

# China Venture Capitalist Confidence Index™

(Bloomberg ticker symbol: CVCCI)

**Fourth Quarter – 2006**

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*Mark V. Cannice, Ph.D.*

*Ling Ding*

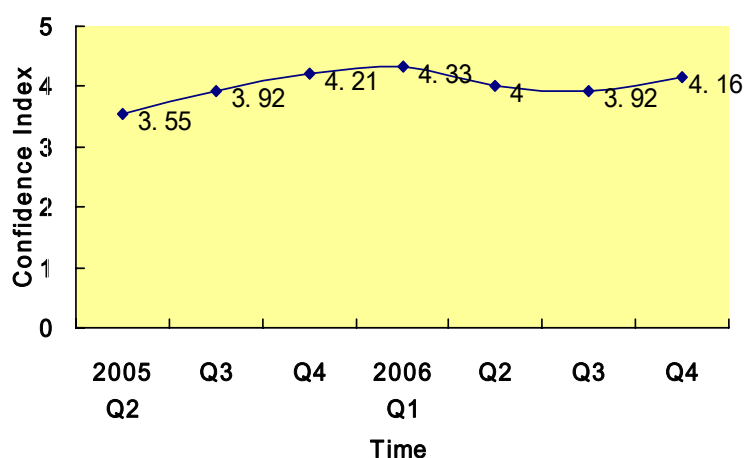
The quarterly *China Venture Capitalist Confidence Index* (Bloomberg ticker symbol: CVCCI) is based on a survey of mainland China and Hong Kong venture capitalists. The China VC Index measures and reports the opinions of China-based professional venture capitalists in their estimation of the high-growth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

The venture capital industry in China is in a relatively early stage, and significant change is likely to occur in it in the near to mid term. These reports and index readings are intended to provide a base-line from which to compare 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 fourth quarter of 2006, based on a January 2007 survey of 21\* mainland China and Hong Kong venture capitalists, came in at 4.16 on a 5 point scale (with 5 indicating high confidence and 1 indicating low confidence), and suggests an increasing level of China based venture capitalist confidence in entrepreneurial activity in the coming months.

**Table 1**  
*Trend line of China Venture Capitalists Confidence over recent 7 quarters*



This quarter's reading is up from last quarter's index of 3.92. (Please see Table 1 for trend data.) This report's commentary and index reading are based on a sample size of 21\* venture capitalists in the China region. 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 provided commentary that supported their degree of confidence in the near term venture investment environment. In the following, we provide many of their comments along with our analysis.

**A positive outlook on the Chinese macro economy prevailed.** Wayne Shiong of WI Harper Group attributed his confidence in the China venture capital industry to “an overall optimistic macro economic environment and a sustained high growth of the country in the short and mid-term (3 - 5 years)”. An anonymous VC contributor agreed with Mr. Shiong, stating, “China is in a massive growth phase and taking a long term view; it will see continuous growth.” Both Dr. Weiping Jiang of Shenzhen Capital Group Co. Ltd and Mr. Marvin Lai of iTM Ventures Inc also expressed optimism about China’s continued rapid GDP growth.

**A maturing regulatory, financial and legal environment was observed.** Albert Wong of New World TMT Limited noted a “huge potential contributed by the PRC market, (*which is*) supported by its maturing marketing, legal, regulatory, and market environment”. Another venture capitalist, who wished to remain anonymous, gave 4 out of 5 as his confidence index, based on his optimism of the “general macro environment”. Some responding VCs expect the Chinese government to institute more new policies that will benefit the venture investment market. For instance, Guojie He of Guangdong Technology Venture Capital Group explained the Chinese government’s positive role in the VC industry, stating “the development of the economy and activities involved in any country are closely connected with government policy. The Chinese government has issued laws and regulations to encourage and support VC and entrepreneurial activities.” Similarly, Dr. Weiping Jiang of Shenzhen Capital Group Co. Ltd believes that the “Chinese government will adopt more open policies for the domestic capital market, such as opening the second board and over-the-counter (OTC) board.” He continued, “China has sped up its process of transforming its high and new technology into productivity. As a result, a great deal of high-tech private companies were established.”

