4. Venture capital in China: high technology investing in an emerging economy*

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INTRODUCTION

Investing in new projects and technologies by mature firms is a challenging endeavour that often fails to create lasting significant growth for firms (Jensen, 1993). Investments in entrepreneurial ventures by outsiders such as venture capitalists that often rely on new technology can, however, be even more challenging (Christensen, 2000). Venture capitalists have found ways to reduce the risk associated with new venture investment by reducing the non-systematic risk involved in investing, though much risk remains (Christensen, 2000). They do this by careful due diligence, providing management and personnel assistance, careful monitoring of the investment, and well planned exit strategies. Venture capital is well established in the developed economies, such as in North America, Western Europe, Israel and parts of East Asia where the rule of law is well established and venture capitalists are able to carry out these activities (Bruton, Ahlstrom & Yeh, 2004). It is less well established in emerging markets where a lack of property rights and an enforceable rule of law reduce the systematic market risk and may add to the complexity of the venture capital process (Bruton & Ahlstrom, 2003).

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Investors are able to reduce the risk of new investments with the help of a clear rule of law, reliable enforcement and established institutions in the accounting profession and business community that serve to guide behaviour of the invested firm, venture capital investors and other associated parties. Institutional stability and predictability helps to create an environment that can help to control the higher risk climate of private equity and venture capital investing (Bruton, Ahlstrom & Yeh, 2004).

But how does high technology venture investing proceed in an emerging economy? The institutional stability of emerging markets is not as established as in developed markets. Emerging economies are known for having volatile environments and a lack of institutions to support business and investment (Peng & Health, 1996; Peng, 2000). In many emerging markets, intellectual property has little protection and assets can be seized and held with little recourse to the owners (Ahlstrom, Young & Nair, 2002; Peng, 2000). Emerging markets lack active markets for corporate control (Peng, Luo & Sun, 1999) and usually lack mechanisms such as established public equity markets by which investors can exit their investments (Bruton & Ahlstrom, 2003). Thus emerging markets add a great deal of risk to venture investments (Bruton & Ahlstrom, 2003; Peng, 2000). Despite these difficulties investment in emerging markets by private equity professionals has been going up. As a general rule, high risk can yield high return. This chapter will examine how venture capitalists meet these challenges and work to control the considerable institutional risk in emerging market private equity investment.

Venture capitalists clearly see a great deal of opportunity, particularly in the fast-growth emerging economy of China (Bruton & Ahlstrom, 2003; Ewing, 2004). China has had one of the fastest growing economies in the world for the past two decades. In the process, enormous opportunities have been created for local and foreign investors alike. Thus our focus here is on China, although one may argue that the lessons are applicable for many emerging markets worldwide. How the specific findings on China may differ in other emerging markets will be discussed at the end of this chapter.

While there has been a rapid expansion of both foreign and domestic venture capitalists, our focus here is primarily on foreign investors. The local investors which are often referred to as venture capitalists are investment funds run by government entities whose investments are directed by concerns other than profitability. Technological advancement is seen as a key element in China’s economic progress. Thus the domestic venture capital funds which are typically a Chinese governmental entity or part of the government-linked science and technology parks focus as much on the political appropriateness of their investment as on economic return. Such government-run venture capital funds act quite differently from those
run by private market-oriented entities and the resulting success of their investment is considerably less. Therefore we focus here on those foreign privately controlled organizations. Experience in other domains would indicate that the private venture capital sources of funds will ultimately be far more critical to the success in the marketplace of China’s technology sector.

Foreign direct investment (FDI) in China was estimated at $50 billion in 2003 (Woetzel, 2004). Just over 2 per cent of that money, or $1.3 billion, was characterized as private equity investment (Asian Venture Capital Journal, 2003). To put this in perspective for emerging markets, India receives a fraction of China’s FDI but attracts more private equity than China (Ewing, 2004). This may be because private equity investors in China face not only the vagaries of the market, but the relative instability and unpredictability of the institutional regime there (Bruton & Ahlstrom, 2003). China’s rule of law is in its most nascent stage, and enforcement of what laws do exist is problematic and capricious (Ahlstrom, Young, Nair & Law, 2003; Lubman, 1999). Yet some investors have been quite successful, just as some private firms have successfully navigated China’s institutional environment (Ahlstrom & Bruton, 2001; Woetzel, 2004). Private equity is starting to venture into previously untapped areas of China’s north and west, as with Morgan Stanley’s successful investment in the Inner Mongolian Dairy Mengniu. Yet, along with the excellent opportunities opening up to venture capitalists in China, there are a number of difficult challenges; this chapter examines how venture capitalists manage these challenges as they fund high tech start-ups in China.1

This chapter begins with a brief examination of the background of the venture capital industry in China. Next, based on interviews with venture capitalists active in China, the chapter identifies a framework by which venture capital operates in China and how this compares and contrasts with that of the West. Specifically, four main elements of private equity in China will be examined: the selection process for prospective funded high technology firms, structuring of deals and monitoring the firm, value added activities provided to the funded firm, and exit. This is followed by a discussion of implications for practice and research on venture capital and high technology ventures in China.

