Venture Capital and Private Equity in China: Structure, Process and Performance

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Prof. Ernst Mohr, PhD
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Abstract

The goal of this study was to obtain preliminary conclusions on factors contributing to the success of venture investments in China. The nature of industry structure and investment process was related in an exploratory fashion to the first set available of performance data of venture capital companies and funds in China. A survey of 20 venture capital funds and industry experts was conducted. For performance information a survey by the China Venture Capital Association and Zero2IPO was used. Six short case vignettes were developed to corroborate findings. The results of the study demonstrate the overwhelming influence the hard and soft dimensions of the Chinese setting have in determining both structure and process as well as, indirectly, performance. Hard factors including the legal and regulatory framework largely determine the structure of the industry. Domestic venture firms are by and large limited to exiting their investments by way of public offerings in China. Foreign funds use the Hong Kong or New York stock exchanges. Process is examined in terms of the investment cycle concept of fundraising, investing and exiting. Hard factors limit choices in fundraising and exiting with the net effect that foreign venture funds raise capital and exit their investments outside China while domestic firms stay inside China. Soft factors play a key role in the investment phase. In addition to the pervasive nature of intertwined business and social relationships in Chinese business, three deal-related complications were identified: Information inefficiencies, unawareness of mutual expectations, and the relative lack of management experienced in private industry. Performance data, the sample being of necessity limited due to the nascent nature of the industry, permit some early conclusions. Foreign funds clearly show higher returns than domestic venture firms, pointing to the notion that the latter are still learning the trade and that a regulatory straightjacket is not conducive to superior performance. More than half the foreign funds generated an IRR exceeding 20%. This shows that mastering a complex environment is possible by combining local know-how and foreign investment professionalism. The Chinese context, in terms of strong government control and engrained cultural peculiarities, significantly distorts the investment cycle for both domestic and foreign venture investors and stifles the growth of the industry. On a broader scale, deregulation would accelerate the positive contribution a vigorous venture industry could make to the nation’s technological development.
1. INTRODUCTION

1.1 Venture Capital in China: Filling the Gap

The rationale for this research was to attempt to fill a gap for investors in venture capital in China. As of yet there is no plausible answer to the fundamental question of which factors make for a successful venture investment in China. Given that the industry in China is still relatively young and also given a corresponding paucity of systematic studies and data, in particular on performance to date, this is an ambitious undertaking. Additional research is certainly needed to provide ultimate answers. This study, however, adds some pieces to the puzzle by deepening our understanding of structure and investment process in the industry and by analyzing the first set of –admittedly crude- data on financial returns achieved. Clearly China is a transitional economy – the world’s largest – and it seems useful to improve our understanding of the roadblocks in the path of venture capital, and whether they are primarily institutional or cultural or both.

The generally accepted wisdom is that providing an efficient set of parameters for venture capital leads to strength in innovation. The emergence of numerous successful high-tech companies in the U.S., such as Google and Yahoo, is a case in point. China has the desire to go beyond creating ‘copycat’ companies applying American business models to the Chinese market. The country aspires to be technological leader in certain sectors such as electric cars but is still in the process of creating the institutional framework needed to provide the incentives to make this happen. The benefits of an efficient system of supplying capital to promising nascent companies generally seem to outweigh the costs, as the emergence of a successful venture capital industry in the large market economies has shown. Costs and
benefits accrue to all three parties involved, donors and recipients of capital as well as
government policymakers.

First, investors providing risk capital have the opportunity to earn above-average returns.
Institutional and wealthy private investors put up capital for funds whose managers will, in
turn, select and invest in generally small, unlisted firms with high growth potential. The fund
has a limited life, usually ten years, in which investments must be made and sold. Investors
expect, as mentioned above, above-average returns over this time span. The costs to them are
related to the high risk they are incurring. Under this high-risk-high-return scenario investors
generally put only a small proportion of their total portfolio into what is known as ‘alternative
assets’. The less-risk-less-return conventional alternatives are stocks and bonds. This is the
perspective adopted for this study – a foreign fund investing in China.

Second, to the entrepreneur in need of funds to start or expand his business, venture capital
funds provide a source of capital. Previously in China, for private companies, this was largely
limited to savings of and loans provided by family and friends. In addition to capital, fund
investors often provide supplementary benefits in the form of management and governance
expertise, access to customers abroad and suppliers, and banking contacts. In China the main
target groups for foreign funds are private companies, often starved of capital by government-
controlled banks, as well as foreign-invested companies (Show us the Money 2003). Parts of
state-owned enterprises in the process of being broken up tend to be less dynamic and, hence,
are less popular. To the entrepreneur, the cost side of the equation is largely related to control.
In order to keep owner/entrepreneurs motivated most funds are content with a minority stake
in the company. However, while leaving operational control to the owners, investors are
typically represented on the board of directors, usually with veto powers on strategic decisions.

Third, the government and its regulatory agencies provide the framework for a venture capital system. The Chinese government has clearly realized that venture capital plays an important role in stimulating technological advances and job creation. This fits in well with the overall objective of becoming not only manufacturer to the world but also of upgrading China’s technological base. With this in mind the government has created numerous domestic venture capital companies, usually under the umbrella of provincial or local government, large state-controlled companies, as well as universities. On the whole, these seem to serve strategic, political rather than commercial ends, are less well managed than their foreign counterparts, and lag in performance. Foreign capital dominates the Chinese venture capital industry. Foreign funds have had some remarkable, highly profitable successes, such as investing early in internet companies like Baidu and Alibaba and subsequently taking these companies public. However, they have had to contend with a regulatory framework that has matured somewhat during the last five years but remains a far cry from providing the favorable conditions prevailing in the West. Regulations appear to be still experimental and do not yet provide a large welcome mat.

Clearly venture capital in China needs further study. The rise and structure of the venture capital industry in China is not well documented. While numerous studies cover venture capital in the U.S. and Europe academic research on China is scarce. The most comprehensive effort to date is Vega’s St. Gallen dissertation on venture capital investment processes in China (Vega 2004). His exploratory work provides the foundation on which this study is based. The dearth of academic literature on the subject points to the need for further research
to improve our knowledge of how venture capital is put to work in China and what makes some structural elements as well as processes uniquely Chinese. Coupled with some initial performance data this study should provide navigational aids for foreign and domestic venture capital companies and guidance for government regulators.

1.2 Research Objectives and Research Questions

Against the backdrop of an industry in full evolution, insufficiently studied in a systematic fashion, the objectives of this effort are twofold:

(1) To deepen our understanding of both the structure of the venture capital industry in China and the nature of the investment process in the light of recent developments. The study refines and updates the work of Vega.

(2) To analyze the first set of performance data ever derived on Chinese companies financed with venture capital. These data on the investment performance of 108 companies will be related to facets of the structure and process studied. This analysis serves to highlight, initially still in crude form due to data limitations, success factors critical for both investors and regulators.

Given this orientation and attendant data-gathering effort my research questions could be distilled. They focus on three areas:

First, what is the current structure of the venture capital industry in China and what are the implications of that structure for investors? We need to become fully aware of the nature and evolution of government rules and regulations in order to understand the context in which venture capital companies and funds operate in China. We need to shed light on the
discrepancy between the setting for domestic and foreign investors. Here we examine ‘hard’ factors, the regulatory framework.

Second, what, if anything, is specifically Chinese about the venture capital investment process? There are different schools of thought spanning the spectrum from ‘the process is universal, numbers are numbers’ to ‘the process is local, numbers must be seen in perspective’. Here we examine ‘soft’ factors and look at how Chinese culture and customs come into play.

Third, what conclusions do available performance data permit in regard to structure and process? This is clearly a question of crucial importance to all parties involved in the venture capital industry as the answers have a normative character. Here we will make an effort to interpret the first set of performance data ever collected and discern some initial, rudimentary patterns. This effort is highly exploratory due to the limitations of the data obtained but it is a first step in the direction of developing a set of success factors. Further research will be needed to provide more complete answers.

This study is structured as follows: Initially we will provide some theoretical underpinnings for the study by surveying the literature on institutional theory as it relates to the venture industry. This survey will be tempered by my own professional experience in the area. Then, in order to answer the three central questions, we will proceed in phases. First we will look, in summary form, at the structure of the venture capital industry in Western economies and at the mechanics of venture capital investing, delineating the sequential steps followed by all investors. This overview highlights that a clearly defined, transparent regulatory environment creates the climate necessary for a dynamic, successful venture industry. We then move to
contrast the Western picture with research findings on China, again at structure and process
level. Mini-case studies will illustrate different aspects of the approach used by investors in
China. This comparison paves the way for conclusions regarding major differences between
the Western model and the current state of the evolving Chinese model. These conclusions are
enriched by information on 108 exits, and the attendant returns, of venture-backed Chinese
firms. The emphasis throughout is on the influence of the respective settings, both in
institutional and cultural terms.

1.3 Relevance of Study

Overall, this study aims to give additional contours to the map of the venture capital industry
in China and fill, at least partially, a knowledge gap. As mentioned, there is a paucity of
scholarly work in the area. Determining what is uniquely Chinese about structure and process
of venture capital, coupled with initial evidence on performance, has great practical
importance for the three major parties involved: Investors, entrepreneurs and government
regulators. As several billion US dollars in capital, mostly from foreign investors, are
available for venture financing in China at the time of writing, the stakes are high.

The Chinese government needs a coherent policy on venture capital. Measures so far have
been haphazard. Hopefully this study will provide elements on which to base a sounder
regulatory framework than is in place at present. Unfortunately, the reform of the Chinese
financial system, in particular the possibility for foreign venture investors (and their Chinese
partners) to exit on the domestic stock exchanges of Shanghai and Shenzhen and the
convertibility of the yuan, plays a key part in this policy overhaul. This will take time.
For investors, both domestic and foreign, and for their local entrepreneur partners, the study hopes to provide a deeper, more systematic understanding of the environment they operate in and the major pitfalls to avoid. For foreign venture capital funds a more profound knowledge of both structure and process is valuable in terms of dealing with both regulatory agencies and entrepreneurs. Preliminary performance figures show the general direction to follow.

A general caveat is in order: What makes an analysis of venture capital in China a true challenge is that the Chinese setting is evolving, both in terms of institutional and cultural characteristics. The transition to a market economy, albeit with a strong role for the State, carries with it frequent changes in regulations. Also, the dramatically increasing interchange with the West leads to gradual cultural changes, although some of these may be superficial. Given these dynamics, any study can only present the state of the art at the time of writing. The puzzle remains unfinished but more pieces have been added.

1.4 Definitions of Venture Capital and Private Equity

Before we launch into an analysis of Western and Chinese settings, we need to clarify what we mean by ‘venture capital’ and ‘private equity’. There appears to be substantial semantic confusion. Ewing (2004) captures succinctly the consensus definition among practitioners:

‘Private equity’ refers to privately transacted equity investments in firms, typically small, growing companies. Private equity investments cover a wide range of deals and include seed, expansion, and pre-offering financing rounds. It also includes buyouts and turnaround investments. While private equity encompasses all of these transactions, venture capital only refers to funding provided in early stages. High risks and large potential rewards define VC deals. For each successful investment there are many failures.

Generally, ‘private equity’ is an umbrella term used for all manner of investments in unlisted firms. Confusingly, over the last few years the term has been used by practitioners.
increasingly to refer to all non-venture capital investments. ‘Venture capital’ typically refers to risky investments in small firms, often start-ups, with a business concept that promises high growth potential. The French ‘capital-risque’ comes probably closest to the true meaning.

However, we must add the caveat that private equity and venture capital are often used interchangeably, both in practice and in the literature. The delineation between the two is somewhat fluid and it is difficult to ascertain the difference between a late-stage venture capital investment in a maturing company and a private equity investment in an established firm. Rather than size, stage of development is the differentiating factor. Venture capital is clearly directed towards start-ups and companies in the early stages of their life cycle, usually (but not exclusively) in high-technology sectors such as internet services, mobile telecommunications, and biotechnology. As these typically go through successive rounds of financing venture capital tends to be invested in phases. The motivation for the investor is to identify and invest in the next Yahoo, Amazon, E-Bay or Google. Private equity funds are oriented towards more mature companies, usually (but not exclusively) in traditional sectors. The idea behind these investments is mostly to unlock unrealized gains, such as a brewery’s downtown real estate carried at decades-old cost.

In China both types of investment can be found, although the high-technology sector has attracted funds more than traditional industries. ‘Copycat’ companies adapting American high-tech business models, such as online search engines and internet travel agencies, to the Chinese market have turned out to be spectacularly profitable investments for venture capital funds. But there have also been high returns in less glamorous industries, such as dairy products and specialty retailing.
I will use the term ‘venture capital’ throughout but differentiate late-stage investments by calling them ‘private equity’ when appropriate.

1.4.1 The mechanics of venture capital investing

It is also important to understand the basic mechanics of the private equity industry. Investments are typically made by funds. These funds raise capital from institutional investors such as government and corporate pension funds, insurance companies, and endowments, as well as from high net worth private investors. In addition, investment banks such as Goldman Sachs and J P Morgan, corporations such as Intel or Siemens, and -- for developing markets -- governments such as Singapore and multilateral institutions such as the Asian Development Bank (ADB) or the World Bank’s International Finance Corporation (IFC) also set up their own funds or invest alongside other private equity funds. Funds also frequently co-invest in the same company to spread the risk.

The structures of these funds are often highly complex, with prime considerations for the investors being tax and compensation issues. In order to avoid taxes most funds are registered in tax havens, with low or no taxation. The Cayman Islands and the British Virgin Islands are two such popular domiciles. Private equity funds are typically ‘closed’, meaning they have a life limited to 10 or 12 years. The average holding period per investment is three to five years so that a lack of exits for a prolonged period puts substantial pressure on the fund management team. Given the long time horizon, these funds are largely illiquid and tend to attract only investors with a long-term perspective. After or during this period, profits, if any, are paid out to both investors and the fund’s managers. The fund managers typically receive an annual management fee of 2% of the capital invested and a 20% share of the profits,
referred to as ‘carried interest’ or ‘carry’, from selling the fund’s portfolio companies. As fund management teams are typically quite small – 30% of funds in the Asia Pacific region have less than 10 professionals - the upside reward potential for individual fund managers is substantial (Show us the Money 2003). Many have become very wealthy and investors in funds in their own right.

The selection of companies and entrepreneurs to support is a core element of private equity investing. Typically funds demand a significant amount, though usually not majority, of equity ownership and control, the latter usually being accomplished by appointing board members. These bring credibility, experience, and contacts to the portfolio company. The final stage of a private equity fund’s involvement is the management of its exit from the investment, primarily by way of listing the company on a stock exchange, by selling out to a strategic investor or to the management of the company. These exit strategies are referred to, respectively, as initial public offering or IPO, trade sale and management buyout (MBO). The returns derived from successful exits, or the lack thereof, are obviously critical to the fund’s success and subsequent raising of fresh capital for a new fund.
2. THEORETICAL UNDERPINNINGS: THE IMPORTANCE OF SETTINGS FOR STRUCTURE, PROCESS AND PERFORMANCE

In line with the dramatic growth of the industry academic literature on the field has also appeared but for the most part limited to the American and European environment. Relatively little has been written on the equally dramatic rise of the industry in China. On theory-building regarding venture capital and private equity in general, let alone for China, there is a marked paucity of literature. In this chapter we will review the literature available on institutional theory as it relates to both Western and Chinese settings and the differences between the two.

2.1 Institutional Theory and Venture Capital

Before reviewing the literature on the subject some general comments are necessary on the availability of academic studies. In line with the growing importance of venture capital and private equity investments a growing body of academic studies on the subject has appeared in recent years, enriched by a vast array of journalistic and practitioner accounts. Sorting through hundreds of the latter to find nuggets of information useful for this study turned out to be a truly daunting task. In particular, for the Chinese setting there are hundreds of news items but only a very small number of academic articles. This picture highlights the need for a study such as the one presented here.

2.1.1 Academic Literature and Trade Press

The academic literature on the subject of venture capital and private equity that has appeared in recent years tends to be relatively specialized. Two academic journals devoted entirely to
the area, *Venture Capital: An International Journal of Entrepreneurial Finance*, and the *Journal of Private Equity*, were established in 1999 and 1997, respectively. Numerous technical articles on the subject have appeared in finance journals, such as the *Journal of Finance*, the *Journal of Financial Economics*, and the *Quarterly Journal of Economics*. Virtually all these journal articles deal with specific operational aspects of private equity, such as profitability (Reyes 2000, Doran 2000, Brav & Gompers 1997, Ritter 1991); valuation (Bartlett 2000, The Pricing of Successful Venture-Backed Companies 2000, Gompers & Lerner 2000); and legal issues (Kaplan & Schoar 2005, Cole & Sokol 2000). The perspective adopted is, in the vast majority of cases, that of the investor and of the Western setting. The only effort, to the author’s knowledge, to cast a wider net—to develop an analytical framework but not to develop theory— is Lerner’s ‘private equity cycle’ to examine processes in the private equity industry, which has grown out of his courses at the Harvard Business School (Lerner et al. 2005). This will be discussed in greater detail later in Section 2.3 on Process.

A multitude of trade magazines, newsletters, and conference proceedings provide news items, statistics and ‘war stories’, or small case studies, of individual funds’ experiences supplement the academic literature. Leading in the US are *Private Equity Week, Private Equity Analyst, Venture Capital Journal* and *Venture Capital Analyst*; in Europe *European Venture Capital Journal* and *Private Equity Europe*; and in Asia *Asian Venture Capital Journal* and *Asian Private Equity Review*.

In addition to traditional printed sources of information a plethora of internet websites providing news on venture capital and private equity have sprung up in the last few years. Most are U.S.-based but some cover international markets as well. The larger ones include *vcaonline.com, venturecapitalreporter.com, vcgate.com, venturebeat.com, penews.com, and...*
altassets.com. Some specialize in industries, such as redherring.com for technology. A site focusing entirely on China is chinaventurenews.com. These are supplemented by blogs of individual industry participants and commentators. It should be noted that these websites, for the most part, provide only news items on individual funds or investments made.

Statistics on investments made, funds raised, exits and other pertinent facets of the industry are collected by national or regional trade associations such as the National Venture Capital Association (NVCA) in the US, the European Venture Capital Association (EVCA), or the China Venture Capital Association (CVCA). In addition, private firms such as Venture Economics and the Asian Venture Capital Journal publish industry data. Government statistical offices do not appear to collect information on private equity or venture capital. The data collected usually represent aggregate flows as, by definition, individual fund performance is ‘private’ and kept confidential. This has repercussions --discussed in the Methodology section-- for the collection of data on fund performance in China, as intended for this study.

Academic literature on private equity in China is scarce, while there are numerous news items on individual investments. The paucity of systematic studies is certainly in a large measure due to the very recent take-off of this market. The jury is still out to determine what elements contribute to success or failure. As mentioned, this study aims to shed light on the differences between Chinese and Western contexts relevant for venture capital investors. A further aim is to explore some initial evidence on causal links between the Chinese context and investment performance.

In order to review the literature on the subject in a systematic fashion we will look first at the suitability of institutional theory for an analysis of the influence of different settings on
venture capital investing. This is followed by an examination of the prevailing Anglo-Saxon investment model in detail. We will look at three major elements of the model: The structure of the industry and its evolution; investment processes seen as a cycle; and performance. As mentioned earlier, the objective of this study is to contrast the Chinese context for these three elements with the Western context.

### 2.1.2 Western and Chinese Settings

The settings in which particular businesses operate exert a powerful influence on the way these businesses function. The role of the institutions which make up the settings has become the subject of institutional theory and this provides a useful theoretical underpinning for our analysis of structure, processes and performance of the venture capital industry in China.

The environment in which we live helps to shape our actions. This truism has lately been couched in terms of institutional theory. The key tenet of institutional theory is that various institutions in our environment strongly influence the goals and actions of individuals, groups and organizations (North 1990; Scott 1987, 1995). A number of authors applied institutional theory to the private equity industry. Institutions affect the investment process of private equity firms (Suchman 1995; Wright et al. 1992). Institutions lead to a highly uniform behavior among investors, as evidenced by numerous similarities between the US and European private equity business (Fried et al 1995; Sapienza et al. 1996). Some authors even argue that there is a global investment model, although Anglo-Saxon New Zealand is the only ‘Asian’ country cited in the study (Jeng et al. 2000).

In the case of Asia and in particular China there is strong evidence for the need for investors to adjust to a substantially different environment and set of institutions (Boisot et al. 1988,
1996; Bruton et al. 1999, 2004; Peng 2000; Vega 2004). This leads to an industry structure and an investment cycle that is operationally quite different from the West.

In order to clarify the nature of institutions the approach developed by Scott seems useful, weaving together the sociological and economic strands of institutional theory (Scott 1995). The former is more concerned with informal forces, such as beliefs and role-shaping whereas the latter focuses on the formal framework of political and legal rules and regulations (DiMaggio et al. 1991; North 1990; Suchman 1995). Scott suggests three types of institutions: Regulatory, normative and cognitive.

‘The most formal are the regulatory institutions representing standards provided by laws and other sanctions. Normative institutions are less formal or codified and define the roles or actions that are expected of individuals. Normative institutions are often manifest through accepted authority systems such as accounting or medical professional societies. Finally, cognitive institutions represent the most informal, taken-for-granted rules, and beliefs that are established among individuals through social interactions among various participants (Bruton et al. 2004)’.

