

TASK B: VENTURE CAPITAL EQUITY INVESTMENT

DEVELOPMENT OF VENTURE CAPITAL IN CHINA

Before discussing the Project activities related to venture capital investing, it is useful to review the history of China's venture capital activities. The following has been provided by one of the Chinese members of the project team.

The Development (1985-2000)

a) The policies of the government

In 1985, China issued "the Decision on Sci-tech System Reform." In this document, it is proposed that "venture capital can be set up to support the rapid-changing and risky high-tech development". The concept and practice of venture capital was first introduced into China's sci-tech policy system.

In 1991, the State Council issued the "The Temporary Stipulations for China's High-tech Industry Development Zones". It is proposed that "venture capital fund can be established in high-tech development zones for the development of the high-risk high-tech industry. Venture capital company can be set up in the high-tech development zones under possible conditions". This demonstrates that venture capital had begun to draw the attention of the government.

In May, 1995, the State Council issued "the Decision on speeding up the progress of sci-tech", emphasizing "to develop sci-tech venture capital and establish the mechanism of sci-tech venture capital". The document further clarified the strategy of developing China with science and education.

In 1996, the State Council issued the "the Decision on deepening the sci-tech system reform during the ninth Five-year Project period" emphasizing on the development of high sci-tech venture capital.

In June 1996, the State Council approved the SETC to implement "technological venture capital project", focusing "enterprises should play an important role in venture capital project and commercializing the new technologies".

In 1996, China issued "P.R. China Law on Promoting Sci-tech Achievements to be transformed", stipulating that "the state treasury fund for sci-tech transformation is used in the guiding fund, discount loan, subsidiary fund and venture capital".

In March 1998, Minjian Party submitted the draft resolution of "On Speeding up China's Venture Capital" to the ninth Political Consultative Conference for discussion. It was listed as "No 1 draft resolution" on the conference. Venture capital drew much attention of Chinese top leaders and became a popular topic of economic field.

In May 1998, Beijing Municipality, Ministry of Science and Technology and Beijing Council of Trade Promotion, organized “Beijing High Sci-tech Industry Week”, aiming at international exchanges for high-tech industry. Financial scholars explored and exchanged ideas on “the development of high sci-tech and venture capital ” and drew great attention of the theorists and entrepreneurs of the industry.

In 1999, the State Council issued No 105 document. It was “Some Opinions On the Establishment of Venture capital Mechanism ”.

On March 23, 1999, seven ministries including Ministry of Science and Technology, Ministry of Education, Ministry of Personnel, Ministry of Finance, Central Bank, Bureau of Tax, Bureau of Industry and Commerce issued “Several Stipulations On The Promotion of The Transformation of Sci-tech Achievements”, pointing out twelve measures and policies.

On May 21, 1999, the State Council issued “the Temporary Stipulations On the Tech Venture Capital fund of SMEs of Sci-tech type” submitted by the Ministry of Science and Ministry of Finance. The State Council decided to build up SME Technical Venture Capital Fund with 3 billion yuan and to have it administered by SME Venture Capital Fund Administration Center. SMEs of sci-tech type will also be given discount loan and assistance without interest (with one million yuan as its limitation) and capital (with 20% registered capital as its limitation).

On June 16, 1999, SETC issued “the Guiding Opinions on the Establishment of Pilot Schemes of SME Credit Guarantee” to promote the guarantee institutions on all levels to support the financing and the venture capital of SME of sci-tech type.

In August 1999, the State Council convened National Technological innovation Conference and made up “the Decision on Strengthening Tech Innovation and realizing industrialization”, planning for the promotion of progress and the development of high-tech industries in the new situation.”

On June 14, 1999, the Shanghai Municipality issued “Some Stipulations on the Transformation of High-tech Achievements”. In the stipulations, the Shanghai Municipality funded 600 million yuan to the financing of the high-tech venture capital. One month after the issuance of the stipulations, Shanghai Council Sci-tech identified 125 projects as major industrialization projects. The 125 projects are involved in the industries of information, new material, environment protection and bio-medicine etc. With a fund of 1.86 billion yuan, they attempted to introduce venture capital to solve the problem of the shortage of funds for these ventures.

On June 20, 1999, the State Council compiled the request of “speeding up the construction of Zhongguancun High-tech Park” submitted by the Beijing Municipality and Ministry of Science. According to the planning, Zhongguancun will be built up into a top sci-tech park on an international level within 10 years.