There are several contributions of this research. First, it expands our understanding of venture capital in China. Specifically, where much prior research has lumped public and private venture capitalists together, this research separates them and focuses specifically on privately held venture capital firms. Such firms are starting to have an important impact on investment and entrepreneurship in China, and if China’s developmental experience is at all similar to that of the US, venture capital firms will play an increasingly important role in new business formation there. Second, this
research examines specifically how these firms select and manage their investments relative to technology concerns. It is in this specific sector that private venture capital firms can be expected to have the biggest impact as high technology firms enter international markets. Finally, this chapter explores the institutional strategies of venture capitalists as they manage their investments and interact with various government entities in China.

VENTURE CAPITAL IN CHINA

'Venture capital' refers to privately transacted equity investments in firms, typically in small, growing firms. The deals in mature markets can include seed, expansion and pre-offering rounds of financing. In mature markets the term 'private equity' is used to cover latter stage mezzanine arrangements plus buy-outs and turnaround investments. However, in emerging markets the two terms are typically used interchangeably.

In exchange for financing venture capitalists, investors receive significant ownership claims and some control over top management. They are active investors, usually appointing directors and exercising strict oversight during the investment period. Venture capitalists bring legitimacy and credibility to their funded firms, supplying experienced management and sometimes providing key contacts in the government.

Starting in the late 1970s, the Chinese government began loosening its stultifying grip on the economy; private enterprise and investment proliferated. Starting from close to zero in 1979, the number of private enterprises zoomed past one million by the end of the century. This proliferation has helped to make the Chinese economy consistently one of the fastest growing in the world over the last two decades. However, China still lacks many standard financing mechanisms, such as efficient equity markets and debt financing for smaller firms (Ahlstrom, Bruton & Chan, 2000). As a result, there are tremendous opportunities for private equity in China.

The first venture capital firms in China entered in the early 1980s. Local governments in China encouraged and sometimes sponsored funds to invest in state-owned enterprises to bring them up to world standard. One early company was China New Technology Venture Investment, founded in 1985. Some were established firms, and others were founded solely to invest in Chinese firms, particularly established state-owned enterprises (Bruton, Dattani, Fung, Chow & Ahlstrom, 1999).

During the early 1980s, venture capital in China was limited primarily to infrastructure and property investments; new hotels and tourist facilities were especially popular (Lau, 1999). Many of these early investments fared rather poorly, and private equity professionals' interest waned (Ahlstrom,
During the late 1980s, however, there was renewed interest in the Chinese market. But the goals of the government and of private equity investors were in conflict. The central government wanted high-tech and infrastructure investment, while, at the time, investors preferred to focus on lower technology industries (Ahlstrom, 1989; Lau, 1999). As a result, the entire industry was shackled and there were few venture capital investments in high-tech start-ups. Emblematic of this problem, the Shenzhen Special Economic Zone adjacent to Hong Kong was charged with attracting high-tech start-ups and venture capital seed money. Those early efforts were largely unsuccessful: the sums invested did not come close to the amounts needed, and what ventures were funded focused principally on property development and tourism that produced little or no return to many investors (Ahlstrom, 1989).

In spite of the fitful start, the venture capital industry has expanded across much of Asia in recent years. Some of its fastest growth has occurred in China; currently there are over 200 private equity firms located there (Bruton et al., 1999; Ewing, 2004). Many of these firms are government-linked funds, some newer ones are private and from outside of China (Ewing, 2004). Well recognized venture capital firms with a history of investing in China, such as Baring Private Equity Partners, Softbank, Hambrecht & Quist, the Walden International Investment Group, Doll Capital Management Inc., ChinaVest and IDG Technology Venture Investment have become quite active in the market (Ewing, 2004).

INSTITUTIONAL SETTING IN CHINA

Despite the growth of venture funding in China, much is still not known about the venture capital industry there. A few articles have appeared recently detailing the historical development and current state of the industry from a macro perspective (for example, Bruton et al., 1999; Saywell, 1998; Ewing, 2004). This research has focused principally on mezzanine financing of established firms or on general conditions and outlook for the industry there.

Some prior research has started to examine venture capital in related settings such as those of East Asia (Bruton et al., 1999; Bruton, Ahlstrom & Yeh, 2004; Lockett, Wright, Sapienza & Pruthi, 2002) or India (Wright, Lockett & Pruthi, 2002). Other research has also examined settings such as China (Bruton & Ahlstrom, 2003; Bruton et al., 1999) and Southeast Asia (Bruton, Ahlstrom & Singh, 2002). This research has found that venture capital can still function in spite of the lack of formal institutions such as laws and regulations, and minimal enforcement of those laws. It also
implies a highly socialized view of venture capital whereby social network
ties, including those of the venture capitalist, can help to substitute for
the formal institutions present in the Anglo-American system and take on
more importance in the emerging market setting (Peng & Health, 1996).
The importance of the societal context was further suggested by the work
of Lockett and colleagues (2002), who found that the sources of infor-
mation that venture capital firms seek out and can utilize are also cultur-
ally determined and can differ from one country to another. Yet despite
research illuminating such differences much research still presumes that all
venture capitalists operate in highly formal institutional environments
present in predominantly Anglo-American economies (see Jeng & Wells,
2000). Venture capital investors making these investments face some
unusual problems with the institutional environment in conducting busi-
ness in China. Successful private firms face a certain measure of hostil-
ity, which comes from two primary sources. First, there is opposition from
many government officials who worry that the socialist system will be
undermined. Labour ‘exploitation’ by investor control over the means of
production violates basic Marxist principles, which still form some basis for
official policy in China. This mentality insists that the smaller funded and
(often) private enterprises of today could become the monopoly capitalists
of tomorrow.

