

Great Leaps Forward:

Three Observations About Investing in China

Venture Capital Update

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In August of this year, the People's Republic of China will host the Games of the XXIX Olympiad in Beijing. For this emerging global powerhouse, the Summer Games are much more than an international athletic competition. They represent an opportunity to demonstrate China's economic success to a worldwide audience. While international athletes train to compete in the Beijing National Stadium, domestic and foreign venture investors are sizing up opportunities in the country's most promising sectors.

In November 2007, SVB led 24 limited partners (LPs) on a trip to Shanghai, Beijing and Hong Kong to learn more about China, experience its culture and meet key members of its business community. These LPs may not be characteristic of all potential investors — many of them represent

small endowments with less than \$5 billion under management — yet they clearly had an interest in investing in China prior to embarking on the trip. SVB surveyed participants after the trip to understand how their perspectives about China and its investment opportunities had changed. The enthusiasm resulting from their on-the-ground experience surprised both the LPs and the SVB team, specifically regarding the LPs' own understanding of risks and the level of uncertainty around investing in China.

LPs reported a few clear insights gained as a result of the trip:

- 1. The magnitude of China's growth is tremendous, tangible and sustainable**
- 2. The policies of China's government are encouraging investment**
- 3. Venture capital in China is becoming more local**

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Although LPs had heard the statistics, they could not conceive what 10 percent compounded annual growth looked like on the ground . . .

In this quarter's Venture Capital Update, we explore our LPs' viewpoints after visiting China and their perceptions of investment opportunities in the country.

1. The magnitude of China's growth is tremendous, tangible and sustainable.

The magnitude of economic growth in China left an impression with most of the LPs who participated in the SVB trip. China's gross domestic product has been growing at a near double-digit rate for the past several years and, assuming these rates continue, China is set to overtake Germany as the third largest economy in the world. This rate of growth has helped to transform the country from a developing economy to a modern

society. Although LPs had heard the statistics, they could not conceive what 10 percent compounded annual growth looked like on the ground until they experienced China for themselves. Some LPs mentioned that iconic images of Beijing's skyline have become outdated due to the recent spate of

construction of high-rises — buildings that are already filled to capacity. Others noted the new, beautifully-landscaped roads along with the multitude of new cars and subsequent traffic congestion. Some LPs were shocked by the size of China's mega cities such as Beijing, which now covers 6,900 square miles due to urbanization and land conversion. "People outside of China don't have an appreciation of how rapidly things are changing," said one LP.

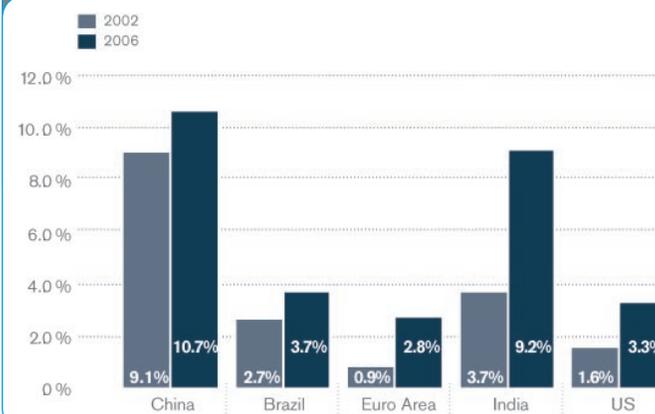
While the outlook for the Chinese economy is positive, challenges persist. The lack of natural resources, such as water and oil, and an aging population, due to a one-child policy, may limit future growth. The limitations may also drive the Chinese to look outside their borders to fulfill demands for

natural resources and skilled labor. What's more, some economists believe that a recession in the United States would trigger an economic slowdown in China. Despite these concerns,

"People outside of China don't have an appreciation of how rapidly things are changing," said one LP.

LPs believe that Chinese economic growth is sustainable. "It's impossible to go backward," commented one LP. The need to create well-paying jobs

GDP ANNUAL GROWTH COMPARISONS, 2002 AND 2006



Source: World Bank

and maintain social stability requires the government to promote policies favoring growth.

GROWING VENTURE AND GROWTH EQUITY OPPORTUNITIES

The venture industry has grown in tandem with the Chinese economy. In 2007, venture investment in China coasted to a record high of \$3.2 billion invested, compared to \$1.8 billion in 2006.¹ These figures contrast with much higher levels of fundraising, nearly \$5.5 billion in 2007, leading SVB to forecast greater investing activity in the near future.

