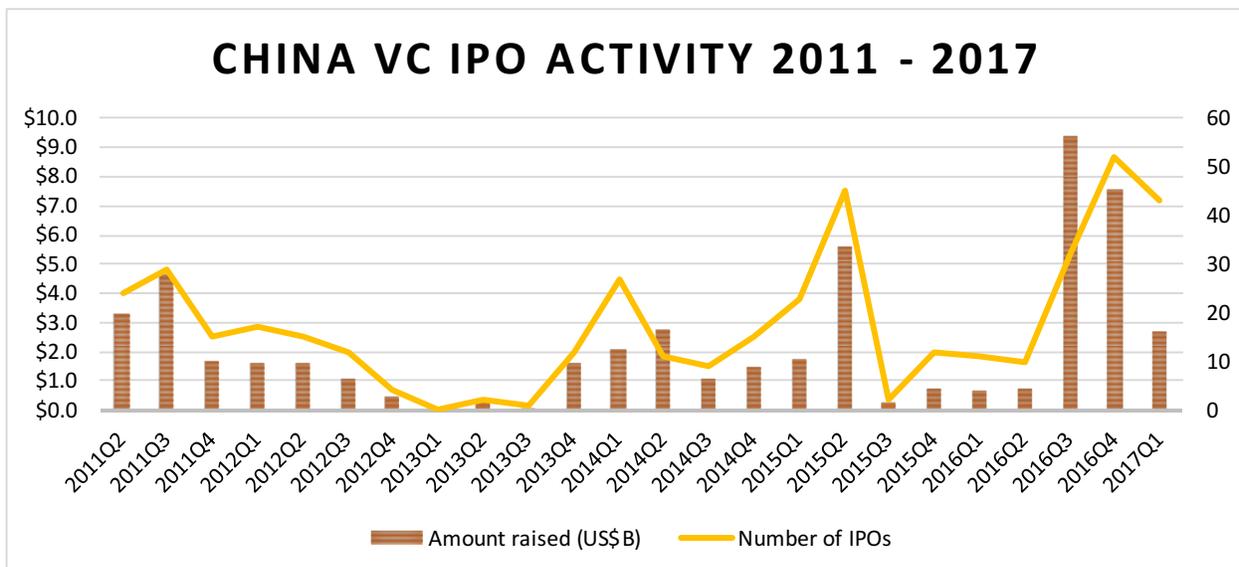
**Equity Markets and IPO activity.** Table 2 compares the Shanghai and Shenzhen stock exchanges with the NYSE and NASDAQ, as well as the Hong Kong Stock Exchange. (Shenzhen includes the ChiNext Board). The Chinese markets are significantly smaller. But a bigger concern is the level of IPO activity: there was an IPO moratorium in China for all of 2013. This was obviously a significant challenge for VC’s planning exits. IPOs on foreign markets continued during this period, but the local exit was closed.

Table 2. Market Size, Depth and Health (World Federation of Exchanges, 2014)

Dec-13 2014	Domestic Market Cap (USD \$M)	Value of share trading (USD \$M)	Number of Listed Companies	IPO's
NYSE	17,949,884	15,308,724	2,371	141
NASDAQ	6,084,968	26,643,654	2,637	117
HKSE	3,100,777	1,447,272	1,643	110
Shanghai SE	2,496,990	3,799,768	953	---
Shenzhen SE	1,452,154	3,938,991	1,536	---

