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# Investment in China

***Opportunities in Private Equity and Venture Capital***

# 在华投资

**私募股权和创业资本的机会**


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## Abstract

This book is the first English book about China's venture capital industry and private equity investment. It addresses relative issues with both quantitative and qualitative methods and integrates general introductions with concrete operations. On the basis of briefing private equity in China, the authors are mainly dedicated to providing a full picture of China's venture capital industry.

The book intends to introduce private equity and venture capital in China, and discuss feasible operations under current Chinese legal, policy and business environments. Therefore, foreign private equity investors and venture capitalists, who are experts in developed economics but know little about China, may benefit from the book if they plan to have their businesses in China. With practices on M&A and a lot of information on areas for investment and opportunities, the book may also help foreign and domestic investment companies to conduct equity investment in China. Although the book is far from "perfect", it may contribute to both domestic and foreign venture capital organizations in China. Additionally, it may be used as references for business students.



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# Acknowledgement

This book is the product of a team of several venture capital professionals in China. I came to have the idea to write an English book about venture capital in China in Nov. 2001 after I finished a few Chinese books on the related topics. The work really started when I went to Macao to meet Mr. Baochun Li who havd been doing research work for quite a few years in the field of venture capital investment and discussed with him to get a rough outline. I went to Zhuhai City (near Macao) to meet Li again in Jan. 2002 when we had a detailed outline, which was then named "100 Q&A about venture capital business in China".

With the first outline, the "100 Q&A", I consulted quite a few overseas venture capitalists who have been doing investment in China actively and know the China market very well. They gave me valuable comments and feedbacks on the outline. I would appreciate Mr. Shaun Fan of NIF Management Singapore, Mr. Jixun Foo of Draper Fisher Jurvetson, Mr. Hugo Shong of IDG, Mr. Y. C. Li of China Merchants & Fortune Assets Management, Mr. Wing-keong Siew of H&Q Asia Pacific, Ms. Margaret Leeof Lombard Asia Pacific, Mr. Richard S. Roque of William E. Simon & Sons (Asia), Mr. Jeff Leng of Warburg Pincus Asia, Mr. Duane Kuang of Intel Capital Asia Pacific, Mr. Douglas Ng of Fidelity Capital Far East, Mr. Edward Lee of Citicorp Capital Asia, Mr. Tony Tsang of Transpac Capital, Mr. Eugene Wong of Crimson Venture Singapore, Mr. Linan Zhu of Legend Capital, Mr. Eng-Seng Ang of Government of Singapore Investment Corporation, Mr. Frank Lu of Acer Technology Venture Asia Pacific, Dr. Peter Hua of Softbank China Venture Capital, Mr. S. K. Mak of Walden International, and Ms. Nancy Ku of GE Equity.

Mr. Jiawen Miao, a senior corporate finance specialist in Guangzhou with an MIM degree from thunderbird of US joined us in Mar. 2002. He suggested expanding our book's content from "venture capital" to "private equity" which is more important to China market, since venture capital alone can not solve the corporate finance bottleneck which many SMEs or private companies or star-ups either in traditional industries or in high-tech sectors in China are facing. He wrote section one of the book with the support of his brother, Mr. William Miao in Zhongshan, who was then just graduated from Manchester Business School of UK. Mr. Baochun Li finished chapters 4, 5, 6 of section two based on his ongoing research since 1998. The team comes from different cities and had group meetings in different cities to discuss the book from time to time while we kept regular communication via e-mail every week.

Mr. James Liang, Investment Director of a VC Fund Management in Shenzhen joined us in

May 2002. However, Mr. James Liang was very busy on his deal flows and has not finished the planned section three: case study. So I decide to have another book with him “Venture Capital and Private Equity Cases Study in China” later if we can be successful in this first English book this year. I also plan to have the third English book “Capital Market Reengineering in China with Lessons from US” based on my earlier researches and a few Chinese books after I return from US as a visiting scholar. The third book will discuss the private equity market, public equity market, bank loan (private debt), corporate bond (public debt) in China in the point of corporate finance view. The book will also discuss the commercial bank and investment bank (security firm), insurance company, pension fund company, trust company, and their interaction with the corporate finance and the function of capital market in China.

