VOLUME 26 | NUMBER 3 | SUMMER 2014

Journal of APPLIED CORPORATE FINANCE

In This Issue: China's Capital Markets and Corporate Governance

UNIVERSITY of ROCHESTER | SIMON BUSINESS SCHOOL

CARE Conference Hong Kong Polytechnic University, June 9, 2014

Equity Financing for Early-Stage Companies in China

A Presentation by Ning Jia, Tsinghua University

Good morning, I'm Ning Jia, Associate Professor of Accounting and Deputy Director of the China Business Case Center at Tsinghua University in Beijing. We have heard a good deal at this conference about how Chinese companies raise equity capital from the public capital markets. But, of course, not all companies in China are able to access the IPO market. The bulk of the smaller private-sector companies that are still in the entrepreneurial stage need external capital to fuel their growth. And it is mostly venture capital and private equity firms in China that provide capital to these smaller entrepreneurial companies. Today I'd like to share with you some of my thoughts and research findings on the development of venture capital and private equity in China, as well as the role they play in the growth of early-stage companies.

Although China's VC industry is much younger than that of the United States, it has been on a high growth trajectory since 1998. Several things happened in that year. The first was the dot.com fever and NASDAQ bull market in the United States, which also had a significant impact on China's entrepreneurial sector. The second was the return from the U.S. of Chinese entrepreneurs, a group we like to refer to as "sea turtles." Sea turtles are people who were born and raised in China but finished their higher education in the West. After finishing their education in western countries and seeing—and in some cases participating in—success stories like Google and eBay, they wanted to return to their homeland and establish their own ventures.

Robin Li, the founder of Baidu, is a good example. He came back from the U.S. around 1998-99 to set up a company in China with a business model similar to Google's—and that was how Baidu got its start. Though the initial business models of Baidu and Google were very similar, Robin did a much better job of adapting the model to local requirements and circumstances. Baidu was the first search engine in China to launch an MP3 search product—that was in November 2002, and the launch followed an extensive market research on its target customers. At the time, about 70 percent of China's Internet users were under the age of 30, and far more interested in entertainment than news, books, or other education-related information. Baidu quickly delivered products that were tailored specifically toward the interests of this Internet user group, including MP3s, images, video, and games. This move effectively differentiated Baidu's products from traditional search engines, particularly Google. And by so doing, it created a distinctive brand image and recognition of Baidu among China Internet users as the domestic search engine, providing more suitable and locally relevant services for the Chinese audience.

So it was this kind of local adaptation that made Baidu a very successful company in China. And it was the return of people like Robin Li that stirred up China's venture capital market as many foreign VC firms started to follow those returnees into China.

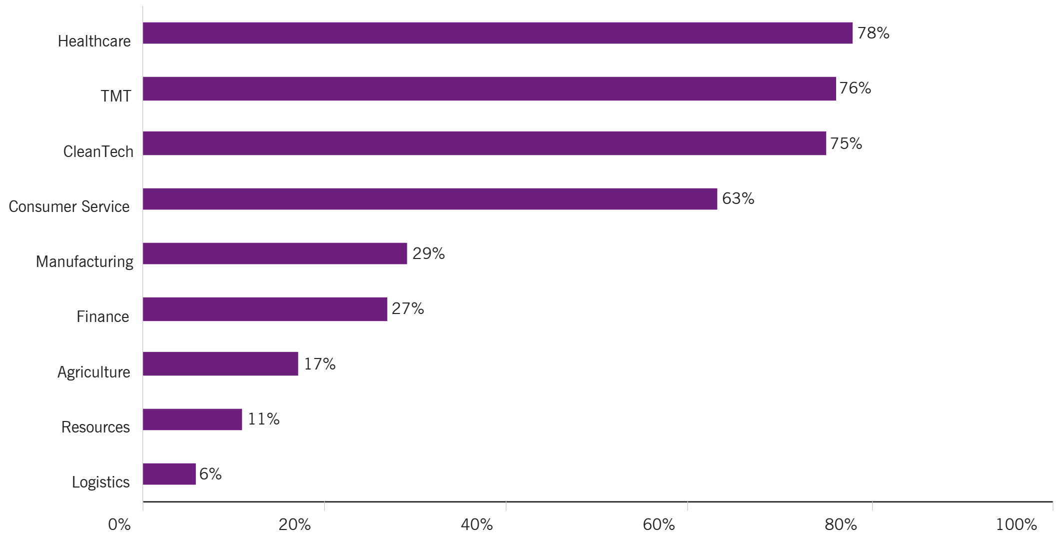
The Development of Chinese VC Markets

VC investment in China can be classified into three main phases. During the first phase, which took place during the late 1990s, VCs in China were primarily interested in start-ups that were copying business models that had proven themselves in the U.S. Most VC investments back then were concentrated in the TMT sector, and applications of existing technology were much more common than attempts to develop new technologies.