Second, many officials and policy makers in China have practical con-
cerns about tolerating increased competition for state enterprises. The
largest employer in China continues to be the state: in 2003, it employed
half of China’s 750 million workers and controlled over 50 per cent of
all industrial assets there. The SOEs still dominate vital industries such as
financial services, power and telecommunications (Desvaux, Wang & Xu,
2004). SOEs and state-owned enterprises (SOEs) must provide numerous
employee benefits that are not required of private firms and as such receive
most government financing. Many officials in SOEs oppose private firms
as potential competitors – threats to their own livelihood (Steinfeld, 1998).

Consequently, government officials and other powerful individuals regu-
larly interfere with investment in and operation of private firms in China as
well as private equity investment in joint ventures with SOEs. This is mani-
fested in the enforcement of government policies towards firms with pri-
vate backing (Clarke, 1991; Tan, 1999). The assessment of taxes, licence
fees, administration fees and penalties by party cadres in China can vary
greatly from region to region. Officials are enthusiastic in seeking invest-
ments, but they seek to use many tactics trying to solicit or share successful
people’s wealth. Thus taxes, fees and penalties levied on private firms are
often at punitive levels for their political and economic interests (Wank,
1996; Xin & Pearce, 1996; Gold, Guthrie & Wank, 2002).
THE STUDY

To develop this understanding of the challenges faced by venture capitalists in China, we conducted semi-structured, in-depth interviews with 26 leading participants in China’s venture capital industry. These included venture capitalists in firms in China, and venture capitalists based in Hong Kong and other parts of Southeast Asia who fund firms in China. The vast majority of these firms were located in Hong Kong, which has the largest amount of venture capital for investing in Asia outside of Japan. However, these firms typically invest very little in Hong Kong. Instead they use it as a base of operations. As a result, 19 of the firms were interviewed in Hong Kong, four in China itself and three in Singapore. The Singapore firms all had significant operations in China.

The firms examined include both independent and captive venture capital firms. Venture capitalists in the United States are typically independent firms that are organized into limited partnerships. These firms only conduct private equity investing. In Europe, there are some independent venture capital firms, but the more common model is to have captive firms that are private equity departments in large multinational banks. Both types of firms were examined, but in all instances the firm was primarily privately held. For example, Transpac from Singapore does have government investment but the management of the firm is largely independent and separated from government involvement. We did not include central and provincial government investment funds. In certain parts of China, these funds supply most of the private equity capital, apart from the developmental capital coming from Hong Kong firms and outside of China. Generally, these funds invest in infrastructure and late stage private equity and restructuring. They commonly do not invest in higher growth start-up firms (Bruton et al., 1999).

Extra effort was made to ensure that venture capitalists in both large and small funds were questioned to provide as wide a perspective as possible. The list of sample participants was developed through initial interviews with senior venture capitalists in the region and with the help of the Asian Venture Capital Association in Hong Kong. This was to ensure a broad coverage of leading venture capitalists and venture capital firms in the region. All of the interview subjects are responsible for funding firms and have played a role in managing some of their funded ventures.

Semi-structured interviews were conducted with the 26 venture capitalists. Using a research design known as replication logic (Eisenhardt, 1989), these semi-structured interviews were conducted to build first an understanding of how venture capital works in China and the problems that venture capitalists face. As noted by Daft and Lewin (1990), such an
in-depth understanding should be developed before quantitative investigation of a topic can begin. The cases were chosen in a manner consistent with the work of Glaser and Strauss (1967), who argued that the number of cases examined should be such that incremental learning from additional cases approaches zero. Diesing (1971) argued that six cases often provide such a number; Zhao and Aram (1995) examined such a number of cases.

All but two of the interviews were conducted in English. Two of the authors speak Chinese, and at least one native speaker was present at all Chinese language interviews to take notes. Most of the interviews had at least two interviewers present to take notes. Interview transcripts were subsequently examined to ensure consistency. If any discrepancy occurred, the interview subject would be contacted for clarification. The results were summarized and venture capitalists were subsequently contacted for verification. Concepts were coded and compared among researchers.

During the interviews, the cases and insights provided by each interviewee were tested against previous findings as well as with the stylized US model of private equity, where appropriate. The summary findings were then shared with two leading venture capitalists active in China, who were not part of the study, for their comments. The concepts and explanations were then revised to reflect their further insights.

