

China Venture Capitalist Confidence Index™

(Bloomberg ticker symbol: CVCCI)

Third 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.

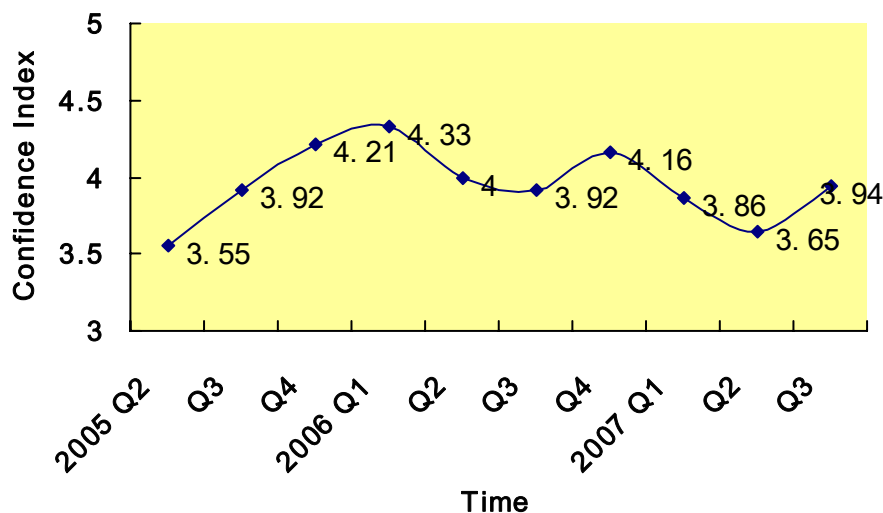
In publishing a recurring confidence index of China-based venture capital investors, we intend to utilize the local knowledge and insight of our respondents to provide an on-going leading indicator of local investment in new high-growth businesses in the Greater China Region. We expect that this local insight will provide a unique perspective into the dynamic Chinese entrepreneurial business environment. Further, by tracking what local venture investors project about the 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 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 third quarter of 2007, based on an October 2007 survey of 9 mainland China and Hong Kong venture capitalists, registered **3.94 on a 5 point scale** (with 5 indicating high confidence and 1

indicating low confidence). This quarter's reading is up from last quarter's index of 3.65 and suggests

Graph 1
Trend line of China Venture Capitalists Confidence over recent 10 quarters



an increasing level of China-based venture capitalist confidence in the future high-growth entrepreneurial environment in China. Please see Graph 1 for trend data.

This report’s commentary and index reading are based on a sample of nine venture capitalists in the China region. All of the Index respondents’ names and firms for this report are listed in Table 1, 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 Chinese macro economy enhanced venture capitalists’ confidence. Michael Scown of Intel Capital, Asia Pacific, commented that “China's fundamental growth story continues.” Max Burger-Calderon of Apax Partners agreed with Mr. Scown, stating, “The Chinese growth momentum is very much alive.” Additionally, Chauncey Shey of Soft Bank China Venture Capital based his strong confidence on a “high and stable economic growth rate in China”, “government support for the venture capital environment”, “increasing capital needs”, and “good deal flow.” As a result, venture capitalist enthusiasm continues with China’s rapid GDP growth. For example, David Zhang of WI Harper Group believes “there are many opportunities for diligent venture capitalists.”

Despite an overall optimistic outlook on the China VC investment environment, increasing concerns over excessive valuations, environmental pollution, and uncertainties in the government policies have led to caution with some venture firms. As David Zhang of WI Harper Group pointed out, “high valuation is still a general concern and is a cause for caution.” Similarly, Michael Scown of Intel Capital, Asia Pacific, noted that “regulatory changes and VC entry into onshore investing will make for potentially volatile times.” An anonymous VC also expressed caution regarding fierce competition for good deals, believing that excess VC funding chasing deals will further worsen the situation. The same respondent asserted that, due to excess investment capital available in the Chinese market, some foreign traders are not being allowed to bring in money beyond certain limits. In addition, Max Burger-Calderon of Apax Partners predicted that “the biggest threats in my opinion during the next few years are the problems around rampant environmental damage (water, air and food)”. Mr. Burger-Calderon continues, “these are solvable issues but only if they are attacked with the necessary determination.”