The second phase took place during the early to mid 2000s. In addition to continuing investment in the TMT sector, VCs also started to move into traditional industries for a number of reasons. First of all, competitive and even crowded conditions in the TMT sectors limited the return potential. Second, in contrast to more developed or mature economies, in China many traditional sectors outside of high tech were seen as providing high-return opportunities, thanks to the high growth rates in the Chinese economy. China's VCs showed a particular preference for start-ups in traditional sectors that were using either cutting-edge technology or introducing a new business model. As one example, MJ Life, a provider of healthcare check-up services, attracted capital from VCs after adopting an advanced, streamlined manufacturing process from Taiwan and applying it to its healthcare business.

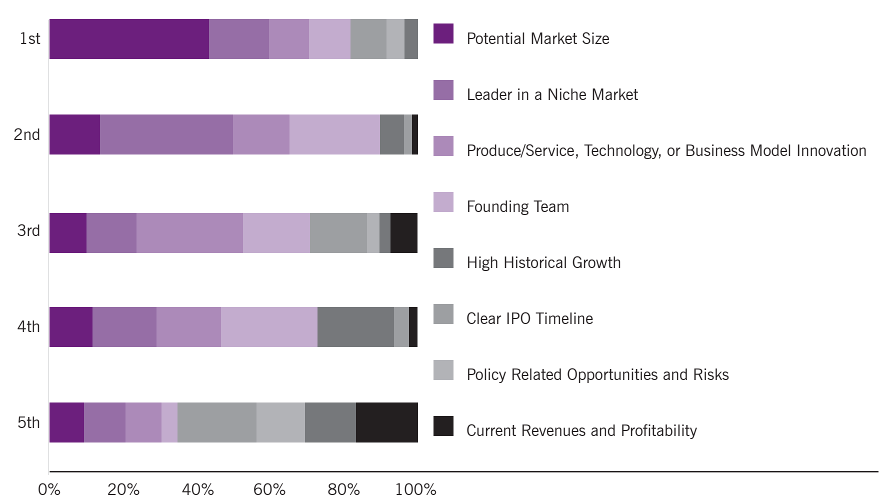
During this phase, the Chinese government developed several new policies to encourage more domestic capital to participate in the VC sector. Of particular importance was an amended version of the Partnership Enterprise Law that went into effect in June of 2007. This new version of the Law provided much more clarity about the kinds

Figure 1 **2014 GP Survey – Industry Preference**



Source: CV Source

Figure 2 **2014 GP Survey – Investment Criteria**

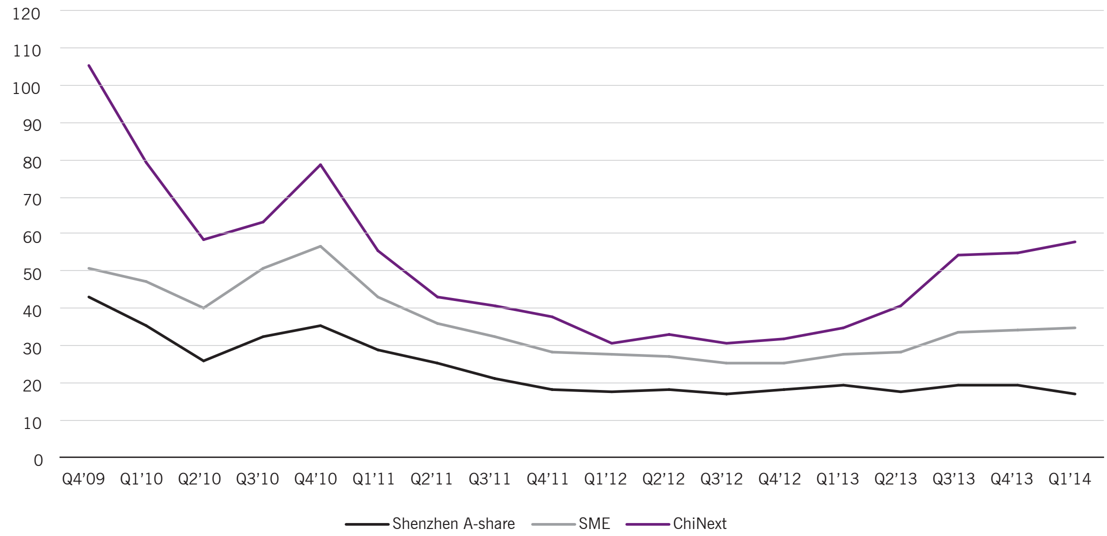


Source: CV Source

of entities could that serve as partners in venture capital firms or transactions, while for the first time differentiating between limited partners (LPs) and general partners (GPs). Since that time, Chinese PE firms, like their foreign counterparts, have been permitted to choose the limited partnership structure as the third organizational option in addition to the two options previously available to them—the corporation and the trust. One of the big attractions of the limited partnership structure is, of course, its ability to eliminate the double taxation associated with the corporate form, as well as reducing the potential legal liability associated with the trust structure.