On Oct 15, 2000, China's first regulation on venture capital came into being. It was "the Temporary Stipulation of Shenzhen Venture Capital of High-tech". It was an audacious exploration of Shenzhen in establishing venture capital.

In 1986, in order to support the implementation of "the Torch Project", China New tech Venture Capital Company, the first venture capital company of China, was approved by the State Council. Its two major shareholders were the Ministry of Science and the Ministry of Finance, respectively holding 40% and 23% of the shares. It provided services such as investment, loan, rental, financial guarantee and consultation etc. (But now the company has closed).

In 1988, the Torch Fund was set up by the Ministry of Science and listed in Singapore. With a fund a \$100 million, it is used for the development of China's new-tech enterprises. The Torch fund is a typical venture capital fund.

In 1989, four companies attached to the Ministry of Science, National Defence Sci-tech Industry Commission and Merchant Bureau funded the second venture capital company of China. That is China Ke Zhao Tech Co., Ltd. It aims at promoting the commercialization and industrialization of high-tech achievements. The projects funded are mainly the projects for sci-tech promotion, such as the Torch project (35.7%), NO 863 project (11.6%), Project of Promoting National Sci-tech Achievements(6.3%), Sparkle Project (10.4%), Project of Transformation from military to civil use (1.5%). The industries of the investment are mainly of high-tech: bio-engineering and medical, new material, mechanical electronics and information and the others.

In 1992, the first sci-tech venture capital fund was established in Shenyang. Multiple methods investment, such as credit guarantee, subsidy interest and discount interest, shareholding, were used to provide venture capital for enterprises. Such venture capital companies (or funds) were set up in Chonaqing, Taiyuan, Jiangsu, Zhejiang, Guangdong, Shanghai thereafter.

In 1997, Venture Capital Consulting Company was set up in Shenzhen, dealing with strategic investment banking business in the industry of high-tech.

In 1998, the Macro-Economic Academia of the State Planning Commission set up a task group to make a feasibility study on the establishment of a venture capital fund in China's mechanical industry.

On Oct 26, 1998, the Ministry of Science and technology declared in Beijing that it would introduce \$ one billion from IDG, an American information service enterprise, in order to set up a high-tech development fund.

On Oct 27,1998, Beijing High-tech Venture Capital Co., Ltd., was established with registered capital of 310 million yuan. Its aim was to support the high-tech industry of Beijing.

On Oct 28,1998, the first company with the name of “venture capital” was registered as “Beijing Sci-tech Venture Capital Co., Ltd.” with a registered capital of 500 million yuan. The business scope covers the investment of high-efficient agriculture, bio-medicine, soft-ware system etc. It also operates a registered guarantee fund, which means it provides loan guarantees when registered capital of a newly-set up company is not sufficient for a bank to make the loan.

In 1997, Pudong Venture Capital Company was established in Shanghai, with its first-period capital of RMB 10 million.

Approved by Shanghai Municipality, Shanghai Venture Capital CO., Ltd., was locally funded with 600 million yuan (RMB) in 1999. As a government solely-supported company, it was an individual legislative body transformed from “Shanghai Sci-tech Venture Capital Center”. As a professional institution, it would be operated in accordance with international practice of venture capital under the guidance of Shanghai Sci-tech Venture Capital Committee. Market-oriented, it would draw various funds from home and abroad and form a varied system of financing and investment in order to promote the development of the transformation of high-tech achievements.

In July, 1999 Shanghai LianChuang Investment Administration Co., Ltd., was set up, funded by the State Planning Commission, SETC, China Science Academia and Shanghai Lianhe Investment co., Ltd.

In August 1999, Shenzhen innovation Sci-tech Investment Company was set up, with 700million yuan as its first registered capital. Among the 700 million yuan, 500 million yuan was funded by Shenzhen Investment Administration Company, entrusted by Shenzhen municipality. In Oct, 2000 the Board of Directors and the meeting of the shareholders decided to increase the first registered capital (799 million yuan) to 1.6 billion yuan. By Oct, 2000 the company had negotiated 1000 projects, assessed 79 projects and invested in 38 projects with 360 million yuan. In the first six months of 2000, it had made profit of 52.89 million yuan.

In Feb, 2000 Shanghai Venture Capital Company respectively set up funds with Shanghai JiaoTong University, Fudan University, and Shanghai Zhangjiang High-tech park. The amount of funds is equally shared and the operation is entrusted to a professional venture capital investment management company.