RESULTS

Laying the Groundwork

The early strategic plans of private equity investors in China were to build relationships with large, state-owned enterprises and then to ask those firms for help finding good investment opportunities among other SOEs or township and village enterprises, often in stable, well-understood industries (Lau, 1999). The private venture capitalist would bring money and managerial expertise to the table. The large state firms would source deals and provide the guanxi, or key relationships among business and government officials necessary for business success in China. Thus a major chemical firm like Sino-Chem would provide a venture capital fund with access to the best chemical-related funding opportunities around China. Once the fund decided to back a venture, a Sino-joint venture between itself and the large state entity that source the deal would be created (Bruton et al., 1999).

However, investors have learned that good guanxi alone is not enough to ensure the success of funded firms. The collapse of Guangdong province’s Guangdong International Trade and Investment Corporation (GITIC) surprised a large number of investors, with a number of funds losing
money. This also proved to be a painful reminder that investors should not depend entirely on guanxi at the top. Although having connections with a central government official is helpful, there are people at a variety of levels with whom connections may be required (Ahlstrom, Bruton & Lui, 2000; Xin & Pearce, 1996). In addition, private equity investors in our sample commented that deals should not be overly dependent on political connections. This is due to the capricious nature of politics; as one private equity investor summarized, ‘if your sponsor is in power you are ok, but if he or she leaves that office, you may end up with an unattractive investment with few prospects’. Venture capital firms are wise to spend time to build their own connections with officials at various governmental levels in China. It is also helpful to ‘buy’ guanxi by seeking firms and managers, but this is just one of many relevant success factors of private equity investing in China and should not be overly relied on.

**Making the Initial Investment Decision**

One of the most consequential difficulties for venture capitalists in any economy is determining the viability of a proposed investment. There are several key concerns for the private venture capital firm in an emerging market like China, including obtaining an accurate financial picture of the firm and conducting due diligence.

**Accounting information**

In China, seed technology ventures that are little more than an idea are rarely funded; investors usually fund going concerns of a later stage than in the US or Britain (Bruton & Ahlstrom, 2003). A key difficulty in making an investment decision in this environment is that China’s accounting standards differ greatly from those in the developed economies (Shi & Weisert, 2002; Tang, 2000). As a result assets such as property and inventory may not be as fully valued as in more developed markets, and accounts receivable may not be realistic. China’s accounting standards as practised today deviate substantially from international accounting standards (Chen, Sun & Wang, 2002).

China’s accounting rules and conventions differ from international accounting standards in three major respects. First is the policy basis of the firm’s goals. Many accounting mechanisms used by Chinese enterprises are aimed at managing production rather than asset valuation. For some established firms, as well as managers trained in such a system, this bent is difficult to unlearn, irrespective of changes in regulations. Second, the significantly different intended audiences for the financial reports can prove to be a challenge for private equity firms to manage. International practice
identifies investors and creditors as the primary users of accounting information, whereas Chinese practice regards the internal customers (the sales managers, production managers, general managers, middle managers and so forth) as the primary users. In spite of recent changes in China's accounting regulations, owing to weak enforcement, Chinese operating statements tend to be dominated by operational data and lacking in accurate summarized financial data. As a result there is a gap between Chinese and international accounting standards earnings results despite much harmonization of accounting regulations in China with those of more developed nations (Chen, Sun & Wang, 2002). Third, terms sometimes may be defined or understood much differently in China than elsewhere, and accounting terminology can take on different meanings in different industries or regions of China, along with differing formats (Broadman, 1999).

These problems result in financial reports often being of very limited help to investors as they seek to evaluate which firms to fund. Recent attempts to align China’s accounting standards with international standards will ultimately make financial reports easier for venture capitalists to interpret in a meaningful manner. But still today such accounting information on a firm seeking funding is of limited value to the venture capitalist. Venture capitalists often must hire auditors from Hong Kong to help confirm the reported accounting statements.

**Due diligence**

Due diligence occurs as the venture capitalist seeks to validate the information that the firm submits. This effort will include efforts at obtaining robust market information. The availability and accuracy of such information is problematic. Yet another challenge is to secure accurate engineering information for an evaluation of the high-tech venture. Venture capitalists must expect to make greater efforts in China than in the West to help aggregate the information typically required.

**Management’s background**

A key part of due diligence is learning the background of the firm founder and other managers. In fact, the most important aspect of an initial investment evaluation in the US centres on the evaluation of the person leading the proposed investment. As legendary venture capitalist Arthur Rock commented, ‘Nearly every mistake I’ve made has been in picking the wrong people . . .’ (Bygrave & Timmons, 1992b). This is even truer in China when a firm’s financial statements may contain only marginally valuable information and the other aspects of due diligence can be problematic. Sometimes the background and connections of the top management team may be among the most valuable resources the firm possesses.
One benefit of operating in the Chinese environment over a long period is that extensive relationships and valuable personal information networks are developed. For example, university professors and individuals at various research laboratories throughout China often control key high-tech projects. These individuals, along with their students and young colleagues, constitute a foundation of high technology information that can be accessed once strong relationships are developed. In fact, many of these individuals in turn will be the ones that become a source of new ventures to fund. For venture capital firms that are new to China, locating these individuals at the research facilities and research parks and then building the necessary relationships with them can be difficult.