And that brings us to the third phase of Chinese venture capital, which begins with the global financial crisis. From 2008 to the present, the market has had pronounced ups and downs. The Chinese government has continued to encourage VC development. For example, the government has gradually relaxed policy restrictions on financial and asset management institutions, permitting insurance companies to invest in the private equity market for the first time, and allowing securi-

Figure 3 **Average P/E Ratio between Q4'09 and Q1'14**



Source: Compiled by author; data obtained from Shanghai and Shenzhen stock exchange

ties trading institutions to also participate in the market.

As a result of these kinds of changes, coupled with the strong expectation of the launch of the Growth Enterprise Board (GEB, also known as ChiNext) in 2009, domestic RMB VC and PE funds began to see new options for both financing and exit. The GEB is a Nasdaq-like exchange that lists high-growth entrepreneurial Chinese companies, and thereby provides them with the financing necessary for the build-up of business scale and profit-making capability, particularly ventures with distinctive technological innovations and business models. Companies listed on the GEB have maintained relatively high PE ratios—well above the average PE ratio of the SME and A-share board—ever since the launch of the new exchange.

In addition to the new funding options, industry preferences have also changed. ChinaVenture, a leading research institute, recently surveyed a group of Chinese GPs and asked them what industries they now find most attractive. The top three choices were healthcare, TMT, and clean tech. Perhaps we shouldn't be surprised that healthcare ranks at the top. It's estimated that by 2020, ten percent of Chinese population will be above the age of 65; and in addition to aging, the effects of increasing pollution are expected to raise the demand for health care.

ChinaVenture also surveyed GPs on their investment criteria. The number one investment criterion appears to be potential market size. Number two was whether or not the company is a leader in a niche market. The third criterion was whether you have an innovation in product or service offerings or whether it's a new business model.

Other Recent Developments

I'd like to also comment on several key features of China's VC market today.

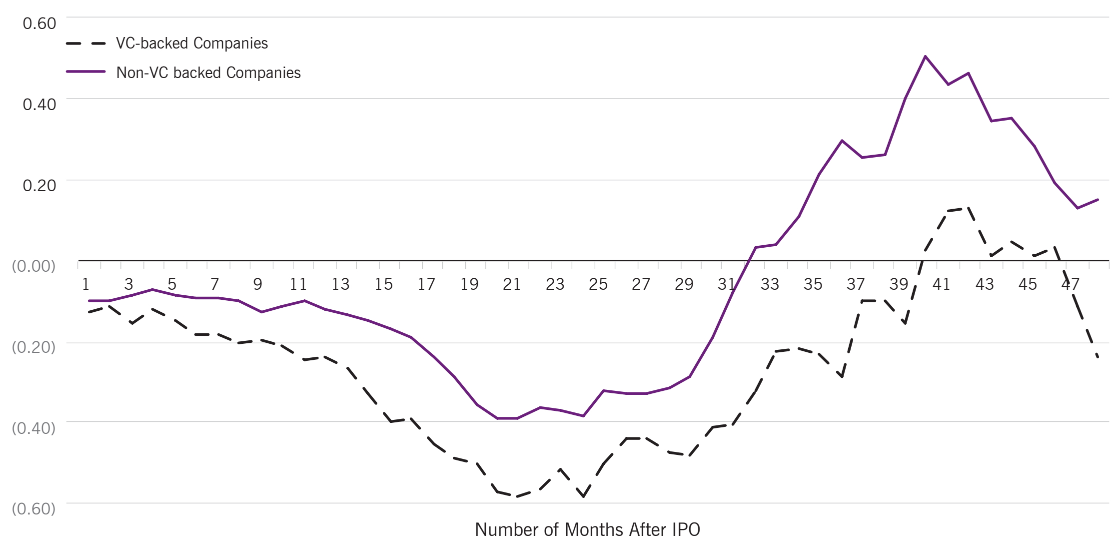
First is a fairly recent notable shift from offshore U.S. dollar investment to onshore RMB investment. Prior to 2008, China's VC market was dominated largely by global firms with U.S. dollar-denominated funds. Such firms saw the emerging economy of China as the next frontier for private equity investment and brought with them unparalleled funding, international connections, and expertise that many Chinese entrepreneurs craved. In contrast, domestic VC firms with RMB-denominated funds were much less active, due largely to organizational challenges—such as the unavailability of the limited partnership structure—and limited onshore exit options.