With support from the Chinese government, the financial market has improved significantly, further nurturing the maturing VC industry. While Michael Chow of JAFCO Asia identified “an increasing volume of deals recently”, George Li of China Merchants Group noticed that “the SME Board in Shenzhen Stock Exchange has achieved great success since launching its operations, and provided a good exit for VC investment”. Li continued, “this improving stock market in China has greatly enhanced the venture entrepreneurial environment in China.” In addition, Yuan Wei of NewMargin Ventures shared that “a fully liquid Chinese stock market” would ultimately benefit the Chinese VC industry. Max Burger-Calderon of Apax Partners Ltd expanded on this point, stating that “the recent dramatic revaluation of Chinese domestic shares, a slowly developing debt market, and China’s transition toward more of a domestic consumption driven economy all point in the right direction”. Finally, Guojie He of Guangdong Technology Venture Capital Group concluded that the “environment for VC in China has been greatly improved in recent years, especially the capital market. The stock splitting reform has been successfully implemented, which resolves the problem of exits for VC projects and attracts more and more international institutional investors and private equity firms to become involved in and share the fast-growth of China. Besides, the Chinese financial market has emerged and grown faster than other markets over the past year, and it will play an important role in

the world economy in foreseeable future.”

**Joining the WTO and preparing for the Olympic Games have accelerated China’s process of internationalization and, therefore, improved the VC investment environment.** As Dr. Weiping Jiang of Shenzhen Capital Group Co. Ltd pointed out, by “joining the WTO and implementing various rules, China has accelerated its process of internationalizing”. He predicts that this internationalization process will benefit China by allowing it to display its unique advantages. Additionally, Marvin Lai of iTM Ventures Inc. pointed to the upcoming Olympic Games in Beijing as one of the two main reasons for his positive rating, noting, the “2008 Olympics in Beijing will have continuing positive effects on most Chinese sectors.”

**VC funding continues to grow in a positive economic environment.** Yuan Wei of NewMargin Ventures noted that, “The drive for growth continues as the long term fundamentals are positive in China..... More industries besides IT and Internet, such as alternative energy, health care, medical devices, and some traditional industries are attracting more and more money.” Wayne Shiong of WI Harper Group pointed out that China is severely under-invested in many areas, and venture capital and private equity make up a very low percentage of GDP. Therefore, the VC/PE growth should be able to continue for a fairly long time. Wayne Shiong continued, “With a steady increase of average GDP per capita and a more effective political system being built (that corrects at least partial corruption by and large), consumer-related business models should still benefit most from VC/PE funding.”

**Despite an overall optimistic outlook on the China VC investment environment, concerns persist.** Kevin Chan with SEAVI ADVENT Private Equity noted that recently enacted regulations require that PRC companies which plan to conduct overseas IPOs obtain additional approval from various Chinese agencies. This restriction has negative implications for funds that invest in Chinese companies. While Mr. Chan expects continued economic stability in China in the medium term, he expects a slowdown in private equity activities in the coming months. An anonymous VC contributor expressed his concern of a “cautionary outlook on world economy”. Additionally, some VCs remain cautious of too much VC funding chasing a limited number of good deals in the current market. Another anonymous contributor gave a lower rating compared to last quarter because “there are many new funds and new management groups, and one must ask if experience is keeping pace with the market’s growth.” As a result, another anonymous VC believes that “there ought to be some small glitches along the way. At the moment, pricing is high; quality of companies/deals is average, but with the amount of money coming in and the bullish capital markets, it will probably continue. Even though there will probably be some sort of correction at some point, it will get back on its growth track fairly quickly.”

Wayne Shiong of WI Harper Group further stated that “there is over-optimism among the institutional private investor sector that has already created unrealistic hype and expectations, which is not a good sign for either entrepreneurs or investors.” One more anonymous VC agreed with this concern and expects that in the short term, “re-correction and re-direction is coming soon”, even though the “mid to long term development” remains positive. This same VC shared other concerns, namely, the RMB’s exchange rate continues to rise and thus highlights increasing competition from Vietnam for traditional manufacturing, the Chinese banking sector faces fierce competition after joining WTO,

local brands lack IP protection and quality control, and due to the increasing foreign brand competition, margins are getting lower. Finally, valuations in the market are unjustified and the soft-infrastructure necessary for a well functioning market is not yet complete.

**Table 2**

**Participating China based Venture Capitalists in the  
2006 4th Quarter Confidence Index Survey**

Albert Wong	New World TMT Limited
Alicia Eastman	Asia Pacific Capital Group
Alvin Ho	CLSA Capital Partners
Cadol Cheung	Intel Capital Asia Pacific
George Li	China Merchants Group
Guojie He	Guangdong Technology Venture Capital Group
Hongwei Zhang*	Shanghai Information Investment
Johannes Schoeter	Victoria Capital Limited
Kevin Chan*	SEAVI ADVENT Private Equity
Marvin Lai	iTM Ventures Inc
Max Burger-Calderon	Apax Partners Ltd
Michael Chow	JAFSCO Asia
Patrick Keen	ChinaVest Services Limited
Steven Kowk	Orchid Asia
Wayne Shiong.	WI Harper Group
Weiping Jiang	Shenzhen Capital Group Co. Ltd
Yuan Wei	NewMargin Ventures
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous

\*(Commentary used in report, but ratings not used in Index reading this quarter as they arrived after reporting date.)