Although these three categories are useful for analytical purposes, I propose a simplification to reflect the usually black-and-white world of investment decisions. Investors are bound by the Chinese regulatory framework, over which they have no or at best very limited influence. These I will call ‘hard factors’ to which investors must adapt. The investment process for foreign funds in China immediately brings into play very significant cultural differences, to which investors may adapt and which, if they raise obstacles, they can try to deflect. This is usually done with various forms of financial incentives. These I will call ‘soft factors’. What
makes an analysis of investment performance and its determinants in China a true challenge is
the fact that both hard and soft factors are in a state of flux. Government regulations on
foreign investment are being changed all the time. Culture is obviously much more engrained
but nevertheless very gradual change is discernible, particularly in the investment world, as
Chinese entrepreneurs become more exposed to Western ways. Against the backdrop of this
dynamism any study can only present a snapshot of the situation under the rules in effect at
the time and customs prevailing. With this limitation in mind we will now turn to an
examination of the role of hard and soft factors in the Western –largely Anglo-Saxon-- setting.

2.2 Structure of the Industry in the West
The private equity and venture capital industry in the US is embedded in the country’s
institutional framework. Hard factors, such as the legal system and regulatory parameters,
allow investment funds to create limited partnerships and other structures, which align the
interests of both investors and fund managers. The two most common types of funds invest in
venture capital, i.e. start-ups and young companies with high growth potential, and in buyouts,
i.e. mature companies that need to be restructured or refocused.

2.2.1 Venture capital funds
At the time of writing there were close to 1,900 venture capital funds in the US with a
capitalization of some $680 billion in 2007. Most funds were set up by individuals or groups
of individuals to invest their own and institutional investors’ capital. Among the Silicon
Valley pioneers are Kleiner Perkins, Draper Fisher Jurvetson, Sequoia Capital, and Doll
Capital. Some funds have their origins to universities and were spun off to commercialize
innovation developed by professors from that university. A third type are funds or investment
companies set up by corporations such as Intel and Cisco, usually to invest in technologies
related to the parent companies’ activities. This is commonly referred to as corporate venture capital. Financial institutions such as investment banks also set up funds but most of these are general investment vehicles directed at more mature companies.

2.2.2 Buyout funds

In the late 1970s groups of wealthy individuals, or backed by wealthy investors, formed investment vehicles such as Kohlberg, Kravis and Roberts (KKR). They began to garner large amounts of capital, mostly from pension funds, to take over firms perceived to be undervalued or badly managed. These firms were then restructured by selling off loss-making or underperforming assets and focusing the business on profitable segments. Substantial leverage is almost always used to finance these deals and the term ‘leveraged buyout’ or LBO characterizes transactions of this type. Since the collapse of Drexel Burnham Lambert in 1988 the level of debt used has decreased. Led by Milken, Drexel had developed a new debt category in the form of high-yield or ‘junk’ bonds, which had a risk level, established by rating agencies, clearly above regular corporate bonds. The industry branched out into middle-market deals and expanded into Europe. Currently buyout funds have tens of billions of US dollars to invest and are poised to take over very large targets.

2.2.3 Evolution of the Industry in the West

What are the underlying reasons accounting for the emergence of private equity worldwide? In a nutshell, the reasons are embedded in the risk/reward view of investors. Investments in unlisted companies offer investors the potential of a high return upon selling their shares in a public offering. The latest data (first quarter 2010) for over 2,040 US venture funds with a capitalization of $983 billion show ten-year and twenty-year returns significantly above the NASDAQ and S&P 500 Index returns, respectively, as shown in Table 1 (Thomson Reuters
These returns are net of management fees and carried interest and *nota bene* include
the losses incurred when the internet boom imploded. As investors became aware that private
equity yielded higher returns than the traditional investments in stocks and bonds, capital
started to flood in. Private equity became a legitimate separate asset class into which
institutional investors allocated part of their portfolio. The high risk of investing in unlisted
firms can be reduced by careful selection and prudent valuation. The perspective of a
successful public offering is brightest in regions with relatively efficient capital markets
functioning smoothly, such as North America, Western Europe and Japan. In countries with
relatively inefficient capital markets such as China, domestic public offerings for foreign
investors are made difficult or near-impossible. For this reason foreign funds needed to
develop creative alternative structures in order to obtain desired returns.

**TABLE 1**

**U.S. PRIVATE EQUITY PERFORMANCE INDEX THROUGH MARCH 31, 2010**

<table>
<thead>
<tr>
<th>Fund Type</th>
<th>1 Year</th>
<th>5 Years</th>
<th>10 Years</th>
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*Source: Thomson Reuters*

In the absence of lucrative public listing prospects venture investors are forced to sell their
shares at a generally lower return to other investors, usually larger companies. Under these
circumstances the Western investor expectation of ‘high risk, high return’ is only partially
fulfilled in China. Some well-publicized successful exits have been exceptions rather than the
rule (Economist 2004). This study documents 79 IPOs for Chinese investments but only a few of these achieved significant returns (see 3.5.3). Overall, the reality appears closer to ‘very high risk, low (if any) return’. This study will shed light on the difficulties of achieving high returns created by the Chinese context for the Western model of private equity investing.

A brief look at the development of the industry highlights the crucial role played by the national context – the hard factors. Risky private investments in unlisted companies, with an eye on above-average returns, were originally an American phenomenon (Lerner et al. 2005). Towards the end of the 19th and the early decades of the 20th century wealthy industrialist families such as the Rockefellers and Vanderbilts invested in numerous companies, including the predecessors of AT&T and McDonnell Douglas. The families increasingly hired outsiders and created so-called ‘family offices’ to select and manage these investments. The first private equity firm, American Research and Development (ARD), was set up in 1946 by East Coast academics and businessmen to invest in companies utilizing technology developed in World War II. ARD’s landmark investment was $70,000 in Digital Equipment Corporation in 1957, which ultimately rose to $355 million. Institutional investors were reluctant to commit capital to high-risk investments so that American Research and Development, and similar firms, were set up as publicly traded closed-end funds. The investors were primarily individuals. The first venture capital limited partnership was set up in 1958 but the majority remained structured as closed-end funds or government-guaranteed risk capital pools called Small Business Investment Corporations (SBICs). However, during the 1960s and 1970s investments by these organizations remained relatively insignificant, as investors never put, even in its best years, more than several hundred million dollars p.a. into the entire industry. For its first three post-
war decades the private equity and venture capital business was still essentially a cottage industry.

An important change in investment rules in 1979 marked the dramatic takeoff of the industry in the US. The Department of Labor, in a policy shift, decided to allow employee pension funds to invest in high-risk assets, such as venture capital. A significant number of funds were formed in the wake of this decision, mostly as limited partnerships, structured to provide incentives to the funds’ managers. Less flexible closed-end funds began to disappear. The first half of the 1980s saw a tenfold increase in the amount of capital allocated to venture capital funds. Private equity or buyout funds investing in mature companies raised even more money. Venture capital backed numerous successful high-technology firms such as Microsoft, Cisco Systems, Sun Microsystems and Genentech but overinvestment in a limited number of industries and the entry of too many inexperienced venture fund managers led to a serious decline in returns. The story was a similar one for private equity, where success stories like Avis and Dr. Pepper led to more intense competition. In the face of disappointing fund performance investors allocated their capital to other asset classes.

History repeated itself in the 1990s, albeit on a much grander scale. The industry recovered dramatically, as inexperienced funds left the scene, thereby lessening competition. A healthy stock market provided attractive exit opportunities via initial public offerings. Technological innovation, particularly in relation to the development of the internet, created unprecedented opportunities for venture capital funding. The combination of these factors, and the spectacular returns generated, led to inflows of capital at unprecedented levels for venture capital and buyout funds during the late 1990s and into 2000. However, the phenomenon known as ‘too much money chasing too good few deals’ recurred, as fund managers grew
negligent. Venture capital funds were particularly affected. ‘Too rapid growth led to
overstretched partners, inadequate due diligence, and in many cases, poor investment
decisions’ (Lerner et al. 2005). The so-called ‘internet bubble’ burst and surviving funds
needed to go back to sound selection and evaluation practices during the first years of the 21st
century. Due to their preference for investing in mature companies buyout groups, such as
KKR, Blackstone, Carlyle and Texas Pacific, weathered the storm virtually unscathed.

Europe is the second most important venture capital and private equity market after the US.
On a per capita basis Europe invests roughly one-third of the US in venture capital. For
buyouts the figure is roughly half (EVCA 2003). By far the most important country, in terms
of capital invested, is the UK. The industry in Europe only began to develop in earnest in the
mid-1980s, with US funds such as Apax setting up offshoots in Europe, usually first in
London, and the emergence of local investment groups, again initially in Britain. Local funds
often started as the arms of financial institutions, such as BC Partners (Barings) and Doughty
Hanson (Charterhouse and Westdeutsche Landesbank). The similarity to the US institutional
setting - the hard factors such as the existence of an efficient stock market, similar accounting
standards and enforceable contracts as well as soft factors such as language - made the UK the
logical first step into Europe for US investors. Continental Europe, with its different national
institutions, traditions and customs as well as languages, provides a tougher challenge.
‘Accounting standards, government regulations, and union contracts inhibit due diligence and
limit the ability to turn around underperforming businesses’ (Lerner et al. 2005). A thumbnail
sketch of major Continental markets looks as follows: Germany is a tough nut to crack
because the perceived opportunities turned out to be complex to exploit. Succession problems
of Mittelstand companies, related to simple demographics, were often solved without the
involvement of financial investors. Another driver, the restructuring of industrial groups in the
light of a new emphasis on shareholder value, proved to be a more effective driver for buyout activities. France and Italy have seen some large transactions but inconsistently so. The Netherlands and Switzerland, on the other hand, have developed significant buyout activities, with solid local pension systems being a key source of capital-raising. Sweden has also seen an even deal flow, as has Finland, primarily in venture capital.

Traditionally the focus of the industry in Europe has been sharply tilted towards buyouts, with venture capital in the true sense only representing about 10% of the total capital invested (EVCA 2003). During the heyday of the ‘internet bubble’ from 1999 to 2001 this rose to 15-20% but has since declined again. To be sure, there had always been a small venture capital industry in Europe but the returns gained never attracted significant amounts of capital. Hence the predilection of institutional investors for private equity. Europe mirrored the US boom-bust cycle fairly closely, with a late 1980s boom, an early 1990s bust, a dramatic late 1990s boom, followed by an equally dramatic bust in 2000 and 2001. Since then venture capital activity has picked up again, albeit cautiously, while buyout funds have raised vast amounts of capital in the prospect of restructuring the European industrial landscape, including several funds co-investing for multi-billion dollar deals.

This brief review of the development of the venture capital and private equity business in the West clearly shows the critical importance of the national context – the hard factors. Why was the cradle of the industry in the US and not in Europe, and within Europe, in the UK and not on the Continent? Bearing in mind the temporary nature of their capital commitments and the overriding goal of venture capitalists and private equity investors to sell, or to exit, their investments, the single most important hard factor is a smoothly functioning, liquid capital market. As we will see in Section 3.5, returns are generally highest when the portfolio
company can be listed on a stock exchange. Both the US and the UK have efficient bourses of long standing.

2.3 Investment Process in the Industry in the West

2.3.1 Venture Capital Cycle Concept

The investment cycle in venture capital and private equity, from the point of view of the fund manager, consists of three major stages: Fundraising and managing the relationship with the investors; investing and managing the relationship with the companies invested in; and finally exiting the portfolio companies. Successful exits permit the cycle to start again with raising capital for the next fund. In the following, we will examine these three steps in the classic Anglo-Saxon setting.

2.3.2 Fundraising

To better understand the first stage in the investment cycle, this section deals with the relationship between the fund management team and the investors who commit capital to the fund. We will analyze the structuring of funds, critical to the alignment of the interests of both parties, as well as the fundraising process itself. The following draws on ‘A Note on Private Equity Partnership Agreements’ (Lerner et al. 2005).

2.3.2.1 Fund Structuring

Virtually all private equity and venture capital funds in the US are private partnerships, due to the long-term and largely illiquid nature of the fund. The general partners manage the fund. The limited partners, usually institutional and large private investors, provide capital for the fund. They are limited in the sense that they are liable only for the amount of capital they
contribute. General partners are personally liable but usually form a corporation, in which they are shareholders, to serve as general partner.

The partnership agreement governs the relationship between general and limited partners. The partnership agreement is usually quite complex as it safeguards the interests of the limited partners by imposing restrictions on the activities of the general partners who manage the fund. However, at the same time it provides financial incentives, based on the fund’s performance, to the general partners.

Key components of the partnership agreement are clauses as to the size of the limited partners’ contribution, the size of the fund, the payment schedule, the life of the fund, and termination and share transfers. We will look briefly at each of these in turn. General partners will typically set a minimum size of the capital contribution made by institutions. Private investors are often allowed a smaller minimum. This rule serves to keep the number of limited partners manageable and also avoids costly disclosure requirements in the case of hundreds of partners. In most cases the agreement also fixes a minimum and maximum size for the fund. Limited partners are concerned that too large a fund will impose undue pressure on the management team. In many cases capital is raised in stages, in that there will be a first closing once the minimum size of the fund has been reached. This sends a positive signal to other prospective investors who may then decide to participate. The agreement also specifies a so-called ‘drawdown schedule’, which stipulates the timing of the limited partners’ payments into the fund. As the fund invests gradually, normally all capital will have been paid in by the third or fourth year. The classic life span of a private equity or venture fund is ten years. This may be extended by one or two years, usually subject to the partners’ permission. Virtually all partnership agreements allow the limited partners to dismiss the fund management team or
even to dissolve the fund, subject to a majority vote of the investors. The other way around, limited partners have certain rights over the shares of limited partners in default. An entire so-called secondary market, served by specialist firms such as Paul Capital Partners and Coller Capital, has developed for the shares of limited partners who want to leave a fund before the end of its life.

Partnership agreements generally impose limitations on general partners in regard to the way they manage a fund, their activities and the types of investments made. We will look in summary form at these three covenants. First, in relation to the fund, general partners are restricted as to the amount of capital committed to any one investment; the amount of debt used; co-investments with the earlier or later funds managed by the same team; and the reinvestment or distribution of profits. Second, in relation to their own activities, the management team will have limitations imposed on investing personal funds in portfolio companies; the sale of their partnership interests; future fundraising; time spent managing the fund; and the addition of new general partners. Third, in relation to the assets invested in, limited partners usually impose restrictions on the amount of fund capital invested in publicly traded securities, other private equity or venture capital funds, and asset classes in which the general partners have little -but hope to gain- expertise, such as foreign investments.

Another key element of the partnership agreement is the compensation of the fund management team. General partners receive two forms of compensation, management fees and the so-called carried interest. Management fees are paid to cover the team’s salaries and expenses. They are expressed as a percentage of the total capital committed or the value of the fund’s assets, or a combination of the two. The carried interest is the management team’s share of the profits. The prevailing pattern in the industry is ‘two/twenty’, meaning a
management fee of 2% p.a. and a carried interest of 20%. Some experienced fund managers with a track record of proven success, particularly in venture capital, may ask for, and obtain, fees of up to 2.5% and a share of the profits of 25% or even 30%. For large buyout funds with more than one billion dollars in capital the management fee may decrease to 1.5% p.a. Given that fund managers have few needs beyond support staff, office space and travel, numerous general partners have become very wealthy and investors in their own right.

2.3.2.2 Capital Raising

While receiving management fees and a significant amount of the capital gains made by the fund, the general partners contribute only a small amount of capital to the fund, usually 1%. In certain circumstances general partners contribute more capital. They may have to in the case of a first-time fund, in order to establish credibility with the other investors. Or they may want to, if they are very wealthy people in their own right.

To raise capital for the fund, the general partners prepare a private placement memorandum. Investors in the fund include institutions and high-net worth private individuals and families. The most important institutional investors are corporate and public pension funds, insurance companies, corporations, and university endowments. In line with their risk diversification strategies these large investors allocate a certain percentage of their total portfolio, usually up to 10%, to private equity and venture capital. Some institutional investors and well-established funds have long-standing relationships which, in the case of successful funds, facilitates fundraising. Conversely, these close links make it difficult for other institutions to invest in the best-performing funds as the latter give preference to their established investors.
In addition to the fund management team and the investors a number of intermediaries may be involved in the fundraising process, assisting either the general or the limited partners. The general partners sometimes hire placement agents who help to raise capital. Some of the major investment banks, such as J.P. Morgan, UBS, and Bank of America/Merrill Lynch, have specialized teams but there are also numerous small boutiques active in this market. Fees have traditionally hovered around 2% of the capital raised, with less for a large buyout fund and up to 3% for a first-time fund. Lately placement agents have negotiated lower flat fees but, in addition, a small share of the management fee received by the general partner as well. Limited partners may employ the services of investment advisors such as Frank Russell, so-called ‘gatekeepers’, whose contribution to potential limited partners ranges from actual asset management and control over which fund to invest in to purely advisory work. Some of these advisors combine investors’ funds and invest in funds-of-funds, so named because they represent a risk-spreading investment in a range of funds. These advisors usually receive about 1% p.a. of the capital under management. A third group of intermediaries are consulting firms, such as Cambridge Associates and Venture Economics. These consultants collect performance data of various funds and, therefore, allow their clients to compare existing and prospective investments.

2.3.3 Investing

Selecting promising investments and aligning the owners’ interests with those of the financial investors is critical for the success of private equity and venture capital funds. The skills developed in selecting and managing portfolio companies differentiate fund management teams from one another. In the following we take a look at the key elements in the relationship between financial investors and the entrepreneurs seeking capital from them.
2.3.3.1 Deal Sourcing, Selection, Valuation and Structuring

In the North American and European settings venture capital funds have numerous sources for potential investments. In most instances entrepreneurs in search of capital for starting-up a new business or expanding a growing one will approach venture capital funds themselves and submit their business plans for evaluation. In some cases the source of a deal may be another venture capital fund seeking a co-investor to spread the risk or to bring in expertise in a particular sector. For larger private equity deals involving established firms the research teams of these substantial funds and investment banks play a key role in identifying target companies.

As regards identifying and evaluating suitable deals, venture capital funds perform due diligence on the proposals shortlisted as meeting their investment criteria, in terms of location, sector and stage-of-development of the potential investment. Due diligence covers the entire array of the business, from analyzing the financial forecasts made to market prospects for the products or services in question, as well as the background and experience of the management. Fund managers tend to use identical criteria. According to my own professional experience, the plausibility of the business model proposed and trust in the competence of the management to bring this model to fruition are the two most critical evaluation criteria. Profitability forecasts made by the entrepreneur play a lesser role as the fund’s analysts will prepare their own forecast based on the results of the due diligence conducted. The venture capitalist will seek to align the fund’s interests with those of the management so as to avoid potential conflicts by having a large degree of congruency. This involves making sure expectations are not too divergent in terms of control over the company, financial rewards for management, and the contribution made by the fund. As one might surmise, investments in foreign countries often bring culturally-rooted differences in expectations to the fore. Venture
capital funds also typically see themselves as providing value added to their investments beyond the capital contributed, such as contacts with suppliers or customers, industry expertise transferred from similar investments, and financial discipline.

In terms of the valuation of a potential investment, American and European funds generally use sophisticated financial techniques. However, the assumptions made in determining, e.g., the value of cash flows in a start-up or a very young company make this often a subjective exercise. ‘Early stage companies typically forecast a period of negative cash flows with highly uncertain - but tantalizing – future rewards. This cash flow profile is very sensitive to the valuation assumptions made.’ (Lerner 1996)

Two of the methods most commonly used, but by no means the only ones, are the use of comparables and the net present value method. By using comparables we look for companies with characteristics similar to the one we are analyzing. This provides for a quick and easy way to obtain a rough valuation. These valuations are typically expressed as a multiple of earnings before interest and tax (EBIT) or share price in the case of a listed company. Easy to obtain for a publicly traded company, they are much harder to find for private companies and difficult adjustments need to be made for a firm’s illiquidity. In start-up settings there are often no comparable companies and in this situation, as Lerner points out, ‘common sense is the best guide’ (Lerner 1996). The net present value method uses cash flow forecasts. A terminal value of the company is then calculated and this value is ‘discounted’, i.e. using a discount rate equivalent to the cost of debt and/or equity capital, to the present. The result is the present value of the firm. As the cash flow estimates are subject to numerous assumptions, a single value for the company is usually unrealistic. Therefore, in practice alternative cash
flow scenarios are being calculated. As might be expected, the assumptions underlying valuations gain in complexity in foreign settings.

The way venture capitalists structure individual deals is first of all a function of the financial structures available in any one legislation - the hard factors. In the Anglo-Saxon setting a complex set of instruments to allocate ownership is available, reflecting the maturity of capital markets in those countries. The way these ‘venture securities’ are used in structuring ownership of a company is a function of negotiations between venture capitalists and company owners. Common stock, the classic unit of ownership, is rarely used by venture capital funds. While common shares convey ownership rights, these rights are subordinated to all bank and trade debt, taxes owed and employee claims in the event of a liquidation of the company. In order to protect their investments better venture funds in the Anglo-Saxon setting resort to additional instruments available, primarily preferred stock, vested owner shares and covenants.

Preferred shares represent ownership units that, in the case of the company’s liquidation, get paid before holders of common stock get paid. The preferred stock in venture companies is not to be confused with preferred stock issued by large publicly listed companies where it entitles investors to dividends preferential to dividends on common stock. Dividends play virtually no role in structuring a deal as venture funds are oriented towards the payout received by way of capital-gains. Dividends would withdraw cash much needed for expansion of the typical venture. Funds also very often negotiate the issuance of vested shares with the entrepreneur. Under this system the entrepreneur does not have full ownership of the shares until a certain time period has elapsed, typically three or four years, or certain events take place, such as the sale of the company. This tool allows venture funds to tie entrepreneurs to
their company. Covenants are also frequently used by investors to protect themselves. These are contractual agreements that specify what the company must do, such as producing audited reports and hold regular board meetings, and what the company cannot do or can do only with the approval of the majority of the board. ‘All in all, the most frequent use of covenants is to effectively disconnect control on important issues from owning a majority of the equity.’ (Hardymon & Lerner, 1999) This instrument allows venture capitalists to control the board for critical decisions while owning only a minority of the company.

