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Don't Invest in China!

by: Sean Foote, Labrador Ventures – October, 2005

If you're an early stage VC or institutional investor, investing in China is far trickier than one might think.

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If there's a market that can do no wrong right now, it's China. Expanding at three times the rate of the US, with economic growth of roughly 7 percent per annum, China – possessing one-fifth of the world's population – is literally a market opportunity waiting to happen.

Early stage U.S. investors – don't be tempted. Picking which early stage China-based companies will be able to capitalize on domestic and international markets while executing on their own growth strategies – including navigating anti-piracy laws, hanging onto IP and recruiting the right business talent – requires substantially different skills than the ones you have honed in Silicon Valley and the U.S.

It's enticing, though. "China has something to offer that the rest of the world can't ignore, massive growth," according to a fund of funds investor active in the China market. Thus, early stage VCs see tremendous opportunity for their portfolio companies and for new investments, with the last four years witnessing a steady stream of VCs heading to China to dip their toes into new opportunities.

The Temptation

By numbers alone, China's size and growth would appear irresistible. China has 160 cities each with more than 1 million people while the U.S. has just nine. In 1990, China's share of world exports was almost 2 percent, yet by 2003 that number had expanded to 6 percent. Now, China's manufacturing sector employs close to 100 million workers versus 14 million in the U.S. according to the AFL-CIO). Moreover, according to the International Monetary Fund, China accounts for 29 percent of world trade in bicycles, 28 percent in toys, 25 percent in footwear and 20 percent in ready-made garments.

On a return on investment basis, the numbers look eerily reminiscent of the dot-com boom. Baidu.com, a Chinese search engine similar to Google, went public less than a month ago in a spectacular Nasdaq IPO. Baidu's shares were offered at $27 and then soared as high as $151.24 on its first day of trading – this wasn't just Google, this was Google on steroids. Now, even a month later, Baidu still has a market cap of $2.6 billion on trailing revenues of $13 million, or 108 times revenue. Google trades at 18 times trailing revenues. Sohu.com, a Chinese Internet advertising, search and online services company, had an equally spectacular rise from early 2002 to mid-2003, soaring from the low single digits to over $40 per share in less than 18 months. Though the stock has since fallen by nearly two-thirds, it still trades at a nearly $650 million valuation.

And on the investing side, money is rapidly tracking China's growth while taking advantage of its bubble-like returns. According to Beijing-based consulting firm Zero2IPO, foreign VCs accounted for about 63 percent of all deals done in the first quarter of 2005, and 80 percent of the total dollars invested in China-based startups. Additionally, a recent survey of the Ministry of Science and Technology indicated that through the end of 2004, there were 250 venture capital organizations in China, with total funds reaching 40 billion yuan (US $4.8 billion). A growing portion of that money has come from US-based LP's.

Enter With Care

All this attention has created at least three major arguments against seed and early stage venture investment in China: first and foremost that it's already a crowded investment marketplace. Quality deal flow is highly competitive. Even though scores of US-educated Chinese nationals, not to mention several already successful Silicon Valley Chinese entrepreneurs, are heading home to start new companies, there are simply not enough good companies to go around; and those that are setting up new companies are generating 'me-too' business models that don't appear sustainable in the long run.

Which brings up the sad but eminently realistic fact that not all news out of China is actually good news, particularly for VCs. Though contributions from privately-owned enterprises (including venture-backed startups) to China's national gross domestic product (GDP) increased from 0.57 percent in 1989 to 20.46 percent last year – indicating that the startup market is indeed producing vibrant companies with strong growth stories – there are also signs that a new "bubble economy" is being created.

"There are more good companies to invest in these days, but there is also far more capital chasing these investments. As a result, valuations are getting bid up and returns will inevitably suffer," says Tina Ju, general partner with a Chinese-based VC fund called TDF Capital. In fact, says Ms. Wang, the market has become so awash in cheap foreign capital that many Chinese entrepreneurs are looking first for American money before settling for Chinese based venture capital. Why?" Because they know they can get higher valuations from

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the Americans, and it will take a year or two for those investors to figure out they paid too much," says Ms. Wang.

Others are even less diplomatic about the implications of too much money in China chasing too few deals. "If you thought the bloodbath was in the Internet, this is going to be just as bad," says Alex Bangash, Managing partner with the Rumson Group, a Washington D.C.-based advisory group that measures the performance of funds and their managers.