**Negotiations**
Negotiating the deal is the last part of the selection of a firm to fund and can be extremely difficult. In part this difficulty is due to the fact that Chinese business owners, government officials and venture capitalist investors often do not agree on company valuations. Chinese entrepreneurs frequently benchmark high valuations based on similar firms in the US. Venture capitalists in China, on the other hand, stress the differences and country-specific risk. Making matters worse, there is no standard methodology for valuing a company. One possible friction point is that, since national growth rates are an important component of a firm’s total valuation, valuations for Chinese firms may be inflated by highly optimistic growth projections and difficult to verify economic figures (Rawski, 2002).

The negotiation process is further complicated by the fact that contracts are not viewed in China in the same absolute terms that they are viewed in the West. As one venture capitalist interviewed cautioned, ‘a signed contract simply provides a green light to more negotiations when it becomes convenient’. As a result the negotiations are typically an ongoing process in funding a firm in which, while a contract may have been signed, there is far more evolution in what those terms mean and there will be greater changes in the contract than would be expected in the West. Moreover, such a process is not unique to technology-focused firms. Thus venture capitalists can expect that Chinese firms may continue to seek revisions in that contract as their relationship with the Western investors develops.

**Monitoring the Relationship**

Once the technology firm is funded, the venture capitalist must monitor its operations carefully. The difficulties in monitoring a firm are magnified because of the problems with the legal system identified earlier. Venture
capitalists must maintain appropriate vigilance to ensure that the firm is performing as desired. Venture capitalists reported that it is important to send people into a firm to count things and to double check that things are generally going smoothly. Several venture capitalists cautioned against maintaining the same number of investments as in the US or UK because of the monitoring and assistance these firms typically need. They also stated that venture capital firms should try to place middle managers with whom they are familiar in the funded firm to help further in monitoring its operations.

Trust
The model of investing predominant among early venture funds in China was largely a ‘hands off’ style limited to monitoring the funded firm. Venture capitalists were not always granted a seat on the board, and financial data were often slowly and grudgingly provided. Even today, while a board seat may be offered when a venture capitalist invests in a high technology firm, the protections that a seat on the board actually offers can be limited. The corporate governance laws in China, though improving, are still rather ineffectual and generally unenforceable. Thus the ability to influence a high technology firm is crucial and the investor relies on the trust developed between the leaders of that firm and the venture capitalist.

As a result of the importance of trust, venture capital firms often work with the managers with whom they have experience since they have already built such trust. Venture capitalists interviewed were quite quick to emphasize that in China it is highly preferable to enter a deal with personnel they know, and more so than in the US.

Another type of firm that these individuals like to fund because of the greater ability to build trust are Overseas Chinese or Chinese who have studied in North America or the UK, and have returned to China to work. These individuals have Chinese language facility but at the same time understand the concept of shareholder value and the need for disclosure and monitoring by the venture capitalist. As a result the ability to build trust with them is typically easier than it is with an individual whose only experience with venture capital may be local firms that focus on political issues as much as profitability.

Recalling that in China, venture capitalists typically fund ventures that are established already to some degree, one private equity investor pointed out that it is particularly crucial to have middle managers in place that you can trust as well. ‘They are needed to act as your information conduit into the function of the business’ he noted. Thus, in building trust with top management it is also important for venture capitalists to have relationships with those in the lower level in the organization.
Regionalism

Although China is described as a ‘target-rich environment’, it is also a country of multiple, distinct provincial and regional markets, not a market of 1.3 billion consumers as is often thought. Each region, province, or industry may require somewhat different resources. Connections with the local government officials are needed as venture capitalists seek to fund firms in new cities and provinces.

The impact of the strength of such strong regions is that economists have coined the term ‘Chinese style federalism’ to illustrate the strength of the provinces and other localities. This regionalism results in goods crossing provincial borders in China facing the equivalent of a 46 per cent tariff in 1997 (Poncet, 2001). Poncet adds that this tariff equivalent of 46 per cent is about what the European Union countries charged each other in the late 1990s. This means that in respect of traded goods and a number of related commercial laws, China is something closer to a loose federation of sovereign states than a unified country with much variety in law and regulation.

The strength of such regionalism is not limited to areas like tariffs. The initial economic reforms in China were aimed at decentralizing decision making (Child & Lu, 1990). As a result, the reforms devolved authority in a number of areas from the central government to provincial and local governments, and even to powerful individuals (Naughton, 1995). Twenty years after the initial reforms, provincial governments controlled about half of the total PRC budget while the central government controlled 20 per cent (Naughton, 1995). There has yet to be a clear delineation of authority among the central, provincial and local governments. This lack of clarity in the authority structure gives local government officials an opportunity for exploitation. The result is that some local officials run their territory as if it was their own enterprise – and treat firms under their purview almost like their own property (Peng & Luo, 2000; Gilboy, 2004).