2.3.3.2 Monitoring the Investment and Providing Value-Added Services

As a rule venture capital funds take minority positions in their portfolio companies. Since the fund managers do not want to get involved in day-to-day operations and leave them to the management of the company, they do need an effective monitoring system to keep track of the company’s performance. The mechanism for monitoring was alluded to in the last section. Furnishing regular audited reports is a *sine qua non* and regular board meetings provide the personal contact required as well as control over key decisions. Venture capitalists in general also want to add value to the company beyond the capital they contribute. Mostly this is advice on financial and accounting matters but also the establishment of contacts in the marketplace through the network they have built. A less tangible but potentially crucial contribution is to act as a sounding board for the entrepreneur and his team, providing strategic direction and helping to avoid pitfalls on the way. This type of interaction in an international context raises questions of how effectively investors can play such a role in a significantly different culture.
2.3.4 Exiting

Obtaining attractive returns for investors upon selling their positions in portfolio companies is the *raison d’être* of venture capital funds. Satisfied investors will provide capital for subsequent funds to be raised. The hard factors, such as the existence or absence of efficient capital markets and of the associated regulatory framework, provide the ‘givens’ in each national market under which funds operate. ‘But since the need for an ultimate exit from the investments shapes every aspect of the private equity cycle, this is a very important issue for both private equity investors and entrepreneurs (Lerner, Hardymon & Leamon 2005).’

The principal exit options are listing the shares of the company on a bourse, selling the company to another firm or to the management, and liquidation in the case of a severely distressed investment. Typically the preferred option used by funds in the Western setting to exit their investment is a public offering of the shares. This avenue generally yields the highest returns as the following section on performance will highlight. In order to facilitate capital-raising by promising young companies, usually in high-technology sectors, a number of countries have created secondary stock markets for that purpose. These are as tightly regulated as the major stock exchanges but the listing rules are relaxed. As a rule, companies are allowed to have a smaller capital base and they do not have to show profitable operations. Prime examples of these markets are:

- NASDAQ (New York)
- AIM (London)
- GEM (Hong Kong)

In Continental Europe these secondary stock exchanges have an erratic track record. The Neuer Markt, set up in Frankfurt in March 1997, was closed again six years later in March 2003. The market’s NEMAX 50 index fell from a high of 9,600 in 2000 to 350 on the last day
of trading. Apparently overly lax regulations contributed to the listing of too many companies plainly not yet ready for the public market. In France and other countries smaller versions of secondary markets survived.

The road to an initial public offering or IPO, though, is not always a straight line, let alone well paved. Potholes, detours and red lights may mark the way in the sense that the timing of the offering is of critical importance. Stock markets are obviously subject to wide swings and also certain sectors may be ‘hot’ and others less fashionable at any one point in time. Therefore, when a fund deems an investment ready for a listing the market may be depressed and not provide a satisfactory offering price. The fund looking to list its investment may be under time pressure as it may be nearing the end of its life – usually ten years. These vagaries may lead the fund and the management of the portfolio company to pursue an alternative exit strategy.

Venture capital funds usually do not cash out of their investments at the time of a public listing. Instead, they distribute the shares to their investors on a pro-rata basis one year after the offering has taken place. A key feature of initial public offerings is the so-called lock-up provision, a set of stock exchange rules prohibiting insiders from selling their shares at the time of the offering. They must keep them usually for at least one year. By virtue of this rule both funds and entrepreneurs are prevented from exploiting inside knowledge they have and new investors in the company are protected.

A second exit option is the sale of the investment to another company. This is often referred to as a trade sale. The acquiring company is in many cases in the same industry, seeking to buy a competitor, rounding out its range of products or services, or gaining access to an innovative
technology. Since this acquisition is a private transaction the proceeds from the sale accrue immediately to both fund and entrepreneur. Proceeds may consist of cash, shares in the acquiring company or a mix of both. On average this approach yields a lower return to the sellers than a public listing as the buyer tends to have detailed knowledge of the industry and its cost structure.

In the case of an investment having turned sour, a fund may seek to liquidate the investment. Here again the role of national laws – the hard factors – determines the latitude the investor has. Most countries in the Western setting have bankruptcy laws that govern the liquidation process. However, in the U.S., distressed companies have the possibility of a second chance by way of the so-called Chapter 11 proceedings. Under this law a company in distress can submit a detailed rescue plan to the authorities who can then set a deadline for achieving the turnaround. Realistically, though, Chapter 11 protection is used by large firms like airlines where the impact of liquidation could be substantial. Small firms in severe distress, as a rule, are allowed to go bankrupt. In recent years an alternative solution to the problem of what to do about an unsuccessful venture has appeared. New fund groups, commonly called secondary funds, were formed to specialize in taking over distressed venture from the original funds. These secondary investors obviously pay heavily discounted prices to the original investors in the hope of being able to do a better job turning distress ultimately into success, on a significantly lower cost basis.

2.4 Industry Performance

The issue of performance has two main elements. First, the performance of the venture capital fund is the yardstick by which institutional investors measure funds against one another and, in the aggregate, the asset class of venture capital and private equity vis-à-vis alternative types
of investment. To the fund managers superior performance facilitates raising subsequent funds. Second, the performance of individual portfolio companies is, of course, of crucial importance to entrepreneurs running these companies, as well as to the fund managers as individual performance *in toto* obviously makes up fund performance.

### 2.4.1 Measurement Issues

Given the unlisted ‘private’ nature of venture capital and private equity funds, the measurement of their performance brings with it a number of issues particular to these types of investments. In contrast to data on publicly listed firms, which is available every single trading day and allows differentiated assessments of returns, venture funds are illiquid and usually do not exit their investments for at least two or three years. The availability of performance data and the way the data are derived are the two key areas of concern.

Aggregate performance data for the Western setting are published regularly by the National Venture Capital Association for the U.S. and by the British and European Venture Capital Associations. For emerging markets such as China, however, no such information is available. Information has to be pieced together from news reports on public offerings or trade sales but often the original investment amount is not published and, therefore, returns cannot be calculated. The national and regional data published for the U.S. and Europe are collected from members of the respective associations and aggregated. Confidentiality of individual fund performance is a major concern, for obvious reasons. These aggregate data do provide institutional investors, however, with a benchmark against which to evaluate their choice of investment. Generally, fund performance is grouped (a) by type of fund, such as venture and buyout funds, and (b) within each fund category by quartiles to highlight the at times dramatic
divergence between highest- and lowest-performing funds. The table below for U.S. venture funds is an example (Cambridge Associates 2010).

As to the measurement of fund performance itself, the principal approaches taken are the calculations of

- the internal rate of return (IRR) of funds
- a multiple at exit of the capital paid into the fund by investors
- as a proxy, an index of the changes in share prices of fund-backed firms recently listed

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Source: Cambridge Associates
NB: Year is the year of formation of the fund. Funds formed since 2006 are too young too have produced meaningful returns; comparison to benchmark statistics may be irrelevant.
The internal rate of return or IRR of venture funds, as reported by the U.S. National Venture Capital Association and others, is arrived at by collecting data from institutional investors on how much capital they invested in and how much capital they received from venture and buyout funds during a particular period. The annualized returns can then be compared to the performance of stock market indices or to the performance of individual funds. The IRR takes the present value of future cash flows plus the terminal value of an investment and makes them equal to the current price of the investment. The IRR reported is time- and money-weighted. The returns to the institutional investors are also reported net of fund management fees and costs. A significant problem with the IRR as a yardstick is, as Gompers and Lerner (1997) point out,

the inconsistency in how private equity groups value their investments. Established private equity organizations are usually conservative in their approach to valuing their investments, often holding investments at cost until they are taken public. Less established private equity organizations are often not as conservative in their valuation practices. Inexperienced private equity groups are often under tremendous pressure to raise follow-on funds.

Many institutional investors refuse to put capital into first-time funds as a matter of principle because they tend to yield lower returns than established funds. As a result, first-time funds, keen to get into the game, often give away a sizeable share of their management fees and carried interest to investors, in order to induce them to put up capital. These new funds then expect to get more favorable terms on subsequent fundraisings. A corollary of this attitude is the willingness to value participations at above cost and not to discount distressed investments. Despite these potential distortions the respected Association for Investment Management and Research ‘supports the use of the IRR as the most appropriate measure of private equity and venture capital performance (BVCA 2005)’. 
A second measure of venture fund performance is the investment multiple. The multiple is the amount of capital received by the fund upon exiting an investment as a percentage of the capital it contributed. This is generally derived on the basis of individual investments. In the case of a public offering, the initial share price at the time of the listing is known and the amount of capital originally invested by the fund is known, hence the multiple obtained can be calculated readily. A problem with use of the multiple is time adjustment as the question is over what time period a particular multiple was achieved – two years or eight years? Also, sequential rounds of financing for one and the same investment have to be taken into account when looking at the capital contributed at different valuations.

Using the changes in share price of recently listed, venture-backed firms as a proxy for fund performance is easy to calculate but fraught with validity problems. Share prices are readily obtainable every single trading day. However, the use of publicly traded firms for privately held investments is a minefield. Venture and private equity funds have their own dynamics, independent of public markets. Valuations may be seriously affected by the boom-or-bust situation of fundraising in the industry. At a time when investment capital is abundant any one fund may find itself in a situation where ‘too much money is chasing too few deals’. Also, a fund approaching the end of its life may be desperate too make deals to show improved performance. Finally, for fund investments, there may be no readily comparable firms in the public market.
3. **EMPIRICAL RESULTS OF THE STUDY**

3.1 **Objectives of Research and Research Questions**

The point of departure in my dissertation research is to attempt to explain, from the point of view of the foreign investor, which factors make for a successful investment in China. In an exploratory fashion I intend to relate performance of individual private equity investments to elements both institutional and cultural of the investment process in China. My own experience with private equity funds since the early 1990s in China and continued contact with investors in Hong Kong provides the backdrop to this study.

The overall objective is to ultimately derive success factors for venture capital and private equity in China. This study serves that aim by analyzing in detail both the structure of the venture capital industry in China and the nature of the investment process. In addition, the only set of performance data of venture funds active in China available up to now will be analyzed and related, in crude form due to the summary nature of the data, to structure and process.

The structure of the industry in China has been studied by a number of authors (Ahlstrom & Bruton 2006, Bruton & Ahlstrom 2003, Bruton et al. 1999, Bruton et al. 2005, Vega 2004, White et al. 2002). This study updates and refines these earlier efforts in the light of recent developments in the Chinese institutional environment.

Several authors have discerned the largely soft elements of the process that are particular to China, as pointed out in the previous section (Bruton et al. 2004, Vega 2004). However, these
elements have not yet been related to performance, as suggested by both Bruton et al. and Vega as areas of further research. This study could, therefore, validate the claim that the ‘Chinese-ness’ of private equity investments results in performance different from Western countries. From my own experience the way funds select, value and monitor investments in China differs significantly from the West. The informed guesses based on this experience, corroborated by a series of interviews with funds investing in China, will form the basis for a number of hypotheses. Coupled with data on exits made so far this exercise should ultimately yield predictions for investors on how to navigate around major pitfalls and increase the probability of success of their private equity investments in China.

3.1.1 Structure, Process and Performance

Given this approach, my research questions focus on the three areas of structure, process and performance:

1. What is the current structure of the venture capital industry in China? We need to look at the evolution of government rules and regulations affecting the industry, the hard factors. The regulatory framework forms the ‘straightjacket’ for investors in which they must operate. In this context we need to examine whether domestic and foreign venture investors are treated differently or not.

2. Turning to the process, is there anything specifically Chinese about the way venture investments are made in China? Opinions range from ‘the process is universal, numbers are the same worldwide’ to ‘the process is local, China is a special case’. Looking at the different elements of the investment process we need to analyze to what extent cultural and customs – the soft factors – come into play.
3. What has been the performance of venture fund investments in China, given the data available so far? What conclusions, if any, do available data permit as regards structure of the industry and investment process? Clearly this question is critical for all parties involved – investors, entrepreneurs and government regulators – as the answers have a normative character. Here, initial evidence is uneven: A relatively small number of funds made highly successful exits from Chinese investments but a number also failed and some even withdrew from the Chinese market.

My intent is to, in an exploratory fashion, link private equity investment performance to the Chinese setting. In this context the study should answer the general question of whether there is a specifically Chinese model of private equity investing and if so, how it differs from the Western model and if there are signs, and hopes, of convergence between the two.

In order to answer these questions the private equity cycle framework, outlined in Section 3.4, provides a useful perspective in which the research process can be embedded. To view the investment process as a cycle is a helpful starting point for analyzing how private equity investing differs between a transition economy and market economies. The private equity cycle is not a theory but an analytical framework that is rendered plausible by industrial logic. The cycle is outlined in detail by Lerner et al. (2005). It does not meet the criteria for 'good' theory in that in itself it does not 'explain, predict, and delight’ (Sutton and Staw 1995). But within the cycle framework theories can be formulated in regard to the elements of the private equity investment process, explaining causal links between investor strategies and elements in the local investment environment.
3.2 Methodology

We need to give thought to the question of how to go about accomplishing our objective and answering the research questions. Given the exploratory nature of the work and the relatively small sample, a qualitative approach was deemed more appropriate than quantitative methods. However, a limited amount of quantitative analysis was conducted on performance data, as shown in Section 3.5.3 of the Research Findings.

3.2.1 Qualitative Method and Case Study Approach

As I intend to proceed in steps methodologies suitable for each step will be used. For the first exploratory phase the most plausible approach to me seems to be inductive, in the absence of theories on the subject. The use of inductive reasoning involves making a series of observations and inferring a new claim based on them. By building on available data, generating case studies, and conducting a series of open-ended, relatively unstructured personal interviews with fund managers in the field, variables can be derived and operationalised in a bottom-up fashion. The relationships postulated between these variables can be used to build a theory. This methodology seems particularly well-suited to new research areas’ (Eisenhardt 1989). Also, this qualitative approach, based on observations in the field, usually breathes some life into theory. Purely quantitative methods usually cannot match this level of detail.

Also, qualitative methods, notably survey techniques, have been used with convincing results in the literature on venture capital and private equity. The seminal study of Bruton and Ahlstrom (2003) for China is a case in point. The use of case studies in qualitative methodology deserves elaboration, as cases are a useful element of triangulation to enhance the validity of research findings obtained by other means. Bearing in mind that case studies
alone are unlikely to yield sufficient patterns to produce results that can be generalized, they are nevertheless very useful in highlighting important issues in analyzing a complex new research domain (Yin 1994).

The process of building theory from case studies goes through a number of steps. The following is paraphrased from Eisenhardt (1989). Getting started involves defining the research question. Without a clear focus data overload may occur. Similarly it is useful to specify potential constructs at this stage so as to arrive at firmer grounding of the theory later on. Both of these are tentative at this early stage, though, and can be adjusted as the research progresses. Above all, no theory or hypothesis should be considered at this stage so as to limit bias. Selecting cases should take place on a theoretical, not statistical base. Crafting instruments and protocols involves the combination of qualitative and quantitative data. Entering the field should result in a desirable overlap between data collection and analysis. Collection methods should remain flexible and opportunistic. Analyzing data takes the form of both with-in case and cross-case pattern search. Shaping hypotheses is based on the iterative tabulation of evidence for each construct. The ‘why’ behind relationships must be addressed at this stage. Enfolding literature takes the form of comparing emerging concepts with both conflicting and similar literature. Reaching closure has two aspects: No more cases should be added to the population once theoretical saturation has been reached. Also, iteration between theory and data should stop when there is no more or very little incremental improvement to the theory.

This theory-building approach is attractive for several reasons: It likely generates novel theory. The new theory is testable with constructs that can be measured readily. And finally, the theory-building process is so intimately tied to the evidence that it is likely to be valid.
What the researcher must bear in mind, though, is parsimony so as not to arrive at a theory rich in detail but lacking an overall perspective. Also, care must be used to avoid too narrow and idiosyncratic a theory that will be difficult to generalize. Despite these two caveats, building theory from case study research might stimulate some researchers to complete the cycle (between theory and data) by conducting research that goes in the less common direction from data to theory’ (Eisenhardt 1989).

It should also be noted that the case studies developed for this paper differ from the Harvard Business School-type of case study used in teaching. The cases presented here describe typical patterns found in the course of the research. They do not raise questions for classroom discussion. Their purpose is to illustrate research findings concerning structure and investment process of the venture capital industry in China. A domestic venture firm is contrasted with a foreign fund and cases were designed for each of the three phases of the venture capital cycle – fundraising, investing and exiting. In conjunction with the results of field interviews and the incorporation of available data they provide fairly accurate contours of the current map of the venture industry in China.

For the second, theory-testing phase I used a survey technique. I took the route of structured interviews with fund managers and industry experts. These interviews varied significantly from those conducted in the first phase in that they tended to focus entirely on specific issues, such as deal selection and monitoring of portfolio companies.

The pitfalls of using the survey technique based on personal interviews are largely linked to the care taken in selecting the sample and designing the questionnaire. A careless approach leads to validity concerns (Punch 1998). Sampling mistakes raise questions of external
validity. Internal validity is jeopardized by questions that are too vague. And too narrow a focus can easily mean that construct validity is imperiled. In my study the sample was of a sufficient size to insure external validity, as the total population is limited in size. The questionnaire design, on the other hand, must be handled with proper care. I attempted to limit the potential internal and construct validity concerns by conducting a Phase I series of interviews which served to sharpen my focus and distill specific questions.

3.2.2 Research Sequence

The research process adopted consists of three steps, as shown in Figure 1. Initially available data were collected from numerous sources in China and the West and a series of exploratory, relatively unstructured interviews with fund managers and experts were conducted. This ‘pulse-taking’ exercise provided an overview of the most important issues confronting foreign fund investors in China. This first step yielded patterns that could be operationalized in the next stage. This second step consisted of evaluating the data obtained, distilling the data into key variables, formulating hypotheses of relationships between these variables, and building case studies. These relationships were then tested by way of a survey of venture and private equity funds investing in China. The third and final step served to validate the findings obtained by way of triangulation. At this stage quantitative methods were used to analyze the data on performance obtained, in order to supplement the qualitative feedback from field interviews.
FIGURE 1
RESEARCH SEQUENCE

STEP I
- Collection of available data
- Exploratory interviews

STEP II
- Evaluation of data obtained
- Preliminary results
- Selection of case vignettes

STEP III
- Second round of interviews
- Refinement of results
- Validation/triangulation
In sum, I attempted to derive robust, generalizable findings by combining appropriate qualitative and quantitative methods in my research. As pointed out by Scandura and Williams (2000), triangulation, or the combination of different methods used to study the same phenomenon, raises validity and reliability. This is what I hoped to accomplish.

Step I: First round of interviews and collection of available data

In line with the three research questions concerning the venture industry’s structure, investment cycle and performance, published information was collected from a multitude of sources.

Structure: Data were primarily gleaned from trade journals such as Asian Venture Capital Journal, Asian Private Equity Review, and Venture Capital Journal. Trade associations, mainly the China Venture Capital Association and the Emerging Markets Private Equity Association, also provided pertinent input. Membership lists and directories of funds provided basic information, however heavily biased towards foreign funds. Problems encountered were related to data availability. First, the important Asian Venture Capital Journal, a key source of information, operates on a purely commercial basis with high rates for its publications and is not included in any academic database; and second, trade associations are member-financed and, reasonably enough, sell their publications, if at all, only at very high rates to non-members.

Investment Process: Here the sources of information on China were twofold: A small number of academic papers such as Vega’s dissertation (2004) and seminal articles (Bruton & Ahlstrom 2003) as well as a vast number of small news items from the trade press regarding particular investments. The latter usually covered just one specific aspect of the investment
process, such as the amount invested in a particular company or the structure adopted for a particular deal.

Performance: Until June 2006 the only source of information on performance of venture capital and private equity funds in China were sporadic news items highlighting particular investments. These virtually all related to a successful exit of a specific investment and highlighted how much money a fund had made upon exiting. No systematic data had ever been assembled. This changed in mid-2006 when the China Venture Capital Association and Zero2IPO, a research firm, published the results of their joint survey (China Venture Capital Performance 1994-2005). This comprehensive survey covered the performance of 62 domestic and foreign funds and provided data on the profitability of the 108 exits recorded until the end of 2005. The author was fortunate in obtaining a copy of the results of the survey as well as access to supplementary data. This remains the only comprehensive information on venture fund performance to date.

After the lengthy process of gathering data on these three key areas, the information obtained was distilled into a checklist of questions that served as the basis for the first round of field interviews in China. The principal areas covered were:

1. The size of the fund and country of origin of largest investors
2. Management
3. The investment parameters of the fund in terms of product orientation, stage-of-investment preference (early vs. later stage), and geographic focus (pan-Asian vs. China only)
4. Number of investments in China / exits
5. Principal problems encountered in the investment process (‘China risk’/China vs. the West)
6. ‘Wish list’ for government regulatory action
7. Key trends for next three to five years

These points provided a structure to the interviews but also left the door open for impromptu observations and anecdotes. This approach also put the persons interviewed at ease in that the interview could be made to resemble a conversation more than a formal inquiry.

