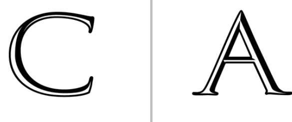

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CHINESE VENTURE CAPITAL INVESTING

2003

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ABSTRACT

1. The People's Republic of China (PRC) appears set on a path of economic liberalization, with accession to the World Trade Organization (WTO) on December 11, 2001, the capstone of reform initiatives undertaken during the 1990s. One result is the sprouting of a vibrant, if immature venture capital industry in the relatively wealthy coastal areas where economic growth has been most dynamic, and increased allocations to PRC ventures by pan-Asian venture funds. Most of these funds are too young to have established instructive track records, however, and so it is premature to assume that *this* time (in contrast to earlier disappointments) the returns will justify investors' optimism. Investors with well-developed global private equity portfolios might consider dipping an experimental toe in these fresh Chinese waters, but most investors should simply wait, watch, and learn—if this proves to be the real deal, rather than another Chinese chimera, there will be plenty of opportunity to participate later.

2. Such caution is not much in evidence among investors dazzled (again) by China's promise. In 2001, private equity funds, broadly defined, invested a total of US$1.6 billion in the PRC—a paltry sum compared to that invested in the United States or Europe, but nevertheless 84% greater than in 2000 and fully 14% of all such investments in Asia last year, including Japan. During the 1990s, as much as $6 billion was raised by some 60 private equity funds for investment in the PRC. As many as one-third of these folded, however, after incurring losses, and almost none of the remainder has provided investors with satisfactory returns.

3. The primary reasons for caution are:

   - Despite their encouragement of free enterprise, the central and provincial governments have by no means relinquished control over the economy. At any time, for whatever reason, they may decide to raise "licensing" fees, impose payroll taxes, or erect legal roadblocks to certain kinds of enterprises—or local authorities, acting in defiance of central government edicts, may do so. The provisions of WTO membership, although important, offer few protections against such governmental intervention.
   - Although China is rapidly developing new laws governing commerce and has pledged (as part of the WTO admission process) neither to discriminate against foreign investors nor in favor of domestic investors, it still lacks *independent* dispute resolution institutions capable of issuing and (especially) enforcing disinterested legal rulings.
   - The banking system is effectively insolvent. By unofficial estimates, as much as 50% of all outstanding loans are nonperforming. As in Japan, there is strong opposition to the effective disposition of nonperforming loans (NPLs), since this would entail the liquidation of "walking dead" state-owned enterprises (SOEs) that provide jobs, housing, rudimentary medical care, and other benefits to workers. Such bankruptcy laws as they exist (and new bankruptcy laws are under consideration) are toothless because they lack any means of enforcement.
   - However, the maintenance of unprofitable enterprises in a given sector destroys profit margins for everyone else in that economic space and leads to stagnation. Authorities must resolve the following formidable problems: the disposition of NPLs; the reorientation of banks to commercial lending; and the liquidation or sale of inefficient and unprofitable SOEs without massive increases in socially disruptive unemployment.

- Meanwhile, wealth disparities are expanding and political protests are increasingly common among those who have not benefited from economic liberalization. Authorities will be challenged to meet social and political tensions arising from such disparities and manage economic growth for the greatest proportion of the population as possible.

- The booming, bustling, and prosperous coastal areas around Shanghai and Shenzhen, for example, should not be confused with "China." Inland, the majority of Chinese remain peasant farmers, many working the land on a subsistence basis, while the gradual dismantling of uneconomic SOE dinosaurs raises the spectre of unemployment for millions of unskilled industrial workers. This disparity is typical of rapidly developing nations or those in transition to a capitalist economy (Russia, for example), but the scale of the PRC's socioeconomic, health care and political challenges dwarfs those of other countries.

4. Nevertheless, there are also many reasons for optimism and the *potential* is alluring. All recent economic initiatives in the PRC have been aimed at further liberalization, including newly announced plans to allow foreign and private investors the right to acquire controlling interests in publicly listed domestic companies, and the gradual emergence of a coherent body of commercial law. Many previous impediments to the development of successful private investments—like the threat of government intervention, murky accounting and corporate governance practices, and the absence of practical exit routes—are being eliminated or at least alleviated. Independent enterprises of every stripe are flourishing and it was recently estimated that a full two-thirds of all economic activity in China may be attributable to such businesses. As a result, promising investment opportunities abound—after all, this is a vast country desperately keen to claim its place at the global economic table, and the Chinese Communist Party knows that it must deliver continued economic growth to have any hope of retaining power.

5. These investment opportunities span several areas and industries, but share the common denominator that they cannot hope to be successful without a combination of local market understanding and an intense hands-on implementation. Irrespective of the type of business, China is not likely to be kind to passive suppliers of capital. Inexperienced entrepreneurs require a steady diet of guidance, unwavering support, and meticulous financial supervision. One of the fundamental differences between the venture capital market in China today compared to ten years ago is that there now exist talented entrepreneurs who appreciate the role of private equity and are amicable to the more transparent management style it demands.

6. Even those with no intention of investing should seek to understand economic developments in the PRC since these are profoundly affecting the evolution of the global economy. For those with well-developed private equity programs, China represents an inefficient frontier, fraught with risk, uncertainty, and market impediments (as inefficient markets always are), but as long as the country remains relatively stable and continues on the current path of economic liberalization, skilled managers should find opportunities to generate attractive returns.

SUMMARY

Introduction

For centuries missionaries, mercenaries, and merchants from far and wide have sought to conquer what even today remains the largest untapped market on Earth—China. Though their wares have varied dramatically—from eternal life, to war, to toothpaste—the results have largely been the same. In fact, with the exception of the highly lucrative opium trade of the 1800s, only a select group of *laowei* ("outsiders") has successfully penetrated, navigated, and, most importantly, profited from their time in the Middle Kingdom. However, the new millennium has brought with it fresh momentum to the significant social, political, and economic reforms initiated by Deng Xiaoping in the late 1970s. As a result, the on-again, off-again fascination with unlocking the Chinese market, which can at times border on obsession, appears to be in full swing once more.

Subsequent to an examination of the macro conditions that have combined to give rise to this most recent flood of enthusiasm for business opportunities in the People's Republic of China (PRC), this report will seek to answer the following:

- Do the sweeping changes taking place in China today signal an attractive entry-point for foreign investors, specifically venture capital practitioners?
- Given the less than stunning track record of foreign private equity vehicles and strategic corporate investors in China throughout the 1990s, is there any reason to think that this time around will be any different?
- Who are the key players in the marketplace, what are the compelling investment theses, and which strategies can be reasonably expected to produce superior results?
- What are the major risk factors to venture capital investing in China and are there ways to overcome these structural and omnipresent impediments?

The Political, Social and Economic Landscape of the PRC Today

If you want one year of prosperity, grow grain. If you want ten years of prosperity, grow trees. If you want one hundred years of prosperity, grow people.

-Chinese Proverb

Political Environment: The Communist Party

Any review of the investment climate in China must begin with a discussion of the political situation, since the Chinese Communist Party (CCP) controls the weather. Notwithstanding the massive degree of economic liberalization undertaken by Mao's successors, the Party retains a firm hold on the levers both of the economy and of political power. As in most developing markets, therefore, investments are subject to *political* risks that are a negligible factor in developed markets.

Party Leadership. Today, the Third Generation of Chinese leaders, as they are know, is in the process of handing over power to a younger, though carefully groomed, team of experienced government administrators. The outgoing group of politicians, led by President Jiang Zemin, has directed the affairs of the nation since 1989.

When he first assumed the CCP's top post, many "China experts" assumed that Jiang would be little more than a transitional figure, keeping the ship on course while a suitable successor for Deng was identified. Proving the pundits wrong, the former mayor of Shanghai has remained in power for over a decade, supported by a core group of political allies including current Premier Zhu Rongji. Jiang has provided great leadership and persistence in steering China towards a more market-driven economy. These efforts have included an ambitious attempt to privatize the country's massive, debt-ridden state sector and the relentless pursuit of WTO entry, which China was granted in December 2001. Under Jiang, the national constitution was amended to fully recognize the legitimacy of private enterprise, and in July of 2001, he went so far as to suggest that entrepreneurs should be allowed to officially join the CCP.

Above all, the government is committed to social stability and economic reform—in that order. This vision is likely to survive the generational change currently underway. At the Communist Party Congress held in November 2002, Jiang stepped down from his position as General Secretary of the Party and was replaced by Hu Jintao. Although he served as China's Vice President for a number of years, Hu is a little known figure in the West and only recently made his first official visit to the United States. After relinquishing the title of General Secretary, Jiang was re-appointed as Chairman of the Central Military Commission, arguably the second most influential position in China, and as such, will continue to have a voice in the affairs of the nation. Jiang's third and least consequential title—that of President—is expected to be passed to Hu at the annual National People's Congress held in March of 2003.

Another key government official likely to have a successor named in March is Zhu Rongji, who is widely regarded as the foremost architect of China's economic restructuring in the 1990s. Many are anticipating that Vice Premier Wen Jiabao, who has been personally groomed for the job by Zhu, will inherit the premiership and continue the reform drive. The current shuffling of positions at the highest level of the Chinese government leads many to believe that major policy changes are unlikely in the near-term, with the incoming leaders choosing to stay close to the course chartered by their predecessors.

Taiwan. And of course, one cannot discuss Chinese politics without making mention of the tenuous cross-straits relationship with Taiwan. The island, which China considers a rogue province, has seen its ties with the PRC strengthened over the past decade, but remains deeply suspicious of Beijing and retains significant restrictions on direct Mainland investment by its citizens. The PRC, for its part, has only recently allowed direct transportation links and is unrelenting in its efforts to deny Taiwan sovereign nation status on the world stage. With that said, it is estimated that there are now several hundred thousand Taiwanese living and working in Shanghai alone. Although impossible to accurately tally, Taiwanese-backed investment into Mainland China over the last ten years runs into the tens of billions of dollars. It is probable that this trend will continue and the two governments will eventually find a way to interact in a stable, mutually beneficial fashion. One can never predict the course such emotionally charged relationships will take, however, and the Taiwan issue continues to be a potential flash point for serious conflict.

Social Environment

A number of landmark events—gaining WTO membership, earning the right to host the 2008 Olympic Games, and qualifying for the 2002 FIFA World Cup—have combined to lift the collective confidence of the Chinese people to a level not

witnessed for some time. In fact, during the nationwide celebrations following Beijing's successful Olympic bid, radio, television, and newspaper commentators chose a familiar phrase to sum up the historic occasion—"the Chinese have once again stood up!"[1]

Overseas Returnees. Not only are the Chinese living in China energized, but perhaps more importantly, the nearly 60 million-strong community of Chinese living abroad appear to have rediscovered their roots en masse.[2] Why is this significant? As part of Deng's crusade to modernize the nation following the Cultural Revolution, the best and brightest minds in China were encouraged to enroll in the finest educational institutions the world had to offer. Invariably, these colleges and universities were found in the West. Recently released statistics from China's State Administration of Foreign Experts Affairs (SAFEA) show that some 400,000 of its most prized students have traveled abroad for university-level education since the late 1970s. Of these, approximately 90% have gone on to earn a graduate degree. Not surprisingly, given the myriad professional opportunities available in the West and an uninviting environment back home—the 1989 incident in Tiananmen Square convinced many there was no reason to ever return—the majority opted to settle overseas. Today, sensing that the country is at a crossroads and there exists the possibility for individuals to help shape its future, these bi-cultural, exceptionally well-educated individuals are beating a path home,[3] primarily to Shenzhen, Shanghai, and Beijing.

Wealth Disparity. Away from the increasingly prosperous cities of the east coast, however, the other half of China that is still employed on the land has seen their standard of living slip in recent years, and their livelihood further threatened by continued deflation in agricultural products. Although a widening chasm between the winners and the losers of rapid development is typical of emerging economies, in China it raises the spectre of significant social unrest as living conditions deteriorate for hundreds of millions of rural workers. Whereas per capita income in commercial centers such as Shanghai and Guangzhou is in the range of US$1,500 and higher per year, there are millions upon millions of peasant farmers in Western parts of the country struggling to survive on less than one US$ a day.[4] In many provinces, this situation is getting worse rather than better. The OECD estimated in March 2002 that China's rural workforce exceeds its requirements by over 200 million, while the United Nations warned in a recent study that "China is on the verge of a catastrophe that could result in unimaginable human suffering, economic loss, and social devastation" as a consequence of deterioration in public health services and the rapid spread of HIV and AIDS. Although inured to suffering, Chinese are increasingly protesting these conditions, which are often exacerbated by rapacious and corrupt local officials extorting onerous taxes from impoverished citizens. The number of collective protests nearly quadrupled in the 1990s, from 8,700 in 1993 to 32,000 in 1999, and the authorities have repeatedly registered their grave concern over the increasing sociopolitical disaffection of the rural masses.

[1] This phrase was used by Mao Zedong in 1949 to hail the CCP's rise to power. See the Appendix for more on the modern history of the PRC.

[2] This number includes the nearly 30 million Chinese living in Taiwan and Hong Kong.

[3] SAFEA estimates that one-third of these foreign-educated individuals, or 120,000, are now back in China.

[4] In 1999, the most recent year in which data were collected, the United Nations estimated that 18.8% of the population in China earned less than US$1.00 per day. Assuming a population of 1.3 billion people, the 18.8% translates into nearly 250 million Chinese.

Economic Environment: Boom Overshadows Bankruptcy

Notwithstanding these mounting problems in the rural interior, China's growth rate in the last 20 years has been stunning, with per capita income doubling and doubling again faster than for any other developing country in the past. Official figures for 2001 show that China experienced annual GDP growth of more than 7% compared to 1.2% for the United States and 1.7% for the European Union.[5] As the fastest growing large economy in the world, China has pulled in staggering sums of foreign direct investment (FDI) over the past decade. From 1990 through the end of 2000, China attracted over US$300 billion in FDI,[6] second only to the United States and more than the combined total for the previously adored "Tiger Economies" of Southeast Asia (see Exhibit 7).

WTO. After more than a decade of lobbying for admission to the world's most influential trade organization, on December 11, 2001, China was accepted as the 143rd member of the WTO. Though heralded with great fanfare as the official and irrefutable sign that foreigners, at long last, would be granted full access to the nation's 1.3 billion consumers, some have suggested the short-term impact will be minimal. Nearly all of the pledges made by China pursuant to WTO requirements have been on the agenda of the central government for some time now. The truly significant news is that the country is now committed to a published timetable that 142 potential trading partners have already recorded in their datebooks. Perhaps of greater significance is that for the first time in history, the government and the CCP have committed themselves to play by the rules of the outside world, the rejection of which was a major part of the foundation of both the CCP and the PRC itself. In any case, there is no question that the announcement has and will continue to have a positive effect on investor sentiment even if tangible results are slow in coming.[7]

Public vs. Private. The Chinese economy today consists of two very distinct economies working in parallel—one dominated by inefficient, heavily indebted state-owned enterprises (SOEs) and an agile, commercially minded private sector. Unfortunately, the very existence of the former means the latter will struggle to realize its full potential. The reasons are obvious. State-run banks lend to state-run companies, and private banks have only been sanctioned in recent months. Consequently, commercially motivated loans to small- and medium-sized private businesses in China represent only the tiniest fraction of aggregate bank financing. Moreover, public equity and debt markets are largely off-limits to private enterprises, which are often cash poor and therefore struggle to find external financing to fuel their rapid growth. There is also, of course, the nagging issue of government-subsidized competition. As generating a profit is not the chief concern of the SOE manager and seemingly endless lines of credit are available, prices frequently work their way down below cost and remain there for extended periods of time.