Since 2008, however, foreign capital has been experiencing increasing competition from Chinese investors with the gradual improvement of the Chinese policy environment and capital markets. RMB-denominated funds have become the new driving force behind China's VC industry, accounting for almost two thirds of overall capital commitments in 2010.

A second important change has been increased focus by VCs on later-stage deals.

In order to quickly establish a track record, many Chinese VC firms have a strong tendency to focus on start-up companies in later stages of development—either in the expansion stage or contemplating an IPO. This was particularly true prior to the suspension of new IPOs in China in late 2012. But, again, it is such early-stage companies that have the greatest need for external capital. And so as a partial solution,

Figure 4 **Post-IPO Performance of Chinese Companies**



Source: Author's own research

the Chinese government set up government-backed funds to help fund the really early-stage companies.

This focus on later-stage companies initially increased the returns of VCs by enabling to capitalize on the remarkably high valuations in the capital markets. But, as the P/E multiple on China's capital market has come down gradually, the arbitrage opportunity between pre-IPO market valuations and post-IPO market valuation is now almost gone. As a result, VC firms are now moving more towards early-stage deals.

A third important development has to do with the investors in Chinese venture capital funds. Unlike Western VC markets, where institutional investors, such as pension funds and endowments, have been the main providers of capital, the lion's share of venture capital in China has come from private business owners and high net worth individuals. Chinese LPs, as new players in the market, have been generally less sophisticated than their foreign peers and less accustomed to the idea of entrusting their capital to fund managers for a lengthy period of time. For this reason, they have tended to have a shorter investment horizon and demanded a faster return of capital and profits. As a result, most domestic VC funds have been set up with a life span of 5 to 7 years, significantly shorter than the fund length of 10 to 12 years that has been the norm in Western markets. Such shorter fund durations have in turn imposed greater liquidation pressure on VC firms, forcing them to push portfolio companies to the public market as soon as possible. And the pressure on VCs for early IPOs may well have had negative effects on the companies they have invested in.

To explore this possibility, I conducted a large-sample study on the post-IPO stock performance of 273 companies listed on China's small and medium enterprise (SME) board between 2004 and 2008. I split the sample between those IPOs that were backed by VC firms and those that were not to see if I could find a difference in their post-IPO stock market performance.

Consistent with this grandstanding hypothesis, I found that Chinese IPO companies underperformed the overall Chinese stock market, and that the VC-backed companies performed the worst. Moreover, the difference in performance does not become statistically significant until about 12 months after the IPO. What's the significance of 12 months? It's the expiration of the lock-up period in the SME board. After that point, strategic investors, including the VCs, have the right to liquidate their shares in the open market—and they typically have fully exited their investments within two years' time.

Another interesting finding is that, around 36 months after the IPO, the performance of IPO companies starts to rebound. After 36 months, the controlling shareholders in China are allowed to sell their shares in the open market, so they have incentives to hype the stock price in anticipation of selling out.

A fourth trend in the Chinese VC market worth noting in recent years is the increasing role of social media in VC deal sourcing, which had previously relied on traditional word-of-mouth referrals. Articles about new companies and business models appear on the Internet every day and, in this way, they come to the attention of VC and PEs. Entrepreneurs are increasingly trying to use the web as a path to financing.

And fifth and last, due diligence has also changed in significant ways. Investors offer incubation and training programs to the companies they're interested in. It used to be that a round of due diligence would take only a few weeks. But you can't really discern the quality of a company within a few weeks; and by extending the process through, say, a four-month training program, VCs can learn a lot more. Well-known entrepreneurial training programs include those offered by Innovation Works and Lenovo Star.

Closing Thoughts

To sum up, then, China's VC and PE market has offered, and will continue to offer, opportunities for global investors as China transitions into a more innovation-based economy. But at the same time, this sector still faces many challenges. For example, the supervisory system and legal environment continue to be a work in progress, with expectations of further improvement. The composition of LPs in Chinese funds would also benefit from greater participation by institutional investors—a goal that can and likely will be promoted through government inducements.

Thank you.

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Journal of Applied Corporate Finance (ISSN 1078-1196 [print], ISSN 1745-6622 [online]) is published quarterly, on behalf of Cantillon and Mann, by Wiley Subscription Services, Inc., a Wiley Company, 111 River St., Hoboken, NJ 07030-5774. Postmaster: Send all address changes to JOURNAL OF APPLIED CORPORATE FINANCE Journal Customer Services, John Wiley & Sons Inc., 350 Main St., Malden, MA 02148-5020.

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