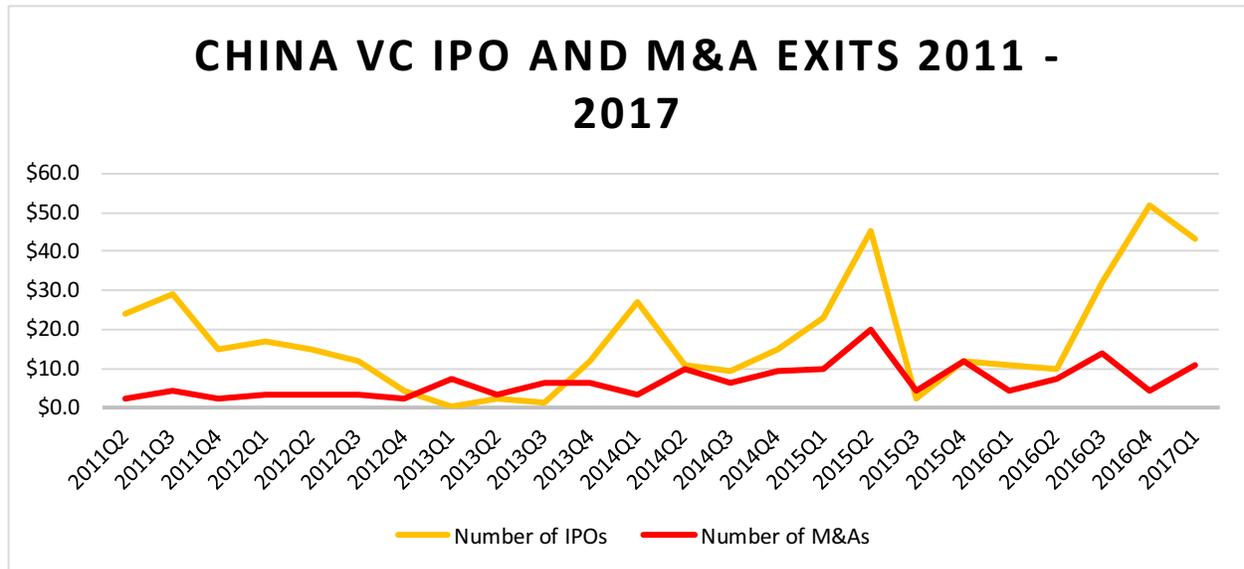
IPO approval resumed in 2014. Figure 5 below illustrates the rebound in IPO activity in the first six months of 2014. IPO activity is still tightly controlled – despite an announced relaxation of listing regulations, there were 676 companies awaiting IPO approval at the end of 2016 (Deng, 2016).

Figure 5. China VC backed IPOs and amount raised 2011-2017 (Dow Jones, 2014, 2017)



Finally, Figure 6 shows that M&A activity increased during the IPO moratorium, and is continuing at historically high levels. But M&A is unlikely to become the dominant VC exit mode given the restrictions on foreign acquisition of Chinese companies.

Figure 6: China IPO and M&A based exits 2011 – 2014 (Dow Jones, 2014, 2017).



**Shanghai Free Trade Zone.** Shanghai's new “FTZ” is expected to permit more capital movement in and out of China, facilitating VC investments. In theory, foreign funds located there can raise up to \$300M in investment capital. The current limit is \$50M. However, the FTZ is new and the “rules remain unclear” (Rabinovitch, 2014).

### Taxation

The taxation regime is critical to encouraging entrepreneurship and fostering a healthy VC market. The most important factor is the taxation incentive to entrepreneurship – the difference between the effective corporate tax rate and that paid by individual earners (Groh, Liechtenstein, & Lieser, 2013).

A September 2013 announcement affects taxation for the 20,000 technology-based startups clustered in Beijing’s Zhongguancun Science Park. Taxes were reduced by up to 15%, and taxes are waived on patent-related income up to 5 million yuan. Tax on patent income above that level will be halved. Personal income tax for investors will also be lowered. According to the State Council, such policies will be “gradually promoted nationwide” (China Daily, 2013). This, and the science park’s September 2013 strategic agreement with the Deutsche Borse to help more Chinese companies list in German stock markets, should have positive implications for VC activity in this segment.

## **Investor Protection and Corporate Governance**

Investor Protection is correlated with healthy capital markets: countries with better Investor Protection develop healthier firms paying higher dividends (Shleifer & Wolfenzon, 2002). Companies which employ professional management, have independent boards, and align executive compensation with shareholder interests have better stock market prospects (Moore, Bell, Filatotchev, & Rasheed, 2012).

Chinese equity markets evolved to meet the Capital-raising needs of SOEs. The state is now the major shareholder and the regulator of these “Public” companies. This is not a positive environment for minority shareholders. It creates severe corporate governance challenges and limits market development (Liu, 2005). Corporate governance concerns are one reason why Chinese IPOs leave money on the table: the average underpricing of IPOs is 247% (Tian, 2011). In November 2013, the Party announced reforms to make China’s economy more market-driven. These include separating CEO positions from political rank, relaxing restrictions on registered capital, and changes intended to encourage foreign companies to open R&D and Financial centers in China (Global Times, 2013). If these changes are implemented, they will have a positive impact on Corporate Governance generally, and VC activity specifically.

