

China Venture Capitalist Confidence Index™

(Bloomberg ticker symbol: CVCCI)

Second Quarter – 2007

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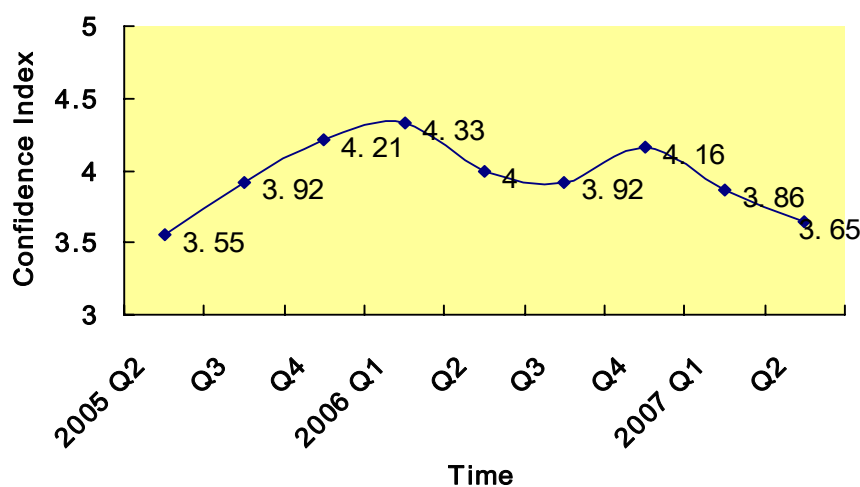
The quarterly *China Venture Capitalist Confidence Index* (Bloomberg ticker symbol: CVCCI) is based on a survey of mainland China and Hong Kong venture capitalists. The China VC Index measures and reports the opinions of China-based professional venture capitalists in their estimation of the high-growth 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 future high-growth venture environment rather than what has already occurred in terms of investment flows, we hope to provide actionable insight for all market participants.

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 baseline 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 second quarter of 2007, based on a July 2007 survey of 12 mainland China and Hong Kong venture capitalists, came in at 3.65 on a five point scale (with 5 indicating high confidence and 1 indicating low confidence). This quarter's reading is down from last quarter's index of 3.86 (please

Table 1
Trend line of China Venture Capitalists Confidence over recent 9 quarters



see Table 1 for trend data) but still suggests a healthy albeit declining trend of venture capitalist

confidence in the future high-growth entrepreneurial environment in China.

This report's commentary and index reading are based on a sample of 12 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.

The declining confidence index reflects venture capitalists' increasing concerns over excessive valuations, a potentially overheated Chinese economy, and a still evolving regulatory environment. Marc Wang of WI Harper Group expressed their "concerns about current high valuations (particularly in the domestic stock market) and recent moves by the government in increasing its level of control in a variety of industries." Marvin Lai of iTM Ventures pointed to troubling macro economic issues, specifically, "China's year-to-year GDP has surged from 11.1% in the first quarter to 11.9% in the second quarter and the CPI has increased to 4.4%; these are signs of an "overheated" economy. Although the Olympics is coming to Beijing next year, with these indicators, the Chinese government will take an even tougher stand to cool its economy, which shall create an adverse investing environment for all in a few more months to come!"

An anonymous VC worried that the "legal and regulatory maze is still an issue". While another venture capitalist, who also wished to remain anonymous, asked "Even though the (investment) law is well written, is execution catching up?" Reiterating this point, a third anonymous contributor noted, "There is and will be for some time a period of uncertainty surrounding the investment process for the PRC. The authorities are trying to move investment funds onshore and this process will only intensify. While the idea does make some sense, implementation must be sensitively done and it will take time for things to settle out." Further, the recent international concern over "environmental contamination and food safety" issues in China was raised by another anonymous VC as another macro factor to account for.

While uncertainties in the legal system and high valuations have led to increased caution in some venture firms, many venture capitalists still hold an overall optimistic sense about the future high-growth venture environment in China. For instance, Max Burger-Calderon of Apex Partners Ltd noted that, "the present "hiccups" we experience on the regulatory front are in my opinion the best proof that the country is moving ahead very quickly. No gain without pain." At the same time, Johannes Schoeter from Victoria Capital Limited identified "very strong deal flow, especially well established companies at reasonable valuations".

Venture capitalists' confidence in China's economic growth and maturing investment environment was also emphasized. Marc Wang from WI Harper Group witnessed "favorable macroeconomic trends fueled by strong long-term opportunities". He continued, "As you know, many industries have a large margin for improvement in China in terms of modernizing to western standards, which translates to huge opportunities for the companies and entrepreneurs that can grow to meet these demands. These demands are huge and real, and combined with the dynamism of the new Chinese economy; there will be plenty of success stories in the coming years for venture investors." In addition, Michael Scown of Intel Capital, Asia Pacific, noticed that "the continued economic growth

in China and the ongoing reform of China's capital markets, which has increased the amount of domestic demand for equities, are improving the M&A environment and driving changes in corporate governance. This has led to overheating and volatility in the domestic stock market, but augurs well for the long term support of domestic entrepreneurs.”

A belief that the Chinese government has learned more about market behavior and is trying to improve the investment environment also resounded. An anonymous VC acknowledged Chinese government efforts in this regard, stating that the Chinese government, now more sensitive to environmental issues, reduced some subsidies in certain industries and enterprises, encouraging companies to pursue innovation and use materials more efficiently. She also noted that the Chinese government and the public have become more accustomed with capital market behavior and, thus, have more finely tuned their expectations.