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[5] There is much debate as to the accuracy of the GDP figures for China. Provincial officials rarely, if ever, fail to match or exceed the growth target promulgated by the central government. In fact, in 2001, only one of the individual provinces reported slower growth than the national rate of 7.3%. Other statistics may offer a clue as to the real GDP growth rate. A study published late last year by Thomas Rawski of the University of Pittsburgh shows that while China's GDP officially grew by nearly 25% from 1997 to 2000, energy consumption actually decreased by 12.8%. The two statistics more often than not move in tandem in rapidly developing economies, such as those of Southeast Asia in the early 1990s.

[6] Many believe that the FDI figures quoted for China may be as much as 20% overstated due to "round-tripping." The term refers to a practice whereby domestic Chinese businesses route capital from the Mainland, through Hong Kong, and back to the Mainland in order to take advantage of government incentives offered to foreign investors.

[7] "For all the optimism generated abroad by China's accession to the WTO, foreigners will continue to encounter many obstacles in trying to do business there. The central government may have good intentions, but a myriad local governments will fight tooth and nail to protect their vested interests." *The Economist*, June 15, 2002.

Despite considerable obstacles, the private sector has managed to advance at a phenomenal pace. In a study published in 2000, the International Finance Corporation (IFC) estimated that aggregate production in the private sector increased, on average, by 71% per year from 1991 through 1997. Over this same time period, the IFC suggests employment at private enterprises grew at a rate of 41% annually, estimating that there were more than two million private companies in China by the end of 2001.[8] The sector's development is even more astonishing if one considers that at the time of Mao's death in 1976, there was not a single privately owned business in China, while private enterprise may now account for fully two-thirds of all economic activity.[9] The progress is most apparent in the knowledge-based, services sector, a segment of the economy where SOEs are not prevalent and generally lack the human capital and creativity needed to compete with the more nimble, independent private sector.

Bankrupt SOEs. As mentioned earlier, profitability has never been the primary goal of China's SOEs. Rather, these firms served as the linchpin of a vast social welfare system established as part of a command economy and were designed not only to employ, but also to feed, clothe, and provide medical treatment for their workers. Managers were held to strict production limits, purchased raw materials at government-set prices, and had virtually no control in the area of human resources. Western measures of profitability were entirely irrelevant. This "iron rice bowl" system, or lifetime employment for all Chinese serving the State, created workforces that are two, three, and four times larger than necessary, where job security and wage levels have little or nothing to do with performance or profitability. Moreover, many of the domestic industrial heavyweights use methods of production long since abandoned in the West because of their inefficiency, yet retained access to unlimited lines of credit from state banks whose allocation of capital was predicated on sociopolitical rather than on pure economic considerations.

The predictable result of these practices is insolvency on a massive scale and the proliferation of nonperforming loans (NPLs) in the banking system. To their credit, authorities have addressed the situation as a top priority: from 1989 through July of 2002, the number of SOEs shrunk by 58%, from 102,300 to 42,900.[10] And although most observers agree that much remains to be done before the structural overhaul of China's SOEs is completed, the government appears firmly committed to seeing this process through.

Bankrupt Banks. The relationship between the SOEs and state-run banks alluded to above has created a more immediate problem for the Chinese authorities—the percentage of NPLs on the books of its financial institutions has reached what many consider to be crisis levels. With interest rates set by the State and lending decisions based on anything but the creditworthiness of the borrower, enormous sums of cash have been pumped into moribund businesses with no capacity to repay. Accurate data are difficult to come by, but probably more than 50% of all loans in the financial system are impaired. If based on internationally recognized standards, capital adequacy ratios would likely fall far below the 8% mandated by the Basle Committee on Banking Regulations and Supervisory Practice. In other words, China's banks are technically insolvent.

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[8] Source: *The Wall Street Journal*, November 11, 2002. However, like so many other economic statistics in China, these data are questionable. For example, the *Financial Times* of December 12, 2002, reported that 150,000 SOEs still employ 50 million workers, despite having shed 25 million from 1998-2001.

[9] Source: *China and the WTO* by Supachai Panitchpakdi and Mark L. Clifford.

[10] Source: *The Wall Street Journal*, November 11, 2002.

The central government recently took its first steps in addressing the problem, establishing four asset management companies (AMCs) to aid in the restructuring of the country's four largest state banks.[11] Outstanding loans with a face value totaling US$170 billion were transferred to the AMCs in 1999 and the first asset sales to foreign investors occurred in late 2001.[12] The restructuring exercise is far from over, however, and mismanagement of this problem remains a considerable macroeconomic risk.[13]

Bankrupt Pension Scheme. Unfortunately, the complications created by an army of walking-dead SOEs and an over-extended national banking system do not end there. The resultant capital crunch means that the cushion intended to break the fall of millions of workers displaced by the systematic streamlining of the public sector is very thin indeed. It was recently estimated that the PRC will face unfunded pension liabilities of US$15 billion by 2005 and US$110 billion by 2010.[14] Demographics are working against the government and new sources of capital on this scale are few. Although the government recognizes the gravity of the situation, agreement on how the costs of the system will be defrayed has yet to emerge.

Early Attempts at Venture Capital and Private Equity in China

To know the road ahead, ask those coming back.

The Trailblazers

Foreign financial and strategic investors reintroduced themselves to the Mainland in the early 1990s, after an absence of more than half a century. Multinational industrial concerns led the charge, but private investment partnerships, such as Jack Perkowski's ASIMCO and the billion-dollar AIG Asia Infrastructure Fund, followed shortly thereafter. The refrain among the corporate investors was largely the same: "Imagine the profits if I can just find a way to sell one [*insert your favorite product's name here*] to every person in China!" As it turned out, the profits were just that—imaginary. Mesmerized by the statistics being used to quantify the potential market and with perhaps more bedazzled emotion than sober business scrutiny, many of these pioneers bought into minority positions in joint ventures with SOEs. With control in the hands of their local partners, the foreigners were left to simply hope—*hope* that their partners delivered on promises to contribute labor, land, and equipment; *hope* that management had the necessary skills to run the business; *hope* the domestic market for their goods materialized; and *hope* that when the time came, there would be a way to get their capital out of the country. In nearly every case, these hopes went unrealized.

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[11] The "Big Four", as they are known, include the Bank of China, the Industrial and Commercial Bank of China, China Construction Bank, and the Agricultural Bank of China.

[12] In December of 2001, it was announced that China Huarong Asset Management had completed two distressed assets transactions. The first, purchased by a consortium led by Morgan Stanley, represented US$1.3 billion in bad assets. Goldman Sachs purchased the second parcel of NPLs, which held a face value of US$240 million.

[13] Standard & Poor's estimated in May of 2002 that it would take the "Big Four" at least a decade to reduce their NPL balance to a level of 15% and an additional 11 years before a more sustainable level of 5% could be achieved.

[14] Source: McKinsey & Company.

From 1992 through 1996, the Cambridge Associates Non-Marketable Alternative Assets Database logged a total of 46 investments made by private equity investment vehicles, broadly defined, in China. The performance of these transactions appears in the table below.

PRC INVESTMENTS MADE BY PRIVATE EQUITY PARTNERSHIPS

1992 to 1996

Industry Sector	Number of Transactions	Amount Invested (in US$ millions)	Internal Rate of Return (%)
Industrial	7	352.1	-30.0
Manufacturing	17	91.8	3.2
Construction	6	45.6	-1.5
Retail & Services	8	79.5	-39.9
Transportation	2	16.6	-13.7
Health Care & Biotech	1	13.9	0.0
Chemicals	2	4.6	22.8
Communications	1	4.2	-35.0
Real Estate	1	1.8	9.6
Hardware	1	0.4	-51.1
Totals	**46**	**610.4**	**-12.9**

Notes: Total amount invested does not total due to rounding. Data are as of June 30, 2002.

The Internet Is Universal

As Internet euphoria swept through the Western world during 1997 and 1998, the allure of China's 2.6 billion eyeballs became hard to resist for more than a few venture capital funds. The fact that the central government is strict in its censorship of all forms of media and reliable electricity remains a dream for many rural communities was of little concern. That said, there were some notable differences in the strategies being employed by this new breed of China investors. Internet applications and services were virgin territory to the PRC and lumbering SOEs had little incentive to dedicate much time or energy to the sector. Any research and development in this area was being carried out by professors and ambitious students. By default therefore, investment in the space was confined to privately owned start-ups. With precious few financing alternatives, entrepreneurs were compelled to accept venture capital and the conditions that came along with it—chiefly, relinquishing a fair degree of control to their backers.

Despite the constant threat of government obstruction and the risks associated with being a front-runner in the creation an industry, the period from 1997 through early 2000 gave rise to several phenomenal success stories. With investors' insatiable appetite for anything Internet-related, not only could a U.S.-based, loss-making company with less than 18 months of operating history gain a Nasdaq listing, a *Chinese* company of similar standing had the very same opportunity. For the first time in the 1990s, a realistic exit mechanism was available to foreign private equity investors in the PRC. During these heady days, companies such as AsiaInfo were brought to market, earning their investors attractive returns. Unfortunately, the window of opportunity closed as quickly as it had opened. Nasdaq-listed Chinese companies watched their share prices plummet, liquidity dry up, and research coverage wane. Those that had missed the gold rush soon discovered that the investment bankers fawning over them just weeks earlier were no longer returning phone calls.

From 1997 through 2001, the Cambridge Associates Non-Marketable Alternative Assets Database logged a total of 100 investments made by private equity investment vehicles, broadly defined, in China. The performance of these transactions appears in the table below.

PRC INVESTMENTS MADE BY PRIVATE EQUITY PARTNERSHIPS

1997 to 2001

Industry Sector	Number of Transactions	Amount Invested (in US$ millions)	Internal Rate of Return (%)
Communications	29	190.7	-24.2
Construction	4	185.5	-37.5
Software	**18**	**148.1**	**22.1**
Energy	2	133.4	0.1
Manufacturing	14	122.4	0.7
Retail & Services	16	113.7	-5.4
Electronics	6	27.6	11.7
Health Care & Biotech	4	19.1	-6.6
Transportation	4	16.6	2.5
Hardware	1	12.0	0.0
Other	1	2.5	-100.0
Financial	1	0.5	0.0
Totals	**100**	**972.2**	**-5.5**

Notes: Total amount invested does not total due to rounding. Data are as of June 30, 2002.

The Chinese Venture Capital Market Today

Nearly three years after the bursting of the technology bubble, venture capital is alive and well in the PRC. The government has identified it as a valuable vehicle for developing the nation's burgeoning private sector and a potentially significant creator of jobs. With this awareness has come meaningful capital allocations. Whereas venture capital was previously a foreign-dominated game, an ever-increasing number of indigenous operators now populate the landscape.

Government-Sponsored Initiatives

In May 2002, Ma Dexiu, Director of the High-Tech Industry Department of the State Development Planning Commission and an influential figure in the local venture capital market, reported that China had more than 250 venture capital institutions controlling nearly US$5 billion worth of local money. The bulk of this capital resides in Shenzhen, but Shanghai and Beijing both boast significant sums.[15] Add to this the more than 50 high-tech industrial parks that have sprung up across the country and serve as incubators for the next generation of Chinese entrepreneurs.

The largest of the state-sponsored venture capital funds is Shenzhen Venture Capital, which was incorporated in August of 1999 and has an estimated US$360 million at its disposal. Since its inception, the organization has reportedly committed to 77 transactions that span the PRC. In addition, nearly all of the provinces, a number of the nation's largest financial institutions and even some cash-rich industrial concerns have established venture capital arms in the past several years.

Although it is far too early to pass judgement on this first batch of homegrown venture capital programs, there exists the possibility that many will fall short of the standards that have been set for the asset class in more developed markets, such as the United States and Europe. The individuals leading these projects in China have, for the most part, no formalized training in venture investing. Many come from a domestic banking background, while others come straight from posts within the government. Moreover, these eager investors must find a way to marry the developmental objectives of the central government with generating a positive investment return—a difficult mandate under any circumstance.

Foreign and Foreign-Funded Venture Capital Operators

So far, most of the foreign capital provided to seed- and early-stage Chinese businesses has come from large, regional investment vehicles that commit only a relatively small portion of their capital to Mainland deals. Funds raised by the likes of Warburg Pincus, Baring Private Equity Partners, H&Q Asia Pacific, and Walden International have been active in the territory for a number of years now. Increasingly however, China-focused partnerships are being raised, where substantially all of the capital is dedicated to opportunities in the PRC. Some firms following this strategy include Chengwei Ventures, Fortune Venture Investments Group, and NewMargin Ventures. Through the first six months of 2002, venture capitalists invested US$545 million in companies throughout the Asia Pacific region excluding Japan. The most popular destination for this capital was China, which accounted for US$114 million, or 21%, of the total.[16]

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[15] On June 14, 2002 China's *People's Daily* newspaper reported that the Shenzhen-based venture capital pool had reached US$1.21 billion, more than the combined total of Beijing and Shanghai, US$605 million and US$484 million, respectively.

[16] Source: Thomson Financial/Venture Economics.

Corporate Investors

A third noteworthy category of venture capital providers in China is the direct investment arms of large, multinational corporations such as Intel, Acer, Cisco Systems, and Alcatel. In April 2002, Alcatel announced that it was forming a joint venture investment vehicle with NewMargin Ventures to provide seed capital to Chinese start-ups engaged in researching wireless infrastructure, optic technology, and next-generation networks. The deal is the first of its kind in China. It appears that well-known domestic technology companies are also interested in joining the party. In 2001, Legend Computer Group launched Legend Capital, a venture capital subsidiary that raised US$30 million for its first fund and is currently in the market seeking capital commitments of US$100 million for Legend Capital-Chinaway II.

Fund Strategies for Addressing the Opportunity

Geographical Differentiation

Although the areas initially likely to develop into centers of venture capital activity are concentrated on the east coast, China is a vast country, and it would be naïve to assume homogeneity in what is already a diverse opportunity set.

