

STATUS OF VENTURE CAPITAL IN CHINA

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Since 1978 with the initiation of the reform program and the decision to open up to the outside, the Chinese Government has paid much attention to the development of science and technology, and especially its role in promoting economic development. In 1985, the Central Commission of the Chinese Communist Party and the State Council proposed a development guideline in the *Decision of Science-Technology System Reform* that science and technology must contribute to and support economic development, and economic development must rely on science and technology. Thereafter, Chinese leader Deng Xiaoping pointed out that science and technology are primary productive forces. Gradually, all social circles began to recognize the importance of science and technology in the industrialization process and with this acceptance, an environment conducive to China's venture capital industry came into being. Despite some early problems, lessons have been learned, and the expectation is that venture capital in China will expand quickly over the coming years and assume a prominent role in promoting innovation, entrepreneurship, high-tech industrial development, and job creation. This will be done within a framework that recognizes western principles of venture capital while adhering to Chinese characteristics and realities.

HISTORICAL BACKGROUND

1. Evolution of Policy Concerning Venture Capital in China

1.1 Foundations

In 1983, the State Science & Technology Commission (SSTC) (now the Ministry of Science & Technology or MOST) set up a Research Group of Countermeasures to the Influence of the New Technology Revolution in order to carefully study the international technology situation. This was the first time for China to truly face the implications that were taking place in the development of the global economy.

In 1984, the Research Center of Science and Technology Development of the SSTC cooperated with British experts to study how to develop high-tech in China. The British experts proposed that venture capital should be developed if China wanted to foster high technology.

In 1985, the Central Commission of the Chinese Communist Party and the State Council pointed out in the *Decision of Science-Technology System Reform* that “venture capital could be set up to support the work of developing high-tech with quick change and high risk”. It was the first time that the concept of venture capital appeared in an official Chinese Government document.

In 1991, the State Council indicated in the *Notification of Ratifying Founding State High-Tech Parks and Related Policies and Regulations* that “related departments may establish venture capital funds in high-tech parks to support the development of high-technology having a greater degree of risk. Those high-tech parks with mature conditions may establish venture capital firms.”

In 1995, the State Council emphasized in the *Decision of Accelerating Science-Technology Progress* that “the cause of science-technology venture capital should be developed and the science-technology venture capital mechanism should be established”.

In 1996, the Standing Committee of the People’s Congress passed and put into effect, the *Law of Promoting Science-Technology Achievements Transformation*, and specified in the 24th item of Chapter 3 that “Government encourages the set-up of transformation funds for science-technology achievements or venture funds and the capital will be provided by state and local governments, enterprises, non-profit units and other institutions or individuals, which will be used to support the transformation of science- technology achievements with high input, risk, and output; and, accelerate the industrialization of important science-technology achievements”. This was the first time for China to bring the concept of venture capital into law.

1.2 Early Practice

From 1985 to 1995, the Central Government and some local governments financed and set-up investment institutions that intended to pursue the venture capital business, such as the China New Technology Venture Capital Company, Shenyang Science-Technology Venture Development Risk Center, Shanxi Head Office of Science-Technology Fund Development, Guangdong Science-Technology Venture Capital Company, Shanghai Science-Technology Venture Capital Company, and the Science-Technology Venture Capital Company of Zhejiang Province.

Moreover, venture centers (i.e., incubators) were set-up in the majority of national high-tech parks, and some of them in Chengdu, Wuhan, Xian, Suzhou and other cities made some attempts with venture capital.

Simultaneously, some overseas investment banks, funds and venture capital institutions also expanded their business into China. For example, the Pacific Technology Venture Capital Fund subordinate to IDG entered China in 1992. It cooperated with science-technology commissions in Beijing, Shanghai and Guangdong, and set-up a number of venture capital companies focused on investing in technology. Also, some foreign capital or joint stock investment institutions established venture capital businesses.