The term “venture” is used in China to describe a broad spectrum of private investment strategies, from

start-up companies to spin-offs of state-owned enterprises (SOEs). A vast number of companies across a variety of sectors need venture capital to maintain real revenue growth of 30 percent and more per year in preparation for exit. Due to these requirements, SVB Capital believes that the opportunity for returns on investments in companies in this growth equity stage is quite promising. Nonetheless, given the entrepreneurial talent and plentiful number of quality engineers in China today, investment opportunities in early-stage companies abound.

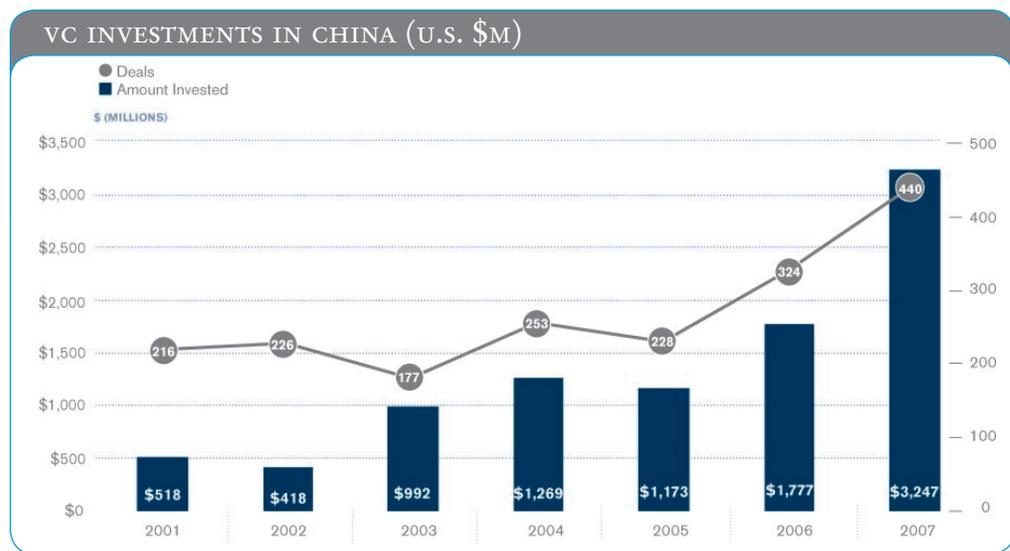
A FLOOD OF CAPITAL?

The heightened enthusiasm for investing in China has fostered an inflow of capital into private equity

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and venture funds. Some observers believe that this rising tide of funding now outweighs the number of opportunities in China. Those who are bearish on venture capital in China point to increasingly high valuations of venture-backed companies, arguing that China has “too much money chasing too few deals.”

A real concern is the sustainability of valuations on the Chinese exchanges. It is also unclear if a stock market correction would arrive as a bursting bubble or a soft landing. Anxiety has only increased as the U.S. and international stock markets become more volatile. The Shanghai Composite Index has nearly doubled during 2007 with an average price/earnings (P/E)



Source: Zero2IPO Research Center

ratio of 60x, on a twelve-month trailing basis.² Much of this growth is the result of policies preventing the public from investing outside China, the undervalued yuan,³ and negative real interest rates, which have prompted citizens to pull savings out of bank accounts and to invest in stocks. A massive amount of domestic wealth has been accumulated in China, due in part to the country's high household savings rate of about 25 percent.⁴

Chinese venture is characterized by investments in companies that are profitable and show substantial increases in annual revenue growth.

Many commentators have compared China to the U.S. market during 1999 and 2000. Indeed, the fast-growing economy, influx of capital into venture and public markets, a large number of public offerings, and ever-increasing P/E ratios ring a familiar tune. However, two important differences make this comparison inaccurate:

1. The bubble period in the U.S. was characterized by investments of millions of dollars into companies that had yet to generate revenues and by public offerings from companies that were bleeding cash. In contrast, Chinese venture is characterized by investments in companies that are profitable and show substantial increases in annual revenue growth, commonly equating to about 50 percent per year. That is, a large proportion of Chinese investment is in growth equity, rather than early-stage startups. Since there is no venture debt in China, these companies attract venture financing rather than taking loans, as typically seen in the U.S.