Shenzhen. Shenzhen, located in Guangdong province, bordering Hong Kong, represents a carefully orchestrated experiment by the central government in bringing capitalism to China—one that has met with great success. As a result, the city and surrounding province may become the model for the broader Chinese economy over the coming decades. With the expertise of Hong Kong and Taiwanese managers, and an abundance of high-quality, low-cost labor, Shenzhen has fashioned itself as a major export-manufacturing center. Serving as the poster child for those who envision China becoming "the workshop of the world," Shenzhen manufactures nearly any labor-intensive product requiring precision assembly—from toys for toddlers to components for cutting-edge consumer electronics.

Importantly, however, the real opportunity in China is *not* primarily that of an export economy based on cheap labor. Although it is certainly true that China is well on the way to becoming the world's factory for manufactured goods, that is yesterday's story. Those foreign companies that have been successful in China—and there are many success stories to offset the conspicuous failures—have been selling their goods to urban Chinese consumers, whose disposable income has been rapidly rising. As *The New York Times* of January 5 noted, the Chinese already buy more cellphones than anyone else in the world, as many cars as the Germans, more film than the Japanese, and so on. Indeed, the Asian investment story in general—but China in particular—is the growth of *domestic* demand for goods and services, not the further development of export industries.

Owing to its proximity to Hong Kong, some observers have characterized Shenzhen as having an opportunistic, quick-flip mentality, where "long-term" may mean six months rather than six years. Investors and entrepreneurs alike run the risk of being unduly influenced by flavor of the month mentality, and at times show more flare for fund-raising and marketing than building a lasting business. The criticism is likely overdone when applied to the investment community as a whole, but there is no doubt that the city has been built around fast-moving traders able to change course on a moment's notice.

Shanghai. During the lull between the two World Wars, Shanghai was the second busiest port on Earth. The effort to re-establish the city as Asia's preeminent commercial hub has been some years in the making and remains a primary, if largely unspoken, goal of the government. Shanghai is the site of the nation's primary stock exchange (the other being Shenzhen), which was launched in 1990 and is fast becoming China's financial epicenter. Hometown of many influential Party leaders, including President Jiang Zemin, the city enjoys a certain amount of preferential treatment from Beijing. Capitalism has been allowed to flourish. The city is a bastion of private enterprise and is attracting overseas returnees and young Taiwanese in great numbers.

It is difficult to point to any one sector that is driving the development of Shanghai. According to figures published in the *People's Daily*, some 176 new private businesses are born every day. The same report holds that more than half of all businesses in Shanghai today are privately owned, with more than 3,000 of these having registered capital over US$1.2 million and 134 boasting registered capital of more than US$12 million. As a result, a number of venture capital funds sense that Shanghai represents the most appealing environment for investment at the moment. Local entrepreneurs are perceived as having superior execution skills, in addition to a better overall understanding of, and appreciation for, the role of private equity.

Beijing. Beijing is home to Zhongguancun, a bustling neighborhood that is the site of some of the nation's best universities and the Chinese government's designated high-technology industrial zone. Situated northwest of central Beijing, Zhongguancun serves as a headquarters for Internet start-ups and established Chinese computer and telecommunications companies alike. Local icons such as Legend Computer Systems, Founder Computer Systems, and Huawei Technology all call Zhongguancun home. It is no surprise, therefore, that information technology, in all its forms, is the primary focus of venture capitalists operating in Beijing.

A fertile base of technically inclined students, brilliant faculty, and the potential for spin-offs/outs (individuals or business units) means that there is ample supply of, and equally high demand for, venture financing. However, several market participants have noted that much of the technical research and development conducted in Beijing is predominantly academic and experimental and that viable commercial applications may be many years off. These investors have also suggested that the entrepreneurs are often scientists at heart and have little, if any, operational, marketing, or employee relations skills—they may be long on enthusiasm and technology, but short on more mundane, but equally critical subjects like accounting and corporate governance.

Industry Focus

Outsource Manufacturing. Of all the industries highlighted in this section, outsource manufacturing and the related investment thesis probably requires the least explanation. With its combination of inexpensive land and low-cost, yet highly skilled labor, China is a manufacturing Nirvana of sorts. Hong Kong and Taiwanese entrepreneurs have been moving their production facilities to the Mainland for over a decade, reaping significant cost savings and expanding margins. Today, China has reached the point where it is able to compete not only on the basis of price, but also increasingly with respect to quality. PRC-based manufacturers are steadily moving up the value chain and have already reached a point that is making even one of the most protectionist nations in the region, Japan, explore previously improbable Sino-Japanese alliances.

Technology exports, in particular, are seeing remarkable growth. China's Ministry of Foreign Trade and Economic Cooperation (MOFTEC) released figures showing a 25.4% rise in high-technology exports in 2001, taking the total dollar value of such trade to nearly US$50 billion. The statistics also show that high-technology exports accounted for a full 17.5% of aggregate export volume in 2001, 2.5 percentage points higher than in 2000. Interesting to note, MOFTEC also reported that roughly 87% of all high-technology exports were manufactured along the coastal areas of China, including Guandong (Shenzhen), Shanghai, and Beijing.

Of even greater importance to international venture capital providers is the fact that foreign-funded businesses are playing a major role in the sector. The Shanghai Municipal Foreign Trade and Economic Cooperation Commission announced in June that overseas-funded enterprises exported just over US$7 billion year-to-date through May 31, 2002, which equates to approximately 60% of the city's total exports. Further, the Commission stated that foreign-funded exporters have reported annual growth rates north of 50% since 1998.[17]

Information Technology. The domestic IT market is booming and the opportunities cited by venture capitalists in this sector wide-ranging. The drive to modernize Chinese businesses means that all manner of information systems will require upgrading. A prime example of this is the Chinese banking sector. In preparation for the WTO-related foreign competition on the horizon, a recent report shows that Chinese banks anticipate more than doubling their 2001 spending levels on IT infrastructure by 2005, to US$10.5 billion. This same report claimed that 31% of all bank branches in China currently lack information technology of any kind.

In terms of hardware, China is presently the third largest market for personal computers, trailing only Japan and the United States; and many analysts believe China will overtake Japan when the 2002 figures are released and assume the top position within five years. The integrated circuit industry is also witnessing a surge in investment. Semiconductor Manufacturing International Corporation, better known as SMIC, received a whopping US$1.5 billion from private investors in 2001 to construct one of the largest wafer fabrication facilities on the planet. This sum included a US$50 million commitment from regional private equity house H&Q Asia Pacific. The new complex, located in the Pudong New Area of Shanghai, will consist of a total of six "Fabs" when completed. SMIC's interim goal is to produce upwards of 45,000 wafers per month from Fab 1 alone by June of 2003.

The prospects for software and Internet-related businesses appear no less compelling. A study published by Nielsen/NetRatings in April of 2002 showed that some 56.6 million Chinese are using the Internet from their place of residence, making it the world's second largest nation in terms of home Internet users. Further, statistics from the Chinese Ministry of Information Industry demonstrate that this figure is compounding at a rate somewhere between 5% to 6% *a month*.[18] While

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[17] The Commission also made public the year-on-year growth rates for the export of three key technology segments through the first five months of 2002: integrated circuits and micro-electronic parts, 57%; mobile phones, 108%; and parts for automatic data processing equipment, 364%.

[18] Nasdaq-listed Sohu.com, one of China's three major portals, posted a profit in the third quarter of 2002 after generating nearly US$8 million in revenue. Of note, more than half the revenue came from non-advertising services.

e-commerce and online-banking applications have yet to gain much traction, this is likely to change. Microsoft provided some indication of the potential of the software market in June of 2002 when it signed a memorandum of understanding with China's State Development Planning Commission that included a pledge to invest roughly US$750 million in the sector over the next three years.

Consumer Goods and Services. In a market hypersensitive to price and prone to imitation goods, one must expect the task of brand building to be an uphill battle. Few companies in China—foreign or domestic—have managed to earn the lasting loyalty of local consumers en masse and in the process, establish a brand name with any identifiable value. Many observers, however, sense that the rising standard of living along the east coast is contributing to a growing culture of consumerism in China. The Chinese middle class can now afford to be more style and quality conscious than in the past and is increasingly willing to spend a bit extra for a recognizable product. The 2008 Olympics in Beijing will provide many companies with yet another reason to plaster their names on everything from taxicabs to soft drink cans over the next several years. Licensing foreign brands for local production and sale and the creation of homegrown trademarks may prove equally attractive strategies.

Transportation and Logistics. As the ranks of the middle class swell and their appetite for everything from luxury automobiles to Starbucks coffee grows, the business of getting goods to market in a cost effective and rapid fashion becomes ever more important. Although improving, the existing transportation system is slow, inflexible, and unreliable. Logistics providers with modern warehouses, strong IT support systems, and a willingness to accommodate specific customer requirements can expect to see increasing demand for their services. Taken on its own, the market catering to domestic businesses manufacturing product for export or local distribution is substantial and primed to expand. Add the obvious complementary business of importation and delivery of foreign goods and opportunity doubles.

Shanghai ranks as one of the busiest ports in the world, handling a record 125 million tons of cargo in the first six months of 2002, a 17.2% year-on-year increase. There are an estimated 1,170 container liners sailing in and out of Shanghai alone every month. To put this figure in context, Hong Kong port, which frequently holds the top spot in terms of annual container traffic, averaged monthly arrivals of 1,507 in 2002.[19] China's total goods imports and exports reached US$510 billion in 2001, earning it the sixth position on the register of global trade, surpassed only by the United States, Germany, Japan, France, and the United Kingdom.

Health Care and Life Sciences. The domestic health care industry is in the very early stages of a massive restructuring. Whereas the State bore sole responsibility for its citizens' health care needs in the past, the goal of the new system will be for such costs to be shared jointly by the government, employers, and employees. At this point, it is difficult to forecast the course and ultimate product of these reforms and investors should exercise substantial caution when wading into the sector.

[19] Data through June 30, 2002.

Another segment of the health care industry that venture capital practitioners have expressed an interest in is pharmaceuticals. Given the sheer size of the Chinese population, its increasing age and the mounting wealth of the coastal areas, some feel branded medicines hold significant promise. Local production is cost effective and of a quality approaching the standards set in the developed nations of the West. The complicating factors here, however, are similar to those of the consumer goods market, with the addition of strict government regulations on pricing. Copycats run rampant and the Chinese are skilled in the art of reverse engineering.[20] Morgan Stanley estimates that there were more than 6,000 drugmakers operating in China in 2001 compared to approximately 200 in the United States.

Telecommunications Equipment and Services. Two decades ago, the Chinese telecommunications industry was controlled by the Ministry of Posts and Telecommunications via China Telecom and a home phone was a privilege to be granted based on bureaucratic rank. Since then, China Telecom has been broken up into four separate companies and is confronting true competition for the first time. China is not immune to the issues plaguing the telecommunications industry globally,[21] and as such, institutional investors should be wary of funds relying heavily on the sector. However, there are some bright spots.

Last year, China surpassed the United States to become the world's largest market for mobile phones. Motorola recorded China sales of US$4.9 billion in 2001 and recently announced it expects to source US$10 billion worth of equipment and services in the PRC by 2006. Siemens AG's mobile phone division announced in July of 2002 that it was moving its Asia Pacific headquarters to Shanghai, the first of the major industry players to do so. Others will probably follow. While this continues to be a sensitive sector vis-à-vis the Chinese authorities, the growth of the market is undeniable.

To illustrate the sort of private telecommunications businesses being backed by foreign venture capital funds, we offer the story of a Beijing-based wireless Internet applications and services provider. The former chief of Motorola's wireless Internet group in China founded the company in April of 2000. Today, the business employs approximately 80 people, and has successfully negotiated contracts with prestigious clients such as China Mobile and China Unicom. The operation was a classic start-up. While at Motorola the entrepreneur identified a niche in the Chinese market and decided to strike out on his own. After securing approximately US$4 million from a group of local angel investors, a small team of engineers set about developing products. A regional private equity fund and the direct investment arm of the Economic Development Board of Singapore discovered the fledgling enterprise and provided US$15 million as part of a second financing round in October of 2000. Today, the company boasts a customer base that spans five Chinese provinces and has signed strategic alliances or cooperative agreements with the likes of Ericsson, Motorola, Nortel, and Legend.

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[20] One such example involves Pfizer's popular Viagra drug. According to an unconfirmed report carried in the *Shanghai Evening News* in January of 2001, the Shanghai Drug Administration stated that 99% of the Viagra pills being sold in the city were fakes.

[21] For more information on the current investment environment in the telecom industry, please refer to Cambridge Associates' 2002 research report entitled *Telecom Investing: Focus On Non-Marketable Strategies*.

Impediments to Venture Capital Investing in China

It is no secret that China is an extraordinarily difficult place for foreigners to do business, and venture capital enjoys no special exemption. Highlighted below are the major obstacles facing foreign and foreign-backed venture capital practitioners in China today. We stress that the list below applies only to this very moment in time as the central government has the ability to dramatically modify the rules of the game overnight should it see fit. Nevertheless, there is reason to believe that the list of complicating factors will shrink over the coming three to five years as WTO reforms are implemented and the gradual process of economic and financial modernization progresses.

Government Restrictions on Foreign Investment

On April 1, 2002, the latest version of the *Regulations for Guiding Foreign Investment* and the new *Catalog for Guiding Foreign Investments in Industries* went into effect. Foreign-invested projects, which include private equity transactions made by offshore and local, but foreign-capitalized vehicles, are divided into four categories: those being *encouraged, permitted, restricted,* or *prohibited*. Unfortunately, the register of projects that fall under the *restricted* and *prohibited* classifications is not a short one. There is, however, a silver lining to the latest release: the number of industries being *encouraged* has grown from the original 186 to 262 and those being *restricted* has shrunk from 112 to 75. Two notable additions to the *encouraged* category include integrated circuits design and software development and production.

Perhaps even more vexing for foreign investors than the restrictions themselves are the ambiguities created by vague terms used throughout the documents. Although some directives are worded in such a way as to provide meaningful guidelines for investors, others leave substantial room for interpretation. One such example is the formerly prohibited, now restricted, business of operating and managing telecommunications services. Investment managers must, for that reason, tread lightly in business segments yet to be definitively categorized. Simply consummating a transaction does not necessarily guarantee the legality of the arrangement. Should an emergent, and therefore loosely regulated, industry draw unwanted attention from the State (as the Internet did in 1997 and 1998), venture capital investors can see months of hard work and millions of dollars in committed capital vanish overnight.

Lack of Transparency

China remains an opaque environment in which to operate, where corporate governance and shareholder rights are concepts only now beginning to be discussed with any sincerity. Due diligence is a time-consuming process fraught with countless opportunities for oversight. Accounting practices vary widely within the country, much less in relation to internationally accepted standards. Further, given the fact that venture capital is a relatively new phenomenon, Chinese entrepreneurs typically fail to understand why it is necessary to provide precise data on the financial standing of their business and some, at least initially, balk at doing so. In the most extreme cases, management may elect to "cook the books," committing outright fraud. However, we hasten to point out that contrary to popular opinion, the Chinese have not cornered the market in unscrupulous business practices—any lingering doubt on that count should have been wiped out along with the retirement savings of former Enron employees.