Improving management talent is also enhancing the value of startups in China. A venture capitalist, who wished to remain anonymous, noticed that “After joining WTO, China eased entry barriers to banking and other industries. In addition, the CEPA allowed more professionals from Hong Kong to operate in mainland China. This increasing competition for better management and services builds a better start-up company in terms of company structure and internal control. This is great news for private equity firms and venture capital firms.”

Positive momentum for domestic exits was also emphasized. Johannes Schoeter from Victoria Capital Limited noted that now “many companies insist on an onshore exit strategy”. And Michael Scown of Intel Capital Asia Pacific recalled “a number of foreign VC's exploring the possibility of domestic exits”. He believes that “if and when these can be made to work, it would expand the universe of investible companies and simplify the investment process.”

Table 2

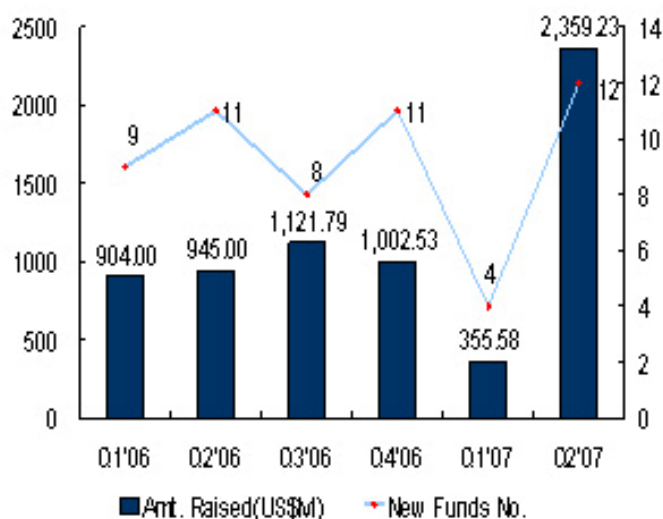
**Participating China based Venture Capitalists in the
2007 2nd Quarter Confidence Index Survey**

Alicia Eastman	Asia Pacific Capital Group
Harry Man	WI Harper Group
Johannes Schoeter	Victoria Capital Limited
Marc Wang	WI Harper Group
Marvin Lai*	iTM Ventures
Max Burger-Calderon	Apax Partners Ltd
Michael Scown	Intel Capital, Asia Pacific
Patrick Keen	ChinaVest
Steven Lin	CLSA Capital Partners
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous

(*Commentary used, but Index rating not included as it arrived after reporting period.)

In addition to positive trends in the investment environment and more management talent in China, the large growth in both VC fundraising and VC portfolio investments suggests a robust venture industry environment overall. According to the *China Venture Capital Report Q2 2007* by Zero2IPO, 13 new VC funds totaling \$2.36 billion were raised in second quarter of 2007. This is 563.5% higher than last quarter and a new record in fund raising. Please refer to Figure 1 below¹.

Figure 1 New Funds Raised by Quarter (Q1'06-Q2'07) (US\$M)



Source: Zero2IPO Research Center

The same report also noted that among the 121 start-ups that received VC investment in Q2, 113 of them disclosed the amount of VC funding, totaling \$693.95 million. This is an 80.6% increase in funds raised by 67 firms last quarter. Please see Figure 2 below². As the rate of inflows to Chinese venture funds is over three times the rate of portfolio investment, we can surmise that the rate of portfolio investment may increase in the near future as VCs must put these new funds to work in a timely if cautious manner. This notion is expressed by Marc Wang of WI Harper Group who stated “... while we believe there is a good long-term opportunity, we still believe it is good to be cautious, critical, and judge everything on a rational basis.”

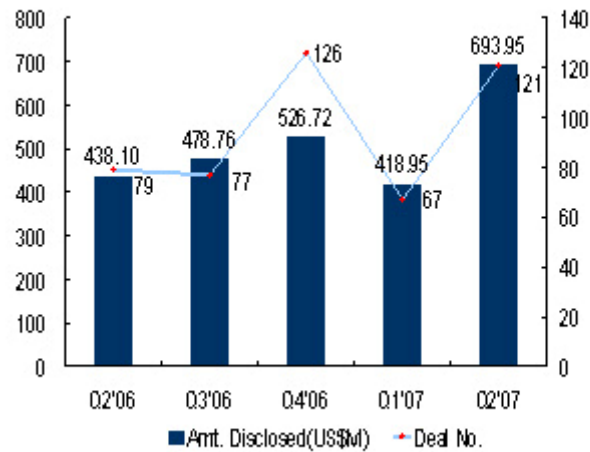
Importantly, foreign VC funds in China accounted for about three-quarters of the total portfolio investment in Q2 and nearly 90% of funds raised.³ This high level of foreign capital funding new China ventures suggests international investor confidence in the long-term prospects of the Chinese entrepreneurial economy and the importation of international methods and standards to the Chinese venture industry.

¹ Zero2IPO - China Venture Capital Report Q2 2007

² Zero2IPO - China Venture Capital Report Q2 2007

³ Zero2IPO - China Venture Capital Report Q2 2007

Figure 2 Overall VC Investments by Quarter (Q2'06 – Q2'07)



Source: Zero2IPO Research Center

This greater integration with world-class international finance standards should encourage quicker regulatory reform and implementation and a more secure horizon for venture investment. Further, as the Chinese venture environment trends more closely with the US and other more established venture markets (e.g. trends in fund raising, investment across stages and industries, and exits), a longer-term strength in the venture capital industry becomes more likely. Therefore, while there does exist some concern with high valuations and regulatory ambiguity in the short to medium term, the further integration of the Chinese venture industry with more mature markets bodes well for the longer term stability of the industry and high-growth entrepreneurial environment in China.

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 - 2007). 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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