The highly local nature of commerce in China presents challenges to monitoring funded firms. Venture capitalists and entrepreneurs interviewed emphasized the importance of understanding the local setting of the firm. Laws can vary greatly from province to province, and implementation is heavily dependent upon both the views and the moods of local bureaucrats (Clarke, 1991; Tan, 1999; Gilboy, 2004).

Some private equity professionals in the West find this concept difficult to grasp because Westerners are accustomed to standardized laws and they depend heavily on their ability to conduct business by telephone, fax, mail or Internet, regardless of where the partner or funded firm is located. In China, the situation is markedly different, and this affects how venture capitalists
structure deals, as one capitalist from Shanghai recalled (Ahlstrom, Bruton & Chan, 2000:6):

I almost never fund deals more than a couple of hours’ drive from my office. The reason is that the deals in China must be monitored very carefully. One Internet firm’s top management recently disappeared with about $300,000 I had invested with them. Although I used to visit that firm about once a week, it was not enough: they were about 300 kilometers away – too far to monitor properly. Now I limit my investments to firms that I can visit more frequently or watch over easily, and this means [firms] in the Shanghai area.

Such problems are amplified for high tech firms. To be profitable, high technology firms are likely to require a national market rather than rely on a single region of the country for product sales. Venture capitalists have addressed this problem by opening local offices throughout China to seek new investments and provide support to current ones expanding across the country. For example, Transpac, headquartered in Singapore, was an early mover in China’s private equity landscape. One of Transpac’s strengths is the network of small offices near to their investments around the region they maintain – an advantage over single-office fund groups. Transpac’s decentralized approach facilitates not only finding new investments outside of the traditional areas, but also investment monitoring.

Input to Managers

While managers may seldom seek strategic input from venture capitalists, the need for their guidance may be greater than in comparable situations in the West, particularly for high-tech firms. As one Hong Kong venture capitalist observed:

Although the Chinese business owners do not want any outsiders involved, we often find we have to be involved. Perhaps the key lender asks management for help to find overseas markets. Sometimes a partner is needed to help handle the local government. The paradox is that although the owners do not want us on the board, I find that my colleagues and I must often get more involved with operational details in our funded ventures in China than we would in similar deals in the West.

The venture capitalists noted that, when there is a need for managerial input, one of the key factors in such situations is to allow managers the opportunity to maintain ‘face’ or respect. This can be undertaken in several ways; for example, rather than giving an ultimatum, an idea might be put forth as a suggestion. The setting where suggestions are provided is important as well – never in front of a manager’s subordinates. This way, the manager can remain ‘in charge’ and take credit for the changes.
Relationships

Social controls have proved far more effective than economic or legal controls in countries with underdeveloped institutional structures such as China (Guthrie, 2002; Peng, 2000). As noted before, the legal system in China is not well developed. Though its importance may be declining as institutions slowly improve (Guthrie, 1998), guanxi is still crucial to the success of the venture. However, these relationships are necessary not only within the firm but also to key individuals outside the funded firm in China. A key part of the value that a venture capitalist can add to its invested firms comes from such individuals outside the firm.

Many new private firms may not have extensive guanxi capital to call upon – these relationships develop over time. To that end, the venture capitalists can connect them with key individuals whom the firm can hire or pay a retainer to. For example, a venture capitalist may have a relationship with a town’s former village head (cun zhang) if they have a relationship with that person and suggest to a new high technology venture that they hire them. Although the village head may even no longer hold that position, his or her influence with the people in the area will probably remain strong. People will listen and are deferential to the village head’s influence; they do their best to give face and not embarrass the village head in any way. Furthermore, many employees may be from China’s inland region and do not want trouble from the local people; so they too are deferential to the village head, which can further aid the high technology venture. This individual likely knows everyone in the area and is accustomed to evaluating and selecting people for work teams. This makes it less likely that workers will steal assets or shirk their responsibilities on the job.

In China, the importance of hiring people with the right skills and connections cannot be overstated. At times, venture capitalists may find that they must also aid the search for professional managers, sometimes helping to recruit individuals from multinationals throughout Asia and offering them a small stake in the portfolio company (Pohndorf, 1997). Outside knowledge and connections that venture capitalist bring to their funded firms in China can be especially valuable in the area of human resources.

Reconciling conflicting goals

In monitoring their investment venture capitalists need to recognize that their goals for the firm may be fundamentally different from those of the entrepreneur. Chinese firms (whether publicly or privately owned) are encouraged by the state to maximize employment and production. For investments in SOE and township and village enterprises, this can be especially troublesome, but it can also affect private firm investments. As a result, without a venture capitalist’s careful oversight, firms can end up
filling warehouses with unsaleable inventory or placing dozens of extra workers on the payroll.

EXIT

Investors in large companies in China expect to exit through IPOs. Presumably the firms would be listed on either the Hong Kong Stock Exchange or, in more recent years, the stock exchanges within China (Shanghai or Shenzhen). But exiting even from successful ventures has proved to be problematic. The market for corporate control is not active in China and around Asia (Peng, Luo & Sun, 1999). China’s Shenzhen and Shanghai stock exchanges typically list state-owned enterprises that are politically connected. The founders’ shares become non-tradeable when listed domestically, which eliminates this venue as a liquidity source.