Just as company-specific data can be hard to come by, so too are accurate statistics on the macroeconomy or any subset thereof. Venture capital investors cannot rely on entrepreneurs to furnish such data and third-party service providers derive estimates based upon many of the same suspect figures published by government agencies that are available to everyone. Unable to quantify the size of a potential market, some investors have elected to substitute comparable percentages taken from the United States or Europe, which almost without fail, produce overly optimistic projections in the short term (i.e., the seven- to ten-year life of most funds).

Lack of Management Talent

Historically, finding visionary entrepreneurs with the requisite management skills to realize their dream has been a significant challenge for investors. While venture capital funds can provide cash, operational advice, and sales contacts, the burden of executing the business plan falls squarely on management's shoulders. The Chinese educational system has never focused on developing professional business leaders. The School of Management at Fudan University in Shanghai, which received approval to offer MBA education in 1991 and remains one of the largest such programs in China, has graduated fewer than 1,000 students to date; hardly enough to support the deluge of private enterprises that has sprung up over the preceding decade. As more and more overseas returnees with Western education and work experience land in Shanghai, Beijing, and Shenzhen, the human resources constraint becomes less of a factor.

Shifting Regulatory Environment

The hand of the government is a ubiquitous force in Chinese business life and the nation is some way off from plausibly advertising itself as a rules-based environment in which public and private enterprises stand on equal footing. WTO ascension and the obligations associated with it represent a momentous step in the right direction, however. To gain membership in the global trade body, China has promised to enforce *uniform* trade-related laws in an *impartial* and *transparent* manner. Further, the central government has sworn not only to refrain from discriminating against foreign companies, but equally important, to prohibit special treatment for Chinese companies.

That being said, it is unlikely that the authorities will open the agricultural sector to the depredations of foreign competition (what country does?), or that local governments will abandon the imposition of the unauthorized fees and regulatory impediments they employ to protect local producers. Fortunately, venture capital investors are principally focused on opportunities arising in and around Shenzhen, Shanghai, and Beijing—three of the most progressive regions in China, where public officials would find it difficult to openly defy national directives for long.

Unpredictable Legal System

The Chinese judiciary system operates in a manner unfamiliar to Western world, and has been a source of frustration and resentment in the past. Critics contend that a nontrivial percentage of PRC judges are ex-military officials who are provided with only the most basic legal training and consider it their primary function to protect the interests of the State. Of late, senior members of the CCP have spoken on the need to establish rule of law, but reforms have been slow to materialize. Property rights, of the physical and intellectual varieties, are not adequately protected. Patent violations are rarely, if ever, enforced. The International Intellectual Property Alliance, a private-sector coalition based in Washington, DC, estimated in

2000 that 91% of all software running on computers in China had been pirated. In cases where fraud has been committed by either management or fellow investors, foreign capital providers will find little recourse available locally. As a consequence, many foreign investors in China have chosen to structure local transactions in a way that ensures any dispute as to terms be settled in an offshore jurisdiction. Even when such cases are won, enforcing the terms of the verdict may prove impossible.

Exits

The fundamental problem with venture capital investing in China is the absence of clearly defined and well-traveled exit routes. It may be increasingly easy to inject foreign capital into a Chinese enterprise, but how does one go about recovering that investment and any capital appreciation that has occurred? Below, we examine the complicating factors associated with the three principal methods employed by venture investors in more developed markets—public stock offerings, trade sales, and recapitalizations.

Initial Public Offerings (IPOs). The price-to-earnings (P/E) multiples of the Chinese stock markets are the stuff venture capitalists' dreams are made of. As of the end of November 2002, the average P/E ratio of the A-share markets in Shenzhen and Shanghai stood at 40.1 and 36.5 times, respectively. Unfortunately, the local bourses, for several reasons, are not currently a realistic exit route for foreign-backed, privately owned companies (although this may change).

Until recently, China followed a strict quota system with respect to IPOs. For the SOEs, the selection process was murky, involving a substantial amount of provincial politics. The prospects for privately held businesses were far more certain—under no circumstances would they be among the chosen few. Since abandoning the system, Chinese-owned private sector companies have made their way to the exchanges, but in exceptionally small numbers. Of the more than 1,200 companies listed in either Shanghai or Shenzhen, only a small fraction represents privately owned businesses. Technically, it is possible for a foreign-invested, private firm to gain approval for a public share issuance, but in practice, the regulatory body responsible for such approvals has made it understood that they are in no rush to do so. Furthermore, with the breakdown of the quota system and a more liberal IPO authorization process, the backlog of firms now waiting their turn is estimated to be in the hundreds. Assuming the government initiated an IPO a week from this point forward, which seems improbable, the logjam would still take years to clear.

Even when foreign-invested enterprises do eventually gain access to the domestic equity markets, as the policy direction appears to be moving, regulations require that the shares issued to company founders, which includes venture capital providers, be held for a period of three years. Upon the expiration of the lock-up, these so-called "promoter" shares, which account for a significant portion of all outstanding stock in China, are still not free to trade on the open market.

Given this prohibitively restrictive environment, venture capitalists have rightly turned to overseas equity markets for realizations—namely, the Nasdaq and Hong Kong. As mentioned earlier, this route proved itself effective in the late 1990s, but has produced mixed results more recently. The finicky Nasdaq aside, markets closer to home for China offer substantially less liquidity than venture investors might hope for. An IPO on Hong Kong's Growth Enterprise Market, for example, may be a psychological victory, but with three-figure daily trading volumes, these exits tend to be largely symbolic.

For some time now, there have been discussions at the highest levels in China of establishing a second board stock market in Shenzhen that would offer relaxed listing requirements and presumably cater to the type of technology start-ups being backed by foreign venture capital. Officials continue to drag their feet, however, wary of the regulatory hassle such an exchange would undoubtedly present and concerned a second board might divert capital that would otherwise be available to absorb the sale of government stakes in SOEs. Venture capitalists and their backers should not expect such an exchange to materialize in the near future.

Trade Sales. A second liquidity option, of course, is for the venture-backed company to be acquired by a strategic buyer. To date, overseas corporations simply have not shown much of an appetite for this type of transaction, preferring either to sell the licensing rights to their product to a domestic distributor or go it alone and establish representative offices led by expatriates. This pattern, however, is simply a reflection of the fact that privately owned, professionally run businesses in China are relatively scarce. Attractive targets are few and far between. There is every reason to expect that if the seeds being planted today by venture investors begin to bear fruit, companies overseas will view acquisitions as an attractive way to quickly establish a presence in the PRC. We are seeing early signs of this in the technology sector. For example, on March 18, 2002, eBay, the Internet auction site, announced it was paying US$30 million for a 33% stake in EachNet, a Chinese-language e-business pursuing a similar model.[22] Domestic suitors have yet to materialize en masse either, although this is expected to change as Chinese businesses reposition themselves to compete better in a post-WTO environment.

Recapitalizations. As stated previously, domestic Chinese banks, for all practical purposes, have restricted their lending to SOEs. With limited experience in Western-style credit analysis, implicit instructions from the central government to provide capital to state-run businesses on demand, and dreadful balance sheets, it is doubtful their lending practices will change over the short term. Therefore, extracting cash from a portfolio company by taking on debt issued by domestic institutions is not a realistic option for the venture capital community. As foreign financial institutions move into the Mainland pursuant to the implementation of WTO reforms, foreign-invested Chinese companies may eventually be able to secure sizable loans from these organizations. At present, however, foreign financial institutions are unable to offer yuan-denominated banking services to local individuals and enterprises, and indications are that their ability to do so will be restricted for many years to come.

Repatriation of Capital

To this day, China maintains a closed capital account and full convertibility of the local currency, the *renminbi*, is not likely to occur for a number of years. Foreign entities have found ways, both legal and not necessarily illegal, to repatriate capital earned in the PRC, but the official process can be cumbersome and fickle. Foreign investors have typically sought to avoid the currency issue by structuring their investments as offshore, special-purpose vehicles and exiting companies via foreign markets.

[22] Shao Yi Bo and Tan Hai Yin founded Shanghai-based EachNet in 1999, shortly after they graduated from Harvard Business School.

Keys to Success

If you must play, decide on three things at the start:
the rules of the game, the stakes, and the quitting time.

One might expect that after hundreds of years of trial and error, a formula for successful foreign direct investment in China would have emerged. This is simply not the case. There is no roadmap for venture capital funds to follow on the Mainland. In many ways, the strategies being pursued today have never before been applied to the Chinese market, and at this stage, it is impossible to point to any one approach destined to deliver superior results. More likely, several methods of addressing the opportunity will prove successful, albeit to varying degrees. What follows is a series of fundamental characteristics we believe one should be looking for when evaluating venture capital vehicles targeting the PRC.

Local Market Understanding

Experience is a comb which nature gives to men once they are bald.

Foreign venture capital practitioners parachuting into China with a Silicon Valley investment model are destined to fail. Whereas it is, in fact, beneficial to be perceived as an outsider in some corners of the Asian private equity world—namely the business of buying and resolving NPLs—locals certainly have a leg up when it comes to venture investing in China. Personal relationships matter a great deal. Chinese use the term *guanxi* to describe the informal network of connections one relies on to, among other things, open doors, negotiate attractive terms, and facilitate government approval when necessary. Although occasionally given more weight than it deserves, earning the respect of key figures early on can significantly reduce the amount of time and money required to accomplish tasks—large and small—down the road.

Equally crucial is that venture investors are able to interpret and react appropriately to government directives and intuit the general direction of public policy. The capacity to understand what is being said—and more importantly, what is not—is indispensable in China. Such skills are directly applicable to evaluating potential investment partners and clearly understanding the motivation and intentions of others involved in a transaction.

Hands-On Approach

A man who waits for roast duck to fly into his mouth must wait a very, very long time.

China is not a country for passive investors. Venture capitalists must be willing to role up their sleeves and actively participate in the day-to-day affairs of their portfolio companies. Green management teams require constant coaching and encouragement. For export-oriented companies, unlike their Indian and Israeli counterparts, local Chinese entrepreneurs lack even the most basic knowledge of international distribution channels and marketing techniques. Even those businesses dedicated to serving the local market often need a navigator able to avoid regulatory pitfalls and commercial missteps in what is an intensely competitive environment.

Financial supervision, on a level unfamiliar to most private equity players in more developed markets, is an absolute must. In many cases, outside investors insist upon being granted the right to staff the CFO position with the individual of their choosing as a precondition to investing. Once fraud is identified, it is generally too late to remedy the situation in a constructive way. The domestic judiciary offers little opportunity for recourse. Illustratively, one investment manager shared the story of a food and beverage business in which their fund had invested. After nearly a year of operation, the company seemed to be faring quite well. Lines in the outlets were long and the brand appeared to be gaining a foothold in the local market. Somewhat puzzling, however, was the fact that cash register receipts were significantly lower than estimated from sales. Following a series of in-store inspections, the investor discovered that employees were systematically raiding the registers and pocketing a nontrivial proportion of store revenues. New management was installed immediately, but the damage had been done and valuable and expensive time lost.

Alignment of Interests

Venture capital practitioners and industry observers regularly lecture on the importance of gaining a control position, or at the very least, a minority stake of influence. In China, as we would argue holds true elsewhere in Asia, financial control can indeed be helpful, but is not necessarily the key determinant of successful ventures. A majority position and board representation are of no value if the interests of the management team are not fully aligned with those of the shareholders. This has been a particularly challenging exercise for venture investors in China. Stock option schemes have only recently been introduced and employees tend to be skeptical of the arrangement—for good reason. Cash in hand is viewed as far more desirable than a promissory note entitling them to a share of a distant liquidation event that has come to pass for only a handful of Chinese start-ups. Given this justified, if somewhat discouraging lack of confidence, investors must show a degree of creativity in structuring compensation packages that provide constant motivation for key staff. Milestone payments, awarded if and when operational or financial objectives are met, are being promoted as a possible solution to this critical issue.

Focus on Private Sector

Once on a tiger's back, it is hard to alight.

Private enterprise is and will continue to be the primary driver of China's economic development. The spirit of capitalism, which the CCP did its best to stamp out earlier this century, has survived within millions and is flourishing along coastal China. Emboldened by success stories such as Edward Tian, founder of AsiaInfo and current president of China Netcom, a new generation of determined entrepreneurs is in desperate need of funding and guidance. The repatriation of thousands of Western-trained Chinese is a very real and very positive trend that is likely to continue. Both the nation's current and projected leaders are strong proponents of a more market-driven economy, and WTO reforms, while they are going to take some time to materialize, will have a meaningful impact. As the SOE restructuring process advances, shining the light on an increasing number of bankrupt businesses, the value generated by the private sector can only become that much more obvious to even the most devoted anti-capitalists.

Disciplined Pricing

The single most effective way to limit the amount of risk associated with any investment is to buy in at a low valuation. This is especially true when applied to venture capital investing in China, where a great number of things are beyond even the most skilled manager's control. Given the recent surge in attention, valuations for private Chinese enterprises have risen across all stages. Savvy local entrepreneurs are well aware of the problems plaguing Southeast Asia, India, and Japan, and recognize they are being held out as "the next big thing" in Asian private equity. This is beginning to translate into a significant "China premium." In order to justify more modest pricing, foreign and foreign-backed venture capitalists need to demonstrate, in an unambiguous fashion, how they intend to add value to the business. Such value-added may include opening the door to a previously inaccessible sales network (domestic or overseas), the implementation of a more efficient organizational structure, or securing licensing contracts for existing Western technologies.

The upward pressure on prices is not the result of external forces alone however; domestic players are having an impact as well. The pool of capital at the disposal of government-funded venture operators and Chinese corporate investors is significant, likely to grow, and a source of real concern. A general lack of private equity experience coupled with return expectations that are not necessarily in line with those of foreign counterparts means that competitive bid situations involving these groups are best avoided. Exclusively negotiated transactions, as always, offer a far more attractive investment route.

Map Out an Exit

A sly rabbit will have three openings to its den.

As a result of the especially challenging exit environment facing private equity investors in China, prudent venture capital fund managers begin mapping out liquidation strategies prior to committing a single dollar to any transaction. Some have gone so far as to structure an exit mechanism into the initial investment agreement. In these cases, the fund seeks to identify a strategic investor willing to jointly take up the deal from the outset and sign a contract stipulating the timing and pricing of an eventual buyout. Assuming the multiple agreed upon reasonably compensates the fund for the time, effort, and risk involved, this may be a sensible model for the China market. However, we are somewhat skeptical that the predetermined pricing accurately reflects the market value of these companies at the time of sale and would be concerned if a fund were relying heavily on this style of realizing investments.