2. While most of the investment during the U.S. bubble was concentrated in telecommunications infrastructure and Internet ventures, investments in China are currently diversified across a number of sectors and industries.

The general consensus among the LPs on the trip is that the venture industry in China today resembles U.S. venture during the 1970s. Indeed, a few LPs pointed out that although the amount of investment in China has grown substantially, it is relatively small compared to the country's GDP. Based on this comparison, the LPs believe that the Chinese venture

... investments in China are currently diversified across a number of sectors and industries.

market is not frothy, but rather has room to grow. In fact, the belief is that investors who are entrenched in the Chinese market and have deep local connections will find an abundance of opportunities across different sectors. The key will be to partner with experienced and well-connected venture capitalists.

The Chinese economy and the venture industry are growing at a record pace and LPs expect that venture's business cycles will be more compressed than in the U.S. The peaks and troughs of

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the cycles will be shorter and have a higher magnitude, with the long-term trend pointing upward.

2. China's government policies are encouraging investment.

Many Westerners are wary of investing in China due to the lack of clarity in government regulations. It is difficult to put money into China due to currency considerations and regulatory obstacles; thus, many funds partner with local Chinese firms with investments designated in renminbi (RMB) in order to process deals through an onshore entity. China has an apparent intent on keeping its capital at home, perhaps to steer investors towards domestic investors, lawyers and business leaders. Consequently, it is also difficult to take money out of an investment and out of the country if the company has a liquidity event domestically in China.

Given these perceptions of potential foreign investors, some LPs were surprised to learn that the Chinese government appears to be indirectly supporting private investments, at least for the near term. It appears that Beijing is looking to venture and growth equity to help to sustain its economic transformation while correcting ensuing social problems.

In fact, the Chinese government is promoting one promising area that also supports its social agenda: cleantech. Both resource scarcity in China and environmental deterioration have propelled the govern-

The LPs did not underestimate the power of the Chinese government to make great strides in areas of aligned interests or the government's ability to discourage investment in areas where interests conflict.

ment — and the market — to search for clean technologies. Some cleantech groups cite Chinese policies as the catalyst for greater venture interest in areas such as energy efficiency, solar power and water treatment.⁵ China has already emerged as a leader in the solar manufacturing industry worldwide. A number of Chinese solar companies are listed on American stock exchanges, including six companies that went public in 2007. Other Chinese heavy hitters include JA Solar Holdings and Suntech Power Holdings, which boast market capitalizations of \$2.5 billion and \$7.5 billion, respectively, as of mid-February 2008.

As an aside, many LPs pointed out that the Chinese press has begun to devote greater attention to domestic environmental issues. The openness with which the Chinese media covers this topic was a surprise to LPs, who had not expected that Beijing would allow such visibility into a potentially controversial issue.

Cleantech represents one area where the interests of investors and the Chinese government have aligned. The LPs did not underestimate the power of the Chinese government to make great strides in areas of aligned interests or the government's ability to discourage investment in areas where interests conflict.

3. Venture capital in China is becoming more local.

The LPs came away from the SVB trip with a sense that venture capital was becoming more local in China. While many foreign venture capitalists and private equity professionals have established operations in China, LPs expect the local Chinese venture and private equity firms to emerge as the winners. They believe that “fly-by” VCs may have some luck in the short-term, but likely will not see sustainable success. One LP commented that the rise of homegrown venture capitalists will be a significant development over the next few years.

LPs also observed that local entrepreneurs are becoming more sophisticated as are local VCs. The fact remains that local Chinese VCs have an advantage. They own the business connections, especially in sectors involving traditional industries, and relationships with the government. Indeed, in the Chinese culture, relationships are still more important than signed contracts. Investors in China need VCs who are flexible and can change with different policies, since regulatory changes can be unpredictable. With an inside connection to the government an investor can anticipate these changes. Moreover, because the economy is developing so rapidly, winning sectors

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will most likely change over time. One VC investing in China noted that sector specialists can always be hired as consultants to provide insights on specific questions. While brands are important in China, many local VC firms have already experienced success in the region, and their brands may already outshine the known U.S. brands.

However, investing in local Chinese funds can be risky. With such swift development and capital flowing rapidly into China, there is a fight for investing talent. Stable investment teams with a track record of investing together are rare. Many junior-level VCs with a few successes are invited to join competing venture firms. Notably, LPs cited team stability as an ongoing concern, especially as firms mature.