The original idea of a sizeable mail survey was quickly abandoned in favor of personal interviews. This survey was conducted in person and on the telephone as initial reactions of fund managers pointed to an overload of written research requests and, therefore, the strong likelihood of a high rejection rate. Also, the powerful confidentiality concerns inherent in the industry weigh in against disclosing information to outsiders. Non-disclosure and confidentiality agreements had to be signed in a number of cases and all answers and quotes are on an anonymous basis. The author was fortunate to have contacts in the field dating to earlier professional experience in Hong Kong and China. Some of these contacts provided introductions to other funds so that establishing credibility, which may be awkward and bias responses, was not a major issue. Most fund managers are interested in obtaining a bigger picture of the industry, as they are focused heavily on their own investments. They attend industry conferences to compare notes with other investors but the offer of access to the results of this study proved to be a welcome drawing card.

Given this background twenty personal and telephone interviews were conducted with foreign funds and industry experts in Hong Kong and Beijing between November 2006 and December 2007. The personal interviews lasted one to one-and-a-half hours. They were conducted at the fund’s premises. The language was English. The interview partners were senior members of the fund’s management, usually managing directors or partners, or knowledgeable service providers such as lawyers. An advantage of this relatively informal ‘checklist approach’ was
the fact that feedback loops could be established. New information could be directly incorporated in the following interviews. Using this iterative approach, a fairly complete picture of the venture industry in China could ultimately be obtained. All respondents volunteered their availability for a follow-up and a number were called back or contacted by e-mail after the interview to clear up conflicting points that arose from subsequent interviews.

**Step II: Evaluation of information obtained, formulation of initial results and design of case studies**

The next step involved analyzing the information gathered. The strands of patterns that emerged needed to be braided into cogent arguments responding to the research questions. This was accomplished by contrasting the venture industry structure and the nature of the investment process in China with the Anglo-Saxon or Western model. The investment process was analyzed using the venture capital cycle framework set out by Lerner, Hardymon & Leamon (2005) and looking at the sequence of fundraising, investing and exiting.

As part of this exercise six case vignettes were designed in order to accomplish two goals: First, to illustrate the industry’s evolution, structure and major steps of the investment cycle in China; and second, to triangulate data obtained from the interviews. The cases served as useful checks on the validity of the interview information. As always, availability of information on the funds and investments determined the depth of the description. Some cases had to be pieced together from sporadic evidence such as news items and conference presentations.
Step III: Second round of interviews, refinement and validation of results

As a final step a series of cross-checks were made to make sure the results of the study represented as accurate a portrait of the Chinese venture industry as possible. In order to safeguard the validity of the research findings, a select group of practitioners and industry experts interviewed in the first round were consulted. A total of ten additional interviews were conducted in person or by telephone. The case studies written-up as part of Step II also formed part of this validation exercise. The practitioners and experts were presented with a brief verbal summary of the key findings of the study and were asked to comment. Also, pieces of seemingly inconsistent evidence were discussed, explained, and if plausible added to the results. As this validation process included some of the most experienced and senior figures in the industry in China, the author takes comfort in saying that the results of the study show an accurate map of venture capital and private equity in China today.

3.3 Sample

As mentioned in the Methodology section above this study was conducted using two samples, one for the structure and process analysis and one partly overlapping one for performance data. The first sample of twenty funds and experts was selected from the membership lists of the China Venture Capital Association and the Hong Kong Venture Capital Association, cross-referenced with the Asian Venture Capital Yearbook 2006. In line with the research objectives, only foreign funds investing in China were chosen – ‘foreign’ for this purpose meaning funds deploying primarily capital from outside China. Foreign funds are in the position to compare their China experience with that in their home or other host markets. Also, foreign funds are the largest investors by far, accounting for some 75% of all venture investments made in China (Zero2IPO 2007). The selection criteria were a minimum of three years’ experience in China –comparatively long in a nascent market-- and a minimum of two
investments made in China. Length of experience and size of operations of the funds
interviewed obviously affect the validity of their responses and, therefore, of the findings. The
geographic focus of the fund was left relatively open in that no specific PRC focus was
required. Funds with a Greater China (PRC, Hong Kong, Taiwan) or pan-Asian brief were
also included. Based on practical experience the author feels that the geographical focus as
defined by the fund’s name is not crucial, as even China funds usually have an ‘emergency
exit’ provision allowing them to invest elsewhere if and when appropriate. De facto the
majority of funds interviewed clearly have the goal to invest in Chinese companies. In sum it
can be said that the sample represents some of the most experienced foreign funds active in
China.

Three approached ended up not participating in the research, primarily due to repeated last-
minute changes in appointments and travel logistics on their or the author’s side. However,
desk research on these funds and cross-checks with other funds showed that it is highly
unlikely that their exclusion resulted in a significant bias of the findings.

The sample used for the performance analysis is a proxy in the sense that the sample of the
China Venture Capital Performance survey was adopted. This survey was published for
members in the very month the author began his field interviews. The original plan was to
include performance of individual investments in the interviews. However, since the survey
made by the China Venture Capital Association and Zero2IPO covered the profitability of
both funds and individual investments exited, and covered a much larger sample, it was
decided to incorporate the survey’s findings into this study.

The Performance Report 1994-2005 draws on two sources:
1. A survey conducted by the two organizations in the last quarter of 2005, covering the performance of 40 foreign and 22 domestic funds, each with more than three years’ operating history in China.

2. The China Venture Database, compiled by Zero2IPO’s Research Center since 1999. This database covers the activities of more than 200 domestic and foreign funds. By November 30, 2005 the number of exits recorded stood at 108 and performance data for these companies were calculated.

The relation between the sample used for the study of structure and process and the Performance Report sample is not entirely transparent, as the sample composition of the latter is kept confidential by the two organizations that conducted the survey. In the author’s opinion there is considerable overlap as most, if not all, the top tier funds who were interviewed for this study also appear to have participated in the Performance Report survey.

3.4 Limitations
The principal limitation of this study is the fact that the venture capital industry in China is still young and in a state of ‘evolution in full swing’. Therefore, the answers given to the research questions cannot be definitive. Rather, they provide a snapshot of the current situation. This applies in particular to performance, as no long time series data are available as of yet, due to the relatively recent nature of the investments.

Also, the funds and investors surveyed for the structure and process sections are not totally identical to those in the chapter on performance. As mentioned, the sample surveyed by the China Venture Capital Association/Zero2IPO was used for performance data. However, the likely degree of congruence of the samples nevertheless makes the conclusions plausible. The
same can be said for the fund performance sample and the Zero2IPO exit performance sample.

3.5 Research Findings: The Chinese Setting

3.5.1 Structure of the Industry in China

In essence, this study found some significant differences between the Chinese and the Western setting. Obviously the structure of the industry is determined by the hard factors of national rules and regulations governing the venture business. The regulatory framework also has far-reaching consequences for the investment process, in that exiting from investments is governed by it. Elements of Chinese culture, or the soft factors, come into play during the investing phase of the cycle, notably in the phases of negotiating a deal with local entrepreneurs, valuing it and monitoring its performance. Despite these significant differences, described in detail in the following sections, a sizeable number of foreign funds have been remarkably successful in China. The first data ever collected on performance show that 7 out of the 62 funds covered had an internal rate of return (IRR) of more than 40% and a further 17 had an IRR between 20 and 40%. Obviously some funds have managed to adjust successfully to the Chinese setting. In the following, after a brief review of the industry’s development, we will try to discern what critical factors are that separate the successful investors from the ones achieving below-par returns.

3.5.1.1 Evolution of the industry in China

Venture capital and private equity investment in China had reached a cumulative total of US$6.1 billion by the end of the first half of 2005 (Asia Venture Capital Journal 2006). The
vast majority of this was invested over the last three years, pointing to an industry in its infancy. Indeed the venture industry in China is only about twenty years old.

The evolution of the venture industry can be seen in two phases. The first phase dates from the first venture investments in the early 1990s until the bursting of the internet bubble in 2000/2001. During this entire phase only 16 exits were realized. The second phase can be said to have begun in early 2003 when the predecessor of the current Ministry of Commerce promulgated rules effectively permitting the listing of venture-backed investments on overseas stock exchanges. As a result 38 exits were made in 2004 alone, almost as many as were recorded in all the preceding years taken together. The boom has continued since then, with some hiccups as described below.

The early stage of the venture industry in China was a corollary of the dramatic economic reforms introduced by Deng in the late 1970s and early 1980s. As the door to private ownership of assets opened, after decades of no such possibility, the legendary Chinese entrepreneurial spirit found itself free of most shackles. The transition to free enterprise, however, was a gradual process and the government was clearly reluctant to give up the reins. The government recognized already in the mid-1980s the role venture capital could play in both financing small companies and in fostering innovation. But, given that the blinders of the communist past were still limiting the view, government policy in this area took some wrong turns. Several ‘venture companies’ were set up in the 1980s, all supported by the government and staffed by government officials and managers of state-owned enterprises (SOEs). But the concept proved too alien for these entities, as the managers lacked experience of the venture investment and business-building process. There were many setbacks, due to inadequate financial resources and operating problems. A well publicized failure of such a company was
that of the China New Technology Startup Investment Company, which went bankrupt in 1997. Counting on continued government fostering of the sector and the establishment of a regulatory framework, a small number of foreign venture capital pioneers entered the Chinese market in the early- and mid-1990s. As the government moved up the learning curve and interest in Chinese internet plays increased dramatically, there were a number of successful exits in the late 1990s, such as Sohu and Sina. After the internet bubble burst in 2000/2001 the industry in China went into a slump, as it did in all major markets, and took a few years to recover.

The venture business really started to take off, at a pace heretofore unknown, when in March 2003 new regulations were issued opening up a new and potentially highly lucrative way to exit Chinese venture investments by listing them on a foreign stock exchange. This ‘shot in the arm’ led to a flurry of more than 50 exits in 2003 and 2004. Spirits were dampened in early 2005, when the State Administration for Foreign Exchange (SAFE), possibly out of concern over capital flight and as a reaction to the hyperbole and stream of success stories of instant wealth of investors and the Chinese entrepreneurs they backed, made two announcements. Known as SAFE Circulars 11 and 29 they required Chinese nationals to obtain SAFE approval to own shares in offshore entities. Since offshore entities were the favored vehicle of venture funds to structure their Chinese investments and make overseas listings possible, as will be shown in more detail in Section 3.5.3.2 on exiting, this obviously caused serious concern for investors and the people they funded. The number of exits dropped to 22 in 2005, from its all-time high of 38 the year before. The authorities showed considerable flexibility when they realized that they had put a roadblock in the way of the industry’s development. In a display of unprecedented cooperation, SAFE consulted with venture fund managers, accountants, lawyers and the China Venture Capital Association. As a
result, SAFE Circular 75 was issued in November 2005 to supersede the two circulars causing concern. This new circular effectively re-opened the door to foreign listings for venture-backed Chinese companies and also eased associated regulations. Under the new rules capital raised offshore by the venture fund does not have to be repatriated to China, as was mandatory before; and Chinese nationals only have to register with SAFE, while before approval was necessary. This business-friendly approach clearly shows that the government is progressing rapidly on the learning curve and is willing to continue to foster the industry.

The government adopted several other measures enhancing the expansion of the industry. Of key importance are the reform of PRC Company Law and the establishment of a stock exchange for growth companies. In 2005 PRC Companies Law and PRC Securities Law were amended. The net effect for venture capitalists was to create more favorable conditions for exiting investments. In particular, profitability and capital requirements for domestic listings were eased and the lock-up period for investors and management reduced. Also, in August 2004 the Shenzhen Small and Medium Enterprises Board (SME Board) was established under the auspices of the Shenzhen Stock Exchanges, one of the two bourses in China. The goal was to provide access to capital and easier liquidity for growth companies, along the lines of similar exchanges in the West. However, the SSME has not yet lived up to its potential. This is discussed in further detail in Section 3.5.3 on exiting. Finally, for the first time an attempt was made to provide an overall framework for the entire industry. In November 2005 ten government departments, with approval of the State Council, jointly adopted Measure 39 (Interim Provisions for the Administration of Venture Capital Firms). While these provisions are quite general they nevertheless set a positive tone for the future, especially as they indicate flexible exit conditions for venture funds, such as listings and sales of shares to other companies. Detailed implementation measures are reportedly work in progress. Taken
together, the current picture is one of an industry in the process of vigorous expansion since the early years of the new millennium, although further regulatory fine-tuning is certainly still required.

In quantitative terms, the amount of money invested by venture capital funds has grown dramatically, albeit it from a very low base. The table below illustrates this trend.

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount ($ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>1,256</td>
</tr>
<tr>
<td>2004</td>
<td>1,219</td>
</tr>
<tr>
<td>2005</td>
<td>4,039</td>
</tr>
<tr>
<td>2006 (May)</td>
<td>4,960</td>
</tr>
</tbody>
</table>

Source: Asia Private Equity Review

The first China funds were established in the early 1990s. By the end of 2003 a cumulative US$4.25 billion had been invested, still only a fraction of the US$53.5 billion in direct investments made by foreign firms in a single year, 2003 (Ewing 2004). However, three major players alone, Goldman Sachs, Warburg Pincus, and the Carlyle Group, have collectively earmarked some US$2 billion for China investments in the near term (Economist 2004). Despite the impressive growth the potential for future expansion is still more significant.
At present, venture capital and private equity still plays a much lesser role in China than could be the case, given that the country has roughly 25% of the world’s population and is one of the fastest-growing economies in the world. The table below highlights that potential. Japan, Korea, Singapore, Hong Kong, and Taiwan all have four to five times the amount of venture capital than China. However, the figures for Hong Kong very likely include a very significant amount destined for China. Indeed Greater China –the PRC, Hong Kong and Taiwan—has attracted an investment volume rivaling that of Japan. But this comparison is, of course, severely flawed, given the three different regulatory frameworks. Overall it can safely be said that the potential for expansion is truly vast. The latest figures show the increasing pull China has exerted on venture funds: From 2000 to 2008 the capital pool under management for China has grown by a multiple of 10 while the total pool for Asia has grown 3.3 times, as shown in Table 4 below.

<table>
<thead>
<tr>
<th>Year</th>
<th>China</th>
<th>Total</th>
<th>China as % of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>3,500</td>
<td>26,000</td>
<td>13.5%</td>
</tr>
<tr>
<td>2000</td>
<td>3,800</td>
<td>65,800</td>
<td>5.8%</td>
</tr>
<tr>
<td>2007</td>
<td>20,500</td>
<td>190,700</td>
<td>10.7%</td>
</tr>
<tr>
<td>2008</td>
<td>38,000</td>
<td>218,200</td>
<td>17.4%</td>
</tr>
</tbody>
</table>

Source: Asian Venture Capital Journal
CASE VIGNETTE:

ASIMCO

Asian Strategic Investments Corporation (ASIMCO) was set up in Beijing in 1994 by Jack Perkowski, an experienced American investment banker, his two partners and US$ 150 million in capital from two U.S. institutions. ASIMCO’s strategy was to become a major player in the Chinese automotive parts industry, against the backdrop of the rapid growth of the domestic car and truck market. By 2008 ASIMCO had grown to be the largest independent manufacturer of automotive parts in China, with 13 factories in 8 provinces, roughly US$ 500 million in sales and some 12,000 employees. ASIMCO started out as an investment company, very similar to a private equity fund, but is unusual in that it evolved into an operating company in 2004 when it became ASIMCO Technologies Limited. Contrary to most venture and private equity funds, ASIMCO took only majority stakes in the companies it invested in and took operational control. Also atypical was its focus on one industry, with the exception of the disastrous excursion into the beer industry described in more detail below.

In the early 1990s Jack Perkowski, former head of investment banking at Paine Webber in New York, decided to pursue investment opportunities in China. Perkowski had no previous China experience. He decided on the automotive components industry and selected initial investments, after visiting some 100 factories in 40 cities in China. He raised initial capital from Trust Company of the West (TCW), a major American asset manager, and from the investment bank Morgan Stanley. He set up ASIMCO in 1994 with Tim Clissold, a British accountant and Mandarin-speaker, and Ai Jian, an English-speaking former official at the Ministry of Foreign Trade & Economic Cooperation, as partners. ASIMCO was incorporated
in the Cayman Islands, as is typical of a foreign investment manager. By 1997 ASIMCO had invested US$ 360 million, including some US$ 70 million in two breweries (Five Star and Three Ring) in the Beijing area. The move into brewing in 1995 was prompted by the strong growth in demand and the fragmented nature of the domestic industry at the time. It was backed by the Miller Brewing Company of the U.S. Serious operating difficulties, including the problem of removing entrenched management installed by government agencies, led ASIMCO to quit the beer business in 2000 and sell the breweries to Tsingtao, China’s largest brewing group, at a loss likely to be in the US$ 50 million range.

In the automotive field ASIMCO’s strategy was three-pronged: Take a majority position; replace most general managers by what the company called ‘New China’ managers, relatively young Chinese with college degrees and some previous experience in the auto industry; and establish partnerships with major foreign suppliers of automotive parts, such as Bosch, Caterpillar, Delco, Delphi, Honeywell and Nippon Piston Ring. ASIMCO lost significant amounts of capital during its early years when Chinese joint venture partners absconded with money or set up copycat factories. Clissold, who had left the company, describes these adventures in ‘Mr. China’ (2004). In 1998 ASIMCO was recapitalized when the General Electric Pension Trust replaced Morgan Stanley as a key investor. With this move TCW, GE Investments (the investment arm of the pension fund) and management each held one-third of the company.

Despite many early obstacles ASIMCO’s strategy turned out have the right ingredients and the company built up a major presence in powertrain and chassis components. For the heavy-duty market ASIMCO produces diesel fuel injection systems and compressors. It also has its own aluminum and ductile iron casting operations with the related machining facilities.
ASIMCO started exporting in 1998 and set up sales offices in the U.S., the U.K. and Japan. Currently some 15% of sales are realized outside China.

In 2004 ASIMCO was recapitalized again with a US$ 100 million capital injection, led by Key Principal Partners, an affiliate of KeyCorp of the U.S. At the same time ASIMCO completed its transition from an investment firm to an operating company and became ASIMCO Technologies Limited. ASIMCO today is one of the largest foreign-owned companies operating in China.

3.5.1.2 Domestic Venture Capital Firms

In China this relatively young industry is made up of a number of domestic and foreign players as well as a small number of joint local-foreign operations. The distinction between domestic and foreign venture and private equity groups is critical in the light of government ownership of most domestic investment operations and the resulting differences in the way they are structured and what their investment motives are. The figure on the next page gives an overview of the complexity of the industry structure.
Broadly speaking Chinese venture capital companies fall into three categories: They are set up by government agencies, such as the Shanghai and Shenzhen governments; by universities like Tsinghua, keen to trade on their technical expertise; and by large listed corporations like Haier and Legend. In general it can be said that, mostly under government tutelage, the domestic VC business is maturing but still a long way from a Western type of VC industry.

**Government-backed Venture Capital Firms**

Domestic investment in venture capital is largely controlled by government entities. The first venture capital firm, China New Technology Startup Investment Company (Zhongchuan),
was set up in 1985 by the central government under the auspices of the State Science and Technology Commission and the Ministry of Finance, with approval from the State Council. This move by China’s highest executive body reflected the acceptance of a role for venture capital as part of the overall economic reforms initiated by Deng in the late 1970s, as mentioned in the previous section on the evolution of the industry. Even though this first venture company did not do very well and ultimately went bankrupt in 1997, the central government did not backtrack and continued to support venture activities. Funding, however, subsequently shifted largely to local government. Local and regional venture firms provided growth funding for local privately-owned small and medium-sized enterprises (SME) which, as a rule, had difficulties obtaining loans from the government-controlled banking sector. The amounts in questions were usually minor, however. ‘Since the mid-1990s, many government-sponsored venture capital funds have been established to provide financial support to SMEs at the national, provincial and local levels (Fung et al. 2004)’. The domestic venture business accelerated in the late 1990s, partly due to the greater availability of capital and potential investments and partly due to the expectation, on the part of both investors and entrepreneurs, of the establishment of a stock exchange for young high-technology companies, a sort of Chinese NASDAQ. In August 2004 the China Securities Regulatory Commission (CSRC) finally gave the green light for setting up a board for small and medium-sized enterprises at the Shenzhen Stock Exchange, one of the two domestic exchanges. The same listing criteria as for the main Shenzhen Stock Exchange apply. Currently (May 2008) 225 companies are listed on this new board, with a very small market capitalization and very low liquidity.

As the Chinese government privatized more and more state assets by listing companies in Hong Kong or New York in the late 1990s and after 2000, some of those newly listed companies found themselves cash-rich beyond their needs. Some of this excess cash found its
way into domestic venture companies. An example is the Beijing Venture Capital Corporation, in which China Youth Travel Service and Beijing International Trust and Investment Corporation each invested $15 million. The five largest venture companies now each have more than $100 million under management (China Venture Capital Yearbook, quoted in Vega 2004).

Still, given full or partial ownership of venture firms by provincial or local government these companies tend to have access to privileged local information. But frequently they find themselves under political pressure to make investments that fit the local government agenda, e.g. funding companies in newly set up local high-tech zones. This is, of course, in marked contrast to foreign funds with a purely commercial orientation, always looking for the best deal.

Unlike foreign venture funds, usually set up as limited partnerships, domestic venture companies are regular corporations and are run as such. This has important implications for management incentives, as the general partner in foreign funds is entitled to the so-called carried interest, usually 20% of the returns made upon exiting investments. Chinese venture firms operate on a salary plus bonus system. Obviously, foreign fund managers have a stronger incentive to maximize their income by finding attractive deals, managing them well and, above all, securing the best exit. In tandem with this argument, Chinese venture firms often cannot attract experienced, savvy talent.
TABLE 5

MAJOR CHINESE VENTURE CAPITAL FIRMS

Shenzhen Venture Capital Co.
Beijing Venture Capital Co.
Shanghai Venture Capital Co.
Qiming Venture Partners
Guangdong Technology Venture Capital Co.
Shandong Innovation & High-Tech Investment Co.
Jiangsu Innovation & High-Tech Venture Co.
Chinavest Ltd.