Traditional trade sales to foreign strategic buyers are expected to be the preferred mode of realization for most venture capital funds operating in China going forward. As the regional stock markets deepen and liquidity improves, initial public offerings may become a more realistic alternative in the future. However, at present only a select group of Chinese businesses can be expected to achieve U.S. listings via the Nasdaq and the domestic exchanges should not even be factored into the discussion at this time. In short, exits will continue to be a major hurdle for venture capital in China, but one that can be cleared by farsighted investors.

Summary

When you want to test the depth of a stream, do not use both feet.

Despite its history of broken promises and general mistreatment of foreign investors, the Chinese government appears increasingly and convincingly dedicated to broad economic reform via the continuation of existing programs and the implementation of WTO commitments as a means to push through its agenda. The domestic venture capital industry is in the very earliest stages of development, but officials have recognized its potential to positively impact the budding private sector and seem enthusiastic to support its expansion. Consequently, there is good reason to believe that the regulatory framework for venture investing will only improve given time. In June of 2002, the China Venture Capital Association (CVCA) was formally launched with 38 founding members, including well-known names such as Baring Private Equity Partners, Newbridge Capital, and Warburg Pincus. The coalition hopes to influence policymakers by way of frank discourse on the market impediments discussed above. The creation of the CVCA is an encouraging event and the exchange of ideas the Association's work intends to generate will benefit all involved.

The obstacles facing foreign venture capital funds in China are material and will not disappear overnight. The difficulty associated with achieving profitable exits is of paramount concern and prospective investors need to spend a great deal of time discussing this issue with venture fund managers. On that point, however, we are cautiously optimistic that seasoned venture capital teams will find innovative ways of extracting value from their portfolio companies and passing on the fruits of their creativity and perseverance to investors. While the challenges are great, so too are the opportunities. Each of the industry-specific investment theses discussed in this report has the potential to deliver outsized returns to investors. Some, such as the outsource manufacturing theme, have already proven successful for private equity investors. In other cases, such as a number of telecom-related services, it is too early to forecast the end result.

As noted above, there are a number of venture capital practitioners who have been active in Asia, and specifically the PRC, for many years. Meaningful China-only track records are difficult to come by, however, and ultimately, the manager selection process will rely heavily on qualitative analysis. Moreover, prospective investors may need to redefine the concept of "track record," stretching it to include not just the number of deals done and the internal rates of return generated, but also mistakes made, lessons learned, and stages of strategy and China-specific business savy refinement.

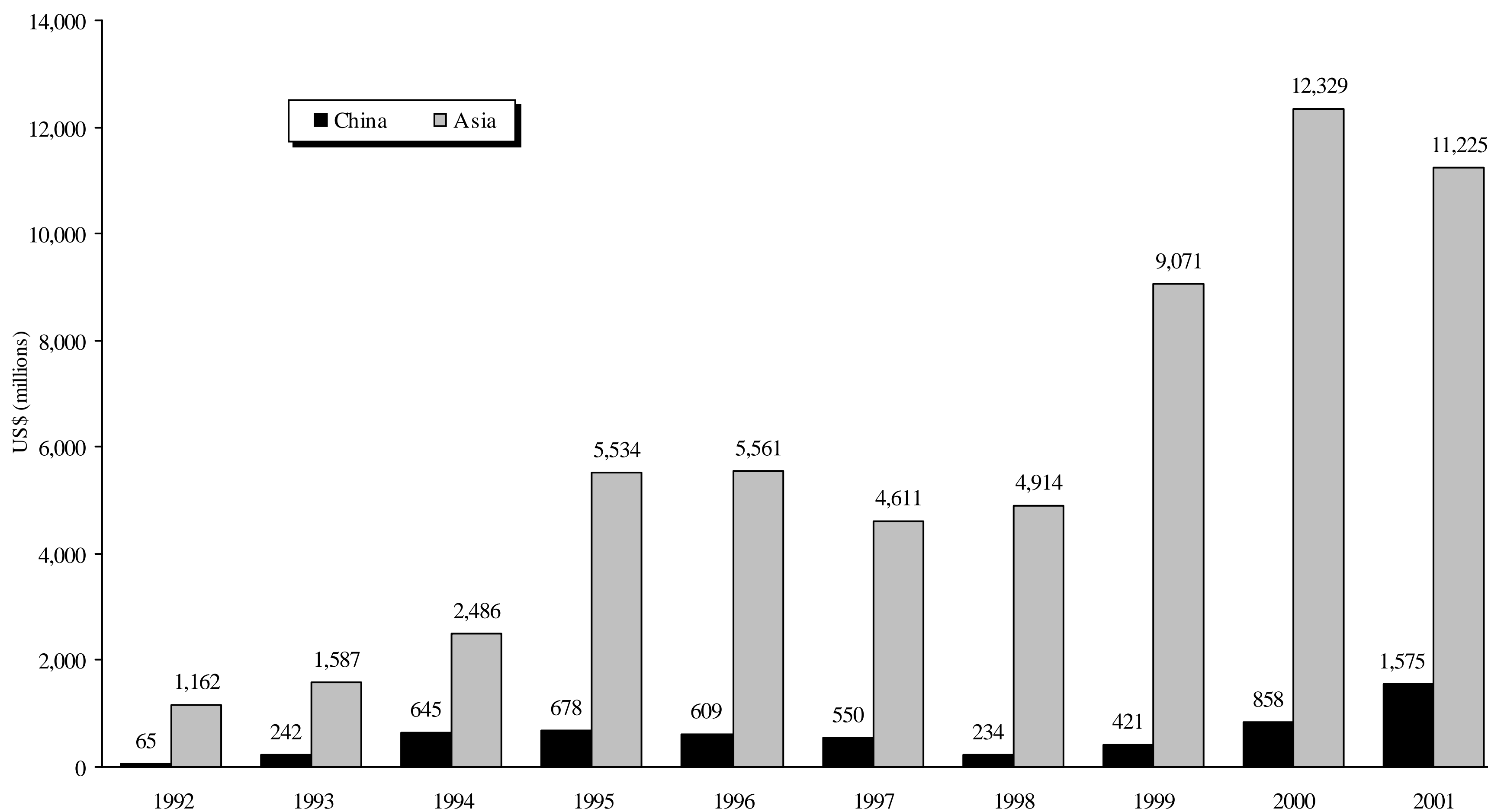
In short, although the PRC provides some compelling venture capital opportunities, a myriad of potential pitfalls remain and only institutions with sizeable, globally diversified private equity programs should consider an experimental allocation at this time. Most investors should take a wait-and-see attitude and need not rush in to China for fear of missing out on a gold rush.

EXHIBITS

Exhibit 1

ANNUAL PRIVATE EQUITY INVESTMENT IN ASIA (INCLUDING JAPAN) VERSUS CHINA

1992-2001

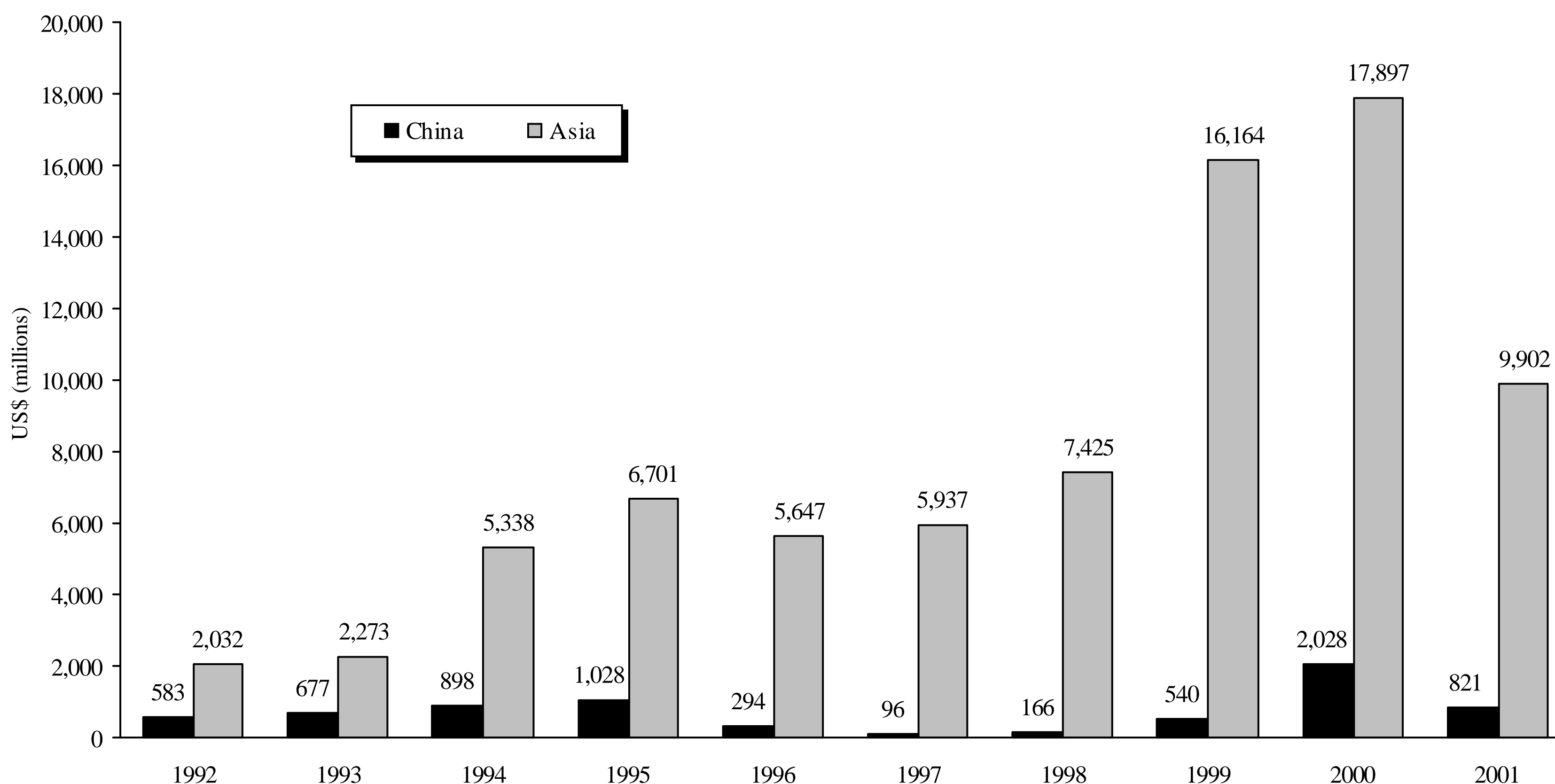


Source: *Asian Venture Capital Journal.*

Exhibit 2

NEW PRIVATE EQUITY FUNDS RAISED IN ASIA (INCLUDING JAPAN) VERSUS CHINA

1992-2001



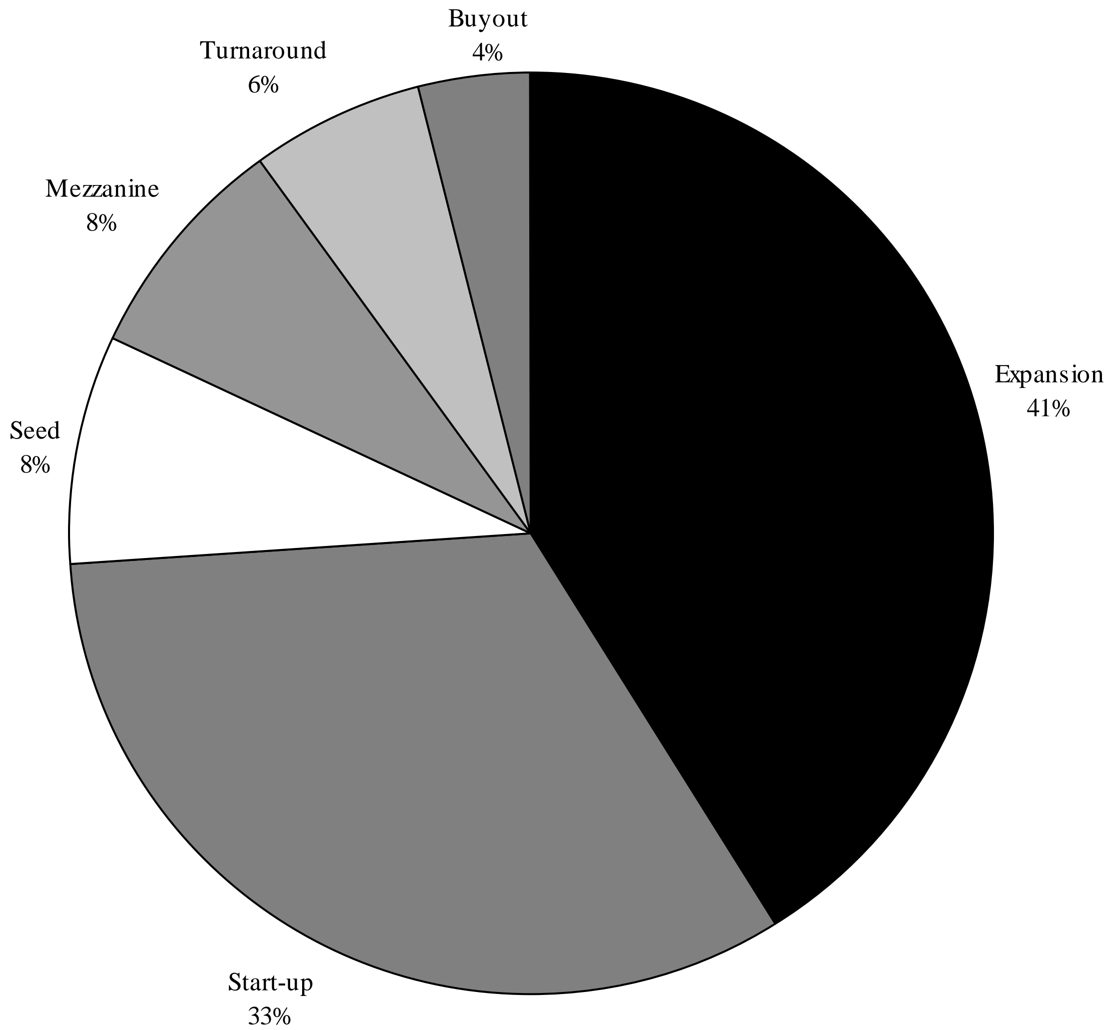
Source: *Asian Venture Capital Journal*.

Notes: The data presented above is meant to provide an illustration of the Asian and Chinese private equity markets, broadly defined. The collection of funds represented includes a wide variety of organizational structures (e.g., independent firm, corporate venture capital arm, government-affiliate) and sources of capital (e.g., third-party institutional investors, corporate balance sheet, friends and family), and as such, should not be viewed as the investable universe of institutional quality vehicles that would be appropriate for Cambridge Associates' Member Institutions.