Thus most venture capitalists investing in large firms have to look to strategic buyers as an exit or a liquidity source. This is clearly the case for almost all high technology ventures. Strategic buyers in East Asia are typically larger corporations looking to acquire new capabilities or institutional positions in China (Peng, Lee & Wang, 2005).

Many firms have discovered that, when they do exit, their returns have not been very high. Venture capitalists typically hope for annual returns of 20–25 per cent, although our sample reported that, to date, actual returns for their funds are much lower. Therefore venture capital firms have wanted to fund deals of lower risk to compensate for the lower than hoped for return. This in part explains why most venture capitalists will not fund a firm that is not already an ongoing venture. The venture capitalists in our sample added that the finding of on-going ventures with follow-on rounds of additional financing is not common in China. Thus, while in the United States there are typically multiple rounds of financing, each at a higher valuation, such multiple rounds of financing are more difficult to achieve in China.

Even when securing a strategic buyer there are other difficulties. A strategic buyer almost always will want a majority stake in the venture. However, in China, venture capitalists normally have but a minority interest in the funded firm. Thus the venture capitalist needs to convince the Chinese firm to sell part of its share and become a minority owner in the venture—a ‘tough sell’ to a Chinese firm that may not want to give up control. The multiple paid on the firm’s revenue stream results in a return significantly lower than that traditionally associated with an IPO.

Some local venture capitalists claim that exits are getting easier. One venture capitalist stated that of the 100-plus companies in which his firm has invested, 24 were already public, 26 were sold 100 per cent to other parties,
and in many other cases their minority stake went back to the majority owner. Exit mechanisms do exist in China, but the options are more constrained and complex than they are in the West.

DISCUSSION

Venture investing in China is no simple task. Understanding the local China situation is critical to success in this market. Until recently, fund managers would argue that their financial success would be quick once they exited their funded firms. However, having been active in the China market for at least five years and managing a number of investment exits, many venture capitalists interviewed affirm that the situation is very complex in China. Success cannot be achieved by simply ‘cherry picking’ a few of what appear to be the best investment opportunities, as was once believed.

A significant change in recent years has been the process of selecting and monitoring the investee firm. Increasingly, investors acknowledge that China is unique but they also acknowledge that they must employ methods similar to those used in the West on issues such as due diligence. Thus the methods need to be the same. However, accomplishing those levels of due diligence is much more difficult to achieve than in the West.

Venture capital investors bring far more to the high technology venture than just money. Their advice and connections and global perspective are all important to their investee firm’s success. However, an investment in a Chinese firm needs to be closely and locally monitored, and venture capitalists should be prepared to be proactive in helping the funded firm in hiring workers with valuable skills and assisting in securing and forging needed connections. Although Chinese business owners have been reluctant to permit venture capitalist access to financial and strategic decisions, they increasingly recognize and accept that investors will not be passive providers of money. The most sophisticated of the Chinese firms actively seek out a broader array of input from the smorgasbord offered by their private equity investors.

IMPLICATIONS FOR RESEARCH

This research has demonstrated that there are significant differences between venture capital in China and that of a mature market like the United States. These differences arise despite the fact that many of these same firms have operations not only in China but in those same mature markets. Venture capital firms seem to be responding to the institutional
differences between China and the Anglo-American venture environment (c.f. Bruton & Ahlstrom, 2003). That is, the continuing lack of a more formal institutional structure in China portends the continuing importance of guanxi in a variety of places in the venture capital process. Future research should explore these differences further. For example, how do such firms integrate their various unique approaches into a worldwide system of venture capital? A firm like Walden Ventures has operations not only in Asia but also in the US and Europe. How does a worldwide firm allow such variances but at the same time maintain their worldwide standards? This has implications for any professional firm that has to conform to both national (local) and professional institutional environments.

This research has also examined both independent and captive firms. The majority of the sample were independent firms, with limited examination of captive firms. One shortcoming of the research is that the sample was not large enough to differentiate between the two types of venture capital firms as regards the nature of their adaptation to the Chinese market. Future research should expand the sample and explore the impact of these different ownership structures on the performance and actions of the venture capital firms, not only in regard to high technology ventures, but in the funding of all types of ventures.

This research has specifically examined privately held venture capital firms. We argue that there is a significant difference in government backed funds called ‘venture capital funds’ and those that are privately held. Such a view is consistent with the dominant literature on venture capital. However, further research is necessary to fully understand such differences. The government-sponsored investments in China can be expected to respond to local political concerns and the need for employment (Gilboy, 2004).

