

China Venture Capitalist Confidence Index™

(Bloomberg ticker symbol: CVCCI)

Third Quarter – 2008

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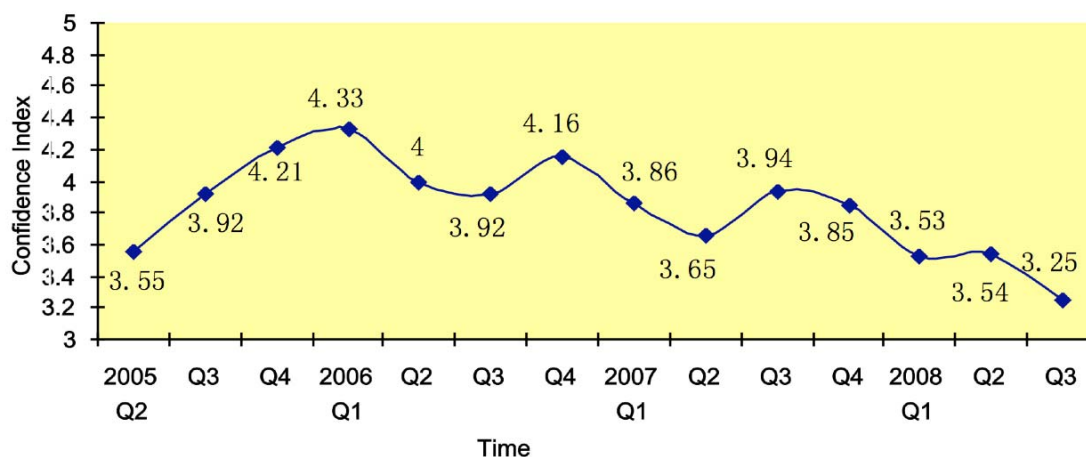
Mark V. Cannice, Ph.D.

Ling Ding

The quarterly *China Venture Capitalist Confidence Index™* (Bloomberg ticker symbol: CVCCI) is based on an on-going 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 essential perspective and an on-going leading indicator of 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 capital flows, we aim to provide actionable insight for all market participants.

The China Venture Capitalist Confidence Index for the third quarter of 2008, based on an October 2008 survey of 14 Mainland China and Hong Kong venture capitalists, registered **3.25 on a 5-point scale** (with 5 indicating high confidence and 1 indicating low confidence). This quarter's reading fell from last quarter's measure of 3.54, to the lowest reading in the 3.5 year history of the Index, suggesting that the global economic slowdown and financial crisis are now also straining the confidence that venture capitalists have in the future high-growth entrepreneurial environment in China. Please see Graph 1 for trend data.

Graph 1
Trend line of China Venture Capitalists Confidence over recent 14 Quarters



This report's commentary and index reading are based on a sample of fourteen venture capitalists in China. 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 Chinese venture environment. In the following, we provide many of their comments along with our analysis.

Growing caution over the spreading financial crisis and its impact on the venture capital business model were recurring themes among this study's respondents. In particular, survey respondents were concerned over declining exit opportunities and less committed new capital to venture funds. For example, Marvin Lai of iTM Ventures confirmed that "The slowdown of the world economy today will impact the investment sentiment of private equity firms in China." An anonymous venture capitalist respondent confirmed that the prospects of the high-growth venture capital industry are closely aligned with the world economy and attributed his low confidence to declining funding sources. And David Zhang of Matrix Partners China indicated that "the global economic depression, especially the decline of the capital markets, will influence the exits of local VC investment in the short term." A participating VC who wished to remain anonymous agreed with Mr. Zhang and further pointed out that "exits will be limited; companies will need to survive for longer periods; many will not get further funding. The days of pre-IPO, quick flip investing, are over."

Indeed, facing a declining global stock market and fewer qualified U.S. investment banks, many start-up ventures have been unable to complete the exit (liquidity) process. The most recent data from Zero2IPO China Venture Capital Report Q3 2008 indicated a decline in exits of Chinese ventures to 19 transactions in Q3 2008 versus 36 transactions in the prior quarter and 35 transactions the prior year (Q3 – 2007)¹. Additionally, frozen credit markets and the shrinking stock portfolios of wealthy individuals and institutions have made it harder for VCs to raise funds. For example, in Q3 20 new VC funds raised \$492.21 million; this compares to 40 new funds with \$3.02 billion in second quarter 2008 and 13 funds with \$1.32 billion in third quarter 2007.²

Considering the declining trends in exits, capital commitments and confidence, it appears that the momentum in China's venture industry has slowed significantly from recent quarters and years. This trend is consistent with the current state of the venture industry in Silicon Valley where VC confidence has also marked a multi-year low along with a decline in exits and investments.³ This congruency in sentiment and venture development between Silicon Valley and China provides further evidence of the increasing human and capital links between these two entrepreneurial regions.

