

China Venture Capitalist Confidence Index™

(Bloomberg ticker symbol: CVCCI)

Third Quarter – 2006

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The quarterly *China Venture Capitalist Confidence Index* (Bloomberg ticker symbol: CVCCI) is based on a survey of mainland China and Hong Kong venture capitalists. The China VC Index measures and reports the opinions of China-based professional venture capitalists in their estimation of the high-growth venture entrepreneurial environment in China over the next 6 - 18 months.

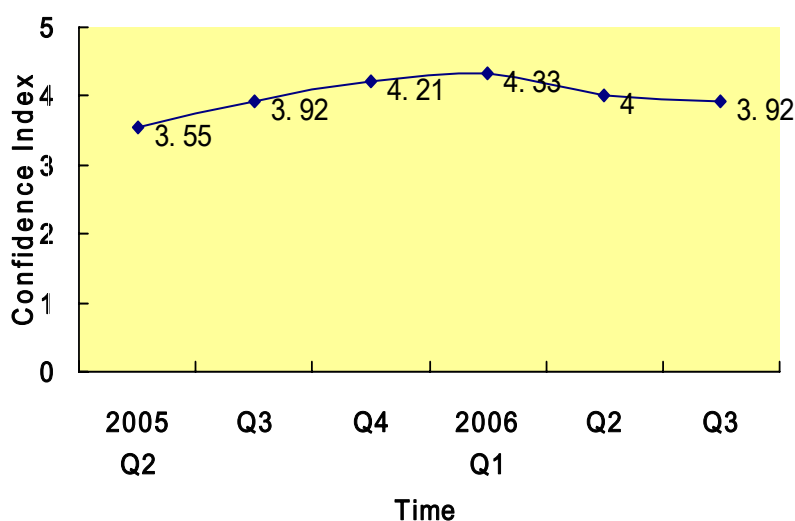
In publishing a recurring confidence index of China-based venture capital investors, we intend to utilize the local knowledge and insight of our respondents to provide an on-going leading indicator of local investment in new high growth businesses in the Greater China Region. We expect that this local insight will provide a unique perspective into the dynamic Chinese entrepreneurial business environment. Further, by tracking what local venture investors project about the high growth venture environment rather than what has already occurred in terms of investment flows, we hope to provide actionable insight for all interested parties.

While the venture capital industry is still in an relatively early stage in China, with significant change likely to occur in the near to mid term, these reports and index readings will provide a base-line from which to compare future index levels to better judge the relative gain or loss of local professional investor confidence in the environment for investment in high growth ventures in China.

The China Venture Capitalist Confidence Index for the third quarter of 2006, based on an October 2006 survey of 13 mainland China and Hong Kong venture capitalists, came in at 3.92 on a 5 point scale (with 5 indicating high confidence and 1 indicating low confidence), and suggests a healthy but declining level of China based venture capitalist confidence in entrepreneurial activity in the coming months.

This quarter's reading is down from last quarter's index of 4.0

Table 1
Trend line of China Venture Capitalists Confidence over recent 6 quarters



on a 5 point scale. (Please see Table 1 for trend data.) While the index reading is based on a modest sample size of 13 venture capitalists in the China region, we expect that it does shed some light on current and on-going issues in the China venture capital and high-growth venture environment.

We can also compare this reading to the Silicon Valley Venture Capitalist Index for the same quarter. The Silicon Valley VC Index (based on an October survey of 30 San Francisco Bay Area venture capitalists) indicated a reading of 3.78 (also down from the previous quarter's reading of 3.89). (See Table 4 for foreign VC fund growth in China.) Interestingly, the Silicon Valley Index is trending down similarly to the China Index. This might be expected given the increasing integration of venture capital industry between China and California.

All of the Index respondents' names and firms for this report are listed in Table 2, save those who wished to remain anonymous. Some of the responding venture capitalists also went on the record with commentary that supported their degree of confidence in the upcoming venture investment environment. In the following we provide many of their comments along with our analysis.

The market cycle surfaces in the Chinese venture financing market. As Michael Scorn of Intel Capital Asia Pacific noted, "Valuations have been rising in China, following a strong run over the past few years. As such, there is potential for the pace of Greater China's VC environment to moderate. This isn't so surprising; business cycles are a natural part of every market."