Table 1

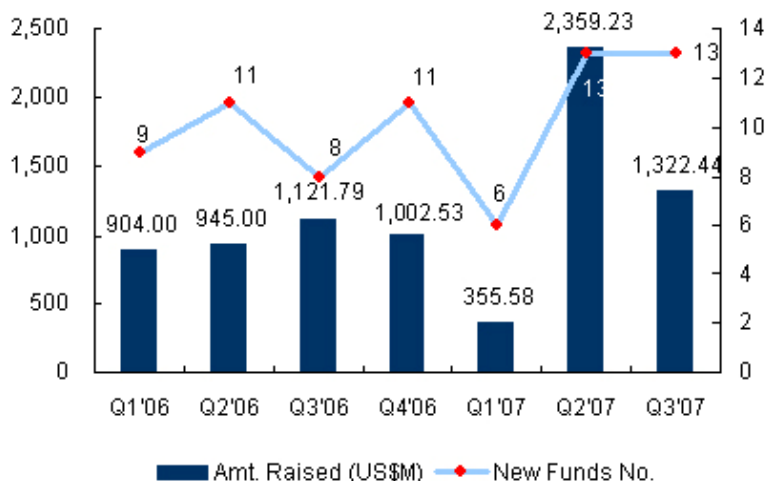
Participating China based Venture Capitalists in the 2007 3rd Quarter Confidence Index Survey

Alicia Eastman	Asia Pacific Capital Group
Amy Yeh	Soft Bank China Venture Capital
Chauncey Shey	Soft Bank China Venture Capital
David Zhang	WI Harper Group
Max Burger-Calderon	Apax Partners
Michael Scown	Intel Capital, Asia Pacific
Steven Lin	CLSA Private Equity Ltd.
Anonymous	
Anonymous	

From a global perspective, the economic slow-down in U.S. does not appear to have dampened enthusiasm for entrepreneurial growth in China. China's GDP growth remains very strong. Therefore, China-based venture capitalists remain optimistic and foreign investors continue shifting their investments to the Chinese market. According to the *China Venture Capital Report Q3 2007* by Zero2IPO, 88 Chinese enterprises received VC investment of US\$896.51M, while thirteen new VC funds raised a combined US\$1.32B in Q3¹. This is a record level of investment in VC-backed Chinese ventures, demonstrating venture capitalists' confidence in sustainable economic growth in the Chinese market. Given the enormous amounts of equity capital pursuing promising Chinese ventures, we don't expect that the credit market concerns in the US and Europe will negatively impact Chinese venture investment. However, Chinese government policies regarding domestic and international exit alternatives could have a significant impact as VC confidence tends to be linked to viable liquidity channels. The same Zero2IPO report stated that the total new funds raised went down by 43.9%. (Please refer to Table 2).

Table 2

Figure 1 New Funds Raised by Quarter (Q1'06-Q3'07)



Source: Zero2IPO Research Center

This down trend in fund raising most likely took place because funding shifted from primarily foreign to local sources. Since about 90 percent of local VC funds are sponsored by Chinese government or state-owned companies², the size of these funds is usually smaller than that of foreign controlled VC funds. This shift from foreign to domestic inflows of funds bears watching. Whether this shift of investing source from international to domestic sources is market driven or whether it is due to new regulatory constraints could have a long term impact on the Chinese venture industry. Still, the total amount raised during the first three quarters of 2007 reached \$4.04B, exceeding \$3.97B, the total amount raised in 2006. At the same time, the total amount of \$2.01B invested in portfolio firms during the first three quarters of 2007 rose by 60.66% compared to \$1.25B for the same period of 2006 and exceeded the total amount of \$1.78B for the year of 2006.³ Thus, inflows into Chinese VC funds and

¹ Zero2IPO China Venture Capital Report Q3 2007.