As to the first book, I would also thank Ms. Hilary D. Claggett, Senior Editor of Praeger Publishers. Though She has not published my book due to the change of the publisher’s publication strategy, she did give me some advice which made me change the “Q&A” format to the present book format which is more academic oriented and research driven. I would thank Mr. Xu, Editor of Tsinghua University Press for his work on the publication of this book. I hope this book can also be published overseas soon. I would also thank Mr. Xiao Hu, one of my best friends, who spent time on contacting publishers in US and UK. I also would thank British Venture Capital Association who showed interest to subscribe our book for its members, which gave us great encouragement to finish the book.

I would particularly thank Prof. Robert Parrino, Muse, Tate & Furst Center for Private Equity Finance, University of Texas at Austin; Prof. Josh Lerner, Havard Business School, the talented and outstanding researcher in private equity/venture capital field in the world; Prof. Geoffery Hodgson; Hertfordshire University at UK; Prof. David H. Blake, Business School, University of California at Irvine; and Mr. McGovern Patrick, Chairman of IDG. These gentlemen reviewed part of our book and gave comment on our points in the book.

I hope these books will be help you understand the private equity/venture capital market in China as well as the whole financial industry in a systematic way. I wish you enjoy reading this book. If you have any question, please feel free to contact me by danielle@szonline.net which you also can find in my website www.co-win.com.

Jeffrey L. J. Sheng

# Preface

Back in 1980 when I first visited China, the country had just opened its doors to the outside world, thanks to the wise policies adopted by Mr. Deng Xiaoping. Everybody was heartily enthusiastic about new technologies and private enterprises, but nobody talked about venture capital investment. Not until the early 1990's did people begin to come across the term but still did not really fully understand the principles of the venture capital investment business. Today, venture capital has become a catchword in China. The Chinese government has taken steps to encourage venture capital investment in a bid to support the development of high technology startups.

China needs to be able to exploit the benefits of venture capital to help support the development of the country's high technology industries and private companies where most of entrepreneurs in China come from. They need to create the governmental, regulatory, legal, and financial market environments that help venture-capital-backed companies succeed. It is with this in mind that I am so happy to see Mr. Jeffrey Sheng and his co-authors' book *INVESTMENT IN CHINA—OPPORTUNITY IN PRIVATE EQUITY AND VENTURE CAPITAL*.

The book analyzes China's investment environment and existing problems blocking the development of venture capital market. The thoughtful viewpoints put forth by the book deserve serious consideration by policymakers and government officials in charge of financial and venture capital market.

The authors carefully conducted a 200-sample survey to collect market data before they started writing this book. Based on their findings, they gave a succinct analysis of the emergence of venture capital in China and the impact of global venture capital on the China market. With typical case studies and rich market data cited in the book, the authors tried to help readers understand the practice of venture capital under various circumstances in China.

Mr. Sheng and his co-authors' writing style is clear and terse. Readers will find this handbook informative yet enjoyable reading. I strongly recommend this book to anyone who is interested in or would like to know more about venture capital market in China.

Patrick McGovern
Chairman of IDG

# Introduction

The contribution of this book to China's venture capital (VC) industry as well as to global VC industry is that: this book is not only the very first English book about China's VC industry aiming at helping overseas investors to understand the China's VC market, but also using the "private equity" conception for the first time in China to indicate that venture capital is just a part of private equity business.

Private equity industry in US covers different types of funds and their management, such as seed fund, money from angel investors, venture capitals (in various stage), management buy out/in fund, investor-led buy out/in fund. leveraged buy out/in fund, mezzanine/bridge fund, direct investment fund or strategic investment fund, restructuring/turnaround funds etc. All the outside investment in a company before its IPO is called private equity investment, while the public equity investment is the investment in the floating or listed company (public company) and can be exchanged in stock market rather freely.

