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China Is Flooded by Venture Capital – Investment Rose 55% in 2006, With Special Focus on More-Mature Start-Up Companies

Venture-capital investment flooded into Chinese companies in 2006, rising 55% from the previous year, with more-mature start-up companies attracting money like never before.

Investors placed \$1.89 billion across 214 deals last year, compared with \$1.22 billion and 156 deals in 2005, according to a report from Dow Jones VentureOne and Ernst & Young LLC.

While venture capitalists continued to flock to early-stage start-ups with little more than a business plan, a striking note was the amount of money going into second rounds and later. Investors spread \$590.7 million over 48 second-round deals, more than doubling the \$230.7 million and 23 such deals in 2005 and by far the largest amount on record. Later-stage rounds jumped even more, with \$313.6 million going into 14 deals, versus \$140 million and eight deals the year before.

For a second-round deal, the median investment was \$10 million, up from \$7.5 million a year ago -- demonstrating that investors in China are willing to provide substantial sums to companies that are maturing their concept. The figure is larger than second-round deals in the U.S. in 2006, where the median was \$8.5 million.

Heavier investment in maturing companies, poising investors for nearer exits, creates a need for venture-capital firms to consider how they will make their exits and satisfy stringent regulators in the country.

No dollar-denominated foreign venture-capital fund has exited via a local exchange yet. These funds have tried to avoid China's strict capital controls by listing the Chinese firms they backed on international capital markets through offshore investment vehicles. But China has introduced new laws that have halted approvals for any new listings overseas.

"Regulators are always a factor, but the Chinese desire to continue to foster growth of their economy and investment in Chinese companies, so I don't see it becoming a problem," Mayfield Fund Managing Director Kevin Fong said. "The normal path for exits will still be available. I don't think there will be any fewer IPOs."

GSR Ventures, a Chinese venture firm sponsored by Mayfield Fund, closed this month its second early-stage technology fund at \$200 million, with Mayfield stepping up from a limited to a general partner.

Mr. Fong said his firm will continue a focus on early-stage companies, because he expects a lot of competition for more-mature companies.

"It's the low- hanging fruit right now," Mr. Fong said. "There's a lot of money to be made with companies that are well developed because there will be quicker liquidity."

Considering the relative newness of the Chinese venture-capital market, seed and first-round deals continue to account for the majority of deal flow in China, at 62%, but that is down from 68% in 2005. Second rounds now account for 22% of the deal flow, up from 15% in 2005. Companies raising seed and first rounds received \$880.5 million across 106 deals in 2006, versus \$693.3 million and 133 deals a year earlier.

Mr. Fong said he expects strong investment opportunities in China to continue for a few years but doesn't predict a long-lasting environment for venture capitalists in China.

"I think, first of all, that the economy and tech sector have been growing for 10 years and we all know that can't go on forever, but I see it sustaining until 2008," Mr. Fong said. "I see great opportunities for China in the next two years. I don't think 2006 will be the peak."

The largest deal of the fourth quarter and among the largest of the entire year wasn't in one of the conventional venture-capital industries. It was for an advanced materials and chemical company -- a \$52 million second round for Cathay Biotechnology of Shanghai, a provider of dibasic acids production technology.

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