1.3 Factors Affecting Venture Capital Development

The ten-year period (i.e., 1985-1995) of exploration and practice allowed China to accumulate certain experiences but, on the whole, the progress was not ideal. The reasons are as follows:

- **Absence of laws and regulations**
Without definitive laws and regulations, venture capital lacks a frame of reference and grounding in a body of normal guidance. Further, the rights of venture investors can not be protected. This can cause investors to have doubts during the actual practice of venture capital initiatives and to influence their decisions. Some aspects of China's current *Company Law*, for example, are in conflict with normal venture capital practice.
- **Lack of effective exit mechanism**
China set-up its stock markets in Shanghai and Shenzhen over ten years ago. Their main purpose is to raise capital for large enterprises with mature technology. These stock market exchanges have listing requirements and thresholds that are incommensurate with the type of enterprise and stage of development typically financed by venture capital funds.
- **Lack of qualified investors**
At present there is a lack of definitive laws and regulations regarding the foundation, operation, supervision, rights and obligations of venture capital companies. Without such, it is not possible to set-up venture capital funds.

Further, the current investment institutions still have a strong characteristic of government. For those established before 1998, government entities finance the majority of them individually or governments are their chief

stockholders. This results in their investment decisions and operations being greatly influenced by changing government policy and not market-related factors. [Since their operational and policy mechanisms are not ideal, these institutions have not performed well and their investment portfolios have lost value.]

- Services provided by intermediate institutions can not meet market demand

Intermediate institutions such as law firms, management consultants, financial and accounting advisors, market analysts, and project evaluators are needed to actively participate in venture capital. But at present, the services provided by them both in scope and range could hardly meet market demand. This makes it difficult for entrepreneurs to effectively communicate with the capital market.

- Lack of talented persons

The lack of ‘talented persons’ who understand both technology and management is a key factor that has prevented venture capital from developing in China. By ‘talented persons’ is meant (i) managers proficient in prerequisite venture capital skills; and (ii) managers who have the necessary experience and abilities to guide the operations of high-tech firms. As is the case elsewhere, it is clearly recognized that skilled management is the most important and critical factor for success in venture capital investments. The reality is that there is a dearth of such people in China.

- Ventures have no clear property rights and hence can not operate normally

A considerable number of ventures have no clear property rights especially with regard to intellectual property and other intangibles. This not only affects the future development of the ventures but also makes venture capitalists and other potential new stockholders shy away. As the ventures can not operate normally under this uncertainty, the potential investors can hardly have a sense of safety and confidence towards them.

1.4 Recent Stage of Study and Policy Formulation

Based on the recognition that the situation with respect to venture capital

was unsatisfactory, the SSTC, in early 1997, set-up a leading group of 'Venture Capital Research' to study how to establish a venture capital system based on Chinese characteristics. SSTC Vice Minister Deng Nan assumed the role of group leader. This group not only studied the problems enumerated above, but also focused on various driving forces necessitating near-term actions to establish a framework for venture capital. The key driving forces include the need to:

- Commercialize the results of R&D considering the inadequate pool of capital now available.
- Increase the rate of innovation in China and strengthen science and technology competitiveness.
- Obtain capital to support science and technology, and especially expand civilian capital channels.
- Reform an outmoded science and technology system that is a remnant of the planned economy wherein the government provides almost all of the funding.
- Increase the participation of enterprises in conducting R&D as a means to encourage innovation.

Some local governments and other units also started to undertake this kind of exploration from differing perspectives. Among them, the Democratic Nation Founding Society conducted some research and submitted suggestions in the form of *Number 1 Proposal* in the First Meeting of the Fifth Session of the National Political Consultation.

In April 1998, according to the direction of the State Council, an inter-departmental leadership group of 'Venture Capital Research' was set-up. Deng Nan, now Vice Minister of MOST, was appointed the group leader. Other members of the group included the People's Bank of China, Ministry of Finance, State Planning Development Commission and the China Securities Supervision Commission. The group took a realistic and practical viewpoint looking at the concrete reality of the situation in China as compared to international practice. The group formulated recommendations that were subsequently approved by the State Council in December 1999.

CHINESE PERSPECTIVE ON THE DEVELOPMENT OF VENTURE CAPITAL

2. Basic Principles on Establishing China's Venture Capital System

2.1 Essential Tenets

The establishment of a venture capital system must be based on the rules of the market economy. Venture capital resources are to be drawn from the market, and market mechanisms are to be used to reinforce the responsibilities of investors as well as to benefit them. Intermediate service institutions are to be cultivated in an orderly and normal process so as to combine the actual situation in China with the need to develop the capital market. This is to be done in a gradual manner so as to expand the high-tech sector and opportunities for venture capital investors. Supervision systems need to be set up to make information transparent and risks known. The environment in China should provide beneficial conditions for international sources of venture capital to enter and exit.