By the year 2000, with 10 years of development, 100 venture capital companies had been built up with capital of 8 billion yuan. Among these companies, 90% were wholly or partly funded by the government.

International Best Practices of Venture Capital Support

In Task A, Activity (i) above, we have discussed best practices for all SME equity funding support schemes, including both those serving traditional industries and those investing in technology-based enterprises (venture capital).

IMPEDIMENTS TO VENTURE INVESTING

By participating in venture capital conferences in Beijing and Guiyang during July, 2001, we have had an opportunity to talk with the managers of at least 30 venture funds, and have visited several in their offices in Beijing, Guandong, and Shenzhen. We have met with foreign venture funds in Shanghai, Beijing, and the United States.

Following are the major impediments mentioned by these fund managers:

1. Chinese law does not provide for limited partnerships, which are the usual organization used in countries with mature venture capital industries. The structures available in China are much more rigid, and therefore make it more difficult for investors and fund managers to divide profits and risk.
2. Minimum capitalization rules require large capitalization of corporations
3. Rules that set a maximum value for intangible assets make it difficult to price technology companies, which have a high goodwill factor.
4. Absence of a second board for public listing of smaller companies. The proposed Shenzhen second board has been postponed indefinitely.
5. Requirements for pre-IPO investors to hold their shares for an extended "lockup" period (usually two years) after public listing, which increases the risk and reduces potential rate of return to venture investors.
6. Lack of transparency and frequent claims of improper use of proceeds, which have resulted in significant losses to investors.

Demand and Scope of Commercially Funded/managed venture capital and SME Equity Funds

With the exception of a few foreign investment funds, which make large investments in mature companies, there has been very little commercial interest in investing in venture capital funds, and no interest in SME funds by private investors. Virtually all the capital of these funds has come from provincial and local governments, with additional capital from listed corporations investing cash received in initial public offerings.

An important exception to this pattern has been a new SME fund located in Sichuan Province, and managed by Small Enterprise Assistance Funds. Principal investors are three development institutions (IFC, DEG of Germany, and SECO of Switzerland), and an American Insurance Company, the New York Life Insurance Company. The development institutions are investing as part of their basic mandate. New York Life is investing in order to demonstrate its support for the Chinese economy. Other foreign corporations might be similarly motivated, if a program were introduced to encourage them. Similarly, where China has offset investment requirements of its foreign vendors, the government could declare that these might be satisfied by investment in SME or venture capital funds.

The lack of interest in commercial investment in these funds is a result of significant losses suffered by investors during the Asia crisis of 1997, and the factors listed above as inhibitors for operation of these funds. Problems of transparency and fraud were most often cited as reasons for investors to avoid these funds. For technology-based venture capital funds, fund managers assume that the opening of the second board for IPOs of younger companies will make their funds much more attractive to investors. Undoubtedly, the second board will help by providing a potential exit opportunity for venture investments. However, the recent experience of similar markets, such as the Neue Markt in Germany suggest that a second board will not in fact be as helpful as hoped, especially during times of poor overall market performance.

Government-financed Venture Capital Funds

The experience of the United States, Israel, Australia, and other countries demonstrates that government support programs can dramatically accelerate the growth of a venture capital industry, which in turn can cause an explosive growth in the rate of new enterprise development. When the U.S. SBIC program started in 1959, there were only about 15 organized venture firms operating in this country. In the year 2000, the U.S. venture capital industry invested almost \$100 billion in small and medium sized businesses. Most of the U.S. venture firms have their roots in the SBIC program.

Israel has gone from one venture fund to over 100 during the past ten years, prompted by the Yozma program that made it attractive for investors to put their money in venture funds. The Australian Innovation Investment Fund program has had similar results during the past three years. Well-publicized availability of venture capital invariably encourages new enterprise development, so the demand for funding increases with the supply.

A government-supported program would not only increase the amount of capital available, but would provide an opportunity for the Central Government to establish important standards for funds receiving such support. We recommend that the following be minimum requirements for funds that receive support:

- Fund managers must demonstrate they have had relevant experience and training for this role.

- Fund managers must be motivated by a compensation system that allows significant sharing of profits of the fund when investments are liquidated and cash is returned to investors.
- Funds must be limited to investing directly into companies that meet specific size limitations, and no investments may be made in open market securities. As a beginning pilot program, the size limitations should be quite small, and coupled with a requirement that the companies should not be more than three years old.
- Funds must agree to avoid investments in real estate and socially undesirable sectors.