Source: own research

CASE VIGNETTES:

BEIJING VENTURE CAPITAL COMPANY LTD. (BVCC)

BVCC is one of the larger Chinese venture capital firms, with more than US$ 100 million under management. Set up in 1998, it has three large shareholders with 25% each and three smaller ones, all directly backed by or affiliated with the Beijing municipal government. The larger shareholders are Beijing International Trust & Investment Co. (BITIC), Beijing International Power Development & Investment Co., and China CYTS Tours Holding Co., one of the largest travel companies in China. This structure is symptomatic for regional venture firms in China. BVCC invests in three areas: Information technology, life sciences, and materials sciences. In general BVCC itself makes the investment and becomes a shareholder of the portfolio company.
The company is organized along traditional corporate lines with a board of directors, a
president, three departments reflecting the three areas of investment focus, and a number of
administrative departments. There is an investment committee which, in addition to internal
know-how, also uses outside experts to arrive at investment decisions. The president and
deputy chairman of the board is also deputy chairman and general manager of BITIC and
appears to have been seconded to his position at BVCC. The 40 or so professionals are on
average in their early thirties. About one-third have an academic background in one of three
investment areas but management and financial experience is relatively thin. In sum, BVCC is
a typical example of a fairly traditional, government-backed Chinese venture firm with a
regional incubator orientation.

NEWMARGIN VENTURES

NewMargin, although set up only one year later than BVCC, has a more dynamic outlook and
represents the newer breed of Chinese venture company. The firm is headquartered in
Shanghai but also has a Beijing office. NewMargin is unique in that it has backing not only
from the local and the central government but also from foreign investors and funds. On the
Chinese side Shanghai Alliance Investment Co., the investment arm of the Shanghai
municipal government, is an investor as is the China Foundation of Science & Technology for
Development, a joint venture between the National Development and Reform Commission,
the Ministry of Commerce and the Chinese Academy of Sciences. Foreign investors include
the Government of Singapore Investment Corporation, the Japanese JAFCO investment
group, Motorola, Alcatel, the Kuok family’s Kerry Group from Singapore, and the K. Wah
Group from Hong Kong. NewMargin has more than US$ 500 million under management.
The investment focus of the group is information technology, sustainable growth technology, healthcare, and high-margin manufacturing. A team of only about 20, led by founder Feng Tao, has invested US$ 200 million in 65 companies and realized 16 public offerings both in China and overseas. The team seems to have more experience than its BVCC counterpart in terms of managing their investments and preparing for an exit. The presence of foreign investors gives NewMargin both exposure to Western technical investment know-how and the flexibility to structure its investments for a listing in China or overseas. In sum, the cooperation of domestic and foreign investors seems to pave the way for more successful venture investments than the purely domestic route.

University-backed Venture Companies

Around 2000, with the internet boom, a number of venture firms tied to universities started to appear. Obviously these firms have the significant advantage of having access to and intimate knowledge of investment opportunities related to research carried out by their university. Tsinghua University, arguably with the best reputation in technology, is a case in point. On the other hand dealflow is usually limited to these opportunities and none other. Again, venture management expertise is often lacking, as is sufficient capital to take full advantage of promising situations. Cash-rich newly listed industrial companies have also become active in this sector and started to provide financial backing to a number of these venture firms. The latter development mirrors to some extent the picture in the West, where industrial companies also sponsor university research projects, although they may not be directly involved as shareholders in university venture spin-offs.
Corporate Venture Capital Firms

After the government published Proposal No. 1 in 1998 a large number of corporate venture firms were set up. Today they represent the majority of domestic venture capital funding and one in ten listed companies has its own venture arm (White et al. 2002).

The first such companies set up in late 1998 were Beijing Venture Capital Ltd. and Beijing High-Tech Venture Capital Ltd. They had strong government backing and were seen by many observers as part of Beijing International Trust & Investment Corporation, the Beijing government’s holding company. Subsequently many true corporate venture firms were set up. As part of the privatization of state assets there was a virtual frenzy of public listings both in China and overseas, starting in the mid-1990s and accelerating after 2000. As mentioned above, many of these companies raised more cash from their IPOs than they had immediate operational needs for and hence were looking for investment opportunities generating quick returns. The hope for an imminent establishment of a ‘Chinese NASDAQ’ also fuelled these moves. Some of the newly listed companies, in conflict with their listing documents presented to the stock exchange, also invested heavily in real estate. Tsingtao Brewery for example, the first Chinese flagship companies to list in Hong Kong in 1993, came under fire for lending substantial amounts of ‘excess’ cash to third parties in 1995 and top management was replaced. Some corporate venture firms underestimated the time it would take to set up a board for small growth companies and overextended themselves. By now the situation is more stable. Some corporate venture firms also at times align themselves with other companies with sizeable cash flows, with individual investors as well as foreign firms, usually for deals in industries where one or the other partner feels he can add particular value.
In general, for the corporate investors behind these venture firms new product and market opportunities might open up by using this vehicle, apart from the potential financial returns. For ventures receiving capital from these investors new customers and suppliers might be found. In contrast to Western corporate venture firms their Chinese counterparts often invest outside the sector their parent is engaged in. A very dynamic example is Hony Capital, set up by John Zhao in 2003 and funded by the large computer group Legend Holdings. Hony has some $700 million under management and 12 investments in China with sales of $2.7 billion. These include the world’s largest manufacturers of vitamin C and of penicillin, respectively; Asia’s largest fiberglass producer; and China Glass Holdings, China’s largest float glass company, which Hony is using to consolidate China’s fragmented glass industry by way of numerous acquisitions.

### TABLE 6

**SELECTED LISTED COMPANIES’ INVESTMENTS IN VC FIRMS**

<table>
<thead>
<tr>
<th>Listed Company</th>
<th>Industry</th>
<th>VC Firm Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Neusoft</td>
<td>Software</td>
<td>Liaoning East Information Industry VC RMB 100 million</td>
</tr>
<tr>
<td>Wanxiang</td>
<td>Auto Parts</td>
<td>Wanxiang VC RMB 200 million</td>
</tr>
<tr>
<td>Ancai High-Tech Co.</td>
<td>TV Components</td>
<td>VC RMB 200 million</td>
</tr>
<tr>
<td>China Youth Travel Service</td>
<td>Travel</td>
<td>Beijing VC RMB 125 million</td>
</tr>
<tr>
<td>Beijing International Trust &amp;</td>
<td>Diversified</td>
<td>Beijing VC RMB 125 million</td>
</tr>
<tr>
<td>Investment Corp.</td>
<td></td>
<td>Tianjin Taida VC</td>
</tr>
<tr>
<td>Capital Iron &amp; Steel</td>
<td>Steel</td>
<td>Beijing High-Tech VC</td>
</tr>
<tr>
<td>Legend</td>
<td>Computers</td>
<td>Hony Capital</td>
</tr>
</tbody>
</table>

Source: White, Gao & Zhan; own research
3.5.1.3 Foreign Venture Capital Funds

Foreign funds have become the most important source of venture funding in China. At the end of 2006 14 of the 20 largest venture investors in China were foreign. Table 7 below lists the most important groups. By the end of 2007 some 75 foreign venture funds were active in China. Hong Kong is by far the preferred location for the fund management teams but many have offices in Beijing and Shanghai as well (Show us the money 2003).

Foreign funds have been active in China since the late 1980s. Pioneer investors such as American International Group (AIG), the Dutch ING insurance group and New York Life from the US as well as Hong Kong tycoon-led groups like Jardine Fleming and Sung Hung Kai set up funds at least partially motivated by the prospect of obtaining a license or favorable treatment for their core businesses in China. These funds invested mostly in township enterprises run by local government in China. The idea was to build on these relationships to ultimately source more sizeable deals from large state-owned enterprises (SOEs). The problem was that SOEs, often concerned with preserving their most valuable assets for a listing in Hong Kong, usually kept the best deals for themselves. These first investors invested directly in joint ventures with their Chinese partners. The current practice, given the impossibility up to now for foreign funds to list their portfolio companies in China, is to create an offshore corporation which then invests in the Chinese company. In this fashion the route to an ultimate listing on a bourse outside China remains open. Domestic venture companies, of course, have the possibility of listing companies they finance in China. Other differences are related to the focus of foreign and domestic firms. Foreign venture funds tend to look for investments with high growth potential in traditional as well as high-tech industries. Chinese venture companies focus more on pure high-tech companies. Also, as
mentioned, foreign funds are almost always set up as limited partnerships while Chinese venture firms are corporations.

A key difference is the foreign funds’ greater experience. In a survey conducted in 2001/02 Zhang and Jiang found the average experience of foreign fund managers in China to be almost 12 years, compared to just over 2 years for their Chinese colleagues (Zhang & Jiang 2002, quoted in White et al. 2002). This longer experience translates into an ability for foreign funds to provide more value-added services to their investments, an issue explored in more detail in Section 6.3.2 on investing.

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**TABLE 7**

**MAJOR FOREIGN VENTURE FUNDS IN CHINA**

- IDG Technology Venture Investment
- Baring Private Equity Asia
- Intel Capital China
- Warburg Pincus
- Draper Fisher Jurvetson
- Softbank China & India Holdings
- Goldman Sachs (Asia)
- Doll Capital Management
- Sequoia Capital
- Granite Global Ventures
- CVC Asia Pacific
- Accel Partners
- CDH Investment
- Actis
- Ignition Partners

Source: own research
Western funds operating in China fall into the following categories: Traditional venture capital funds, corporate venture arms established by large foreign technology companies; and, more recently, large buyout funds taking strategic stakes in large Chinese firms. These three types are described briefly in the following.

Traditional foreign venture capital funds, in a nutshell, have entered China with a strong capital base and an experienced team usually supplemented by Chinese educated abroad. They tend to avoid start-up companies, invest larger amounts per deal than domestic venture firms and are oriented towards exits offshore. In the area of access to quality information they often lag behind their Chinese counterparts. They are virtually always structured as limited partnerships, with the fund managers being the general partner.

Foreign corporate venture firms have developed a strong presence in China. These are the venture arms of large U.S., Far Eastern and, to a slightly lesser extent, European high-tech firms like Intel, Cisco, Softbank, Acer, Nokia, and Siemens. The main objective of these firms is to create a conduit to research & development conducted in their sectors of expertise in China that parallels their own internal research efforts. As a longer-term benefit demand for their products could be stimulated due to their very presence and contacts made via their investments.

Foreign buyout funds in China are a relatively new phenomenon. As the Chinese government accelerated its massive privatization program since the early years of the new millennium, some of the largest public offerings in the world were launched. Following the telecom sector, all four giant state banks were privatized, as were insurance, oil, chemical, aluminum and coal companies. These unique opportunities to buy into basic Chinese industries attracted a
number of primarily U.S. funds like the Carlyle Group, Texas Pacific, Goldman Sachs, Newbridge Capital but also Temasek, owned by the Singapore Government. These financial investors took so-called ‘strategic stakes’ of up to 5% of the capital at the time of the listing, particularly in the financial services industry. The motivation in these cases was purely commercial and has so far paid off handsomely for these investors.

### TABLE 8

**STRATEGIC STAKES TAKEN BY FOREIGN BUYOUT FUNDS**

<table>
<thead>
<tr>
<th>Chinese Company</th>
<th>Foreign Financial Investors</th>
<th>Capital Invested</th>
<th>Stake</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lenovo</td>
<td>General Atlantic, Newbridge, Texas Pacific</td>
<td>$350m</td>
<td>10%</td>
<td>2005 (March)</td>
</tr>
<tr>
<td>China Pacific Life Insurance</td>
<td>Carlyle Group, Prudential</td>
<td>$409m</td>
<td>25%</td>
<td>2005 (Dec.)</td>
</tr>
<tr>
<td>Industrial &amp; Commercial Bank of China</td>
<td>Goldman Sachs</td>
<td>$2,580m</td>
<td>7%</td>
<td>2006 (Jan.)</td>
</tr>
<tr>
<td>Bank of China</td>
<td>Temasek</td>
<td>$1,550m</td>
<td>5%</td>
<td>2006 (Feb.)</td>
</tr>
<tr>
<td>Shandong Chenming Paper</td>
<td>CVC Asia Pacific</td>
<td>$623m</td>
<td>30%</td>
<td>2006 (May)</td>
</tr>
</tbody>
</table>

Source: own research

### 3.5.1.4 Joint Sino-Foreign Venture Companies

A final element of the structure of the Chinese venture industry is the small group of joint ventures between foreign and domestic investment companies. For the foreign partners the motivation for entering into such an arrangement tended to be access to local information and
contacts. The Chinese side was looking for a stronger capital base and a faster move up the
learning curve by associating with an experienced foreign team. An example is the $200
million fund jointly run by Qimeng Venture Partners of Shanghai and Ignition Ventures of the
U.S.

3.5.2 Process: Venture Capital Cycle in China

Before an analysis of the investment process in China in the light of the research findings, it
may be useful to look at the question for foreign venture funds of whether to invest in China
at all. While most of the trade literature is full of hyperbole about the attractions the Chinese
market offers to funds, the occasional warning voice proclaims ‘don’t invest in China’ (Foote
2005) or ‘show us the money’ (PriceWaterhouseCoopers 2003). How does China fit into the
overall risk/reward equation for private equity investors?

On a macro level, country risk, exchange risk and the non-convertibility of the Chinese yuan
are concerns. The former consists less of the threat of a second Tiananmen uprising but more
of the discrepancy between central government laws and local implementation, or rather the
lack or distortion thereof. Politically motivated regulatory changes, or just plain greed at the
provincial or local level, may abruptly and drastically change the assumptions of a carefully
designed business plan. Arbitrarily lowering agreed-upon electricity tariffs are only the most
visible manifestation because of the size of the investments involved (Woo 2005). Exchange
risk is less of a problem for foreign investors in China as the only likely move under current
circumstances would be a revaluation, resulting in enhanced returns. Hedging tools are
virtually unavailable due to the inconvertibility of the yuan. The non-convertibility of China’s
capital account also poses the critical question for foreign investors on how to repatriate their profits.

In a recent survey by PriceWaterhouseCoopers of 84 funds the following were found to be the key challenges to investing in China: Ability to exit, transparency and reliability of information, corporate governance, legal concerns, management quality, currency convertibility/funds repatriation, and political issues (Show us the money 2003). These were mentioned, in order of importance, by at least 40% of all respondents. These results point to the conclusion that hard factors, the ‘givens’ of China’s institutions, are of major concern before the decision whether to invest in China or not. Soft factors seem to come into play more after the investment was made. The role of these soft, more culturally determined factors play and how foreign investors cope with them, and ultimately perform, is an intriguing area for research. Both hard and soft factors are the subject of this study and the findings are presented in the following sections.

In line with the private equity cycle framework outlined by Lerner et al. (2005) and presented in Section 3.4 on the Western setting, we can differentiate a number of key elements. In a nutshell, the private equity cycle goes from fundraising and structuring a fund to selecting, managing and monitoring investments to harvesting profits from exiting. Hopefully, based on successful performance, fresh capital can be raised for a new fund. The initial and final stages appear to be pre-determined: Foreign investment groups raise capital for China funds much the same way they raise capital for US or European funds, primarily from institutional and wealthy private investors. The fund’s structure has to strike a balance between investors’ expectations of significant returns and Chinese regulations allowing few exit alternatives. The regulatory straightjacket of the Chinese setting, although it is being adjusted periodically, is a
given all foreign funds have to live with. What is inherently different between China and other markets, and therefore intriguing to study in depth, is which of the softer elements of the investment process need to be mastered in order to ultimately insure superior performance.

3.5.1 Fundraising

The initial capital-raising stage is identical worldwide. Fund managers raise capital from institutional and high-net worth private investors for investing in a portfolio commensurate with their expertise. For investments to be made in China foreign institutional investors have entrusted venture and private equity funds with billions of US dollars in recent years, as the table below illustrates. The latest available data show that in 2007 a dramatic US$10.4 billion was raised by China funds, almost double the amount of the year before (Asian Venture Capital Journal 2008). Technically some of this capital may be invested elsewhere in Asia as foreign funds, given their ten-year lifespan, are usually structured in such a way as to leave the backdoor open to find target companies in other countries as well. However, it can be safely assumed that the vast bulk of this capital raised is destined for China.

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount US$ mill.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>210</td>
</tr>
<tr>
<td>2004</td>
<td>310</td>
</tr>
<tr>
<td>2005</td>
<td>2,240</td>
</tr>
<tr>
<td>2006</td>
<td>5,300</td>
</tr>
<tr>
<td>2007</td>
<td>10,400</td>
</tr>
</tbody>
</table>

Source: Asia Private Equity Review, Asian Venture Capital Journal
In terms of fund structuring the Chinese regulatory framework definitely presents challenges to foreign venture and private equity funds. There is a marked difference in the way foreign and domestic funds are structured. While domestic funds are straightforward corporations governed by the PRC Companies Law, foreign funds are limited partnerships. Chinese company law does not know limited partnerships. Why do foreign funds choose a different structure? The answer lies in the expectations of the investors who put up the capital for the fund. Historically funds in the US and Europe have been organized as limited partnerships so as to be able to pass the gains made by the fund to the investors with an absolute minimum of deductions in the form of taxes. Under the partnership agreement limited partners’ liability is limited to the capital they contributed to the fund. They have the right to monitor the fund’s activities but cannot get involved in day-to-day operations, which are the realm of the general partner/fund manager. As shareholders of a corporation the investors’ gains would be subject to local taxation. In addition, given the non-convertibility of the Chinese yuan, there would be difficulties in repatriating funds.

Geography in the form of the Chinese setting introduces another dimension into this complex relationship. A Chinese venture firm, as a corporation, cannot easily list the shares of a company in its portfolio. Listings made in China and listings made offshore by Chinese companies are subject to approval by the China Securities Regulatory Commission (CSRC). To circumvent this obstacle foreign funds make their investments in China by way of a special purpose vehicle (SPV), a company incorporated outside China, usually in a tax-sheltered jurisdiction like the Cayman Islands or the British Virgin Islands. As a foreign investor in China this SPV is in a position to ultimately list its investment on a foreign bourse, without the need for approval by the CSRC. As a successful exit is the raison d’être of the fund this structure is critical for the fund to achieve the returns required to satisfy investors.
The figure below highlights the difference in structure made necessary by the need to balance investor expectations and the Chinese context.

CASE VIGNETTE
GEMS & MACQUARIE / ASIA RESOURCES FUND

In 2007 GEMS, a Hong Kong-based private equity fund management group, and Macquarie Bank from Australia joined forces to raise capital for the Asia Resources Fund, a vehicle to invest in a diversified portfolio of natural resource companies or assets in China and the Asia Pacific region. Having raised an initial US$ 200 million the fund had a first closing in January 2008. The aim is to raise a further US$ 800 million by September 2009. The fundraising process, in this case strengthened by the networks of two partners, and the structure adopted are typical of foreign funds investing in China.

General Enterprise Management Services International Limited (GEMS) manages three private equity funds (GEMS I, II and III) that invest in China and the Asia Pacific region. Taken together the three funds have over US$ 650 million in capital, raised from private investors and major multinational institutions, including GE Capital, Hutchison Whampoa, Japan Tobacco, Mitsui, Mitsubishi, Richemont and the Dubai Investment Authority. This fund management firm was founded in 1998 by Simon Murray, formerly head of Deutsche Bank in Asia and a key executive with companies controlled by Li Ka-Shing in Hong Kong. Macquarie Bank is one of the largest Australian banks and is also active in fund management in Asia through its investment arm Macquarie Capital.
The fund targets both controlling and minority stakes with an investment size of US$ 20 to 100 million in companies active in the following sectors: Oil and gas, coal, metals, forestry and services related to the resource sector. China is one of the key target markets of the fund. The capital provided by the fund is intended for resource development and for expansion or consolidation strategies.

The structure of the fund, shown below, allows for flexible exits from investments by way of public offerings on stock exchanges worldwide, as the portfolio company shares are held by an entity registered in the Cayman Islands for tax purposes. Investors pay their contribution into this Cayman Islands fund, which has a board and advisory committee. Actual investment decisions are made by the investment management company and sanctioned by its investment Committee. The management company has an agreement with the fund, compensating it for its services. The management company is registered in the British Virgin Islands for tax purposes but its offices are in Hong Kong. The management team consists of representatives from both GEMS and Macquarie.
FIGURE 3

SCHEMA OF DOMESTIC VS. FOREIGN FUND INVESTMENT

Investment by PRC Venture Company

Investment by Foreign Venture Fund
3.5.2 Investing

For this analysis incorporating the results of the research interviews in China we will follow the same outline as in Section 2.3.3 on the Western setting.

Deal Sourcing:

While in developed economies funds can select investments from a wide array of transactions, private equity investors in China, as in other emerging markets, mostly target established firms in established sectors. In China, where all firms were state-owned until the dramatic reforms instituted by Deng starting in the late 1970s, these tend to be of two types: Private companies run by dynamic entrepreneurs and co-investments with foreign companies when private equity funds can serve as risk-spreading buffers and monitors (Show us the money 2003). In line with patterns prevalent in other developing economies three additional types of transactions can be found in China:

--- Privatizations: In order to modernize the country’s infrastructure the PRC government over the last ten years began the process of privatizing significant state assets, such as the telecoms, oil, steel, airline and banking sectors. This was accomplished primarily by listings on the Hong Kong and to a lesser extent on the New York Stock Exchange.