The second major argument against investing in China is that U.S.-based skills and networks do not readily translate to China. In the same way that regional investors in the United States complain about the differences in deals, style, network and infrastructure between California, New York, and Kansas, China presents an order of magnitude difference. And this difference can lead to substantial risk despite the growth story.

"The real story is very disruptive for US venture investors and private equity firms, because these Chinese companies are going to be the dominant companies in the world in a few years, and Sand Hill Road knows that," says Mr. Bangash. "Yet, the US guys who are investing in China through consultants or directly into funds just by simply visiting the country for a few weeks are going to get their heads handed to them."Or as one of the wealthiest businessmen in China said about a U.S.-based investor, "He's so nice, he's so smart. We're going to eat him alive."

Such horror stories are already emerging. Two American VCs who thought they had just won a bidding war against another investment group to invest in a Chinese gaming company found out the hard way that knowing whom to trust is just as important as knowing what to invest in. The startup turned out to be a phantom company that disappeared just as quickly as did the venture capital. Big companies, too, are suffering. Microsoft China has been hamstrung with its own China-based management problems and is reported to be generating more revenues from licensing infringement fines than from selling licenses in China.

This points towards the third argument against early investment in China: substantial additional risks beyond normal start-up risks. The China experiment in single party capitalism is still in its early stages. Many good rules have been placed on the books, including strengthening intellectual property laws in China as part of WTO admission. However, enforcement remains spotty. In fact, an estimated 90 percent of software in use in China is pirated according to a Business Software Alliance/IDC study – and a recent report in the Chinese press stated that approximately 50 percent of mobile phone batteries in use in China are actually counterfeit.

Meanwhile, new regulatory structures can lead to very different investor expectations of risk and exit. For example, a regulatory initiative known as Document 11 was circulated in late January by the Chinese government. The rule makes it difficult for Chinese entrepreneurs to establish the complex corporate structures that allow them to list on international stock markets – thus making potential future exits for VCs that much more difficult.

A second regulatory endeavor put a chill through an entire investment sector. Chinese online gaming companies were chased by hordes of VCs wanting to invest in a bright new crop of game-makers targeting the Chinese market. In addition to evaluating the growing market for online games, these VCs were hopefully considering substantial regulatory risk. Chinese government policies could, and in fact did, put in place new regulations limiting the number of hours children were allowed to play video games.

The overall risk of the environment is underlined by anecdotal evidence from Ying Wang, co-President of the Carret China Opportunity Fund based in Washington D.C., who states that over just the past decade, one-third of all private and public equity funds in China lost money, one-third broke even, and only one third reported making any money at all – and this during China's period of hyper-growth.

What (not) To Do

What's a VC to do with money to burn and a desire to head East? Some Chinese experts have sober advice.

"U.S. VCs should exercise the same kind of prudence making investments in China as they do in the U.S. I don't see why they should adjust their standards when investing there. After a few deals under their belt, they can decide whether to be more aggressive in doing their own deals or opt to form a formal relationship with a local partner. But it's important they conduct the same type of due diligence on their entrepreneurs and on the business before making an investment," says Ms. Ju, who isn't the only one recommending picking the right partner on the ground.

"This is like the vintage years 1997-98 in the US, when if you had to invest in Silicon Valley you had to do it with the Kleiners and Sequoias," says Mr. Bangash. "The same is true for China. You need the people with the good deals, the good networks, and the good operational expertise who still need to co-invest with the best local Chinese VCs."

Thus, the right partner is ultimately the key to not losing one's shirt in China. "For LPs investing in new China funds, it's important to pick the right fund managers who will stay with the fund long term, and who have the track record and integrity to keep the LPs' interests at heart," continues Ms. Ju. "Without the right expectations and time horizon, I would not be surprised to see some LPs wanting to exit the China market in the next five years." Indeed, that process may have already started. VC investment in China slipped to $165 million during the first quarter of 2005, from $285 million in the prior quarter and $216 million during the first quarter of 2004.

Which brings the argument for, or against, investing in China full circle – back to what early stage VCs and investors know best: their own markets. California, the destination for $9.5B of venture capital investments in 2004 according to Venture Economics, remains a net importer of venture capital dollars. Of the total investment figure, only half was provided by California-based funds. And as Mr. Bangash puts it, "for deals, American VC's should definitely steer their companies to China, but for investments? No. There are plenty of good deals and plenty of good opportunities right here in the USA."

This is one in a series of monthly columns on seed and early stage investing that Labrador Ventures was selected to contribute to the *Venture Capital Journal.*

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