The importance of using "private equity" as the book title is that there is no private equity industry in China so far while there are huge but unhealthy bank industry and growing but unhealthy public equity industry or stock market. China needs a balance capital market with four corporate finance instrument available at least as the below figure indicates.

| | Financing mode: public offer | Financing mode: private placement |
|---|---|---|
| Finance instrument: debt | Corporate bond | Loan |
| Finance instrument: equity | Stock | Private equity |

Corporate bond market is very small now in China, and private equity is limited within venture capital which basically is emphasized as a stimulation to high-tech industry in China rather than an priority of corporate finance strategy and important component of China's capital market. Therefore, this book emphasizes and starts from "private equity" investment in China though the book's major content still is about China's VC industry. We will discuss more about China's private equity business in terms of capital market restructuring in another book later on.

Actually, private equity investment and M&A are good choices for many Western investors who want to get into China, and they need to have a better understanding of the economy and the business environment. Chapter one provides some information of the lucrative industry sectors and gives a better idea of the demand and market size, opportunities of these sectors. Once the private equity investor has chosen the industry he wants to focus in, screening investment candidates is the second important step. Chapter two provides some information on how to perform project searching and screening process in China. The discussion is focusing more on the differences in project selecting criteria between in China and in Western countries.

The Chinese private companies, which are a more dynamic sector compared with the SOEs, constitute an important portion of the candidate for acquisition and private equity investment. There is no doubt that the Chinese private sector is different from their foreign counterpart. Knowing their management style, and way of doing business is very beneficial to the foreign investors if they want to cooperate with the Chinese entrepreneurs. Chapter two also gives a clear picture of the feature of the Chinese private companies, the difficulties they are facing, and the trend to the future. Enterprises started by people who have education and working experiences in the Western countries are the favorites of many foreign investors because their management style and business ethic are closer to the Western investors comparing with other Chinese enterprises.

Merge and acquisition plays an important role in the private equity operations in China. This M&A trend is enhanced by the fact that in recent years more and more multinational companies have chosen M&A as a quicker and easier way to catch the Chinese market or to establish their international manufacturing base. The Chinese government also has realized the trend and policies encourage such activities. Moreover, most private equities invested companies are SMEs, they are eager to realize their potential to investors and to gain bigger market share. So they chose the fastest way to enlarge their companies: to grow by M&A. Therefore chapter three gives some practical guide on how to do M&A in China, talking about both the opportunities and the risk concerned.

Section one of the first three chapters summarizes some important points for the foreign private equity investors:

1. The real hi-tech industry is still in an immature stage in China comparing with that of Western countries. Investing in early stage companies in China is risky in that business environment and legal system set-ups are far from sophisticated in the western standard.

2. Some industry sectors newly opened to foreign investors have large potential in terms of profitability and growth rate. We also see special investment value in the area where Chinese companies have comparatively competitive advantage in the global manufacturing supply chain.

3. MBO/MBI should be one of the effective ways of entry in the coming years for the private equity investors. LBO and restructuring/turnaround funds are hardly found in China now. As the capital market is maturing, more and more different forms of private equity investment should become familiar to the Chinese.

Section two gives the details of venture capital industry in China along its fast development in the past 5 years. Chapter four reviews the history of venture capital and discusses the government's roles, then talks about advantageous conditions and existing problems, briefs features of venture capital investment.

Chapter five systematically introduces laws and regulations relate to venture capital business in China. We describe them by categories: capital raising, capital structure, intellectual rights, taxation system. Fortunately, governments have recognized they have to create a favorable legal environment to foster venture capital. Therefore, authorities have promulgated the regulation on establishment of foreign funded venture capital firms to attract foreign venture capital.

Besides the legal environment, social cultural factors also have impacts on venture capital business. Chinese cultural values on business among social cultural factors may be most significant to foreigners doing businesses in China. Chapter five also briefs attitudes of foreign invested enterprises on China's business environment.