--- Restructurings of state-owned enterprises (SOEs): The larger SOEs, bloated by ‘iron rice bowl’ cradle-to-grave welfare obligations and beset my huge debts, have begun to refocus on profitable activities. This involves breaking up huge monolithic corporations and spinning off operations that have, in some cases, been of interest to private equity funds. The most attractive of these, however, have been packaged for listings on the Hong Kong and New York stock exchanges.

--- Infrastructure funds: Foreign funds specializing in infrastructure investments, usually along with multilateral institutions, have invested in Chinese power generating plants,
toll roads, and harbor installations. In market economies bonds are the classic instrument to finance these large projects. For projects in China bonds convertible into shares if and when the company is listed in Hong Kong are attractive alternatives, as evidenced by Hutchison Whampoa’s financing of Hutchison Delta Ports. The latter company runs a series of container ports along the Pearl River delta.

**Deal Selection:**

Private equity investors in the West have developed broad criteria to select promising deals among the hundreds of proposals received and to then subject the opportunities thus selected to detailed evaluation, or due diligence. In China the number of attractive deals is lower and, therefore, subject to more competition among funds. Private equity funds in China must use a more proactive approach, often by attempting to break into the sets of relationships -- political, business, or social -- that exist at the central government, provincial, and local levels or even those in a family or clan. Hence soft factors take on an important dimension in this context. Overall, the criteria used to select investments tend to be identical. The quality of management tops the list. In addition, market prospects and exit opportunities are also crucial. All three present serious problems to the investor in China. Exiting warrants separate treatment and is dealt with at the end of this section.

Due to the significant cultural gap the quality, in particular the honesty, of management is very often extremely difficult to assess. Horror stories of Chinese entrepreneurs absconding with the capital invested by foreigners abound. The experience of the single largest foreign investment fund in China, ASIMCO, is particularly poignant (Clissold 2004). This makes the negotiations with local entrepreneurs, especially regarding control issues, particularly challenging. Based on anecdotal evidence this could well be the largest single hurdle for
foreign investors. The culture gap translates also into diverging attitudes towards valuation (see below). Given the lack of trust Bruton et al. (2004) found in their study that investors recommended to put money only into companies geographically close enough for easy supervision and to avoid start-ups altogether.

Commercial due diligence is often flawed. Availability and accuracy of information is not assured (Bruton et al. 2004). Market statistics tend to be unreliable or intentionally or unintentionally distorted.

**Deal Valuation:**
While elaborate evaluation models are in use for US and European investments valuation of Chinese assets is notoriously difficult. Most private companies do not have audited financial statements. State-owned assets must be valued by a government agency. Accounting and auditing standards are improving but not yet at par with generally accepted Western standards. Price expectations on the Chinese side are often emotionally tinged. Western accounting firms’ local offices are building up valuation expertise and have begun to narrow the gap somewhat. As mentioned above, statistics may be distorted and regulatory risk is high. All these uncertainties make the pricing of, in particular, assets and accounts receivable, let alone forecasting future cash flows an extremely volatile exercise.

**Deal Structuring:**
As a function of the degree of sophistication of the financial markets in question, a variety of financial instruments is available to the private equity investor in the US, Europe and Japan: Common stock, different types of preferred stock, several classes of debt, convertible bonds. In China virtually all investments are made in a local company’s common stock. Shareholder
agreements, in the West standard tools governing relations between the partners, feature similar control rights for investors no matter which market is being invested in. The significant difference in China is the relative lack of enforceability, due to the absence of a Western-type rule of law. ‘For a Westerner a contract is a contract, but in China it is a snapshot of a set of arrangements that happened to exist at one time (Clissold 2004, p 252)’. Therefore we can argue that what is definitely a hard factor in the West is a soft one in China.

Monitoring the investment and providing value-added services:
The studies conducted by Bruton et al. (2004) and Vega (2004) show this area to be a veritable minefield for foreign investors, as in many instances different goals, expectations and cultural proclivities meet head-on. In the Western context fund managers support their portfolio companies, usually via board members they appoint, in that they give advice to management, provide strategic direction and market or supplier contacts. The China investors studied by Bruton et al. (2004) list as their principal problems in this regard very weak boards of directors, often made up of friends and cronies; the need to get involved in low level problems, e.g. help with basic accounting; the close personal supervision required; recognizing that advice must be provided in a face-saving manner; and the need to obtain information about guanxi, or the relationship network that management has, e.g. as far as the nature of debt and accounts receivable is concerned. Chinese and Western views of corporate governance in general and the role of boards in particular diverge in most cases. Technically boards are not even required in China (Fung et al. 2004). Although most portfolio companies have one this does not mean that it plays a key role as it does in Western countries. The legacy of decades of state ownership weighs heavily on governance issues. All these important differences require foreign funds to play a much more active role than they are used to from the West.
CASE VIGNETTE

WAHAHA – DANONE

In March 1996 Hangzhou Wahaha Group, one of China’s largest beverage companies, and the French Danone Group, one of the world’s largest food and beverage producers, set up a string of five joint ventures, with the private equity arm of Peregrine Investment Holdings, the Hong Kong investment bank, as a co-investor. Jointly Danone and Peregrine owned 51% of the joint venture and Wahaha 49%. Peregrine, through its network of relationships in China and overseas, was instrumental in bringing the two companies together. Hailed at the time as a showcase joint venture, with private equity participation, the company became China’s largest beverage producer with sales exceeding US$ 100 million. However, the cooperation has since turned sour and the two parties have been involved in legal battles since 2007. The reasons for the disagreements between the partners are a classic illustration of the different approaches to business in China and the West, in particular the divergent views of the role of the board of directors. In this instance the early departure of the financial investor triggered the conflict and the very success of the company exacerbated it.

The Wahaha company grew out of a school-run business in Hangzhou. Zhou Qinghou set up the original company with two retired teachers in 1987 to produce ‘Wahaha Oral Liquid for Children’, a milk drink with a medicinal effect. ‘Drink Wahaha to have a good appetite’ became a highly successful slogan and after production capacity was expanded by way of a merger with a Hangzhou canning company in 1991, the group set up a number of subsidiaries in other provinces and grew substantially in size. Main products are milk drinks and bottled water.
The initial deal structure of the 1996 joint venture with Danone pioneered a pattern adopted subsequently by other private equity funds in China. The investment in Wahaha was not a pure fund investment but a co-investment by a foreign firm with a fund. Jointly these two players set up an investment vehicle in Singapore called Jinjia Investment Company, which held the stake in the joint venture companies. Danone and Peregrine together invested slightly more than US$ 70 million, which allowed the venture to bring in advanced technology in the form of production lines from Europe, North America and Japan. The board of Jinjia consisted of two representatives from Danone and one from Peregrine. Peregrine Direct Investments, the private equity arm of Peregrine, made its investments for the traditional reasons of financial investors: Ultimately it wanted to exit by selling its shares to either Danone or Wahaha, or to benefit from listing the joint venture. The business had grown to 39 joint venture companies by 2007 with an injected capital in excess of US$ 130 million.

In the wake of the Asian financial crisis of the late 1990s Peregrine Investments Holdings collapsed in early 1998 with immediate repercussions for Peregrine Direct Investments’ stake in Jinjia and, therefore, in the joint venture. It transferred its Jinjia shares to Danone and its representative on the board was replaced by a third Danone director. The deal structure was critical in this context as a transfer of shares in the joint venture would have been subject to government approval in China but a transfer of shares in Singapore-registered Jinjia was outside the Chinese government’s control. With the acquisition of Peregrine’s shares Danone became sole majority owner of the joint venture. Zong later accused Danone of orchestrating a stealthy takeover in bad faith.

As chairman of the joint venture companies, Zong was left considerable leeway by Danone in the day-to-day running of the business. Obviously his entrepreneurial acumen was held in
high regard. But Zong felt constrained by the limits of the control structure, requiring board approval for strategic decisions and board meetings taking place only every quarter. Danone allowed Zong to become a minority partner in businesses that made Wahaha products outside the joint venture structure, as some local governments preferred to have him personally as a partner. Allegedly, though, Zong set up more than 80 companies between 2001 and 2006 making Wahaha products outside the joint venture. These activities are at the core of the current legal dispute.

3.5.3 Exiting

The prospect of listing a portfolio company is critical for a private equity fund as this avenue usually provides the highest returns. It is, therefore, the prime driver for making an investment in the first place. However, an exit via an IPO on one of the two Chinese stock exchanges in Shanghai or Shenzhen is so highly regulated as to be uninteresting for a foreign investor. The China Securities Regulatory Commission (CSRC) determines which companies may list and their agenda for priorities is usually politically motivated. Companies with foreign participation are viewed as not needing the capital provided by the stock exchange. The two Chinese exchanges are de facto reserved for companies with 100% Chinese ownership. The establishment of a new board for small and medium-sized companies on the Shenzhen Exchange in August 2004 provides a source of capital for young, high-growth Chinese firms. However, since the same listing requirements as for the main board apply, companies with foreign ownership are effectively barred.

In terms of an exit via IPO this picture leaves foreign funds only with listings on stock exchanges run along Western standards. In the years 2005 and 2005 foreign fund investors
listed a collective 38 companies (Chosen the Favorite 2006). The Hong Kong Stock Exchange (HKSE) attracted 21, or just over half, of these; NASDAQ and the New York Stock Exchange 14; and the Singapore Exchange 3. The HKSE tends to offer slightly lower valuations at the time of the IPO than NASDAQ but has shown stronger post-listing performance. In order to list their portfolio companies on one of these exchanges funds must adopt an offshore structure for these companies. If they were incorporated in China they would be subject to the placet of the CSRC.

For many funds investing in China whose portfolio companies do not meet Western listing standards this effectively only leaves a trade sale with the attendant lower returns as the only exit option (Bruton et al 2004). Another exit door common in the West, the buyout route allowing management to buy the investors’ shares, was only opened in China very recently by the government. But this option is restricted to the privatization of state-owned assets.

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**CASE VIGNETTE**

**ALIBABA**

The story of the Alibaba Group is a classic case of success stemming from the marriage of Chinese entrepreneurial talent and foreign venture capital. Alibaba was founded in 1999 by Jack Ma, a former English teacher in Hangzhou. Alibaba is a group of internet-based companies engaged primarily in business-to-business (B2B) trade, search functions, retail and payment systems. Its flagship company, Alibaba.com, made a public offering in Hong Kong in 2007 that was the largest internet IPO since Google’s NASDAQ listing in 2004.
Ma set up Alibaba.com as an internet trading platform bringing together Chinese small and medium-sized manufacturers and buyers from China and around the world. In 1999 and 2000 he received US$ 25 million in venture capital funding. Masayoshi Son, the founder of the Japanese software company Softbank, invested US$ 20 million and the investment bank Goldman Sachs and several venture capital funds, such as the venture arm of Fidelity and Venture TDF Technology, collectively put up another US$ 5 million. Alibaba.com became profitable in 2002 and in early 2004 Ma raised another US$ 82 million from venture investors to finance expansion of Alibaba.com and to set up new businesses, such as the e-commerce retailer Taobao. In this second round of financing early backers Softbank, Fidelity and TDF were joined by Granite Global Ventures from the U.S. as a new investor. The fresh injection of capital made Softbank the second-largest investor in the company, after management and employee shareholders.

In 2005 privately-held Alibaba Group entered into a strategic partnership with Yahoo from the U.S. Yahoo paid US$ 1 billion for a 40% stake in Alibaba Group and contributed its Chinese assets, estimated to be worth some US$ 700 million. Jerry Wang, Yahoo’s chief executive, joined Alibaba Group’s four-man board of directors. This move gave Alibaba the financial strength to cope with the expected expansion in China of Google and E-Bay, two of the largest American internet-based companies.

In November 2007 Alibaba.com floated 17% of its capital on the Hong Kong Stock Exchange in an initial public offering for US$ 1.7 billion, valuing the company at US$ 10 billion. This volume was only surpassed by Google’s listing in 2004. The early venture capital backers of Alibaba realized double-digit multiples of their original investment.
3.5.3 Performance

Access to the first survey ever conducted on the performance of venture funds in China allowed for an analysis of the returns of both funds and individual venture-backed companies, the China Venture Capital Performance Report 1994-2005 (CVCA & Zero2IPO 2006). The conclusions drawn from this analysis are preliminary as the survey covered only basic characteristics such as industry and location and did not go into depth on specific elements of the investment process. Nevertheless, the map of the venture industry in China is given some first performance contours.

The survey was conducted jointly by the China Venture Capital Association and Zero2IPO, a well-established research company specializing in the Chinese venture industry. The sponsors approached 70 venture funds in the last quarter of 2005 and received 62 valid responses, 40 from foreign and 22 from domestic funds. Funds with an operating history of less than 3 years were excluded, as it generally takes a minimum of three years to realize a first exit. In addition, data on the 108 recorded exits of venture-backed companies up until November 30, 2005 were analyzed. These do not contain performance data. The records on these exits are derived from Zero2IPO’s proprietary China Venture Database, which has monitored investment activities by some 200 foreign and domestic funds since 1999. The exits analyzed were not necessarily all made by the 62 funds surveyed but for the majority this can assumed to be the case.

3.5.3.1 Fund Performance

The data on the performance of domestic venture firms and foreign funds show very clearly the powerful influence of the Chinese setting in terms of the still evolving nature of the regulatory infrastructure. The limitations that the regulations in place force on local venture
firms clearly restrict their room to maneuver. Exit-by-listing options for them are restricted to China while foreign funds, using sophisticated structures for their investments in China, have their choice of foreign stock exchanges. As listings abroad usually achieve significantly better returns, foreign funds performed significantly better than their domestic counterparts. The following table underscores this point.

**TABLE 10**

**IRR OF DOMESTIC AND FOREIGN VENTURE FUNDS**

<table>
<thead>
<tr>
<th>IRR</th>
<th>Domestic VC Firms</th>
<th>Foreign VC Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;40%</td>
<td>0</td>
<td>7</td>
</tr>
<tr>
<td>20-40%</td>
<td>0</td>
<td>15</td>
</tr>
<tr>
<td>10-20%</td>
<td>5</td>
<td>16</td>
</tr>
<tr>
<td>0-10%</td>
<td>17</td>
<td>2</td>
</tr>
<tr>
<td>Total</td>
<td>22</td>
<td>40</td>
</tr>
</tbody>
</table>

Source: Zero2IPO & CVCA

More than half of the 40 foreign funds surveyed had an internal rate of return (IRR) of 20% or more and the IRR of 7 funds exceeded 40%. The IRR, as mentioned in detail in Section 3.5, is a widely used measure of fund performance. Generally an IRR of 20% or more is deemed by investors to be a satisfactory return for this asset class. Among the Chinese venture firms in the survey, 17 out of 22 had an IRR below 10%. Only 2 of the 40 foreign funds were in the same category. The best performing local venture companies – 5 with an IRR between 10 and
20% -- managed to leverage their local information advantage and their cooperation with foreign funds.

The reasons for this poignant discrepancy can all be traced to the relatively early, evolving stage of the industry infrastructure in China.

First, domestic venture firms have fewer attractive exit options. Even if permission for a listing in China is granted by the CSRC, shares held by the venture firm were until recently locked up for three years. This is now reduced to one year, following the reform of the Securities Law. Foreign venture funds can structure their investments in such a way that allows offshore listings.

Second, local firms tend to have a significantly smaller capital pool at their disposal than foreign funds, as their fundraising is severely limited. Chinese pension funds and insurance companies are not allowed to invest in venture firms.

Third, in tandem with the limited fundraising alternatives, domestic venture firms are directly or indirectly government-funded. This has led in some cases to politically motivated investments.

Fourth, domestic firms are corporations under Chinese company law, as opposed to the partnership structure of foreign funds. This limits their flexibility in terms of taxation and also the incentives management can be offered.

A fifth reason is not related to the regulatory straightjacket for venture firms but to the nascent nature of the industry. By virtue of the relatively short operating history of Chinese venture firms their managers tend to have less experience than their foreign colleagues, although this gap is bound to close over the next few years.
3.5.3.2 Investment Exit Performance

The survey of the 62 venture funds also yielded performance on individual investments these funds exited. Unfortunately the total number of investments covered was not divulged due to confidentiality reasons. However, the survey sponsors also made available data on the 108 exits recorded until the end of November 2005. This information is broken down by a number of variables such as type of exit, industry, and location but does not contain performance data. We will use this information to supplement the performance data on the exits made by the 62 funds, although the amount of overlapping between the two samples cannot be determined in detail. We assume it to be significant. In the following we will refer to the sample of the exits made by the 62 funds as the ‘performance sample’ and to the sample of the 108 individual company exits as the ‘exit sample’.

Performance of the exits made by the 62 funds was measured by calculating the investment multiple for each company, equivalent to the amount of capital gained by the fund when compared to the original investment made. As an example, a company in which 2 millions were invested and that was sold for 6 millions would have a multiple of 3. Mean and median of the multiple were derived for the funds and broken down by a number of variables such as industry and location. These results will be presented in the following. In toto, the mean investment multiple for all funds was 8.2 while the median was 3.6.

While on the surface it may seem impressive that the 62 funds covered on average made eight times the capital they invested it seems useful at this stage to very briefly review the statistical concepts of mean and median. The arithmetic mean or average is calculated by obtaining the sum of the observations made and dividing it by the number of observations. The median of a series of observations is the point which divides the series so that half the observations are on
one side and half on the other. The mean can be affected by a small number of excessively
high or low figures which distort it upwards or downwards while not reflecting the values for
the majority of the cases. The median has often more explanatory power as represents a truer,
less distorted picture of the values for most of the cases than the simple average.

Therefore, an overall mean of the investment multiple of 8.2 vis-à-vis a median of 3.6 shows
that a handful of investments generated significantly higher returns and distorted the general
picture for the sample. Against this backdrop, we will now examine more specific findings of
the survey.

**Performance by Type of Exit:**

Two exit types were distinguished: Public offering (IPO) and trade sale (M&A). Again, no
absolute numbers of the investments for each category were indicated in the performance
sample. In the exit sample of 108 companies 79, or roughly three-quarters, were IPOs and 29
M&A exits. So IPOs were clearly the preferred exit route. For the entire performance sample
the mean and median for IPO exits were 8.9 and 3.9, respectively; the corresponding figures
for M&A exits were 6.2 and 2.7. Again, a number of extraordinarily high multiples realized
by way of an IPO or a trade sale hide the ‘normal’ returns achieved. One single M&A exit of
a Zhejiang Province company, for example, provided an investment multiple of 24 to its
investors. Overall it seems fair to conclude that IPOs with an investment multiple of around 4,
as measured by the median, were the more attractive exit route than trade sales, not far behind
with a multiple of almost 3. This means that very decent returns can be made by trade sales
and that an exclusive focus on an exit by IPO is not always the best solution.
For IPO exits the choice of which stock exchange will offer the best return for a listing is a critical question. For the companies in the performance sample NASDAQ in New York provided by far the highest investment multiple, with a mean of 14 and a median of 12. Apart from attractive valuations NASDAQ also provides a good measure of liquidity, due to its access to a wide range of institutional and private investors from the U.S. and overseas. The newly established Shenzhen Board for Small and Medium-Sized Enterprises was the second best venue, with an investment multiple median of 8. As the number of IPOs in the sample was not divulged it is uncertain to what extent this can serve as an indicator of the success of this board. As the survey was conducted in the last quarter of 2005 and the Shenzhen SME Board opened in August 2004, it may be premature to make generalizations. However, the high multiples obtained show that setting up the Board was definitely a step in the right direction, in terms of providing listing alternatives. The Shanghai Stock Exchange provided a multiple of 5.2, although this was for only one listing. All other bourses –Hong Kong (both the Main Board and GEM), Singapore, Shenzhen, New York—showed a median investment multiple of between 2 and 3. Again, this may be misleading as only one or two listings were recorded for each exchange. The following table illustrates this pattern.
For the larger exit sample of 79 IPOs the picture is probably more representative. About 80% of the listings took place outside the jurisdiction of the CSRC. The Hong Kong Main and Growth Enterprise Boards accounted for 19 and 16 listings, respectively, while NASDAQ managed 17. Singapore, New York and London were distant alternatives. About 20% were domestic listings in Shanghai and Shenzhen, with the new Shenzhen SME Market accounting for one-third (6 out of 18) of the IPOs. While Hong Kong and NASDAQ offerings remain the clear favorites, the establishment of the infant Shenzhen SME Board again was shown to be a very useful move for domestic venture firms.

The table below clearly highlights the climax in performance during the internet boom years 1998 to 2000, primarily via exits achieved by IPO. This was the classic worldwide pattern
during those years. It can be fairly safely assumed that during many of the other years shown below only one or two M&A exits took place per year in the performance sample.