Exhibit 3

PRIVATE EQUITY INVESTMENT BY STAGE IN CHINA

2001



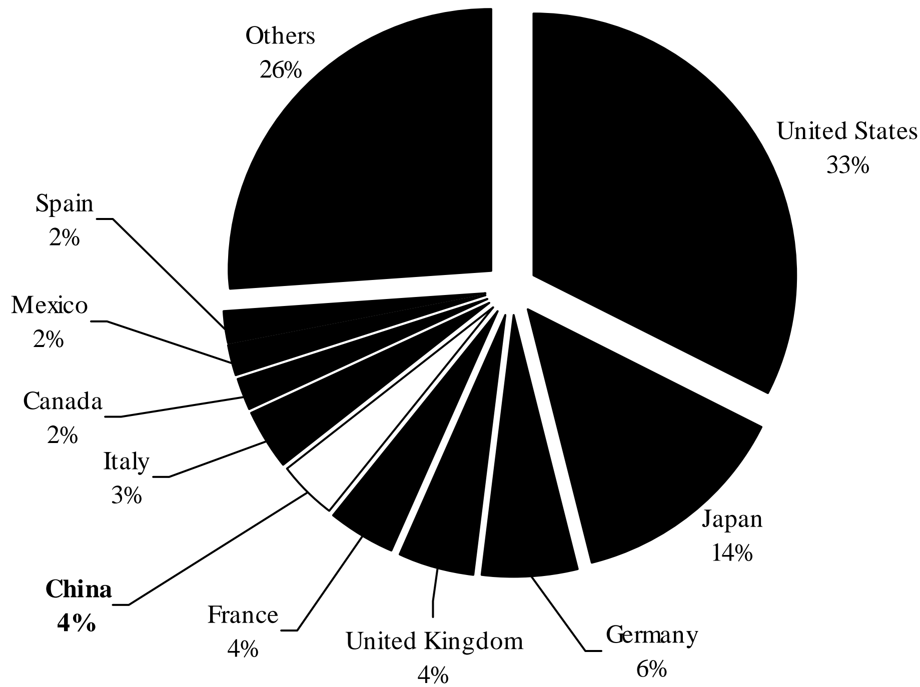
Source: *Asian Venture Capital Journal.*

Exhibit 4

NOMINAL GDP OF THE TEN LARGEST NATIONAL ECONOMIES GLOBALLY

2001

National Share of the Global Economy



Rank	Nation	Nominal GDP (in US$ billions)	Percentage of Global Nominal GDP
1	United States	10,171	32.5
2	Japan	4,245	13.6
3	Germany	1,874	6.0
4	United Kingdom	1,406	4.5
5	France	1,303	4.2
6	**China**	**1,159**	**3.7**
7	Italy	1,091	3.5
8	Canada	677	2.2
9	Mexico	618	2.0
10	Spain	578	1.8
	Others	8,163	26.1
	Total	**31,284**	**100.0**

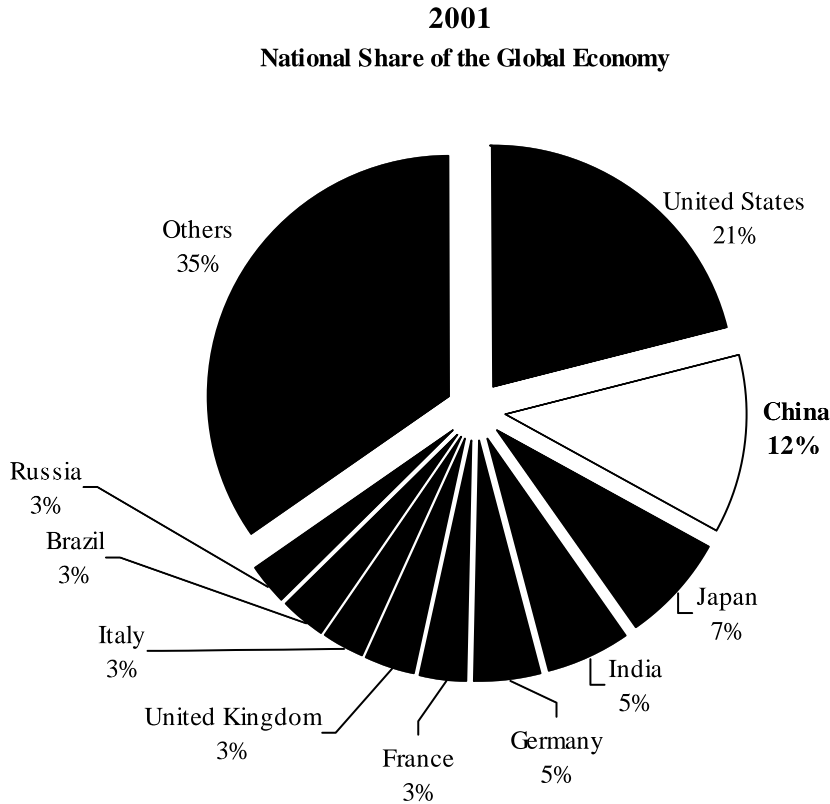
Source: World Bank.

Exhibit 5

PURCHASING POWER PARITY GDP OF THE TEN LARGEST NATIONAL ECONOMIES GLOBALLY

2001

National Share of the Global Economy



Rank	Nation	PPP GDP (in US$ billions)	Percentage of Global PPP GDP
1	United States	9,907	21.2
2	**China**	**5,506**	**11.8**
3	Japan	3,445	7.4
4	India	2,546	5.4
5	Germany	2,114	4.5
6	France	1,483	3.2
7	United Kingdom	1,463	3.1
8	Italy	1,414	3.0
9	Brazil	1,340	2.9
10	Russia	1,296	2.8
	Others	16,278	34.8
	Total	**46,791**	**100.0**

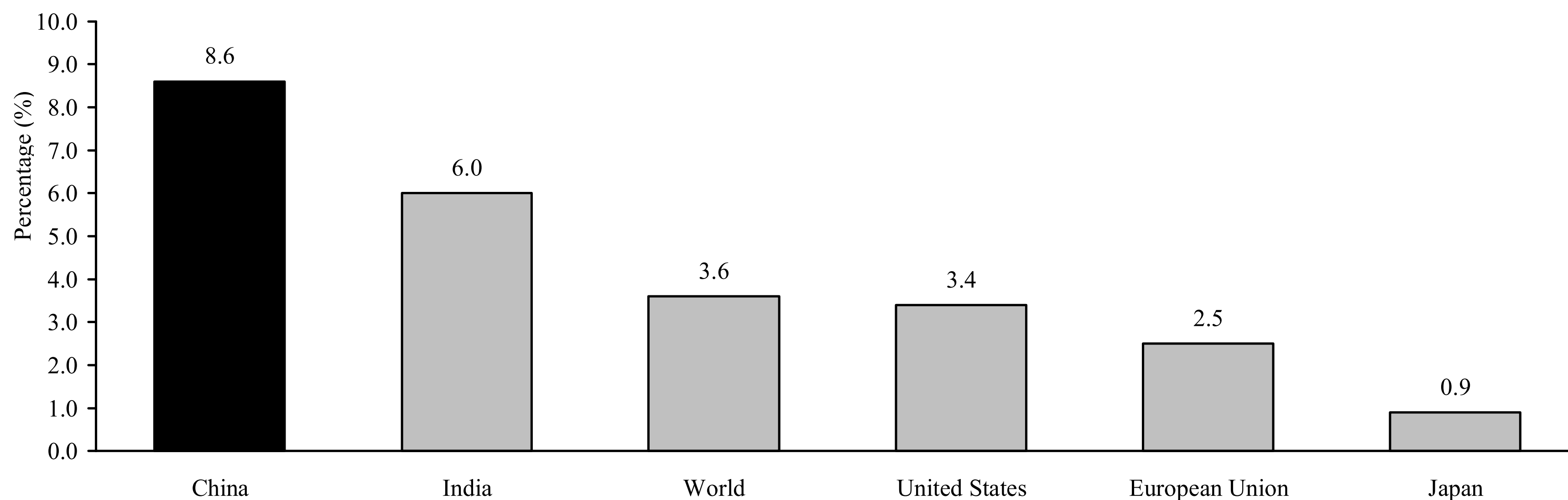
Source: World Bank.

Note: Purchasing Power Parity reflects the amount of goods the local currency is able to purchase within that country and attempts to minimize distortions caused by fluctuating exchange rates when comparing national economies.

Exhibit 6

PROJECTED TEN-YEAR AVERAGE REAL GDP GROWTH (%)

1994-2003



Country/ Region	Projected Ten-Year Average	Real GDP Growth (%)									
		1994	1995	1996	1997	1998	1999	2000	2001	2002 (P)	2003 (P)
China	**8.6**	**12.6**	**10.5**	**9.6**	**8.8**	**7.8**	**7.1**	**8.0**	**7.3**	**7.0**	**7.4**
India	6.0	6.8	7.6	7.5	5.0	5.8	6.7	5.4	4.3	5.5	5.8
World	3.6	3.7	3.6	4.0	4.2	2.8	3.6	4.7	2.5	2.8	4.0
United States	3.4	4.0	2.7	3.6	4.4	4.3	4.1	4.1	1.2	2.3	3.4
European Union	2.5	2.8	2.4	1.7	2.6	3.0	2.7	3.4	1.7	1.5	2.9
Japan	0.9	1.1	1.5	3.6	1.8	-1.0	0.7	2.2	-0.4	-1.0	0.8

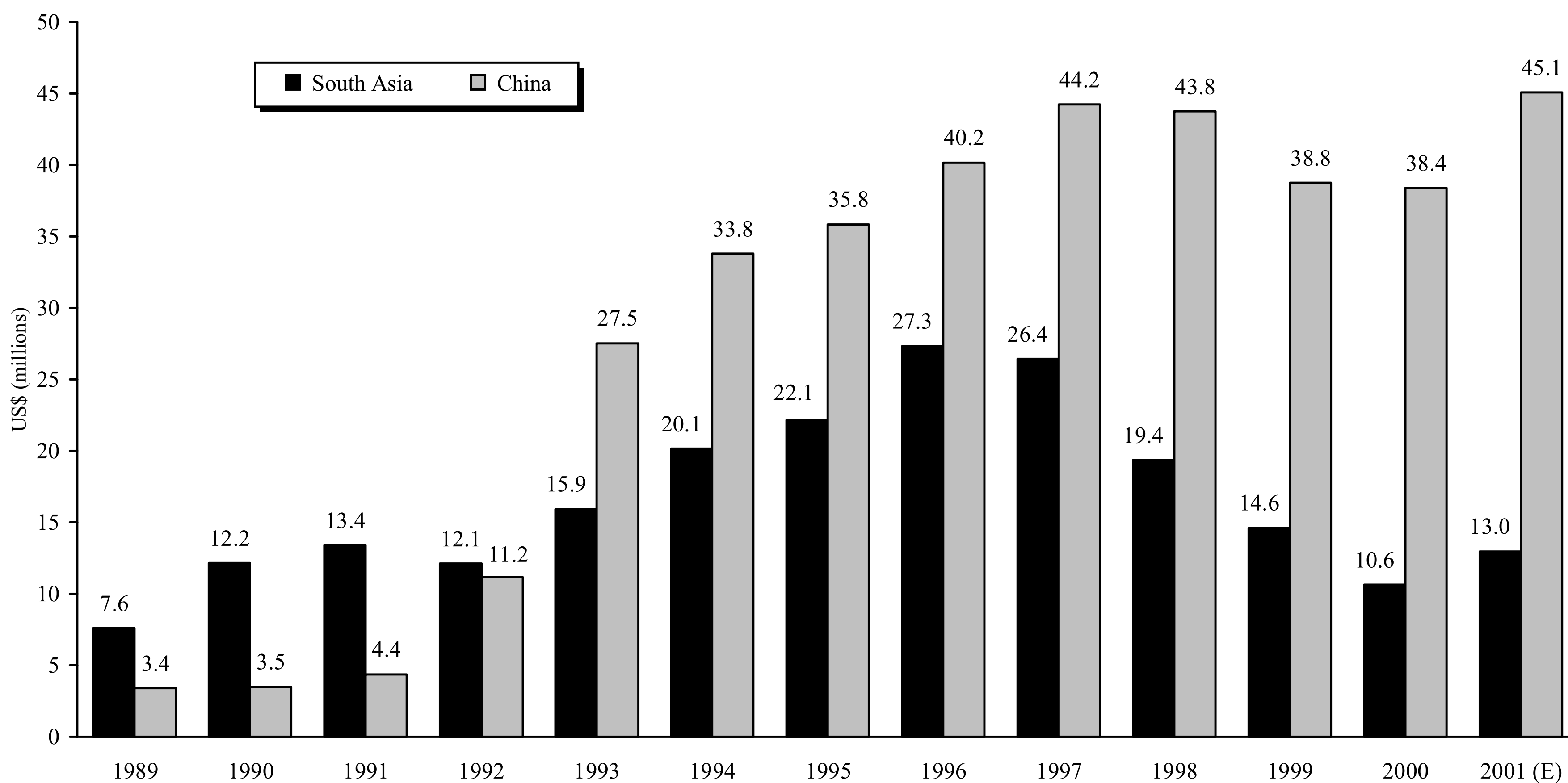
Source: International Monetary Fund.

Note: (P) = Projections.