Chapter six mainly intends to present facts and operations about domestic venture capital organizations in China. The lack of incentive and restrictive mechanisms make a few of these firms tend to change to link international practices under the existing legal environment. When governments are reluctant to continuously pool capital into venture capital, non-government capital, in particular, private and foreign venture capital becomes more and more important. We elaborate foreign venture capital in China, and introduce exiting Sino-foreign venture capital cooperation. In addition, we seek to introduce existing Chinese venture capitalists from multi-perspectives.

While chapter four, five and six give material description and discussion about venture capital in China, chapter seven tries to present it in a quantity way based on a simple survey. This chapter first discusses how the measurements of the questionnaire come. The measurements include the 12 comments on specific current situation of China's venture capital industry and 16 proposed development strategies for China's VC industry. A questionnaire with two parts is designed. The surveyees were asked to answer to which degree they agree or dis-agree each comment of the first part of the questionnaire. The second part of the 16 proposed development strategies tries to disclose the importance and corresponding feasibility of such measurement according to the surveyees answers.

The survey was conducted in six cities where 180 effective questionnaires were collected. The data analysis based on 28 pieces of opinion distribution par figures is quite straightforward and informative. The discussion based on the data in chapter seven tries to conclude three characteristics of China's venture capital with some supportive argument.

The research paper in appendix is an important part of the book as we need to understand thoroughly the mechanism that contributes the success of private equity and venture capital business in US that can be helpful to the evolution of China's counterpart. Based on information asymmetry and agency cost theory, this paper tries to identify that in the matured venture capital practice, there not only are human capitals and information resources besides financial capitals contributing the success of VC business, but also there is an interactive effect among these three kinds of resources in terms of either substitutability or interdependence. Furthermore, the paper argues that the institutional advantages and operational procedure of VC model can facilitate the efficient utilization of all resources to maximize their economic value, which is the integration or synergy of these resources.

This paper also compares the dynamics of public equity model with the VC model to highlight the higher productivity and efficiency of VC model resulting from its integrative resources mechanism than that of public equity model. On the other hand, the public equity model has low resources integration among financial capital, human capital as well as information and the low interest alignment between the investors and investees. The paper finally implies that the venture capital and private equity industry start to change the institutional design and monitor mechanism of capital market.

We end the book after you come to get a much broad perspective of private equity and venture capital both in theory and in practice, both in US and in China.

Hope you enjoy this book. Your comment is highly appreciated. Thank you very much.

Jeffrey Sheng

# Contents

## Section Two Venture Capital Industry in China

# Chapter 1 Areas for Investment

Private equity investment and M&A are good choices for many Western investors who want to get into China. In order to do a successful private equity investment in China, you need to have a better understanding of the economy and the business environment.

In this chapter, we are going to provide some information of the lucrative industry sectors. The focus is on new emerging industries for the next few years. We are trying to give you a better idea of the demand and market size, opportunities, and current issues.

Industries that have some well-established companies with well-known brand or wide spread distribution network are attractive to private equity investors when balancing the risk and return. These industries include petrol-chemical, pharmaceutical, and computer software. Industries where there are big gaps in business model and management skill compared with Western counterparts should be the focused area for Western investor. Most of this kind opportunity is in the service industries.

## 1.1 Market in General

Why private equity investors shall consider China, and why shall we pay attention to the capital market of Mainland China? To answer this question, let's look at the big picture. As the world economy is growing at an average rate of 2%~3% a year, the China's GDP has been growing and will continue to grow at a yearly rate of 6%~8%. After entering WTO, the finance and stock market will gradually open to foreign capital. And this will bring great opportunities for international investors to enter the US$ 52 billion Chinese stock market, which is only 45% of US$ 116 billion GDP as compared with 130% of that of the US.

There are good reasons for global investors to focus on the opportunities in China, a market that is moving from international trading to manufacturing and service industry. China's agriculture and manufacturing industries have already been opened to foreign investors for some time now. After entering the WTO, other industries such as infrastructure and service will be open to foreign investors as well. Constrains such as ownership percentage limits, re-export percentage requirement, and domestic composition requirement will gradually be reduced or even eliminate. At the same time, legal environment and policy transparency are expected to improve, which will