Although some VCs are cautious, overall they are optimistic about the Chinese market given its strong economic growth. For instance, Kevin Chan of SEAVI Advent Holdings Ltd is confident of the current market environment because of "political stability" and "economic growth". An anonymous contributor added, "The drive for growth continues in China.....the long term fundamentals are positive." Johannes Schoeter of Victoria Capital Limited remains confident as he reiterated his comments from last quarter on the Chinese venture market, namely, "continued high growth and a large number of high growth private companies". Finally, David Zhang of WI Harper Group illustrated his recent deals to show his strong confidence in the Chinese market, stating, "China is at the very early stage of venture development, and, of course, high technology development in general. The macro environment is very positive and entrepreneurship is being rewarded and encouraged by the government. I believe China is entering a golden time for IT and VC. We will surely see some up and downs in the years to come but I am confident an experienced and committed local VC firm, with a clear investment strategy and long term view can be very successful in China. You can read more about WI Harper's most recent exits in both Focus Media (China), and Divx (US and China) on the internet."

However, the confidence index continues to decrease from previous quarters due, in part, to the following concerns. Felix Wong from JAFCO Asia identified "too many funds in the competitive market" and "high company valuation" as problematic. An anonymous VC contributor agrees with Felix in that the "Environment is sound; the danger is over-enthusiasm and, hence, over-paying and overly optimistic investments". Another venture capitalist who wished to remain anonymous further stated that, "Too much hot money is investing into China, with an insufficiently large volume of high quality deals or companies to invest in." Summarizing, while direct investment leads to value

creation, doubts persist in the use of money. This same VC revealed a specific concern as a “lack of innovation, branding and strong marketing and distribution channels”. Another venture capitalist was concerned because “there are economic and regulatory risks to be overcome”. In addition, Richard Roque of SA Capital Ltd pointed out that “Changing policies (those just announced in September) are making it difficult for investors or at least making them more cautious. This will slow activity for a while.”

A Primer on the New China Investment Policies Announced in September 2006

A new policy that regulates foreign investors’ acquisition of Chinese companies became effective on Sep. 8, 2006. Some VCs use the SPV (Special Purpose Vehicle) to take start-ups to IPOs outside China. According to Ms. Jingna Wu, a Chinese journalist, the new policy adds uncertainty to this investment exit in terms of timing and the Chinese government’s permission.¹ Before this new policy, start-ups that went public overseas through SPV only needed to get approval from the local government (government organization in the district, city, or province). But after Sep.8, 2006, the Ministry of Commerce of the People’s Republic of China became responsible for reviewing all cases and making a decision for permission. In addition, those SPVs established by companies in China have to finish an IPO outside China within one year after its incorporation. Otherwise, the government’s approval would be withdrawn.

This policy’s initial intention was to regulate private equity in their acquisition to protect domestic companies. Although it doesn’t intend to “hurt” VC industry, it does affect Chinese start-ups’ IPO channel, which is also the VCs’ investment exit channel. Even so, a lot of Chinese VCs continue to be optimistic. Although the new application process for IPO through SPV might require more information, it clarified the application process and might be more efficient and save some time.

Table 2

Participating China based Venture Capitalists in the 2006 3rd Quarter Confidence Index Survey

Chauncey Shey	Soft Bank China Venture Capital
David Zhang	WI Harper Group
Felix Wong	JAFCO Asia
George Li	China Merchants & Fortune Assets Mgmt Ltd
Jamie Paton	3i Asia Pacific Plc
Jianhui Zhou	Com Ventures
Johannes Schoeter	Victoria Capital Limited
Kevin Chan	SEAVI Advent Holdings Ltd.
Max Burger-Calderon	Apax Partners Ltd
Michael Scown	Intel Capital, Asia Pacific
Patrick Keen	ChinaVest Services Limited
Richard Roque	SA Capital Ltd
Anonymous	Anonymous

In addition to the commentary of the responding China-based venture capitalists, we provide in the following additional context of the maturing China venture market in which these VC operate in.