---

**TABLE 12**

**MEDIAN OF INVESTMENT MULTIPLE BY EXIT YEAR**

<table>
<thead>
<tr>
<th>Year</th>
<th>Median IPO</th>
<th>Median M&amp;A</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>5.6</td>
<td>0</td>
</tr>
<tr>
<td>1995</td>
<td>2.9</td>
<td>0</td>
</tr>
<tr>
<td>1996</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1997</td>
<td>3.5</td>
<td>5.8</td>
</tr>
<tr>
<td>1998</td>
<td>10.0</td>
<td>0</td>
</tr>
<tr>
<td>1999</td>
<td>17.3</td>
<td>2.9</td>
</tr>
<tr>
<td>2000</td>
<td>14</td>
<td>12.8</td>
</tr>
<tr>
<td>2001</td>
<td>3.4</td>
<td>1.2</td>
</tr>
<tr>
<td>2002</td>
<td>4.5</td>
<td>2.0</td>
</tr>
<tr>
<td>2003</td>
<td>3.6</td>
<td>1.1</td>
</tr>
<tr>
<td>2004</td>
<td>2.8</td>
<td>8.0</td>
</tr>
<tr>
<td>2005</td>
<td>3.1</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>3.9</td>
<td>2.7</td>
</tr>
</tbody>
</table>

Source: Zero2IPO & CVCA

The exit sample, included in the table above, makes it very obvious that the venture industry in China is still in its infancy. Only 10 of the 108 recorded exits took place until the end of 2000 and 78, or roughly three-quarters, during the last three years, from 2003 until 2005.

Trade sales have come into their own also only recently. Until the end of 2002 there were only 4 M&A exits. One can infer from the data above that the median investment multiple for the bulk of exits is around 3.
Performance by Exit and Industry:

The portrait shown above is corroborated if we look at performance by industry. The broadly defined information technology sector, including internet, software, IC manufacturing, telecoms, and IT services, clearly offered the highest returns during the past ten years. This is unaffected by the type of exit -- IPO or trade sale. The following table illustrates this pattern. It must be said that during the period covered by the survey there were very few exits in sectors outside information technology, such as biotechnology and traditional industries. During the last two to three years the focus of venture investments has shifted more towards companies in these industries. The exit sample of 108 recorded exits underscores this point. Investments were heavily focused in three sectors: Information technology (broadly defined as above), traditional industries and biotechnology accounted for all but 6 of the 108 exits made. One can conclude from this picture that the performance sample is biased towards information technology investments.

<table>
<thead>
<tr>
<th>Industry</th>
<th>No.of Exits</th>
<th>Median</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internet</td>
<td>19</td>
<td>13.7</td>
</tr>
<tr>
<td>Telecom</td>
<td>25</td>
<td>2.7</td>
</tr>
<tr>
<td>IC Manufactg.</td>
<td>7</td>
<td>2.3</td>
</tr>
<tr>
<td>Software</td>
<td>7</td>
<td>7.3</td>
</tr>
<tr>
<td>IT Services</td>
<td>1</td>
<td>5.0</td>
</tr>
<tr>
<td>Traditional Industries</td>
<td>32</td>
<td>3.2</td>
</tr>
<tr>
<td>Biotechnology</td>
<td>11</td>
<td>4.7</td>
</tr>
<tr>
<td>Services</td>
<td>3</td>
<td>3.0</td>
</tr>
<tr>
<td>Other</td>
<td>3</td>
<td>n.a.</td>
</tr>
<tr>
<td>Total</td>
<td>108</td>
<td>3.6</td>
</tr>
</tbody>
</table>

Source: Zero2IPO & CVCA
Performance by Exit and Stage of Investment:

The survey showed that clearly investments in companies in the early stage of their development yielded substantially higher returns than investments in companies in the growth or expansion phase or in mature companies. It is obvious that the highest returns will stem from listing companies with high growth potential at the beginning of their life cycle. It is unclear to what extent these findings are a function of investments made primarily in the information technology sector during the period covered by the survey. This issue will need to be elucidated by further, updated research. Evidence from interviews conducted clearly show a current reluctance on the part of foreign funds to invest in start-up and early-stage companies.

---

TABLE 14

MEDIAN OF INVESTMENT MULTIPLE BY STAGE OF INVESTMENT AND TYPE OF EXIT

<table>
<thead>
<tr>
<th>Stage of Investment</th>
<th>Median IPO</th>
<th>M&amp;A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Early Stage</td>
<td>10.3</td>
<td>5.9</td>
</tr>
<tr>
<td>Growth Stage</td>
<td>3.4</td>
<td>2.4</td>
</tr>
<tr>
<td>Later Stage</td>
<td>2.0</td>
<td>1.1</td>
</tr>
<tr>
<td>Total</td>
<td>3.6</td>
<td>2.7</td>
</tr>
</tbody>
</table>

Source: Zero2IPO & CVCA
Performance by Exit and Region:

The performance sample demonstrates that there are three centers in China where sustainable performance can be achieved: Beijing, Shanghai and Guangdong/Shenzhen. Investments in companies located in these three regions yielded consistently higher returns than capital invested in other provinces. There are, to be sure, isolated ‘high-flyers’ elsewhere, such as the well-publicized listing of venture-backed Mengniu Dairy, based in Inner Mongolia. The larger exit sample corroborates these findings: Three-quarters of the 108 exits recorded were companies based in the three centers of Beijing, Shanghai and Guangdong/Shenzhen. Jiangsu and Zhejiang provinces are up-and-coming with 8 and 5 exits, respectively. Virtually all other provinces had only one exit to claim. Undoubtedly venture funds will diversify their investments into other regions of China in the future but the three core areas remain powerful magnets for venture capital, given their role as breeding ground for innovation with political backing.

---

**TABLE 15**

**NUMBER OF EXITS BY REGION**

<table>
<thead>
<tr>
<th>Region</th>
<th>No.of Exits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beijing</td>
<td>31</td>
</tr>
<tr>
<td>Shanghai</td>
<td>21</td>
</tr>
<tr>
<td>Guangdong</td>
<td>15</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>13</td>
</tr>
<tr>
<td>Jiangsu</td>
<td>8</td>
</tr>
<tr>
<td>All other</td>
<td>20</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>108</strong></td>
</tr>
</tbody>
</table>

Source: Zero2IPO & CVCA
3.6 Conclusions: Chinese vs. Western Setting

This study clearly shows the highly significant influence the Chinese setting has on the structure, investment process and performance of the venture capital industry. The hard and soft dimensions of the Chinese context affect the three areas studied in different ways.

3.6.1 Structure

The hard factors, constituted by the legal and regulatory framework, have a direct bearing on the structure of the industry. Domestic venture firms are treated, to a large extent, like any other Chinese company. They are funded by government ministries or agencies and the excess cash of Chinese listed firms. Some fulfill strategic government objectives, such as establishing domestic ‘champions’ in particular industrial sectors. Foreign venture funds set up sophisticated structures overseas to make investments in China so as to allow them to list their investments outside China and meet their objectives of providing significant returns to their institutional and private investors. Foreign investors are still effectively barred from public listings of their investments in China.

3.6.2 Process

While any venture capital or private equity fund goes through the investment cycle of fundraising, investing and exiting, irrespective of its location in the world, significant differences exist between the cycle’s Chinese setting and the West. In part these differences are a function of hard factors, such as the legal and financial framework, and in part they reflect soft factors that come to the fore when foreign investors meet Chinese entrepreneurs to strike a mutually beneficial deal. In order to be successful foreign funds need to be aware of these differences and adopt measures to overcome them. Using the investment cycle as a framework we will look at the differences and similarities between the Chinese and the
Western context in the following paragraphs. Generally speaking, the hard factors affect fund raising and exiting, the first and the last step of the cycle, while the soft factors are important for the investing phase.

**Fundraising & Structuring:** Western funds raise capital for investing in China the same way they raise capital for investments elsewhere in the world – from institutional and wealthy private investors. They cannot raise money from Chinese pension funds or insurance companies as these are not allowed to invest in venture capital. Chinese venture firms, therefore, rely heavily on funding by the government and cash-rich listed Chinese companies.

When it comes to structuring the fund, Western investors are in a bind, due to the Chinese legal and financial system: Given their orientation towards listing their investments in order to generate the highest tax-advantaged returns Chinese bourses are closed to them as foreigners. If they were to incorporate as a Chinese company they would be subject to taxation and restrictions on capital transfer abroad. Also the partnership structure prevalent among Western funds is not possible in China. Hence, foreign funds resort to relatively complex structures to put them in a position to achieve their return objectives. The China fund is incorporated in a tax haven and special purpose vehicles are created to invest in individual Chinese companies as ‘foreign investors’. These SPVs can then be listed in Hong Kong or any Western stock exchange. Domestic Chinese venture companies do not have this option and need to be Chinese corporations.

**Investing:** As regards deal sourcing, China’s transition economy by now provides numerous investment alternatives. Foreign funds target for the most part private companies to tap into the most dynamic sector of the Chinese economy and the often-quoted commercial acumen of
private entrepreneurs. In addition to investing in high technology companies foreign funds have a distinct preference for traditional industries, which account for almost one-third of all exits made so far. Large foreign buyout funds have recently begun to take stakes in strategic assets being privatized, like banks. Domestic investment firms at times have to contend with local pressures to invest in projects that may not present the most attractive potential returns. Overall, the array of deal opportunities is certainly determined by the Chinese context. However, the ‘cherry-picking’ skills required of foreign investors are seriously put to the test when it comes to deal selection in China. This is the area where soft factors become of paramount importance as Western capital-giver’s and Chinese capital-taker’s expectations meet head-on. Mutual trust is a key area of concern. Foreign funds need to be proactive and seek out deals, contrary to what they are used to in the West where funds are swamped with unsolicited business plans. Principal difficulties for the foreign fund managers are the assessment of the Chinese entrepreneur’s guanxi – the set of social, business and political relationships he is embedded in; of the potential for the business plan to succeed in the Chinese market, as market data are often non-existent or unreliable; and of financial information such as the level of debt. Deal valuation is a related area where again soft factors play an important role. Elaborate Western valuation models rely on accurate inputs which often are simply not the case in China. Audited financial statements are not the norm for small private Chinese companies. Valuation of assets –although improving—frequently is arbitrary, with ‘emotional valuation’ clashing with a hard-numbers approach. As to deal structuring, both hard and soft factors are at play. In contrast to the West, no different classes of stock are in use in China, common stock being the only manifestation of ownership. In addition, shareholders’ and other contractual agreements –seen as a hard factor in the West—are often seen in China as re-negotiable after they were signed and sealed. Company law exists but enforceability is a problem at the local level. For a key function of venture and private equity
funds in the West—monitoring the investment and providing value-added services—soft
factors again make for very different attitudes in China. In the West support, strategic
guidance and contacts to local management is usually given by the board of directors, to
which the investors have appointed their representatives. Boards of small and medium-sized
Chinese companies are often made up of family or clan members and cronies and, as a result,
tend to be weak. Views on governance diverge more often than not.

**Exiting:** The Chinese setting, in the shape of its legal and financial framework, clearly
determines the exit options for foreign and domestic funds. We need to remember that a
string of successful exits is the *raison d’être* for any venture or private equity fund. Foreign
investors are, for all practical purposes, not allowed to list their investments on the two
domestic stock exchanges in China. Therefore, foreign funds need to structure their
investments in such a way that they can list them outside China. The Hong Kong Stock
Exchange is not subject to PRC government regulations, although technically the Hong Kong
Special Administrative Region is part of China. The two domestic exchanges in Shanghai and
Shenzhen are only open to Chinese companies. The long-awaited opening of the Shenzhen
Small and Medium-Sized Enterprise Board in 2004 has so far not yet led to a significant rush
of public offerings as the listing rules are just as stringent as for the Shenzhen Main Board.

V

3.6.3 Performance

Bearing in mind that a successful exit is the driver of all venture fund investments even the
broad-brush conclusions of the, by definition, limited sample provide some benchmarks.
Foreign funds’ performance is clearly superior to that of domestic venture companies, lending
weight to the argument that the local setting is not conducive to producing significant returns.
Foreign listings are more lucrative than those on domestic bourses. More than half of the
foreign funds surveyed produced an IRR of more than 20%, showing a relatively steep learning curve. These initial results need to be differentiated in further studies.
4. IMPLICATIONS OF THE RESEARCH FINDINGS

4.1 Lessons for Foreign and Domestic Investors

One of the objectives of this study was to make it relevant for practitioners and government policy-makers. In the following paragraphs we will present conclusions important primarily for foreign venture and private equity funds as they were the focus of the study. These conclusions and their implications are related to the investing phase of the venture cycle. The fundraising and exiting stages are hard factors almost totally outside the control of foreign investors. Section 8 deals with the implications of the study’s findings for government policy.

In the following we will first point out the implications of the all-pervasive guanxi mentality as they relate to making venture investments in China. This is clearly a distinctly Chinese cultural phenomenon and understanding its significance is the foundation for dealings of any consequence with potential partners. As such, it also has repercussions for the three underlying differences specific to venture fund management –information asymmetries, governance, and management competence. However, these three key differences are not the result of guanxi but rather a consequence of the five decades of a rigidly planned economic system. They will be discussed after the ramifications of the ever-present guanxi are explained.

4.1.1 Dealing with Cultural Discrepancies

A very basic difference foreign fund managers have to deal with in China is the powerful reliance on the relationship network known as guanxi, which permeates most levels of life in China and certainly has major repercussions on doing business. Truly a cornerstone of
Chinese culture, *guanxi* reflects basically an attitude towards trust. ‘*Guanxi* is a highly personalized Chinese system of social capital enabling mutual, preferential favors based upon trust or mutual benefit. It can substitute for and even override institutional or legal guarantees… (Seven Disciplines for Venturing in China 2005). In the Chinese context business dealings of any consequence are almost never conducted with strangers. In contrast business between strangers is the norm in the Western setting, where ultimate reliance can be placed on the rule of law and its enforceability. *Guanxi* is frequently mentioned as important for business in China ‘but its multidimensionality and influence is often misunderstood in the West… *Guanxi* is practically universal – influencing the most mundane to the most critical Chinese relationships’ (Seven Disciplines for Venturing in China 2005).

For foreign venture investors, as they deal in person with local entrepreneurs, strands of *guanxi* are woven through the entire investment phase of the cycle in China. The following figure outlines the ramifications of the ‘*guanxi* mentality’ at each stage of the investment cycle and the corresponding implications for Western investors.

In terms of *deal sourcing*, the message for Western funds is that they need to search for deals themselves as Chinese entrepreneurs are unlikely to seek them out. Dealflow is not automatic, as is usually the case in the West. Local entrepreneurs will usually allow foreign funds to come in only after they have exhausted other sources of funds. *Evaluating a deal* can be very protracted affair due to both information asymmetries, discussed below, and the need for building *guanxi* between investor and entrepreneur. This is a critical step and can take a year or more as the relationship needs to be built in a variety of settings, business and personal. At this stage it becomes very obvious how much more the potential Chinese partner relies on
personal relationships and less on contractual arrangements. This process spills over into the valuation and structuring of the deal, as these steps are intertwined with the negotiations.

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FIGURE 4

CULTURAL DISCREPANCIES AND IMPLICATIONS FOR FOREIGN INVESTORS DURING THE INVESTMENT PHASE

<table>
<thead>
<tr>
<th>Phase</th>
<th>Cultural Stumbling Blocks</th>
<th>Implications for Foreign Venture &amp; Priv. Equity Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deal Origination</td>
<td>Avoid involvement by outsiders if possible; keep control</td>
<td>CONDUCT PROACTIVE SEARCH</td>
</tr>
<tr>
<td>Deal Evaluation</td>
<td>Long process to establish trust with outsiders &amp; give information; rarely solid market information available</td>
<td>NEED UNCONVENTIONAL, THOROUGH DUE DILIGENCE ON PARTNER’S GUANXI AND ON MARKET</td>
</tr>
<tr>
<td>Valuation</td>
<td>Cavalier accounting (mix of personal &amp; business accounts); ‘emotional’ value of physical assets &amp; know-how; sales prospects based on trust/promises</td>
<td>NEED FOR SOLID ACCOUNTS SEPARATING BUSINESS AND PERSONAL; SPECIAL ATTENTION TO DEBT; VALUATION BY OUTSIDE EXPERTS; COPYCAT RISK</td>
</tr>
<tr>
<td>Deal Structure</td>
<td>Cavalier attitude towards contracts; undifferentiated view of strings attached to outsiders’ equity (minority protection)</td>
<td>MAKE REQUIREMENTS FOR IPO CLEAR; BUILD IN TANGIBLE INCENTIVES FOR PARTNER</td>
</tr>
<tr>
<td>Monitoring &amp; Adding Value</td>
<td><strong>Strategic:</strong> Weak board made up of clan &amp; cronies</td>
<td>BOARD TO INTRODUCE CORPORATE GOVERNANCE, INTERNATIONAL CONTACTS</td>
</tr>
<tr>
<td></td>
<td><strong>Day-to-day:</strong> Prefer no outside interference; employees loyal to boss</td>
<td>HANDS-ON ADVICE, IN PARTICULAR FINANCE; PREVENT NON-BUS. INVESTMENTS BY PARTNER</td>
</tr>
</tbody>
</table>
Given the almost universal absence of audited accounts in small private companies and the frequent practice of mixing business and private investments, particular attention must be paid to hidden debt, often in the form of private loans by friends and family. Also, an assessment of the recoverability of accounts receivable is crucial. For the valuation the barriers to entry for the product or service in question need to be kept in mind, as the copycat risk is significant in the Chinese context. Sometimes competition emerges in the shape of the local partner setting up a highly similar operation. Explaining the deal structure desirable for foreign investors supposes a certain level of trust has been established. The Chinese partner is unlikely to be familiar with the fairly sophisticated ownership structures needed to bring about an IPO at a foreign stock exchange. Technically, the Chinese company will end up being owned by a foreign company domiciled in the Cayman Islands or the British Virgin Islands. But reassuringly, financial incentive structures difficult to create in China can be incorporated into the foreign entity. Also, the foreign venture fund can by now point to numerous examples of successful exits using the exact same route. Once the deal has been struck, monitoring the investment and adding value is by no means an easy task. What is usually regarded by Western entrepreneurs as a prime attraction of having experienced venture investors aboard, in addition obviously to the capital provided, are the contacts and the strategic and operational guidance contributed. The very same is often viewed with suspicion by Chinese entrepreneurs. Again, mutual trust becomes the key. The Westerners have to convince the Chinese partners of the value of a board of directors, which may have played a perfunctory role before or may not have existed at all. The foreign investors need to demonstrate in regularly held board meetings tangible benefits like international contacts for exports, as well as more abstract ideas like the rights of minority shareholders and the need to meet corporate
governance standards if institutional investors abroad are to be satisfied. As an added
dimension of strategic guidance, a keen eye must be kept on investments by the local partner
that are unrelated to the business at hand. Real estate is a classic use of what may be perceived
as ‘surplus’ funds. Day-to-day management is an area venture investors usually leave in the
hands of their entrepreneur-partners. In China, however, hands-on assistance –diplomatically
administered—is frequently necessary both to improve operations and to prepare for an
eventual sale of the company. Most frequently mentioned was the finance area, where
Western-standard accounting systems are far from entrenched. Credible accounts are an
obvious prerequisite for a listing or a trade sale. Frequent ‘hand-holding’ also makes
geographic proximity of the partner company desirable. This probably contributes to the
concentration to date of venture-backed firms in three regions of China (see Section 6.4).

After this look at the implications of the all-pervasive guanxi mentality, which affects all
business dealings of any consequence in China, we now turn to more specific, investment-
related implications for foreign investors and how to deal with them. The multitude of
differences between the Chinese setting and the West, identified in the interviews, can be
distilled into three major areas underlying these differences.

4.1.2 Dealing with Information Asymmetries

The availability of reliable information is a major stumbling block for foreign venture
investors in China. Compared to Western economies the local information infrastructure is
just beginning to be developed. This picture pertains to all levels important to the foreign
investor – information related to the person of the potential entrepreneur-partner, to his
company or group of companies, to the market for his products or services and the potential
growth, and to the likely nature of future regulations, important to the business at hand, that
may be in the pipeline. As elaborated earlier, confidence in the business model and in the partner’s ability to bring it to fruition in the marketplace are vital ingredients in an investment decision. Hence, the unreliability or total lack of information on these critical points is serious. Due diligence in the conventional Western manner can only be conducted to a limited extent. Lists of companies active in a particular sector can be obtained but, again, these need to be checked on. Credit checks on individuals, if they can be obtained at all, provide partial information at best. Detailed financial information is particularly difficult to obtain, due to the lack of audited accounts and the frequent practice of mixing personal and business investments. This state of affairs calls for an unconventional approach. To overcome these information inefficiencies and the trust gap with the potential partner, Western investors need to invest the time and money it takes to build their own guanxi, first and foremost with the entrepreneur being courted. The ‘checking on the partner’ process is mutual, as the Chinese entrepreneur wants to be comfortable in the relationship as well. Usually he is in the driver’s seat as he may weigh the pros and cons of having a Western partner virtually unknown to him, having been approached by the Western investors and not the other way around. Frequently consultants are involved in seeking references and to act as go-betweens to resolve delicate issues. Consultants are also used for government relations, to keep tabs on regulatory developments and to facilitate approvals. Obviously the whole process of bringing a deal to a close takes much longer than the average deal in the West. The onion has many layers to be peeled.

In some cases thorough due diligence yields positive side effects in that a way to adapt a U.S. or European business model to the Chinese market may be found. As an example, Yaolan, a venture-backed company that distributes imported baby food and other baby products, devised a new channel through which to sell. Bypassing pharmacies, the traditional outlet for baby
formula, the company recruited mothers to sell its products to expectant mothers, similar to the Tupperware party concept. This innovation might well find a use in other countries.