Government initiatives and societal resources should be used to speed up the building of the venture capital system. State governments should propel it according to the principles of enacting policies, creating

environments, strengthening supervision and controlling risk. They should also encourage local governments, enterprises, finance institutions, individuals and foreign capital to advance and participate in the development of China's venture capital industry. Venture capital activities are to be supported by broadening market channels for various institutions and individuals to enter and invest in venture capital institutions.

2.2 Cultivate Venture Capital Investors

The leading entities among venture capital investors are venture capital companies and venture capital funds. Venture capital companies are non-financial entities that specialize in venture capital operation. Venture capital funds are industrial investment institutions that accumulate capital resources to invest in/promote the development of small and medium-sized high-tech enterprises. They should be set up as closed-end funds, meaning that the capitalization amount and other rules governing the fund such as its duration should be decided beforehand. During this period, fund shares cannot be redeemed.

To make full use of the advantages that venture capital can bring, it is recommended that: (i) capital resources of venture capital institutions are sufficient; (ii) venture capital institutions should primarily invest in high-tech deals and these investments should take up the majority of their investment capital; (iii) to minimize risk, the proportion of the investment capital in specific enterprises or any single project should not be too high.

The key managers of venture capital institutions should be talented specialists who have a technology background, management experience, good reputations, are open to scrutiny, and are willing to take personal responsibility for business decisions and their consequences.

Venture capital institutions should establish internal controls and incentive mechanisms. They should be based on the following: (i) various types of incentives and compensation packages can be used such as revenue participation, stock options, and bonuses; (ii) legally binding employment contracts should govern the conduct and behavior of management.

2.3 Set up Exit Mechanisms

Setting up and broadening exit channels is a crucial step to drive the development of the venture capital system. It is only by following the

objective rules of capital operation and creating smooth exit channels that social capital can be effectively attracted to enter the venture capital industry. This will then allow pools of venture capital to be in circulation, balance investment risk, and create valuation benchmarks. Although exit channels include mergers and acquisitions, share buy-backs, and stock market listings, the most effective channel should be the establishment of a new kind of domestic stock market to list new ventures.

In addition, venture boards such as NASDAQ and the Growth Enterprise Market (GEM) established by the Hong Kong United Stock Exchange in November 1999 should be used, as they tend to support high-tech enterprises. For example, through the end of 2000 about 49 companies listed on the GEM raised approximately \$2.1 billion. This is beneficial as it uses international capital to develop China's high-tech sector and helps attract foreign venture capital. Further, it allows China's high-tech enterprises to enter the international market.

2.4 Improve the Intermediate Service System

Full use should be made of intermediate service institutions' important functions of consultation, supervision, and assessment. Specialized intermediate service institutions should be set up, including industry associations, science and technology project assessment units, technology brokers, and venture capital consultancies.

The intermediate service institutions should be organized according to the principle of government being separated from enterprises, and make them a responsible legal corporate entity. Operationally they should provide credible and impartial advice.

Investors, high-tech enterprises, and intermediate service institutions should establish venture capital industry associations. The associations should operate according to an internal code of self-regulation, and foster the orderly development of the venture capital industry. The associations can become focal points for training and a conduit for international communications with foreign venture capital entities.

CURRENT SITUATION

3. Current Status and Future Development of Venture Capital in China

The policies and suggestions submitted by MOST and other ministries were ratified by the State Council and have facilitated the development of the venture capital industry in China. Progress is being made on a number of fronts and the future prospects are bright.

3.1 Venture Capital Institutions Come into Existence

From 1985 to 1998, the Central and some local governments set up about 20 venture capital institutions. A small number of foreign venture capital institutions also set up agencies in China. However, as noted elsewhere, due to the lack of a suitable environment for the development of venture capital, these institutions have not fared well.

Since 1998, there has been a discernible recognition of the critical success factors necessary to create an environment in which venture capital can operate smoothly and flourish. Specifically, the Government's official decision to support the development of venture capital is the key factor that has allowed China's venture capital industry to come into being in a new and more positive environment. In Beijing, alone, there are about 30 independent venture capital institutions, and their capital amounts to an estimated \$450 million. In Shenzhen, there are at least 20 independent venture capital institutions, and their capital amounts to over \$500 million.