Chinese auditing standards also present a corporate governance challenge for VC’s hoping to list their companies in the US. The China units of the Big 4 accounting firms were at one point barred from practicing before the SEC. This was due to a dispute over the firms’ refusal to disclose working papers which they claim are Chinese “state secrets” (Romann & Yang, 2014).

## **Human and Social Environment**

**Education.** Literacy in China is high, and University output is impressive: China currently graduates 900,000 Engineers per year, compared with 80,000 in the US (People's Daily Online, 2014). It is also the world’s top producer of PhDs. But questions have been raised about the quality of all that output, given the drive for quantity (Group of Eight, 2013).

**Labor market rigidity.** China’s *hukou* system prevents the free movement of labor by restricting migrant’s access to jobs and services. The Urbanization Plan for 2014-2020 calls for 100 Million migrant and other urban residents to get full “urbanite status” (China Economic Net, 2014). If successful, these reforms will transform the labor market by 2020. This is potentially very positive for its entrepreneurial sector and VC market.

**Levels of bribery and corruption.** Transparency International rates China business as more corrupt than Western countries. President Xi Jin Ping is driving an anticorruption initiative, in the belief that corruption is corrosive not only to business, but to the Party’s ability to hold power. Senior Party officials have been expelled for taking bribes. Anecdotal reports suggest that bribe taking and corrupt deals have been severely reduced.

**Is the market attractive?** Based on the above analysis, we can make the following observations: The industry has produced reasonable returns in the last 20 years. With GDP growth rates slowing, and an uncertain economy, VC is losing some of its attractiveness. But the “rebalanced” economy

will create investment opportunities in industries serving domestic consumption. The internet industry needs to move on from the “copy to China” model. But other technology sectors, including Telecommunications, Media, and Mobile applications will continue to grow. As the 911 Wireless Case in the Appendix shows, these sectors are increasingly open to M&A exits by VCs.

IPOs have resumed on Chinese exchanges, reopening another viable VC exit path. New tax initiatives will spur entrepreneurial activity, and the anticorruption drive may level the playing field for deal makers. So we conclude that the market is still attractive to VC’s who can navigate the changes identified in the analysis.

## CONCLUSIONS AND RECOMMENDATIONS

Given China’s immature capital markets, a healthy VC industry is essential to the SMEs that drive the economy. VC is currently experiencing a boom, but it goes regularly through boom and bust cycles. In this way it is failing to achieve its potential. The regulators of China’s financial industry should act to improve the stability and dependability of VC investment. From the perspective of the VC firms, there is currently a lot of money on the sidelines. Deploying those funds will make them productive, and allow the general partners to practice their craft and the limited partners to profit from their investments.

So what steps should be taken to address the challenges identified? Below is a list of our recommendations.

- (i) Build a more predictable IPO process to end the Boom and Bust cycle.

CSRC currently controls the number of IPOs allowed in a given year. It has announced new policies that would allow market forces to set IPO prices and determine timing. But at the time of writing there are hundreds of firms awaiting approval.

- (ii) Valuations are driven up by too much money chasing too few deals.

The state should reduce its role in VC and Private Equity. It is claimed that the industry in China has too many inexperienced players who contribute to over-valuations (Knowledge@Wharton, 2014). The industry should be allowed to consolidate along market lines.

- (iii) Improve disclosure regulations and enforcement to reduce underpricing of IPOs

Underpricing is associated with information asymmetry; investors can’t make a fair assessment of a company’s value. China’s weak disclosure regime reinforces this. CSRC should mandate better disclosure and prevent public companies from hiding behind secrecy laws. Ultimately, China and the US should harmonize their disclosure regimes. This would defuse the situation where the Big 4 accounting firms are unable to certify the finances of Chinese companies listed in the US. It would also allow for the collection of better data on the VC industry.

- (iv) Remove some of the impediments to M&A activity.

Foreigners are prohibited from investing in “sensitive” industries, including energy, technology, and value-added telecommunications (Shi, 2014, p. 1265). While workarounds have been found, including the VIE structure employed by Alibaba and others, a less restrictive M&A environment would facilitate the development of these industries with Venture Capital.

