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VC Players Look East, to China

U.S. tech startups are competing for venture capital funding with China, a land of low costs, huge markets, and ample opportunity—and significant risks

by [Aaron Ricalde](#)

Mainland China doesn't yet boast a Silicon Valley, but an influx of venture capital funding in promising new areas could put U.S. startups at a disadvantage as they compete for funds.

Venture capital players are increasingly betting on Chinese startups that supply the software, chips, and networks to feed the country's 400 million cell-phone users' voracious appetites for wireless data. That includes applications like instant-messaging, video-uploads, and mobile Web searches, along with consumer-level Web services such as social networking. The influx of funding saw a brisk increase last year—VCs bet \$920.7 million on information technology companies last year, up 34% from 2005, according to a Feb. 13 study from Dow Jones ([DJ](#)) VentureOne and Ernst & Young. And that funding shift across the Pacific could pressure Silicon Valley startups to devise business models with extremely meager cost structures as a way to attract venture capital.

EXPANDING BEYOND CHINA?

"The Valley investors I know are generally much more reluctant to make investments in American firms than in previous years," says Reed Hundt, the former Federal Communications Commission chairman and author of *In China's Shadow*, a book published last October on American competitiveness with China. Hundt also sits on several tech company boards.

Question is, can China's fledgling dragons spread their wings and expand beyond their home market? Investors hope so. If China's wireless and Internet companies make the trans-Pacific leap, it could mean new competition for U.S. startups. "Some days I wake up thinking that in areas like mobile services and social networking, the Americans better watch out," says Drew Clark, director of strategy at IBM's ([IBM](#)) venture capital group. Still, despite Chinese tech companies' success at home—Baidu.com ([BIDU](#)) and Alibaba.com have respectively given Google ([GOOG](#)) and eBay ([EBAY](#)) fits in China—"whether any of those will escape China's gravity and come over to the U.S., I don't know," Clark says.

While VCs have hedged their bets in China by backing later-stage companies, "we're also seeing a surge in early-stage deals," Clark says. Venture investments in China last year hit a three-year high of \$1.89 billion, according to VentureOne, and 22% of the 214 deals struck last year were second-round investments or later—up from 15% in 2005. But early-round deals still accounted for \$828.2 million in venture investing, or 62% of all deals (see [BusinessWeek.com](#), 7/24/06, "[To China, With Venture Capital](#)").

PARTNERING ABROAD

Overseas expansion is difficult under any circumstances, and Web and mobile-phone apps are particularly bound by culture, says Richard Lim, managing director of GSR Ventures, the Chinese affiliate of Mayfield Fund, which manages nearly \$300 million in China-focused venture capital. For example, Mayfield in December, 2005, invested \$1 million in PingCo.com, which makes software for sending ad-supported SMS messages that are free to users. "You can't build that business outside of China," he says—other markets lack a large enough pool of wireless Internet subscribers to make the business model fly.

What has changed is the ability of venture-backed Chinese firms to strike deals with companies that have international reach. IBM sells consulting and technology to VC-funded startups including YeePay, an electronic payments company that has a deal with Visa of China; Lingtu, a creator of digital maps that supplies location-based services to mobile-phone giant China Unicom ([CHU](#)); and Digital Media Group, which operates a network that transmits ads to electronic billboards. DMG recently won the exclusive right to serve ads aboard the express train connecting Hong Kong with its international airport.

Chinese startups' aspirations—combined with the lower investments necessary to build a profitable Mainland company—are putting pressure on U.S. entrepreneurs to keep costs down. VCs are trying to keep investments in U.S. companies below \$10 million if possible, and certainly below \$20 million. "Everybody's living by the rule of keeping the burn rate really low," says Hundt. Whereas a 100-person startup in the U.S. might burn through \$20 million a year, a like-size Chinese firm would probably consume just \$2.5 million, according to Lim. "That's why Chinese companies get very profitable very fast," he adds.

VCs are also shying away from U.S. startups with high capital requirements and operating expenses, Hundt says (see [BusinessWeek.com](#), 2/5/07, "[Venture Capital's Growing Aspirations](#)"). Take wireless Internet service providers, a category of companies long absent from VCs' U.S. portfolios. With the exception of Craig O. McCaw's Clearwire—which has amassed \$900 million in backing from Intel ([INTC](#)) and Motorola ([MOT](#)) to assemble a high-speed wireless network using WiMAX technology—those plays aren't getting launched in the States. "In China, you still see investment activity in 20th-century service-provider models," says Hundt.

STILL AN EMERGING MARKET

That's partly because average subscriber revenues in China are a fraction of what they are in the U.S. and Europe, leaving plenty of room for expansion. Indeed, the potential for big returns from backing companies that sell in China alone is often enough to justify investments, Cadol Cheung, a managing director at Intel Capital, said in an e-mail. Intel has a \$200 million fund aimed at Chinese investments. Even though many Chinese executives aren't experienced in international business, and lack sufficient English skills to expand overseas, China's IT market is so large that "the opportunity cost of going out is too high," he says.

The top investors in China last year included IDG Ventures, Sequoia Capital, Jafco Ventures, Walden International, and Softbank Capital, according to VentureOne. Among the richest early-stage deals last year, TV shopping company LuckyPai in November raised \$15 million from Intel Capital, DT Capital Partners, and Lightspeed Venture Partners. Semiconductor and networking equipment companies whose technologies underpin the emerging Web are also ripe for investment, says Gina Chan, a research manager at VentureOne. NTS Technology, a maker of equipment for 3G wireless networks, announced on Jan. 4 that it had raised \$10 million in first-round funding from Softbank Asia Infrastructure Fund.

The hottest area for technology investing overall last year was in VentureOne's "information services" category—filled with companies focused on social networking, online video, and other user-generated Web content. They garnered \$464.6 million—more than half of all venture investments in Chinese IT companies last year (see [BusinessWeek.com](#), 1/15/07, "[China: Falling Hard For Web 2.0](#)").

REGULATORY HURDLES

Still, several factors could hamper future investments. First, China's Internet economy generates less cash than that of the U.S., which could limit the number of successful companies reliant on revenue from online advertising, e-commerce, and Web site subscriptions. The Chinese government is also working on country-specific technology standards in areas including digital television, Radio Frequency Identification (RFID) chips, and software encryption methods. That could boost costs for foreign companies and help Chinese firms compete, but it's potentially at odds with VCs' interest in building the broadest possible markets for companies in their portfolios. And the Chinese government has been slow to issue operating licenses and construct 3G data networks, which could power new cellular applications like mobile blogging, searches, and mobile video uploads.

Beijing also introduced new foreign-investment rules on Sep. 8 that could subject mergers and acquisitions and initial public offerings to longer approval periods and more scrutiny. Possibly as a result, fourth-quarter venture investments in China slowed by 23% compared with the third quarter, to \$417.5 million, according to VentureOne.

According to GSR's Lim, some of the most important technology companies of the next decade will emerge from China. "The most valuable Chinese companies have some significant degree of innovation—whether in their business models or technology—compared to their counterparts in the United States," he says. The hope for profits now rests with the VCs' ability to help the Chinese startups navigate a daunting course of technical, regulatory, and cultural barriers.

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