As for the current status, a number of venture capital institutional models are being experimented with, as follows:

- **Governments Provide Funds and Appoint Managers**
Governments or State companies administrated directly by governments provide capital and governments also appoint their managers. In Beijing, Shanghai, Shenzhen, Shenyang, Guangdong, Zhejiang, Shanxi and other regions, there are some venture capital institutions such as this. Financed by government, these institutions have relatively strong power albeit there are some unsatisfactory aspects, such as unqualified management and directed decisions related to investments. Institutions established early-on follow this model.
- **Governments Provide Funds and Select Civilian Managers**
Governments are one of the sponsors and funders of the venture capital institution and serve as the key anchor investor. This anchor status is then used to attract capital from societal sources. Management is primarily undertaken by civilian institutions.
This model has just recently appeared in China, and it is being replicated in a number of places.
- **Civilian Investment Institutions**
The institutional capital mainly comes from civilian enterprises, individuals and other non-state units. Most of these institutions are located in advanced economy

areas such as Beijing, Shanghai and Shenzhen. The institutions' actual power is

relatively weak, and many of them pursue both investment business and related investment consulting. The number of such institutions is accelerating rapidly.

- **Institutions Set up by Foreign Capital**

As there are still no laws and regulations about setting up foreign venture capital institutions in China, many overseas investment institutions have established their

branches in Hong Kong, aiming to invest in the mainland. They have also located

representative offices in some major cities, primarily Beijing and Shanghai.

- **Investment Institutions Subordinate to High-tech Parks or Incubators**

In China, there are 53 national high-tech parks and hundreds of local ones and incubators. Some of them, especially those in Beijing, Nanjing, Suzhou, Xian, Wuhan, and Chengdu have progressed to a fairly good scale. In order to support the development of enterprises in parks and incubators, a number of the parks have established venture capital institutions (on a small scale), aimed at 'seeding' those enterprises that locate within the parks.

- **Venture Capital Institutions Subordinate to Public Companies or Large State-Owned Enterprises**

Some of the parent companies are independent entities while others are not. Companies that have gone this route include the Yunnan Hongta Group (China's largest tobacco company), Legend Group (the largest

computer manufacturer), Tsinghua Unisplendour Corporation, Ltd., and the Stone Company. All of these companies have relatively ample funds and have all set-up their own venture capital institutions.

- **Venture Capital Departments of Securities Institutions**

Such departments are subordinate to the investment banking arms of securities companies. Due to this relationship, they have sufficient financial resources and

usually invest in comparatively mature enterprises. Since they currently lack comprehensive internal capabilities and knowledge of high-tech, they typically use the strategy of teaming with other professional investment institutions. At present, the majority of securities companies have set-up their own venture capital departments.

- **Venture Capital Departments of Industrial Investment Institutions**

Under the central planning economy, many industrial investment companies were set-up according to the division of industries, such as electric power, minerals and metals, coal and textiles. As the reform of the economy has moved more to one based on market principles, and the restructuring of the industrial sectors has progressed, these sector industrial groups have gradually begun to turn to the high-tech industry and have established venture capital departments. An example of this is Beijing Electricity.

It is anticipated that the desired outcome of the above experimental models will be a future in which the:

- ‘mechanics’ of venture capital are uniformly understood and practiced

- number of successful examples becomes widespread and this, in itself, becomes synergistic to the expansion of the venture capital industry
- pool and skill level of venture capital staff increases at a rapid rate

3.2 Chinese Venture Stock Market Will Soon be Operational

According to the instructions of the State Council, the China Securities Supervision Committee is planning to establish a new market for ventures, particularly for high-tech enterprises and those second stage firms with good development prospects. Compared with the listing requirements of the current Chinese stock markets (in Shenzhen and Shanghai), the conditions of enterprises appearing on this new market will be relatively loose. For example, the company's operational history should be more than two years; total capital stock should amount to more than \$2.5 million; and the minimum profit amount is not cited. Furthermore, stocks can totally circulate as contrasted to the current stock exchanges where stocks of juridical persons cannot circulate.

This market will use rules similar to NASDAQ and the GEM. Compared with China's current stock market, its operation will correlate more with the rules of the market. Its examination committee will consist of professionals. To help make the companies operate normally with as little interference as possible, independent directors will be required so as to strengthen the governance structure of juridical persons. At present, suggestions concerning the operating rules of the Venture Board Market are being solicited. It is expected that the formal establishment of the Market will be in 4/20/01 late 2001 or early 2002.

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