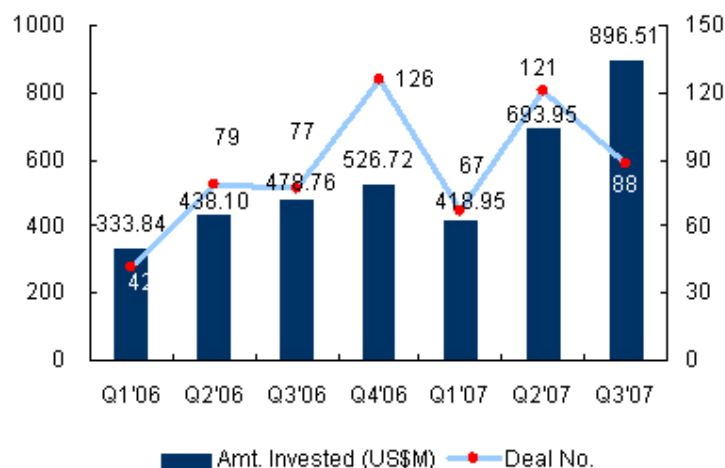
² Local VC Funds account for 30 percent of VC funds in China, translated from 中国风投行业内地资本仅占三成, <http://www.wineast.com/news/cjnews.asp?id=83050>.

³ Zero2IPO China Venture Capital Report Q3 2007.

investments from these funds continues to be robust and an early indicator of continued high levels of entrepreneurial activity in China.

Table 3

Figure 2 Overall VC Investments by Quarter (Q1'06–Q3'07)



Source: Zero2IPO Research Center

However, as most of the responding VCs mentioned, huge amounts of venture capital flowing into the Chinese market also bring a note of caution for the over-heated public equity market and venture capital industry in China. Excess investment capital has turned the venture capital industry into a buyer's (*entrepreneur's*) market. As a result, venture capital had been chasing limited good deals, while in the past entrepreneurs have pursued limited sources of funding⁴. A better equilibrium of supply and demand for capital would allow for more sustainable growth at reasonable valuations.

Additionally, more venture capital has flowed into traditional industries. According to *China Venture Capital Report Q3 2007* by Zero2IPO, "Q3 saw a decline in Broad IT investment: its deals and amount invested simultaneously fell to below 50.0% of the total quarterly deals and amount invested. By contrast, venture investment in services showed very strong growth on a quarter-over-quarter basis. Sixteen services enterprises received US\$210.46M of venture capital, comprising 18.2% and 23.5% of the quarterly total deals and amount invested, respectively. This compared favorably to the preceding quarter when the two ratios were 10.7% and 10.2%, respectively."⁵ Whether this movement from investment in IT to service ventures signals a shift in investment focus and what that shift in focus might mean in the long term is unclear at this time.

In sum, we expect continuing rampant growth in China's venture capital industry. However, regulatory risk and high valuations give cause for concern. While enormous and emerging opportunities make the venture market attractive, uncertainty in regulatory issues that can affect inflows of funds and eventual liquidity events make for a very high risk environment going forward. Furthermore, excess investment capital, not only in venture capital industry but also in the public

⁴Songde Ma's speech in Shanghai Venture Capital and Private Equity Conference on September 17, 2007, translated from 马颂德：中国风险投资已是买方市场，<http://www.wineast.com/news/2007/200709/w82444.htm>.

⁵ Zero2IPO China Venture Capital Report Q3 2007.

stock market, portends the risk of financial bubble. However, barring sudden regulatory or other external shocks, an eventual transition to sustained if less frantic growth is possible and even probable. For the near term, we expect continued rapid growth and expansion in the China venture market.

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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