CHINA: FROM RED TO GREEN?

China has made a number of efforts to publicize the need for green technology solutions:

- In March 2005, China's National People's Congress passed the Renewable Energy Law which is expected to boost renewable energy usage to 10 percent by 2020.
- Underscoring the importance of fighting pollution, Prime Minister Wen Jiabao made 48 references to the words *environment*, *pollution* and *environmental protection* during the country's equivalent of the State of the Union address last year.⁷
- In November 2007, China issued a new five-year plan that will require 1.35 percent of the country's GDP be invested into environmental protection.
- China announced plans to raise a \$1.5 billion fund by 2012, which would channel revenues raised from the country's carbon emissions trading program into a fund that will finance projects aimed at reducing climate change. Contributions to the fund would come from a levy on sales of carbon credits.⁸

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To invest successfully in China, not only must an investor select and have access to the top performing funds, it is also crucial to have the ability to understand macroeconomic parameters, the regulatory environment and social considerations. Almost all LPs noted that their own lack of understanding about the Chinese market was a risk to investing there.⁶ For the most part, the LPs interviewed have small staffs and told us, “there are huge opportunities and no shortage of risks.” Clearly, having a local partner on the ground would supplement their knowledge base and assuage this concern.

THE ROAD AHEAD

The venture industry is still developing in China and investing is not

without risks. Many challenges stem from the speed of China’s economic development, such as the widening wealth gap, greater air pollution and water shortages. Others view the vagaries of Chinese government policy as a great uncertainty. Nonetheless, LPs came away with confidence that China has attained the critical mass of capital, entrepreneurs and investors to become a global player in the venture market. Many LPs agreed it is highly unlikely that progress will slow given the overwhelming drive forward.

But what are the long-term prospects for Chinese venture? Many successful U.S. tech entrepreneurs say that regions are most prosperous when they can develop technology ecosystems. Combined with an educated workforce, a strengthening entrepreneurial environment and the gradual maturity of the country’s venture capital network, China’s most advanced cities have the potential to take off in much the same way that Silicon Valley has over the past 30 years. China’s most elite colleges already turn out large numbers of capable engineers and nascent entrepreneurs; but so far, China lacks a business culture that embraces innovation, rewards risk-taking, and forgives failure, as has happened in the Valley.

To the Chinese, eight is a lucky number, and the year 2008 may well

turn out to be especially auspicious for the country. International coverage of the Beijing Olympics will throw a spotlight onto China’s successes as well as its formidable social and political challenges. While international athletes prepare for the competition, LPs will have their work cut out for them as well. They must conduct the necessary due diligence to determine whether to invest and how to invest in this emerging international power. Will they train for the upcoming games or will they take a seat on the sidelines and watch them unfold?

Let the games begin.

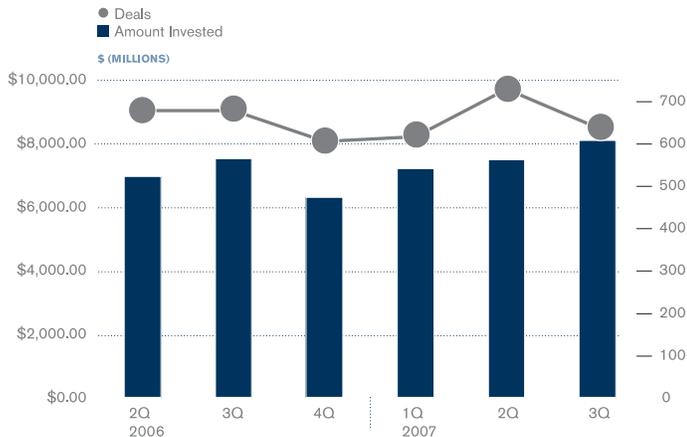
[Tell us what you think](#) (survey)

Send your comments and suggestions for topics to Bronwyn Bailey at bbailey@svb.com.