The regulatory changes described above are necessary, but they will take time. Some of them, like the harmonization of disclosure rules, may never come about. In the meantime, there are specific things that investors and entrepreneurs can do to improve their chances of success:

(i) Adjust to the changing China Model

As the economy rebalances, domestic consumption of goods and services will begin to dominate. VCs should seek investment opportunities in the industries described in Section IV above, and downplay manufacturing and related sectors. Telecommunications, Media and Technology (TMT) all appear to have growth potential, particularly as they advance beyond the old “copy to China” model. With the BATS on an acquisition spree, this sector is increasingly promising for trade sale exits.

(ii) Play to the strengths of the VC model

By emphasizing the value that they add to target firms, experienced VC firms can differentiate themselves in a market which appears to be awash in capital and inexperienced investors.

(iii) Improve Corporate Governance before the regulators do

Corporate Governance and Investor protection are positively correlated with firm valuation. Entrepreneurs can make their firms more attractive to investors by implementing good governance: professional managers replacing founders, independent boards providing strategic guidance, and compensation schemes which align management interests with shareholders.

By taking the steps outlined above, both VCs and investors can maximize their chances of success in the dynamic world that is Chinese Venture Capital. In the Appendix below, we briefly examine a recent VC deal in the technology sector to illustrate the key trends in China’s VC industry.

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## APPENDIX

### THE CASE OF THE SALE OF 91 WIRELESS TO BAIDU IN 2103

There are three key trends in the technology VC sector in China right now.

- (i) Technology Firms are increasingly valuable as IP protection improves.
- (ii) Trade Sales are becoming a viable exit strategy.
- (iii) As the internet sector matures, buyers will value firms that have users and revenue.

#### **Background to the Deal**

Baidu has been China's dominant search engine since Google exited the market in 2010. Baidu built its lead in pc-based search, but the internet is going mobile. In 2014 China had 632 million internet users, of whom 83% were mobile users (Reuters, 2014). Baidu has difficulty winning mobile customers, and its business model has not translated well to the mobile space (Mozur, 2013).

Most Chinese cellphones use Google's Android platform, but access to the Google Play app store has been difficult since Google's departure. Instead, apps are downloaded from several competing third party stores. 91 Wireless is one of the largest, with 200 million users and around 100,000 developers offering 900,000 apps. The company had 2012 revenue of 280 million yuan and projected 2013 profits of over 6 million yuan (Xiang, 2013).

In 2013, 91 Wireless was owned by HK-listed NetDragon Websoft, with minority investments by VC firms IDG, Temasek, and Pacific Century. In April 2013 Dragonsoft announced its intention to spin-off 91 Wireless through an IPO in HK (CaixinOnline, 2013).

#### **The Transaction**

In July 2013 the HK listing was abandoned when Baidu agreed to buy Dragonsoft's holding. The price valued 91 Wireless at \$1.85 Billion. Baidu offered the same terms to all other shareholders. IDG Ventures owned 10.39% and IDG founding partner Hugo Shong described it as "his happiest moment" that year (Lee, 2014).

In a 2011 Series B funding round, 91 Wireless Company had been valued at \$140 Million (Xiang, 2013). The \$1.85 Billion valuation was therefore much discussed. One analyst observed that Baidu had limited choices, given how late it came to the mobile market (Xinhua, 2013). Baidu's CEO Robin Li had previously announced that it preferred "buy to build, because that will save us time" in developing its mobile offering (Chen, 2013).

## **Implications**

M&A is becoming more prevalent in China's tech sector. Firms wanting another company's technology previously found it "much easier to just steal their ideas and hire their employees" (Blank, 2013). A combination of improved IP protection and a sense of urgency around market penetration is changing that dynamic. From 2002 to 2010, China's BATS (Baidu, Alibaba, Tencent, and Sina) spent just \$800 million on acquisitions. Since 2010 they have spent over \$6.5 billion (Borroughs, 2013).

The fact that Dragonsoft chose the trade sale over an IPO, and at a rewarding valuation, is also a counter-trend. Previous VC exits in the tech sector were overwhelmingly by IPO.

While this was China's biggest domestic Internet transaction at the time, it may not hold the record for long. Alibaba announced in June 2014 that it intends to complete its acquisition of mobile browser developer UCWeb. It claims "this will create the biggest merger in the history of China's Internet" (Clover, 2014). VCs invested in technology firms can clearly target buyers with deep pockets for strategic sales.

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