If government venture capital funds focus on the employment and political concerns as expected, there will be a wide range of implications not only for the performance of the venture funds themselves, but also for the actions taken by the venture capitalists. Thus there is a rich set of issues that need to be examined for domestic Chinese venture capital. The findings here for independent firms in the nation can serve as a foundation for the issues that need to be examined. A few critical areas that should especially be examined are how new ventures are chosen for funding, how such investments are monitored and how advice is provided to the firm: specifically, what advice and actions are taken by the venture capitalists when difficulties in the funded firm are identified. It can be expected in each of these areas that differences will be found from independent firms. These findings have implications not only for venture capital firms but also for the various government entities in China as they seek to encourage technology development.
IMPLICATIONS FOR PRACTICE

Today, three broad strategies seem to be emerging in China for venture capital investors. First, the SOEs are far from closing up shop in China, as they have elsewhere around the world. China is still giving a lot of attention to SOEs as they employ about half of China’s workforce. Hundreds of SOEs are considering selling, restructuring or privatizing portions of their assets and trying to get a public listing. The demand for repackaged, competitive SOEs with low costs, good assets and strong political connections, and maybe even a semi-captive provincial market in a more isolated part of China, is a very attractive target for private equity firms and their minority shareholders. This category is challenging to navigate as it is dominated by political insiders in China, and is fraught with hazards, but some private equity firms have been able to do so. The central government and bureau and departments with SOEs under their purview have been testing the viability of these strategic sales and repackaging, and our sample has reported that more are likely.

Venture capital firms have also funded many well-established private firms. Private investment funds are often drawn to entrepreneurial start-ups that can take advantage of China’s low cost coupled with the growing East Asian market. Private equity firms are trying to target firms that can take advantage of China’s peculiar demographics, such as the one child policy and an aging population, firms in the health care sector and firms in life sciences that can take advantage of China’s strong life sciences and agricultural programmes in the universities.

CONTRIBUTIONS OF RESEARCH

As noted above, this research focuses on private venture capital efforts in China. Prior research has lumped private and government venture capital firms into a single unit. The expectation is that researchers will ultimately find that they can view venture capital as a continuum. At one end will be the pure model that is widely understood from mature markets like the US. In the middle will be private firms active in China that we have detailed here. These firms have differences but also strong similarities with the actions of firms in mature markets. It is expected that the domestic firms with strong government influence will be substantially different from the Western model and will anchor the other end of the continuum. This research helps to extend the understanding of venture capital in emerging markets by suggesting models of venture capital practice that differ from more traditional approaches that have developed in the West. This can facilitate further
research on understanding the role venture capital can play in the reform of state-owned and other government-linked firms – a very important sector in China and certain other emerging markets.

The research also helps to establish for the first time the interaction between technology and venture capital in a transitional economy. Prior research has tended to treat the investments of venture capitalists as a uniform set with little differentiation between the different types of investments. This is the first effort to differentiate and focus on one specific investment type, high technology investments.

Finally, the research expands our understanding of institutional theory. In particular, this research expanded the understanding of how different institutions affect a specific industry. It is clear from the discussion that cognitive institutions and regulatory institutions both influence the strategic choices of the firms in a transitional environment. Future research can build on such information to examine in greater detail which institutions have the greatest power in different settings.

**CONCLUSION**

Despite the many challenges, the private equity market in China has been improving. The standards and professionalism of the industry in the country are also improving. One symbol of this movement is the fact that, in June 2002, a group of private equity firms founded the China Venture Capital Association (www.cvca.com.hk) to promote the rights of entrepreneurs and laws on investor protection and disclosure. The new association has about 50 members, including big private equity names such as Newbridge, the Carlyle Group and Goldman Sachs. Additionally, new regulations governing venture capitalists have been promulgated that have increased the stability of the industry (Burke, 2003). Additional positive steps for venture capitalists are also occurring with the approval of Shenzhen Stock Exchange’s separate board for small and medium-sized enterprises, much like the NASDAQ and Hong Kong’s GEM market.

The future for China venture capital is likely to be a model much more similar to that predominant in the US or Europe than the old China mould of the past. For example, due diligence is already starting to look more like the Western template. Where once China’s information on market research may have been neither available nor reliable, the sophistication of such data is expanding, and most private equity investors are taking advantage of that information. Additionally, investigation of the investment opportunity now goes much deeper than merely getting to know the promoter presenting the business concept. This trend is likely to continue, especially
for the high-tech investments that are likely to be a major part of China’s future.

Venture capital in China will continue to grow. This nation, with a quarter of the world’s population, undergoing such rapid levels of economic growth and change, offers an assortment of investment opportunities. Additionally, as institutional investors seek to diversify their investments, an obvious move is to include China-based firms in their portfolios. The low rates of return that some firms are experiencing will discourage other investors, and there will be a period of transition as the market continues to mature. Nevertheless, private equity in China holds many interesting opportunities and challenges, and Western venture capitalists must be prepared and well versed in the nuances of the environment there if they hope to seize the opportunities present in this intriguing and complex market.

NOTES

1. For more details on the historical development of China’s venture capital industry, as well as general differences at a macro level from the US model, see Bruton et al., 1999.
2. Recently Shenzhen has been attracting more high technology manufacturing, based on a nascent venture capitalist industry, local university talent and the approval of a new NASDAQ-type stock market.
3. Some private equity investors halt their investigations after the first step of evaluating the entrepreneur, as they believe no other type of information from China is adequately and consistently reliable for them to make a judgment on the business plan.

REFERENCES


Overview of new technology ventures