Exhibit 7

ANNUAL FOREIGN DIRECT INVESTMENT IN CHINA VERSUS SOUTH ASIA

1989-2001



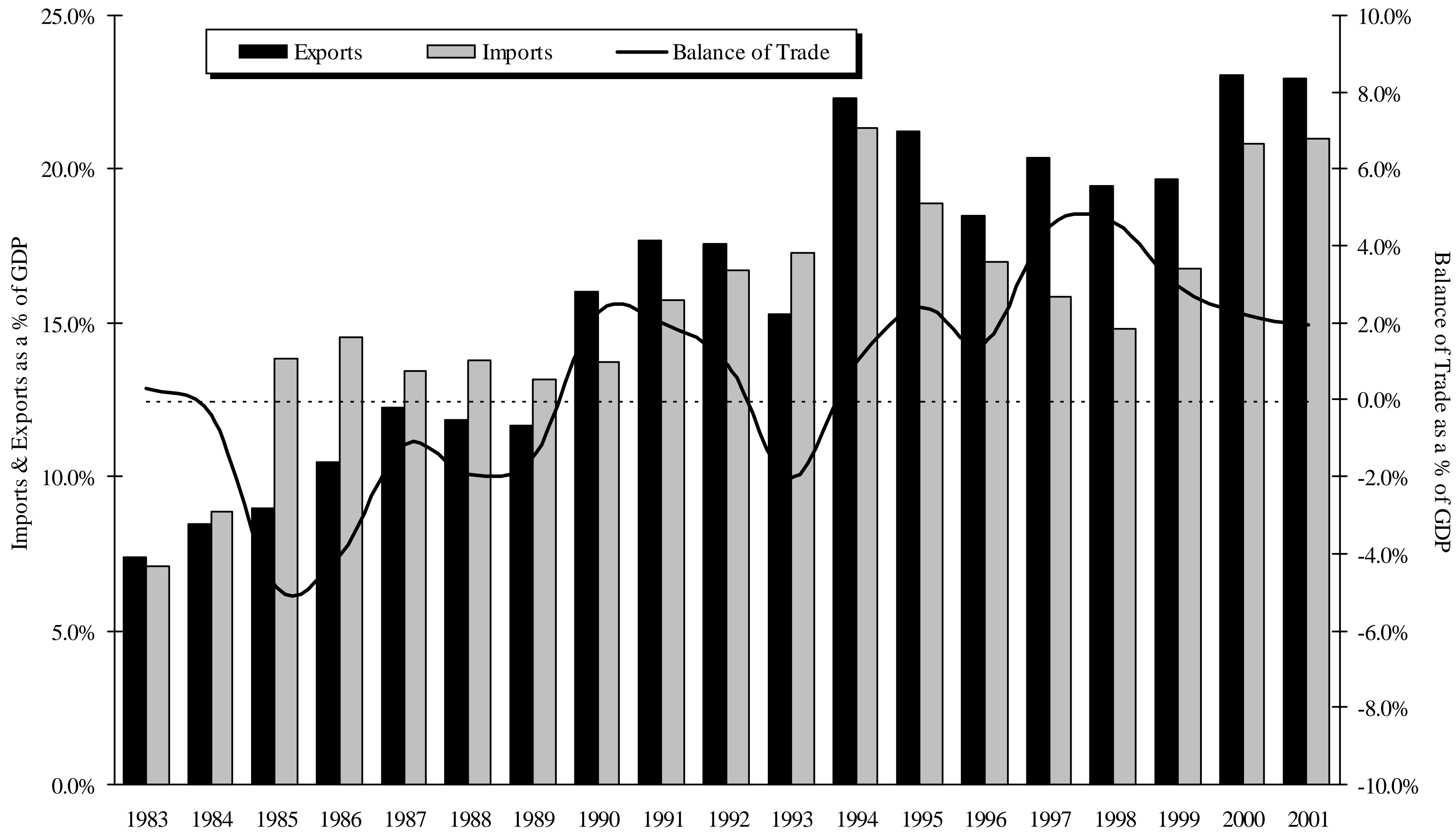
Sources: Asian Development Bank, World Development Indicators, and United Nations Conference Trade & Development Database.

Notes: South Asia includes Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam. Data for 2001 are estimated.

Exhibit 8

CHINA'S INTERNATIONAL TRADE

1983-2001

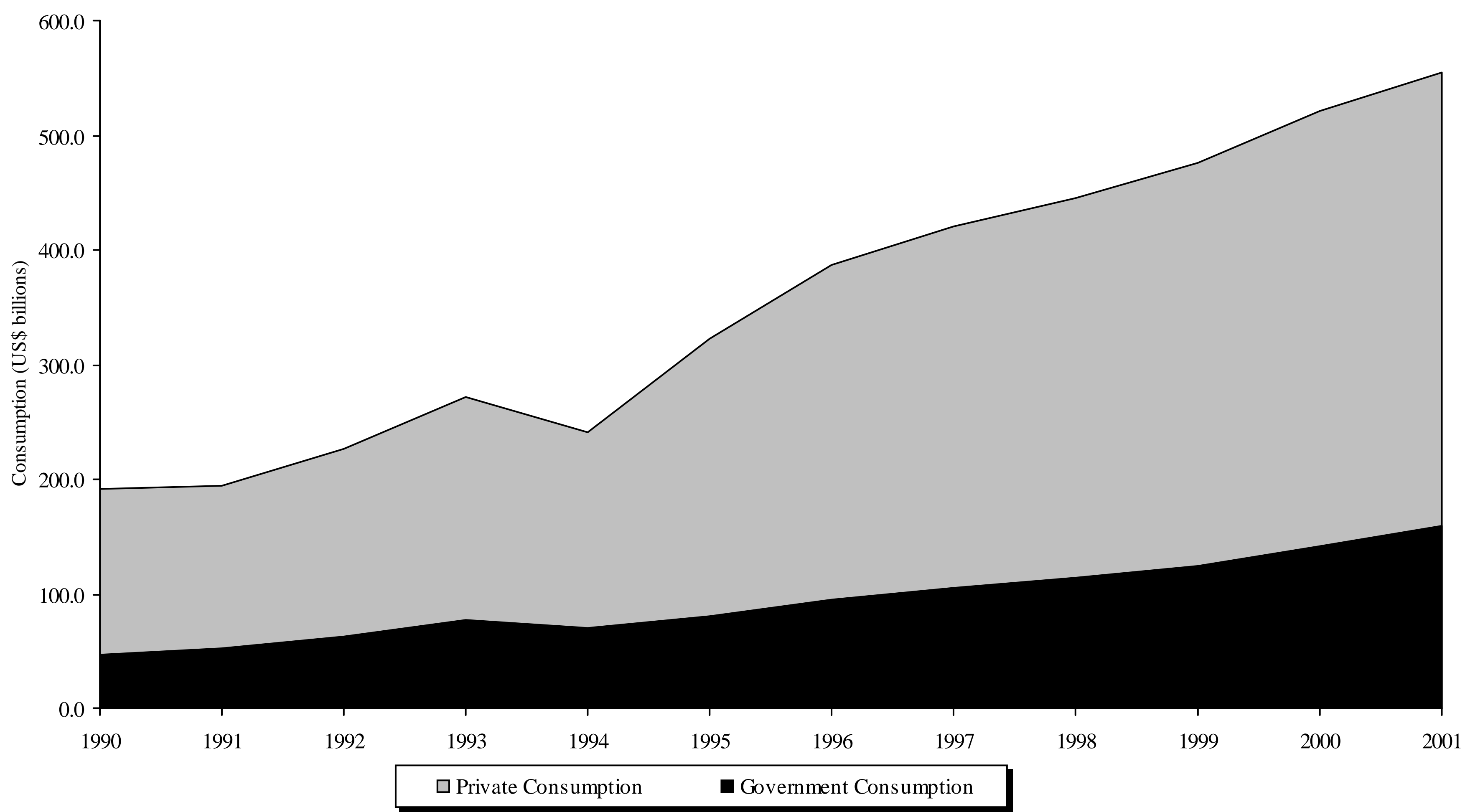


Source: International Monetary Fund.

Exhibit 9

PUBLIC AND PRIVATE SECTOR CONSUMPTION IN CHINA

1990-2001



Source: International Monetary Fund.

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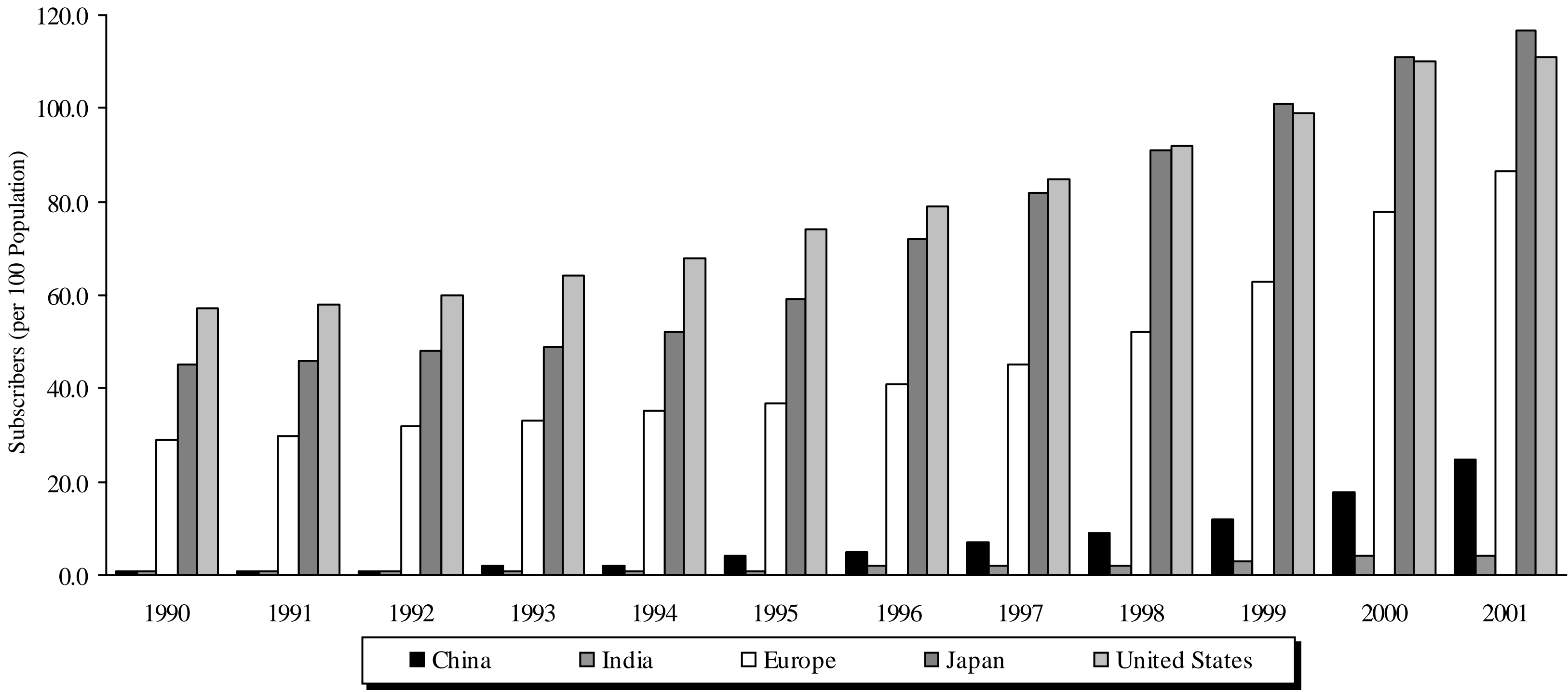
Exhibit 10

FIXED LINE AND CELLULAR TELEPHONE SUBSCRIBERS (PER 100 POPULATION)

1990-2001



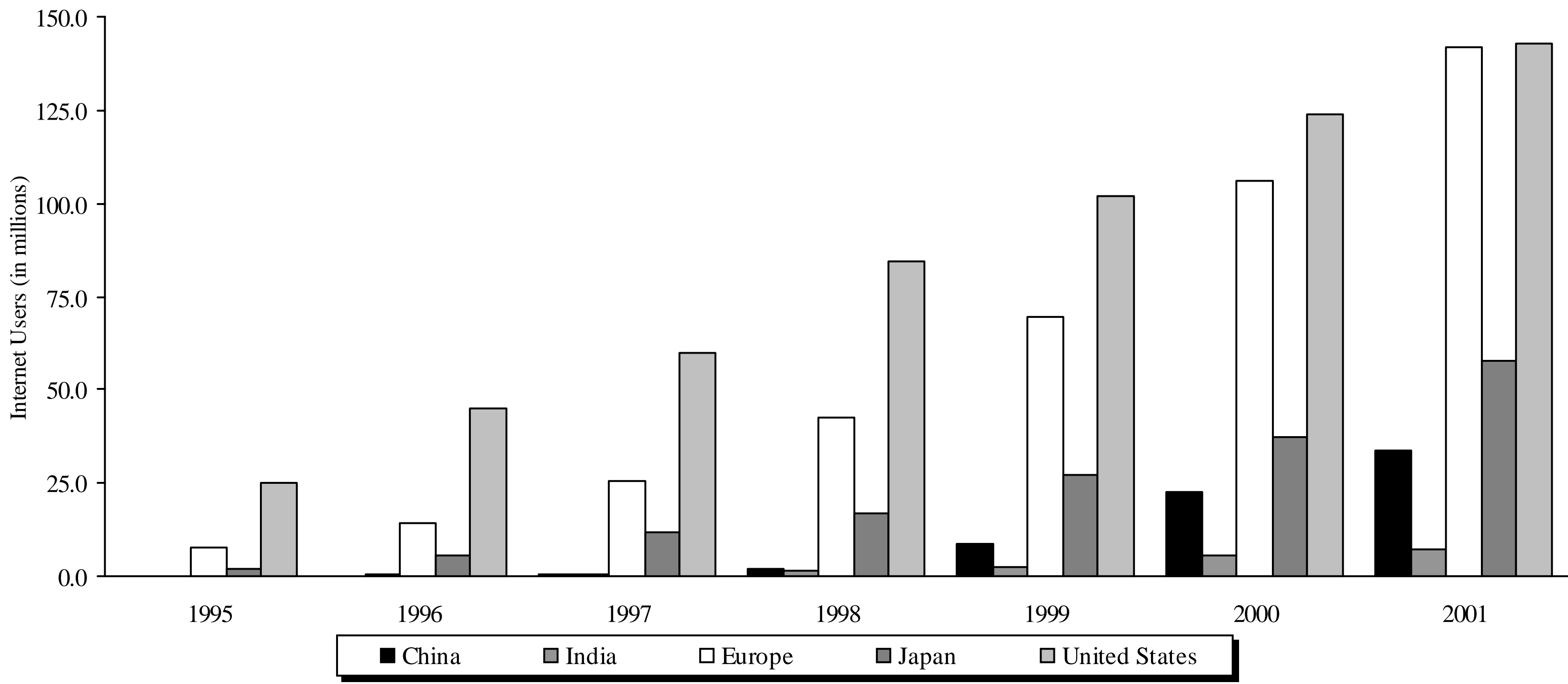
Country/ Region	Growth (%) 1990-2001	Number of Fixed Line and Cellular Telephone Subscribers (per 100 Population) 1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
China	**2,399**	**1**	**1**	**1**	**2**	**2**	**4**	**5**	**7**	**9**	**12**	**18**	**25**
India	294	1	1	1	1	1	1	2	2	2	3	4	4
Europe	199	29	30	32	33	35	37	41	45	52	63	78	87
Japan	160	45	46	48	49	52	59	72	82	91	101	111	117
United States	95	57	58	60	64	68	74	79	85	92	99	110	111

Source: United Nations Department of Economic and Social Affairs.