More broadly, the global macro economy is impacting China's economic growth and Chinese companies' outlook in the short term. An anonymous participant predicted that "PRC growth will slow due to the financial crisis and quality scares; domestic consumption will not make up for this." Another VC who wished to remain anonymous also believed that "most sectors, no matter export or domestic consumerism, will be hurt by the gloomy economic outlook in one way or the other." In

¹ <http://news.zero2ipo.com.cn/n/2008-10-15/20081015202851.shtml>, 三季度VC募资额骤降84%，人民币投资额占比翻番，大额投资更谨慎，退出交易陷低迷。

² <http://news.zero2ipo.com.cn/n/2008-10-15/20081015202851.shtml>, 三季度VC募资额骤降84%，人民币投资额占比翻番，大额投资更谨慎，退出交易陷低迷。

³ Cannice, Mark V. (October 2008). Silicon Valley Venture Capitalist Confidence Index – Q3 2008.

addition, Jixun Foo of GGV Capital noted that “global financial turmoil and commodities’ prices would impact the short-term profitability and growth of Chinese companies.” But, he added that “Venture Capital should look long term.”

With the global downturn limiting the availability of investment exits and capital sources, China VCs have become more cautious in their choices for investment. Consequently, Chinese start-ups have had a harder time raising funds. For instance, Harry Man of Matrix Partners China stated that “during the global economic downturn, funds have becomes harder to raise. Therefore, deployment becomes more conservative while entrepreneurs’ expectations haven’t lowered at the same magnitude.” Another seasoned observer also pointed out that “the (venture capital) market is somewhere between uncertain and non-existent! The key issue will be availability of funding for investments. (The issue is) not some flaw in the invested company but the investor’s other needs for cash and concerns over its own investment base, etc. I don’t believe that many deals will be done, only those already committed and rock solid from all standpoints.” Validating this perception, Zero2IPO China Venture Capital Report Q3 2008 indicated that 99 start-ups raised \$787.73 million, the lowest amount during the last 5 quarters⁴.

And excessive valuation expectations remained a concern, though some saw signs of improvement. One anonymous VC was worried that “valuations are way out of line with (the new) reality.” However, another anonymous participant stated that “we are finally seeing valuations at reasonable levels.” Jessica Mak shared this point of view observing “more realistic valuations and transparency in the nature of assets in deal sourcing due to liquidity challenges.” As VCs are experiencing a more challenging environment in terms of exits and capital commitments, we expect that valuations will continue to decline.

However, VCs are confident that entrepreneurs will emerge despite the tougher economic reality. For example, Jixun Foo of GGV Capital believed that “a tough environment builds great companies.” And while one anonymous participant was worried that Chinese entrepreneurs will need more entrepreneurial experience to produce true innovations, Max Burger-Calderon of Apax praised Chinese entrepreneurs on how they deal with hard times by noting that “in a tightening global economic scenario, Chinese entrepreneurs kick in extra energy and excitement and find themselves focused on what they do best - building revenues through great products and services.”

And a confidence in the essential underpinnings of the Chinese economy and government oversight remained. David Zhang of Matrix Partners China noted that “we’re confident of the steady growth of China’s macro economy, as the new rising local high-tech, healthcare, and clean-tech industries become mature, more investment opportunities emerge.” Mr. Zhang continued, “solid venture capitalists can survive by seizing cheaper assets and through effective portfolio management.” Moreover, Jessica Mak expressed her confidence in the Chinese administration by noting that “government is more mature in executing their macroeconomics policy.” While Ms Mak was hopeful for further improvements in the regulatory system, she anticipated that “China and Vietnam at some point will be the earning drivers in the coming years if commodity prices stabilize.”

⁴ <http://news.zero2ipo.com.cn/n/2008-10-15/20081015202851.shtml>, 三季度VC募资额骤降84%，人民币投资额占比翻番，大额投资更谨慎，退出交易陷低迷。

In conclusion, although the global economic slowdown and financial crisis have led to the lowest level of China’s venture capitalists’ confidence in the 3.5 year history of this Index, there is cause to maintain a positive outlook for the long term. While valuations have begun to decline, this is a natural and healthy response to the changing market conditions which require longer holding periods of portfolio firms and smaller multiples at exit. Declining capital commitments, while posing a challenge to some venture firms, should lead to more competitive and, thus, more fruitful investment decisions for the industry as a whole. Further, as China’s venture environment matures with more consistent regulation, more conservative valuations, and more seasoned entrepreneurs and investors, a sustainable growth of innovative enterprises that respond to critical market needs in high-tech, green-tech, and life science industries is more likely to occur. Still, in the near term, we expect a continuation of the challenging environment - fewer exit alternatives and scarcer capital commitments and investments. But in time, credit markets will come unseized, a higher tolerance and patience for risk capital will return, and this current difficult environment will spawn a new wave of innovative and efficient entrepreneurial Chinese ventures.

Table 1

Participating China-based Venture Capitalists in the 2008 3rd Quarter Confidence Index Survey

Alicia Eastman	Asia Pacific Capital Group
China Vest	China Vest
David Zhang	Matrix Partners China
Harry Man	Matrix Partners China
Jessica Mak	
Jixun Foo	GGV Capital
Lip-Bu Tan	Walden International
Marvin Lai	iTM Ventures
Max Burger-Calderon	Apax
Michael Scown	Intel Capital, Asia Pacific
Raymond Gu	JAFCO Asia
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous

Mark V. Cannice, Ph.D. is an Associate Professor of Entrepreneurship and the Founder and Executive Director 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 Business School (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 as well as Tomosue Den (USF MBA candidate 2009) for his survey and technology support. Webmasters are welcome to link to this report with courtesy notification to Cannice@usfca.edu. When citing the Index, please refer to it as: The China Venture Capitalist Confidence Index, and include the associated Quarter/Year, and the full names of the authors.