Make up of the Current Chinese Venture Capital Market. Zero2IPO compared Chinese local VC companies to foreign VC companies and revealed two revealing characteristics. First, foreign venture capital funds are larger and more powerful than local VC funds in mainland China.

Table 3

The number and size of venture capital funds in mainland China in 2005 (Source: Zero2Ipo)

VC Fund Type	Number of Funds	% of Total Number of Funds	Size of Funds (\$ million)	% of Total Amount of VC Funds
Local Funds (Mainland China)	130	67.71%	4,792	28.37%
Foreign Funds	45	23.44%	11,463	67.87%
Joint Funds	17	8.85%	635	3.76%
Total	192	100.00%	16,890	100.00%

As the above table shows, the 45 foreign funds are very powerful in the China venture capital market. Although they constitute less than 1/4 of the total number of VC funds in mainland China, the money under their management exceeds 2/3 of total available VC funds. This demonstrates the increasing influence that foreign funds are having in the local China high-growth venture market. It also helps to explain the convergence in confidence between China and Silicon Valley VCs somewhat.

Table 4

Foreign VC Funds Growth (Source: Zero2Ipo)

Year	# of VC Funds	Total Money under Management (\$ million)	Average Money under Management (\$ million)
2002	36	5,967	166
2003	37	5,739	155
2004	40	8,081	202
2005	45	11,463	255

Second, as shown in Table 4 and Table 5, foreign VC funds are steadily growing in terms of number of companies and amount of funding while local VC companies in mainland China, while greater in number, are much smaller in scale. This increasing influence of foreign venture investment in the China high-growth market presents additional opportunity for local firms to finance rapid growth; however, it also points to an increasing likelihood of overvaluations as the global supply of venture capital available exceeds the local supply of venture ready firms. It may also point to the increasing potential for government oversight (e.g. new investment oversight policies instituted last month).

Table 5
Local (Mainland China) VC Funds (Source: Zero2Ipo)

Year	# of VC Funds	Total Money under Management (\$ million)	Average Money under Management (\$ million)
2002	149	4,109	28
2003	162	4,853	30
2004	130	4,107	32
2005	130	4,791	37

Final Thoughts

According to Zero2IPO research institute, the venture capital investment in China reached \$1.25 billion during the first three quarters in 2006.² This high level of venture capital activity in the first three quarters this year reflect VCs' generally optimistic attitude. It is also a function of the increasing influence of foreign VC funds in the China market. However, some of the comments from our venture respondents indicate a note of caution for the near term. For example, concerns over high valuations of prospective portfolio companies and over enthusiasm on the part of some investors coupled with new regulatory constraints as of September point to a cautious outlook in the coming quarters. Still, a generally sound and encouraging entrepreneurial environment and respectable confidence index level suggest continued health in high growth entrepreneurial activity and new company formation in the greater China region for the balance of 2006.

Mark V. Cannice, Ph.D. is an Associate Professor of Entrepreneurship and the Executive Director and Founder of the University of San Francisco Entrepreneurship Program (Cannice@usfca.edu). He has also been a Visiting Associate Professor with Peking University's Beijing International MBA Program (2005) and the Hong Kong University of Science and Technology School of Business (2005 - 2006). Ling Ding is a partner with MCLD Venture Resources and holds an MBA from the University of San Francisco (2006). The authors wish to thank the participating venture capitalists who generously provided their expert analysis and commentary. Please see the reports for the previous quarters at: www.EntrepreneurshipProgram.org under the publications tab. Venture capitalists who wish to participate in next quarter's Index survey are asked to contact Professor Mark Cannice at Cannice@usfca.edu. Webmasters are welcome to link to this report with courtesy notification to Cannice@usfca.edu. To post this report on your website, please request permission by email to Cannice@usfca.edu. When citing the index, please refer to it as: The China Venture Capitalist Confidence Index (Bloomberg ticker symbol: CVCCI), and include the associated Quarter/Year, and the full names and titles of the authors.

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¹ <http://www.zero2ipo.com.cn/2006/9/19/200691918369.html>, published on 9/19/06

² <http://www.zero2ipo.com.cn/news/news.html>