Exhibit 11

NUMBER OF INTERNET USERS

1995-2001

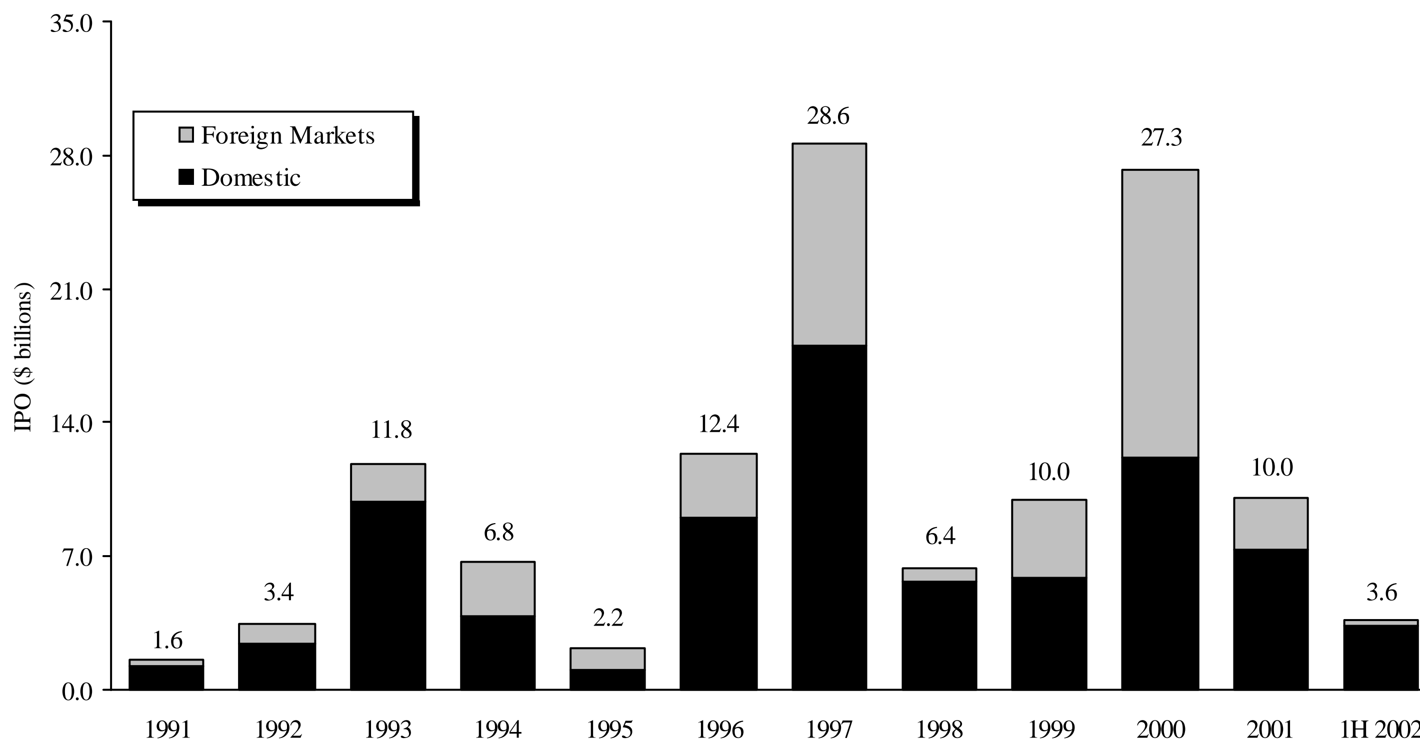


Country/ Region	Growth (%) 1995-2001	Number of Internet Users (in Millions) 1995	1996	1997	1998	1999	2000	2001
China	**56,067**	**0.1**	**0.2**	**0.4**	**2.1**	**8.9**	**22.5**	**33.7**
India	2,700	0.3	0.5	0.7	1.4	2.8	5.5	7.0
Europe	1,701	7.9	14.3	25.8	42.3	69.6	106.2	141.9
Japan	2,795	2.0	5.5	11.6	16.9	27.1	37.2	57.9
United States	471	25.0	45.0	60.0	84.6	102.0	124.0	142.8

Source: United Nations Department of Economic and Social Affairs.

Exhibit 12

INITIAL PUBLIC OFFERINGS: CHINA (INCLUDING HONG KONG)



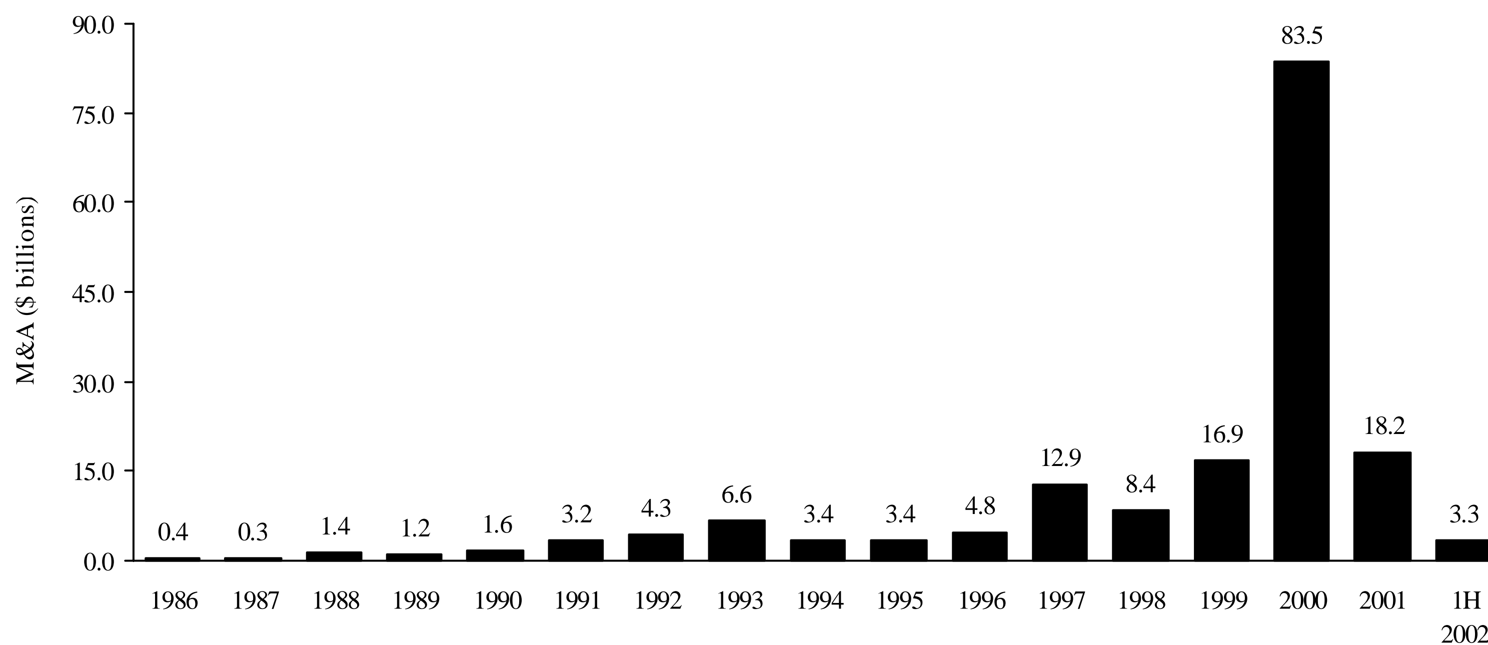
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	1H 2002
<u>Foreign Markets</u>												
Amount ($ Billion)	0.4	1.0	2.0	2.9	1.1	3.3	10.6	0.7	4.1	15.1	2.7	0.3
Number of IPOs	2	16	30	37	25	42	76	17	27	75	39	12
<u>Domestic IPOs</u>												
Amount ($ Billion)	1.2	2.4	9.8	3.9	1.1	9.1	18.0	5.7	5.9	12.1	7.3	3.4
Number of IPOs	64	130	174	80	41	200	242	127	100	197	133	76

Source: Securities Data Company, Inc.

Note: Initial public offerings data exclude mutual fund share offerings.

Exhibit 13

COMPLETED MERGERS AND ACQUISITIONS: CHINA (INCLUDING HONG KONG)



	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	1H 2002
Total Number of Transactions	27	36	27	27	48	97	90	138	142	164	161	229	274	237	295	234	143
Number of Disclosed Value Transactions	6	6	9	11	20	67	67	96	106	92	97	148	153	155	197	150	89
Average Disclosed Price ($ million)	63.8	44.3	160.4	104.9	82.2	47.8	64.3	69.1	31.8	37.4	49.5	87.1	55.2	109.2	423.9	121.5	36.7

Source: Securities Data Company, Inc.

Exhibit 14

REPRESENTATIVE LIST OF VENTURE CAPITAL FUNDS ACTIVE IN CHINA

Firm Name	Fund Name	Fund Size (US$mm)	Date Raised	Geographic Focus
Legend Capital	Legend Capital - Chinaway II [1]	100	2002	China
Gobi Partners	Gobi Fund I [1]	75	2002	China
Fortune Venture Investment Group	China IC Fund	60	2001	China
TeChina Investment Management	Sienna TeChina Venture Fund I	50	2001	China
NewMargin Ventures	C Tech Fund	120	2000	China
Chengwei Ventures	Chengwei Ventures Fund I	60	2000	China
DragonTech Ventures	DragonTech Ventures	100	2000	China
WI Harper	Beijing Technology Development Fund	60	1999	China
ChinaVest	ChinaVest VI [1]	250	2002	Greater China
Fortune Venture Investment Group	CMF Technology Fund I [1]	60	2002	Greater China
Softbank China Venture Capital	Softbank 02	75	2000	Greater China
H&Q Asia Pacific	Asia Pacific Growth Fund V [1]	500	2002	Pan-Asia
Inter-Asia Venture Management	Inter-Asia IV [1]	100	2002	Pan-Asia
Baring Private Equity Partners	Baring Asia Private Equity Fund II	258	2001	Pan-Asia
The Carlyle Group	Carlyle Asia Venture Partners II	170	2001	Pan-Asia (excl. Japan)
Warburg Pincus	Warburg Pincus International Partners	2,500	2000	Pan-Asia
Walden International	Pacven Walden Ventures V	750 [2]	2000	Pan-Asia (incl. U.S.)

[1] Fund is in the market currently. Fund size represents the current target capitalization as indicated by the firm.

[2] Pacven Walden Ventures V originally closed on US$1 billion in 2000, but the General Partner reduced the fund size by 20% in 2002.

APPENDIX

CHINA: MAJOR EVENTS OF THE LAST 150 YEARS

During much of the last 150 years, relations between China and the rest of the world have ranged from problematic to hostile. Moreover, the Chinese believe that for the first half of this period they were humiliated and exploited by foreigners armed with superior weapons. Even when engaged in a bitter civil war, both the Kuomintang and the Communists appealed to resurgent Chinese chauvinism and the universal hatred of foreign exploitation. President Nixon's historic trip to China was only 30 years ago, and only in recent years has China's visible distrust of foreigners begun to ebb. Any investor interested in China should therefore acquire at least a rudimentary idea of Chinese history since 1839, especially foreign relations. We would particularly recommend Jonathan Spence's *The Search for Modern China*, but for those in a hurry, herewith a thumbnail sketch.

The Opium Wars and Boxer Rebellion: 1839 to 1900

In 1839, the first of many Sino-Western clashes during the nineteenth and twentieth centuries erupted. At the core of the dispute was the morally questionable, yet exceptionally profitable, opium trade in China. With millions upon millions of its citizens addicted to the narcotic, the Chinese government decided it could no longer tolerate the destructive impact the trade was having on society and began clamping down on the foreign (principally British) drug traffickers. Determined not to lose out on this thick and seemingly endless income stream, the British protested fiercely. Two armed conflicts ensued. Aptly named the Opium Wars, the first battle came to an end in 1842, with the second lasting from 1856 to 1860.

The result of the Opium Wars, in which the more powerful British were victorious, was a series of agreements with Western trading nations that have come to be known by the Chinese as the "unequal treaties." As part of the settlements, China ceded Hong Kong to the British in 1842, opened 15 ports to foreign residence and trade, paid indemnities to the victor, and finally in 1898 were forced to lease the "New Territories" for a 99-year period. The one-sided accords laid the foundation for what would be 100 years of "national humiliation," marked by further incursions, wars, and treaties that gave added privileges to the British, French, Americans, and Japanese, among others.

Against this backdrop, in 1900, a secret society calling itself the "Righteous and Harmonious Fists" set out on a murderous rampage against Europeans and Americans living in northeastern parts of the country. It was a physical manifestation of the intense hatred and fear these outsiders had aroused in the local population. Rather than confronting the root cause of the uprising, the allied foreign governments sent a regiment of 19,000 troops to Peking (now Beijing) and crushed the so-called Boxer Rebellion. Although the Boxers failed to drive their foreign oppressors from China, they generated grass roots support for future nationalist revolutionaries and unknowingly set the stage for the ascent of the Communist Party just a few decades later.

Two World Wars and Domestic Strife: 1901 to 1948

The first half of the twentieth century in China was one of constant struggle, with battles being waged within its own borders and abroad. Driven by the vision of Dr. Sun-yat Sen, known as the father of modern China, the nation was, after much conflict, unified and declared a republic in 1912 with the resignation of the last of the Qing dynasty emperors. But following the conclusion of World War I and China's refusal to endorse the peace treaty at Versailles, which largely snubbed Chinese interests, infighting engulfed the country. Increasingly disillusioned with the West and facing Japanese aggression on a number of fronts, Sun's Nationalist party, or Kuomintang (KMT), found itself in a political tug of war with the emerging CCP. By the time WWII ended in 1945, a full blown civil war between the KMT and CCP was underway and despite the best efforts of the United States to first broker a peace deal, and later, provide the KMT with military support, the CCP grabbed control. Leaders of the KMT fled to Taiwan, where what they claimed to be the rightful government of China was promptly established.

The Rise of Communism and The Cultural Revolution: 1949 to 1976

On October 1, 1949, Mao Zedong, then the undisputed leader of the CCP, climbed atop the Tiananmen Gate in the heart of Beijing and proclaimed that the people of China had finally stood up. The CCP hailed its takeover of China as the people's victory over and liberation from imperial domination. Mao launched a massive campaign aimed at dismantling the very foundations of Chinese society. Land was confiscated from property-owners and redistributed to peasants. People were commanded, via various government initiatives, to eradicate "The Four Olds"—old ideas, old habits, old customs, and old culture. Prominent churchmen were ordered to denounce their religion as cultural imperialism and the concept quickly spread to the arts and literature. In short order, scores of writers, artists, and scholars were branded "reactionary bourgeois authorities" and publicly vilified. By mid-1966, Mao's campaign had mushroomed into what came to be known as the Great Proletarian Cultural Revolution. This nationwide, government-led witch-hunt would last a full ten years. Schools were shuttered, countless men, women, and children were sent to labor camps to be "rehabilitated" (or worse), and China became, for all intents and purposes, completely cut off from the outside world.

China Opens for Business Once Again: 1977 to 1992

When Mao died in 1976, so did the Cultural Revolution. After a protracted power struggle with Mao's wife and her cohorts, Deng Xiaoping, a man who had been made to wear a dunce cap and paraded through the capital during the Cultural Revolution, emerged as the country's leader. His goal was to make China a first-world nation through economic development—no small feat, and a radical idea at the time. To accomplish this, Deng offered the "Four Modernizations" program, which was meant to foster advancements in agriculture, industry, national defense, and science and technology. Led by the agricultural sector and beginning from a base of near zero, economic activity surged. Although the lion's share of the credit for China's resurgent domestic market of the 1980s must be given to a rejuvenated and industrious population, Deng's dedication to growth at all costs served as a call to arms for his inherently entrepreneurial populace.