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

**Makeup of the Current Chinese Venture Capital Market.** Zero2IPO compared Chinese local VC companies to foreign VC companies and discovered two notable characteristics.

**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%

First, foreign venture capital funds are larger and more powerful than local VC funds in mainland China. 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.

**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

**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

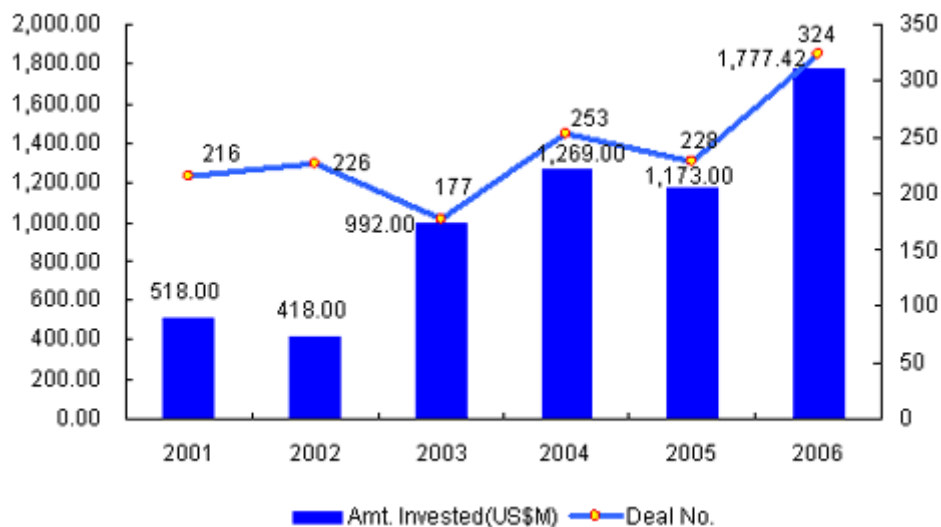
Second, as shown in Table 4 and Table 5, foreign VC funds are steadily growing in terms of number of companies and amount of funding while local VC companies in mainland China, though greater in number, are much smaller in scale. This increasing influence of foreign venture investment in the

China high-growth market presents additional opportunities for local firms to finance rapid growth. However, it also points to an increasing likelihood of overvaluations as the global supply of available venture capital 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 recently).

**Table 6**

**The amount of VC investment and the number of deals from 2001 to 2006**

(Source: *China Venture Capital Annual Report 2006* by Zero2IPO)



**Final Thoughts** According to Zero2IPO’s *China Venture Capital Annual Report 2006*, venture capital investments in China in 2006 set a new record with \$1.78 billion, 52.1% higher than the \$1.17 billion of VC investment in 2005. The number of venture investment deals increased by 42.1% from 228 in 2005 to 324 in 2006 (please refer to table 6 for more information).<sup>1</sup> This high level of venture capital activity and high volume of VC investment in 2006 reflect VCs’ generally optimistic attitude and Chinese entrepreneurs’ enthusiasm for entrepreneurial ventures. Additionally, a higher proportion of venture investment is backing second round investments.<sup>2</sup> This trend toward financing more established firms, indicates a maturing venture capital industry and a greater likelihood and nearer time frame of successful exits.

However, some of the comments from our venture respondents once again 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 the challenges local entrepreneurs face, such as lack of IP protection, brand identification, quality control and international experience, point to a cautious outlook in the coming quarters. Despite the above concerns, many VCs remain optimistic. As an anonymous VC noted, “whilst the market is tough and the legal environment changes regularly, a smart investor that acts wisely and uses its international network to deliver value and discipline, can do very well.” Furthermore, a generally sound and encouraging macro economic and entrepreneurial environment as well as a confidence index level that is trending higher suggests continued health in high growth entrepreneurial activity and new company formation in the greater China region for the first half of 2007.

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](http://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](mailto: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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<sup>1</sup> <http://www.zero2ipo.com.cn/2007/1/26/vc.htm>

<sup>2</sup> McMahan, Ty, "China is flooded by venture capital", Wall Street Journal, February 13, 2007, p. C9.