- 1 "US\$3.25B VC Investment Touches New High; Fundraising & Exit Active," Zero2IPO, January 23, 2008.
- 2 In contrast, S&P P/E ratios averaged approximately 18x at the end of October 2007.
- 3 Chinese currency is called "renminbi" ("RMB"), which means "the People's currency," and is denominated in "yuan."
- 4 Figure represents savings rate from after-tax income (Source: "National Bureau of Statistics of China Household Income and Expenditure Survey," *China Statistical Yearbook, 2004*, cited in "The value of China's emerging middle class," *McKinsey Quarterly*, June 2006.) By comparison, the personal saving rate, measured as the percentage of disposable personal income, has been less than one percent in the U.S. annually since 2005. U.S. Bureau of Economic Analysis, www.bea.gov/briefm/saving.htm.
- 5 China Cleantech Venture Capital Investment Report: 2006-Q1 2007.
- 6 Other important risks that LPs mentioned include uncertain government policy, an overheated market, inflated valuations, team instability and inexperienced managers.
- 7 Joseph Kahn and Jim Yardley. "As China Roars, Pollution Reaches Deadly Extremes," *The New York Times*, August 26, 2007.
- 8 "China expects \$1.5 billion for climate fund by 2012," Reuters, December 7, 2007.

THIRD QUARTER 2007 U.S. PRIVATE EQUITY SNAPSHOT

U.S. VENTURE INVESTING ACTIVITY



Source: Dow Jones VentureOne and Ernst & Young Quarterly Venture Capital Report

MOST ACTIVE VENTURE INVESTORS

| Firm Name | Under Mgmt | # of Deals |
|-----------------------------------|------------|------------|
| New Enterprise Associates | \$ 8,500 | 20 |
| Draper Fisher Juvetson | 4,214 | 15 |
| Menlo Ventures | 4,000 | 15 |
| Kleiner Perkins Caulfield & Byers | 1,560 | 14 |
| U.S. Venture Partners | 3,200 | 12 |
| VantagePoint Venture Partners | 4,000 | 12 |
| Foundation Capital | 1,600 | 11 |
| North Bridge Venture Partners | 2,117 | 11 |
| Sequoia Capital | 2,153 | 11 |
| Austin Ventures | 3,000 | 10 |
| Polaris Venture Partners | 3,049 | 10 |
| Bessemer Venture Partners | 2,000 | 10 |
| Highland Capital Partners | 2,964 | 9 |
| Oak Investment Partners | 8,400 | 9 |

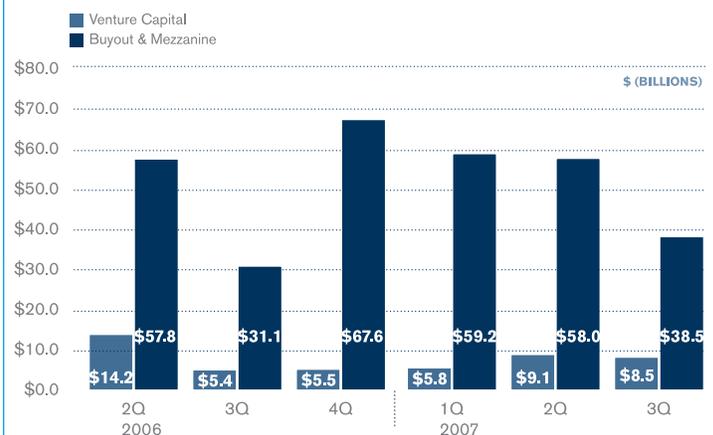
Source: Dow Jones VentureOne

VENTURE INVESTMENT BY REGION, ALL INDUSTRIES

| Region | # of Deals | # of Investing firms | Average Per Deal | Sum Inv. (\$ MILLIONS) |
|-------------------|------------|----------------------|------------------|------------------------|
| Bay Area | 196 | 294 | \$ 13.9 | \$ 2,522.6 |
| New England | 76 | 130 | 11.9 | 849.1 |
| Southeast | 27 | 50 | 32.8 | 810.3 |
| New York Metro | 57 | 98 | 12.4 | 672.0 |
| Los Angeles | 31 | 46 | 17.5 | 443.4 |
| San Diego | 33 | 60 | 13.5 | 416.5 |
| Texas | 26 | 56 | 14.3 | 373.5 |
| Southwest | 23 | 49 | 16.5 | 360.0 |
| Potomac | 26 | 37 | 10.0 | 266.0 |
| Washington State | 26 | 49 | 8.1 | 210.4 |
| Philadelphia | 15 | 25 | 19.4 | 190.1 |
| Colorado | 18 | 38 | 9.5 | 151.0 |
| Orange County | 14 | 33 | 6.9 | 101.3 |
| Midwest | 10 | 18 | 9.2 | 89.5 |
| Oregon | 5 | 9 | 9.1 | 40.5 |
| Research Triangle | 4 | 5 | 8.3 | 33.0 |