4.1.3 Dealing with the Unawareness of Expectations

Once a deal is struck the Chinese company must be transformed to meet the expectations of U.S. and other Western institutional investors, in the light of often highly different expectations by the Chinese principals. This major challenge puts the relationship between venture investor and local entrepreneurs to a severe test. Most Chinese entrepreneurs, unless they are returnees from America or Europe, do not have a clear understanding of forms of financing beyond equity and bank debt. The notion of institutional capital, and the rights and obligations that go with co-ownership, require careful explanation to convince the local partner and his advisers of the benefits. The perception of the entrepreneur that ‘I am the boss with full control’, prevalent especially if the company has been bootstrapped into a profitable operation, needs to give way to ‘we are all in this together for mutual benefit’. Guanxi as a system of favors such as employment may actually be a stumbling block in this situation. Foreign venture investors have put up capital to produce ultimate financial returns and pursue this goal fairly single-mindedly. However, the prospects of substantial financial gains and the prestige of listing abroad are very tempting, especially if examples of successful companies having trodden the same path before can be demonstrated.

The specific steps required to meet Western investors’ expectations constitute a radical transformation. The Chinese company needs to be restructured into a foreign company so that it can be listed abroad. An effective board of directors needs to be set up, with a blocking vote on clearly defined strategic issues. This makes clear that minority shareholders are co-owners
and have certain rights. Strict financial controls need to be instituted with the Finance Manager ideally reporting to the Board and not to the CEO. Deadlines for payments of accounts receivable must be set and adhered to. Personal investments cannot be made with company capital. Accounts need to be independently audited and presented in a timely manner. These basic governance rules need to be introduced in a diplomatic manner, the coaching being done by a senior foreign partner who commands respect based on business experience and personality. It is in this area of coaching the Chinese partner that the venture investor can be a true change agent and act as a bridge between the *guanxi* mentality and the strong focus on financial returns.

The Western expectation of being able to replace the CEO if necessary is usually not an option in China. The foreign investor, as a rule, is the minority partner. Also, the allegiance of the core managers is to the CEO, not to the Board or outside investors. Being comfortable with the CEO is a *sine qua non* for the foreign venture investors, as the choice can determine the ultimate success or failure of the company. So this ‘marriage’ needs to be for better, not for worse.

Special attention needs to be paid to the protection of the company’s intellectual property, now co-owned by outside venture investors. A cultural dimension comes into play as copying *per se* is not viewed as a criminal act but as a way of honoring superior work. Obviously, though, there is in today’s China plentiful evidence of premeditated copying of products. Intellectual property issues may take three forms: A successful entrepreneur sets up a new company, using the proprietary processes of his current company. Competitors could copy the venture company’s products. Also, new employees joining the firm may bring with them confidential information from their previous employer. The local partners are usually aware of
what is going on in their markets but they need to be made aware that these are very real risks and that intellectual property can be protected. However, the ultimate firmness of local authorities in dealing with infringements is, unfortunately, not always guaranteed.

4.1.4 Dealing with the Lack of ‘Bridge’ Managers

The interviews clearly showed that good-quality managers for venture-backed companies in China are a rare species, although the supply is bound to increase over the next few years as graduates and managers with foreign work experience return to China. Ideally the foreign investor needs a member or two of the management team to bridge the gap between the local partner and the investors but without alienating local colleagues. In most cases a CFO from outside needs to be integrated into the existing team in order to prepare for an IPO. Differences in compensation can lead to counterproductive situations. For the time being, foreign venture investors tend to recruit managers from Taiwan, Hong Kong and also returnees for these jobs. American-born Chinese (ABCs) in a number of instances fail to live up to expectations, according to the interviews. While they speak Mandarin, Shanghainese or Cantonese they are often not sufficiently familiar with the peculiarities of the current Chinese setting. To build a strong management team in China is a slow and challenging process which requires sufficient attention, perseverance and diplomatic skills from the foreign investors.

4.1.5 Dealing with the Time Dimension

Although it may be obvious from the aforementioned, a key difference between venture investing in China and the West needs to be stated explicitly: It simply takes longer to close a deal in China. Several respondents mentioned periods of more than one year between making the first contact and providing capital. Needless to say, foreign investors need to bring perseverance with them to China. Dealing with the partner’s guanxi and developing one’s
own, coaching the partner and welding together an effective management team, all in the face of an inefficient information infrastructure, is a test of patience for all but the most stoic of Westerners.

4.2 Implications for Government Policy and Regulations

Before we launch into the implications of the study’s findings for Chinese policymakers and administrators, we should recall the basic objective of foreign venture and private equity funds. The basic objective of fund managers is to achieve financial returns for their limited partners and for themselves. They are long-term investors, with each fund having a life of 10-12 years, but they are temporary investors in that a successful exit from individual investments is all-important. The exit is the driver. As mentioned before, exits can take the form of public stock offerings, sales to other companies or liquidation.

What is the contribution of foreign venture funds from the government’s perspective? Obviously they provide capital to small and medium-sized companies with attractive growth perspectives. Theoretically, these companies could also be funded from other sources, such as subsidies, bank loans at preferential rates or tax incentives. However, in addition to capital, foreign financial investors also bring in less tangible benefits, both in terms of operations and strategy. They add value to their investments by bringing in Western management expertise to make the operation more disciplined and efficient. This is especially the case in the area of finance where the legacy of state planning is still – but decreasingly so -- entrenched. By exposing their Chinese investments to the harsh winds of international capital markets and foreign competition the investors shape a certain toughness that usually makes the company in question a stronger competitor and potentially a champion.
In looking at the costs and benefits of financial investors the government also considers a political dimension. What do foreigners contribute that domestic venture companies cannot? On balance, current policy clearly reflects the realization that foreign funds can make a unique contribution, along the lines outlined above. Therefore, they are allowed to operate in China in the first place and they are permitted to circumvent local listing regulations by offering shares in their Chinese investments on foreign stock exchanges. What is significant in this context is that the authorities, after issuing regulations virtually closing the foreign IPO loophole, opened it again after consultations with individual practitioners and the China Venture Capital Association. However, a red threat going through a number of interviews conducted for this study was that the role of domestic venture companies is going to increase significantly in the future. The creation of an efficient local bourse providing growth capital is an essential ingredient in this policy.

4.2.1 Capital Market Reform

In line with the argument that successful exits are all-important to venture investors and that listings, as demonstrated in Section 3.5.3, provide the highest returns, foreign venture funds currently do not have the possibility to make public stock offerings in China. Access to the two exchanges in Shanghai and Shenzhen is strictly regulated by the CSRC whose approval for IPOs must be obtained. This is at present only granted to Chinese firms. The Hong Kong Stock Exchange counts as ‘foreign’, due to the special status of Hong Kong. Foreign institutional investors such as mutual funds also only have limited access to the two Chinese stock exchanges to buy and sell shares, although steps have been taken recently to open the door a bit further. As to venture investors, a major improvement came about in August 2004, after a lengthy debate, when the government opened a new exchange specifically for small and medium-sized companies, the Small and Medium Enterprises Board (SME Board) under
the umbrella of the Shenzhen Stock Exchange. A second step was the launch in October 2009 of a ‘Chinese NASDAQ’ for small private companies whose access to growth capital is usually limited by the preference of Chinese banks for companies with state ownership.

The new SME Board turned out to be less attractive than hoped for. Access was restricted to Chinese companies and the listing rules were identical to those for larger companies on the Shenzhen Main Board. Generally, bourses for smaller companies like NASDAQ in New York or AIM in London have less restrictive rules so that companies with a small amount of capital and a short history of profitability, or even no past profits, can gain access to growth capital. Nevertheless, almost 500 Chinese companies, some of them backed by venture capital, used this avenue to raise capital. As the section on performance showed, the relatively small sample achieved a median multiple of 8, the second highest after NASDAQ. However, the total market capitalization of all companies on the SME Board with $437 billion, or almost $1 billion per firm, and the unrealistically high P/E ratios point to another soft factor in the Chinese setting – a predilection for gambling and speculation. Table 16 below gives an overview of the current size of the SME Board, compared to the ChiNext Board.

ChiNext, the new board for private high-growth companies, was launched only very recently. Listing requirements are less stringent than those for the SME Board and safeguards such as temporary trading suspensions and lockup periods for senior managers were put in place to curb excessive speculation. It is still too early to pass judgment as many lockup periods keeping founders, friends and family to sell their shares have not yet expired. But clearly the inflated valuations and excessive P/E ratios, which exceeded 100 at their peak, show a gambling mentality at work. Table 16 gives a snapshot picture of the ChiNext Board less than one year after it was launched.
TABLE 16

SHENZHEN STOCK EXCHANGE SME AND CHINEXT BOARD OVERVIEW  
SEPTEMBER 30, 2010

<table>
<thead>
<tr>
<th></th>
<th>SME</th>
<th>ChiNext</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of Listed Companies</td>
<td>483</td>
<td>123</td>
</tr>
<tr>
<td>Stock Market Capitalization ($ million)</td>
<td>436,688</td>
<td>75,560</td>
</tr>
<tr>
<td>Market cap. per company ($ million)</td>
<td>904</td>
<td>614</td>
</tr>
<tr>
<td>Trading Volume 30/10/2010 ($ million)</td>
<td>3,889</td>
<td>601</td>
</tr>
<tr>
<td>Average P/E Ratio</td>
<td>50.1</td>
<td>63.2</td>
</tr>
</tbody>
</table>

Source: Shenzhen Stock Exchange

It is obvious from the interviews that there is consensus for a change in the listing rules in the direction outlined above, to turn it into a true board for growth capital. Also, the board should be opened for foreign-backed companies. In general, China’s stock exchanges are moving towards greater liberalization but the theme is a domestic one. Foreign-backed venture companies still need to rely on bourses outside China for raising capital. Also, capital market reform has to be coordinated with the reform of other elements of the financial system such as full convertibility of the yuan. Demand from domestic and foreign investors is strong as people want to participate financially in the dramatic growth of the Chinese economy.

However, the SME and ChiNext boards are still plagued by insider trading and share price...
manipulation. Progressive governance rules exist but are not always strictly enforced. Investor confidence needs to be strengthened further by consistently applied sanctions.

4.2.2 Legal Reform

China’s economy is in transition, after five decades of state planning, to a regulated market economy. Laws and administrative regulations are constantly revised and updated. There is no specific law dealing with venture or private equity investment as of yet, although a draft is apparently being prepared. The Company Act was promulgated only in 1994. The Securities Act is also fairly recent. Compared to their elaborate counterparts in Western market economies they are relatively simple, reflecting—despite updates—still largely the state of the economy in the mid-1990s. For venture investors key elements that are missing include provisions for additional types of company structure, financial incentives and liquidation. The law in its current form only allows basic types of corporations. The partnership structure preferred by venture funds cannot yet be set up in China. As mentioned, foreign funds retain the partnership structure and are domiciled abroad. In the Anglo-Saxon setting stock options are a major incentive provided by venture investors to the entrepreneur-partner and his team. Chinese law currently does not cover this area. Therefore, foreign funds incorporate stock options and similar features into the company established abroad to make the investment in China. A critical gap is the lack of a bankruptcy law governing the liquidation of companies. This was lamented by virtual all respondents in the study. Again, a draft has apparently been under discussion for several years. It is noteworthy that in the last few years Chinese ministries and regulatory agencies have become more open to, and sometimes have actively sought, comments from parties with an interest in the sector.
4.2.3 Enforcement

As a separate point it was pointed out in several interviews that the enforcement of laws and administrative regulations was not consistent and sometimes downright arbitrary. This reflects in part the absence of a tradition of the rule of law, in part the friction that exists in some sectors between the central government in Beijing and provincial or local authorities, courts and judges, and in certain instances a resentment of foreigners. This is obviously an area where the foreign investor must proceed with great caution and the lack of *guanxi* can work to the detriment of the foreigners. In serious cases pressure could be applied by the embassy or foreign news media.

4.3 Areas for Further Research

This study dealt with structure, investment process and performance of the venture industry in China. Clearly performance is the area where further research seems most useful, as – due to the relative paucity of data -- it could be covered only in a very exploratory manner here.

As the industry grows the number of exits multiplies and a larger sample will become available to yield more meaningful results. It would be fascinating to be able to answer the basic question whether venture investments in China produce higher returns than in other emerging markets such as India and Russia or in the market economies of the U.S., Europe and Japan. Using the geographical dimension, performance could be compared for other variables such industry sectors, types of exit and early vs. late stage investments. The results of this research would be very beneficial for international venture and private equity investors.

The control aspect is also a crucial factor for investment decisions. In the West most investments made by venture funds are majority stakes. In China minority investments are the
norm. In the purely Chinese context investors would be interested to look at the performance of investments in which minority investments were made and majority-controlled companies.

In terms of the investment process the extent of the learning curve effect warrants further study. It would be interesting to analyze if sequential investments take less and less time to complete or if each case takes roughly the same amount of time to bring to a close. Again, international comparisons could be made as well as looking at the same question in Chinese venture companies. Do they spend more or less time on a deal than their Western colleagues? Finally, there are two areas of interest from a macro-economic perspective. A first area to explore is where in China foreign venture capital investment stops and foreign direct investment begins. Is corporate venture capital not direct investment? A second one is the role venture capital plays in bringing about innovation in products and services, in contrast to other sources of capital and support. Related to this issue is the question whether there is a minimum level of aggregate venture investment, as a percentage of GDP, to create a critical mass for innovation. This may be interesting to policymakers in helping them to assess to what extent venture investments should be fostered.

4.6 Summary and Conclusions

This study demonstrates the overwhelming influence the Chinese context plays in determining the structure, investment processes and, indirectly, also the performance of the venture capital and private equity industry. The context has both a hard and a soft dimension: The hard being the legal and regulatory framework which provides boundaries within which venture investors must operate; and the soft being the less tangible but crucial cultural differences which foreign investors would only ignore to their detriment.
An analysis of the industry structure reveals the controlling role of the government, in contrast to the West. Domestic venture firms have a structure totally different from foreign funds: The former are Chinese companies subject to Chinese law and taxation, alimented by the government and increasingly also by the excess cash of Chinese listed firms; the latter are partnerships domiciled abroad, with capital provided by institutional investors, acting as foreign direct investors for each individual company they finance in China. The foreign funds have every interest, to the extent possible, to stay outside the Chinese regulatory straightjacket, which runs counter, to a large degree, to their prime objective of achieving significant financial returns for their investors. The current regulations put the domestic venture industry at a disadvantage, limit the potential for foreign funds and, in general, stifle the growth of the industry. Further deregulation would yield immediate results.

Both hard and soft factors affect the investment process in China. When looked at in terms of the investment cycle concept of fundraising, investing and exiting, followed by a new cycle of setting up follow-on funds, both fundraising and exiting offer only limited choices to the foreign investor. Again, the regulatory framework does not allow Chinese institutions to invest in Western funds; permits only structures that are unattractive to Western investors; and do not allow foreign companies to list on Chinese bourses. The net effect of these hard factors is for foreign venture funds to do their fundraising and fund structuring outside China and also to do IPOs on foreign stock exchanges. During the phase of investing in Chinese companies, obviously Western fund managers come face-to-face with Chinese entrepreneurs and this is when the degree of cultural awareness can make or break a deal. Among the soft factors at play, the pervasiveness of guanxi, the social, business and political relationship network of potential Chinese partners that permeates all business dealings of any consequence, is generally underestimated by novice Western investors to their detriment. In addition, three
underlying deal-related differences were identified in the study. Foreign investors need to deal with serious information inefficiencies; unawareness of the expectations of Western investors; and the lack of competent management, ideally versed in both Chinese and Western business systems. The interplay of these factors specific to the Chinese context means that deals generally take longer to come to a close than in the West. The message is that investing in Chinese companies takes not only patience and perseverance but also diplomatic skills, based on a thorough understanding of deep-seated cultural differences.

This study presents the first set of data ever derived on the performance of venture funds and venture-backed companies in China. A successful exit being the driver of all venture activity, these data are important for comparisons, to be made in later studies, with other investment locations. The sample is not large due to the nascent nature of the industry but permits some early, broad-brush conclusions, which need to be differentiated by further research. Foreign funds clearly show higher returns than domestic venture companies. This supports the notion that domestic venture companies are still learning the trade and also that a tight regulatory straightjacket is not conducive to superior performance. Acting as foreign investors, Western funds can be more nimble in finding the most lucrative exit avenue. Listings on foreign exchanges such as NASDAQ on average yielded higher returns than domestic listings open only to Chinese companies. While more than half of all exits were predictably in the high-tech sector, almost one-third was in traditional industries. This may look surprising on the surface but shows the predilection of foreign funds to invest in ‘businesses we understand’ in a very different setting. Overall, the fact that more than half of the foreign funds surveyed generated an IRR exceeding 20% shows that they are well on the way to mastering this difficult environment.
As the venture industry in China is by no means mature and new or modified regulations, generally more liberal, appear every year this study could provide only a snapshot. However, first performance contours could be added to the map of the industry which will open the way for further studies. The general message derived is that the investment cycle is, in its basic sequence, the same in China as elsewhere. But a combination of the strong government role and engrained cultural particularities seriously distorts the steps along the way for foreign venture investors. Significant returns are possible, as the first-ever performance data set highlights. There is no magic formula for success but the confluence of local know-how of how to make a fluctuating environment work for one’s benefit and foreign investment discipline and professionalism has the potential to create champions. In the final analysis, the common goal of achieving superior returns overcomes virtually all obstacles. In the words of Deng Xiao-Ping, to get rich (together in this case) is glorious!
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List of Abbreviations

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<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>CSRC</td>
<td>China Securities and Regulatory Commission</td>
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<td>CVCA</td>
<td>Chinese Venture Capital Association</td>
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<td>EVCA</td>
<td>European Venture Capital Association</td>
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<td>HKVCA</td>
<td>Hong Kong Venture Capital Association</td>
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<tr>
<td>IPO</td>
<td>Initial Public Offering</td>
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<tr>
<td>IRR</td>
<td>Internal Rate of Return</td>
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<tr>
<td>M&amp;A</td>
<td>Mergers &amp; Acquisition (also used for trade sale)</td>
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<tr>
<td>NVCA</td>
<td>National Venture Capital Association (USA)</td>
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<tr>
<td>PRC</td>
<td>People’s Republic of China</td>
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<tr>
<td>SAFE</td>
<td>State Administration for Foreign Exchange</td>
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<td>SME</td>
<td>Small and Medium-Sized Enterprises</td>
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<td>SPV</td>
<td>Special Purpose Vehicle</td>
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<td>VC</td>
<td>Venture Capital</td>
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Glossary

Asset Class – One of a number of investment categories—such as bonds, real estate, and private equity—that institutional and individual investors consider when making asset allocations.

Burn Rate – The rate at which a business uses up the funds provided.

Carried Interest – The substantial share, often around 20 percent, of profits that are allocated to the general partners of a private equity partnership.

Common Stock – The equity typically held by management and founders. Typically, at the time of an initial public offering, all equity is converted into common stock.

Corporate Venture Capital – An initiative by a corporation to invest either in young firms outside the corporation or in business concepts originating within the corporation. These are often organized as corporate subsidiaries, not as limited partnerships.

Due Diligence – The review of a business plan and assessment of a management team prior to a private equity investment.

Early Stage (Company) – A state of a company that has a product or service in production and commercially available. In some cases, the product may be commercially available and may or may not be generating revenues.

Earn-Out – An arrangement by which owner/managers can buy back shares from the venture company at a multiple of the price at which they were originally sold.

General Partner – A partner in a limited partnership who is responsible for the day-to-day operations of the fund. In the case of a private equity fund, the venture capitalists either are general partners or own the corporation that serves as the general partner. The general partners assume all liability for the fund’s debts.

Growth/Expansion Stage (Company) – A state of a company that has a product or service in production and commercially available. The company is demonstrating significant revenue growth but may or may not be generating profit.

Initial Public Offering – The sale of shares to public investors of a firm that has not hitherto been traded on a public stock exchange. An investment bank typically underwrites these offerings.

Internal Rate of Return (IRR) – This is arguably the most appropriate performance benchmark for private equity/venture capital investments. It is a time-weighted return expressed as a percentage. IRR uses the present sum of cash drawdown (money invested), the present value of distributions (money returned from investments) and the current value of unrealized investments and applies a discount.
Leveraged Buyout (LBO) – The acquisition of a firm or business unit, typically in a mature industry, with a considerable amount of debt. The debt is then repaid according to a strict schedule that absorbs most of the firm’s cash flow.

Limited Partner – An investor in a limited partnership. Limited partners can monitor the partnership’s progress but cannot become involved in its day-to-day management if they are to retain limited liability.

Limited Partnership – An organizational form that entails a finitely lived contractual arrangement between limited and general partners, governed by a partnership agreement.

Management Buyout (MBO) – a European term for an LBO initiated by an existing management team, which then solicits the involvement of a private equity group.

Management Fee – The fee, typically a percentage of committed capital or net asset value, that is paid by a private equity fund to the general partners to cover salaries and expenses.

Mezzanine – Either (a) a private equity financing round shortly before an initial public offering, or (b) an investment that employs subordinated debt that has fewer privileges than bank debt but more than equity and often has attached warrants.

Net Present Value – A valuation method that computes the expected value of one or more future cash flows and discounts them at a rate that reflects the cost of capital (which will vary with the cash flows’ riskiness).

Portfolio Company – One of the companies backed by a private equity firm.

Preferred Stock – Stock that has preference over common stock with respect to any dividends or payments in association with the liquidation of the firm. Preferred stockholders may also have additional rights, such as the ability to block mergers or displace management.

Private Equity – Organizations devoted to venture capital, leveraged buyout, consolidation, mezzanine, and distressed debt investments, as well as a variety of hybrids such as venture leasing and venture factoring. Often refers to later-stage investments.

Trade Sale – A European term for the exiting of an investment by a private equity group by selling it to a corporation.

Venture Capital – Independently managed, dedicated pools of capital that focus on equity or equity-linked investments in privately held, high-growth companies. Many venture capital funds, however, occasionally make other types of private equity investments. Outside of the United States, this phrase is often used as a synonym for private equity.
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