

Valley VC firms boost bets on China;  
TALENT, MONEY FLOW EAST TO HUGE MARKET

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The scene was pure Silicon Valley: a throng of venture capitalists and entrepreneurs schmoozing and noshing on caviar appetizers and chilled sauvignon blanc at a swanky Palo Alto bistro.

But the talk was pure China. And many of the 200 guests at the capitalist lovefest two weeks ago at Zibibbo were entrepreneurs from Beijing and Shanghai.

Silicon Valley venture capitalists are placing more bets on China, accelerating a trend that began about three years ago. China's swelling consumer market and turbocharged growth rate are capturing the eyes and dollars of such top-tier VC firms as Draper Fisher Jurvetson, Kleiner Perkins and Gobi Partners.

China's ability to attract Silicon Valley's leading venture firms, which have been instrumental in transforming the Bay Area into the world's leading technology center, raises questions about the valley's prospects of maintaining its competitive edge. Already, the infatuation with the Middle Kingdom is causing changes in the Bay Area.

"There's no doubt that any dollars or resource of time that goes toward Asia takes away from the region," said Kevin Fong, a managing director of Mayfield Fund, which invested in an \$80 million China fund run by its partner, GSR Ventures. Venture capitalists such as Fong invest in private companies in exchange for an equity stake. "Maybe that's also a sign that there's too much money and competition in the valley."

Most venture investments in China are in high-tech companies serving the ballooning Chinese domestic market.

#### Growth potential

Last year, \$1.05 billion in venture capital flowed to China, with 30 to 40 percent of that coming from Silicon Valley, estimates Gavin Ni, chief executive of Zero2IPO, a venture research firm in Beijing. The percentage coming from Bay Area firms has doubled from just three years ago, he said.

That \$300 million to \$400 million is small compared with the \$7.69 billion in overall venture money that flowed into Bay Area companies in 2005.

But a string of eye-popping public offerings, most recently of Beijing-based Baidu, which has been described as China's Google, will help China net more Silicon Valley dollars. Baidu's shares skyrocketed 354 percent on its public offering day.

Seven Chinese firms went public last year on the Nasdaq Stock Market. Their total worth today is about \$7.6 billion -- the equivalent of the top 12 U.S. firms that also went public in 2005.

"You are following the money," said venture capitalist Tim Draper of Draper Fisher Jurvetson, one of the earliest big-name firms to invest in China. The firm's \$14 million investment in Baidu has swelled to \$325 million. "The great minds and the capital will move to the places that are the most aggressive, most active and where the growth rate is highest."

Over the next year or two, Draper and others say, bigger and better deals will increasingly come out of China, not Silicon Valley. That anticipated shift has already brought about behavior changes.

Entrepreneurs and venture capitalists agree that some start-ups are more likely to get funding if they are Chinese-based companies serving the Chinese market, as opposed to Silicon Valley-based firms.

AMEC, a Shanghai-based semiconductor equipment company whose 18 founders all left Silicon Valley to start the firm in China, "never" would have received funding if it were based in Silicon Valley, said Hina Group's chief executive, Hong Chen. Hina, the Chinese equity investment firm that hosted the Zibibbo party, brokered the \$30 million deal and AMEC eventually received funding from several Silicon Valley venture firms, including a handful of China first-timers.

"No one would fund a start-up in Silicon Valley that's going to compete with Applied," said Chen, of Santa Clara-based semiconductor equipment giant, Applied Materials. "But . . . you get a lot of attention and traction from Silicon Valley VCs if you have a presence in China."

More consumers

Start-ups in wireless, mobile phone services and semiconductor design may also have better chances at funding if they are China-based. China has eclipsed the United States as the largest consumer of integrated circuits, used in many electronic products.

And Silicon Valley venture firms may be more willing to assume more risk in Chinese investments because their dollar goes further. "Ten million allows you to make a lot of mistakes in China," Chen said.

Because it's relatively cheap to get a Chinese company running, the standards used to judge whether a company is a good investment may be lower in China, others said. On

the upside, the venture capitalists get larger stakes of the company because Chinese entrepreneurs are hungry for money.

Too distant for some

But not everyone is betting on China. The partners of Tallwood Venture, which invests its \$180 million fund only in semiconductor start-ups, went on an exploratory trip to China in late 2004. They decided to hold off. The primary reason: The investment across the Pacific would require a more passive approach. Along with putting money into its start-ups, the firm joins the board and takes on a full-fledged coaching role.

“We work with them a lot between board meetings. That's the kind of active involvement we take,” said Ron Yara, a partner. “You can't do that if you have to hop on a plane.”

China is attracting not just Silicon Valley money but also its talent. Many of the Chinese-based firms with Silicon Valley funding proudly tout executives from the valley. Baidu's chief executive, Robin Li, left valley firm Infoseek to found Baidu.

“Being able to speak the language of Silicon Valley to venture capitalists is very important,” Li said from his Beijing office.

About 70 percent of Silicon Valley firms' investments in China are in companies with an executive from the Bay Area, estimates Tony Luh, co-founder and managing director of DragonVenture, which has been in China since 1999.

All three of the people who served as presidents of Hua Yuan Science and Technology Association, a Bay Area group that attracts mainland Chinese, have returned to China to start firms in the venture investment arena. Min Zhu, current president of Hua Yuan and co-founder of WebEx, was tapped by New Enterprise Associates to run its China fund.

It's difficult to predict what the long-term impact of this movement of money and brains away from Silicon Valley will be. Venture capitalists say innovative start-ups will continue to get funded in the valley. Most don't believe a “brain drain” will occur because the area's acclaimed business schools will continue to attract top students from around the world.

“Some people will look at it as a zero-sum game,” said Marc Verissimo, Silicon Valley Bank's chief strategy officer. “That's a limiting view. India and China will be competitors in one sense. But valley companies can get something from working with them.”

Foot in both worlds

What may emerge is a “hybrid” model, businesses that capitalize on the best that both sides of the Pacific offer.

One example is Anda Networks, a Sunnyvale telecommunications equipment manufacturer that was struggling to improve its margins. It acquired a Chinese firm in 2000 and moved most of its operations and manufacturing to China. The firm recorded a profit for the first time last year.

"It was a good marriage," said Charles Kenmore, Anda's chief executive. "I think it is reasonable that by 2010 virtually all infotech companies in the valley will have made the transition."

The shift to China, most say, will force Silicon Valley entrepreneurs to focus on what's made Silicon Valley stand apart: innovation.

"The valley's still the best place to start a business anywhere in the world," said Richard Lim of GSR Ventures. "Because of China, the valley will be less dominant, but it will still remain important."