Source: Dow Jones VentureOne

FUNDRAISING BY U.S.-BASED VENTURE AND LBO/MEZZANINE FIRMS



Source: Thomson Financial Venture Economics / National Venture Capital Association

CUMULATIVE IRR PERFORMANCE (%) BY STAGE (U.S.)

| Fund Type | Num of Funds | Cap Wtd Avg | Pooled Avg | Upper Quartile | Median | Lower Quartile |
|----------------------|--------------|-------------|------------|----------------|--------|----------------|
| Early/Seed VC | 559 | 8.4 | 19.4 | 15.9 | 3.4 | (5.0) |
| Seed Stage VC | 65 | 4.9 | 9.5 | 13.3 | 3.9 | (1.3) |
| Early Stage VC | 504 | 8.5 | 20.3 | 16.3 | 3.4 | (5.6) |
| Balanced VC | 443 | 9.1 | 14.1 | 15.5 | 5.6 | (0.4) |
| Later Stage VC | 192 | 7.6 | 13.6 | 16.1 | 6.5 | (1.0) |
| All Venture | 1,204 | 8.5 | 15.8 | 15.9 | 4.8 | (2.4) |
| Small Buyouts | 179 | 9.8 | 24.9 | 17.4 | 7.5 | (0.3) |
| Med Buyouts | 109 | 13.2 | 17.7 | 22.7 | 9.1 | (0.1) |
| Large Buyouts | 91 | 9.3 | 12.5 | 17.4 | 6.6 | (1.9) |
| Mega Buyouts | 118 | 11.4 | 12.1 | 18.5 | 9.1 | 0.3 |
| All Buyouts | 497 | 11.2 | 13.8 | 18.3 | 7.8 | (0.3) |
| Mezzanine | 72 | 5.3 | 8.7 | 12.8 | 7.7 | 1.2 |
| Buyouts and Other PE | 656 | 11.0 | 13.0 | 17.7 | 8.0 | - |
| All Private Equity | 1,865 | 10.3 | 14.3 | 16.4 | 6.2 | (1.7) |

Source: Thomson Financial Venture Economics / National Venture Capital Association; data as of June 30, 2007

U.S. VENTURE LIQUIDITY EVENTS BY INDUSTRY

| Industry | 2005 | | 2006 | | 1Q-3Q 2007 | |
|------------------------|-----------|------------|-----------|------------|------------|------------|
| | IPO | M&A | IPO | M&A | IPO | M&A |
| Biopharmaceuticals | 14 | 40 | 20 | 29 | 2 | 19 |
| Healthcare Services | 0 | 11 | 0 | 6 | 0 | 3 |
| Medical Devices | 7 | 14 | 6 | 23 | 5 | 11 |
| Medical IS | 1 | 18 | 2 | 16 | 2 | 5 |
| Comm. and Networking | 3 | 40 | 5 | 49 | 9 | 26 |
| Elect. & Computer Hdw. | 1 | 12 | 1 | 14 | 2 | 7 |
| Information Services | 0 | 43 | 5 | 48 | 4 | 48 |
| Semiconductors | 4 | 17 | 2 | 18 | 3 | 12 |
| Software | 3 | 148 | 7 | 157 | 6 | 116 |
| Other | 10 | 70 | 8 | 60 | 5 | 45 |
| TOTAL | 43 | 413 | 56 | 420 | 48 | 292 |

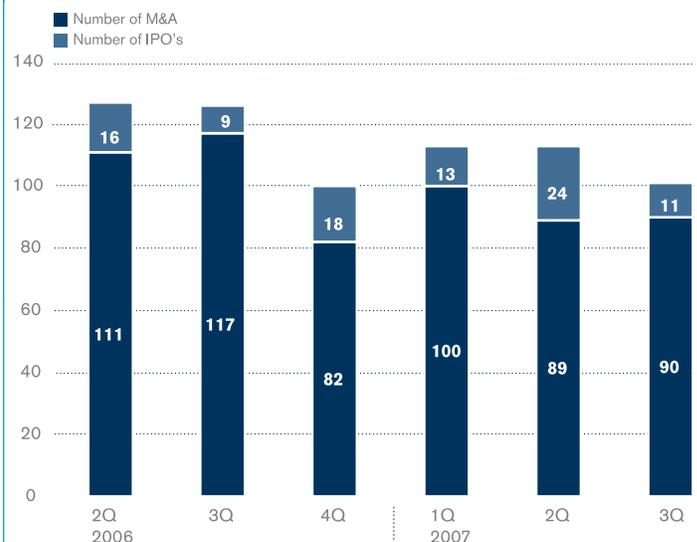
Source: Dow Jones VentureOne and Ernst & Young Quarterly Venture Capital Report

U.S. VENTURE-BACKED M&A ACTIVITY



Source: Dow Jones VentureOne

U.S. IPOs VS M&A TRANSACTIONS FOR VENTURE-BACKED COMPANIES



Source: Dow Jones VentureOne and Ernst & Young Quarterly Venture Capital Report

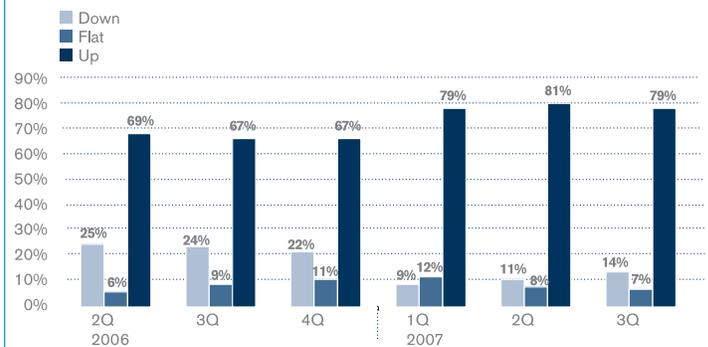
IRR PERFORMANCE (%) BY VINTAGE YEAR (U.S.)

| Vintage Year | Num of Funds | Cap Wtd Avg | Pooled Avg | Upper Quartile | Median | Lower Quartile |
|--------------|--------------|-------------|------------|----------------|--------|----------------|
| 1996 | 35 | 59.6 | 83.7 | 114.0 | 32.0 | 1.5 |
| 1997 | 61 | 46.8 | 50.0 | 59.8 | 20.3 | 0.4 |
| 1998 | 76 | 24.1 | 19.9 | 10.9 | 1.6 | (4.3) |
| 1999 | 109 | (8.1) | (7.0) | 0.5 | (7.9) | (16.0) |
| 2000 | 122 | (0.3) | 0.9 | 1.5 | (2.9) | (7.7) |
| 2001 | 54 | 2.4 | 3.2 | 10.5 | - | (3.7) |
| 2002 | 19 | 1.8 | 4.0 | 5.0 | 2.4 | (2.7) |
| 2003 | 15 | 3.0 | 3.3 | 7.9 | (0.1) | (1.9) |
| 2004 | 19 | 1.7 | 5.9 | 7.4 | (1.2) | (12.1) |
| 2005 | 10 | 0.1 | 2.4 | 8.4 | (2.2) | (4.6) |
| 2006 | 17 | (16.6) | (12.2) | (6.6) | (21.5) | (38.3) |

Source: Thomson Financial Venture Economics / National Venture Capital Association as of June 30, 2007

PRICE CHANGE

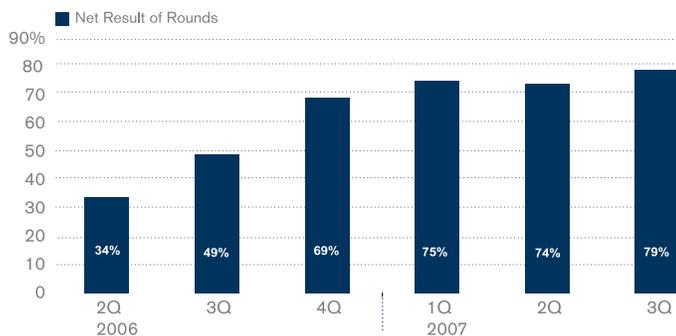
The direction of price changes for 104 San Francisco Bay Area companies receiving financing, compared to their previous rounds.



Source: Fenwick & West L.L.P.

VENTURE CAPITAL BAROMETER™

Average per share % price change from previous round of Silicon Valley companies receiving VC investment in the applicable quarter. Complete report available at <http://www.fenwick.com/vctrends.htm>



Source: Fenwick & West L.L.P.

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