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www.emeraldinsight.com/0025-1747.htm

Received March 2006
Revised February 2007
Accepted February 2007

Venture capital in China: a culture shock for Western investors

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Abstract
Purpose – This study seeks to examine the peculiarities of the venture capital market in China and seeks to compare it with Western markets.

Design/methodology/approach – The paper provides insights based on both the practitioner and academic literature in the field.

Findings – It is noted that different cultural norms, corporate governance structures, a lack of appropriate exit strategies, and governmental intervention are important factors that set the markets apart and should be taken into consideration when making venture capital investments in China.

Practical implications – The paper should be of interest to practitioners considering investing in China and to academics doing research in this area.

Originality/value – The paper is to the best of the authors' knowledge the first to provide a detailed and comprehensive review of the Chinese venture capital market.

Keywords Venture capital, Economic policy, Entrepreneurialism, China

Paper type General review

1. Introduction
James Wolfensohn, the recent World Bank President, once said, "The Chinese have accomplished in only 20 years what would take many other countries two centuries to achieve". Statements such as these are not far-fetched: apart from undergoing many structural changes, China has maintained GDP growth rates of 8 per cent *per annum* since 1980, has an increasingly affluent population of approximately 1.3 billion and an emerging middle class, making it an economic powerhouse in the region. In 2005, China overtook Britain and became the fourth largest economy in the world in terms of gross domestic product (GDP)[1]. These developments have attracted a lot of attention from overseas investors and – not surprisingly – a considerable amount of foreign capital. Of particular interest to investors have been venture capital investments in recent years (*Business Week*, 2006). Statistics show that in 2004, China took third place in the world as the country with the largest amount of venture capital (VC) investments after the USA and the UK[2]. According to the Hong Kong based *Asian Venture Capital Journal*, VC investments in China amounted to approximately US$1.17 billion in 2005 – almost four times as much as the $325 million that was invested just three years earlier, in 2002. In 2006, venture capital flows to companies headquartered in mainland China continued to be on the rise and reached a new high, with 54 deals valued at more than $480 million in the second quarter of 2006 alone – twice the amount invested during the same quarter in 2005[3]. What may contribute to the excitement are a

Management Decision
Vol. 45 No. 4, 2007
pp. 708-731
© Emerald Group Publishing Limited
0025-1747
DOI 10.1108/00251740710745999

number of recent success stories involving venture-backed firms that recently went public in the USA and have done exceptionally well[4]. While some experts view these developments cautiously – warning that too much funding that is too eagerly "thrown around" may cause the Chinese economy to overheat – others argue that venture capitalists have only just begun to tap into what may become one of the industry's most successful undertakings, with a highly favorable environment allowing the venture capital industry to grow strongly for a long time to come. Zeng (2004), for example, predicts that "[China] is expected to continue to increase its venture investments in the coming ten years and will take the second position in global venture investments in the near future".

Venture capital investments involve a high level of risk, but on average also yield high returns. Given China's promising future, Western interest is unlikely to subside any time soon. Yet, entering the Chinese market is not straightforward. Even outside of Asia, there is ample evidence of significant cross-country differences in venture capital markets and their internal structures, making it difficult for industry professionals to move from one market to another. While the gap appears to be shrinking among Western – particularly European and North American – markets in recent years[5], the disparities between the Western VC markets and the emerging VC market in China remain large. In the West, profit maximization, efficiency, and public information disclosure are important factors for investors. In contrast, personal relationships, networking, and harmony are ranked highly in East Asia (Ahlstrom and Bruton, 2001; Chen, 2001). The Chinese culture in particular places a large emphasis on the maintenance of so-called "*guanxi*" networks, under which harmony with and within organizations is frequently favored over information disclosure and shareholder rights (Bruton *et al.*, 2004). While Western business culture emphasizes profit maximization, shareholder rights protection, and transparency, Chinese business culture focuses on networking, harmony, and seniority. In addition, the Chinese culture typically has a high tolerance for information asymmetry between the firm's insiders and external investors as well as outside board members (Bruton *et al.*, 1999).

A proper understanding of these differences and the challenges they create is very important, particularly in an industry that is already as complex and risky as the venture capital market. To help Western investors avoid potentially costly mistakes, our study aims to provide a detailed look "behind the curtain" and aid in the understanding of how the local VC markets work. In addition, we raise and address several important questions that we hope will assist Western investors in making appropriate and well-informed investment decisions.

The remainder of this paper is organized as follows. In Section 2, we discuss the historical developments and recent trends that have shaped the venture capital industry in the West. In Section 3, we focus our attention on the venture capital market in China and outline how it differs from Western markets. Section 4 discusses some of the recent measures the Chinese government has taken to aid the development of the local venture capital industry and to implement laws and regulations that are at par with international standards. Section 5 summarizes our findings and provides concluding remarks.

2. Venture capital in the West

No comparative study on venture capitalism would be complete without looking at the USA, the country that is considered by many the industry's birthplace. In the late 1970s, the venture capital industry started to enter the international arena, with the UK and Ireland being among the first countries to attract venture capitalists. Early VC funds in both countries were typically set up as affiliates of US firms and drew heavily on American capital and expertise. Continental Europe followed in the early 1980s, where VC funds were frequently set up by large domestic banks (see Oehler *et al.*, 2006). The prime motivation that drives the VC industry in these countries is generally profit maximization or, as Sahlman (1990) put it, "the desire to do as well as financially possible".

During its early years, when the US venture capital industry was comparatively small, it had to find ways to control the risk associated with financing start-up ventures. As it was growing, however, and more players entered the arena, VC firms increasingly syndicated with each other. This allowed them to spread their risk without having to rely on external guarantors and resulted in the development of strong inter-relationships among the VC firms (Bygrave, 1987; Reiner, 1989). Yet, as time passed and VC firms became increasingly larger, so did their investment portfolios. As a result of this growth, VC funds have become sufficiently well diversified, and today there are only few instances where venture capitalists still syndicate their financial investments. However, this has not affected the relational ties among the VCs, which continue to be strong. It is common practice, for example, for VCs in the USA to seek advice from venture capitalists at other firms (Fried and Hisrich, 1994), or to provide assistance and share information with each other to monitor a given investment more efficiently (Bruton *et al.*, 1998a, b). These ties among US VCs are also responsible for the strong similarities one can observe in the way business is conducted in the industry, resulting in what some researchers call the industry's dominant logic. According to Sapienza (1992) and Black and Gilson (1998), VCs in the West not only provide money to the venture but also add value by providing management assistance, recruiting key executives, sitting on the firm's board of directors, and providing access to their existing networks and contacts (Megginson and Weiss, 1991).

Bruton *et al.* (1998b) note that the similarities one can observe among VCs in the US venture capital industry are reinforced by a strong trade association, i.e. the National Venture Capital Association, which was conceived in 1973 and since then has taken up the task of supporting public policy initiatives and providing continuing education and industry research services. A major goal of the organization is to develop a code of conduct for the promotion of professional behavior. The Association drafts professional standards with which members are bound to comply. While it is a voluntary organization, it has earned its reputation as an institution and presently over half of all American venture capitalists are members (Bruton *et al.*, 1998b; Oehler *et al.*, 2006).

3. Venture capital in China

Although Japan has been the focal point of venture capitalist activity in Asia for most of the last two decades, China has received increased attention in recent years, likely because it has many of the right elements that are required for a strong venture capital

industry, including robust economic growth, a growing commitment to intellectual property rights protection, and a strong entrepreneurial culture. The latter not only drives much of the economic development in mainland China, but also in many other Asian countries such as Taiwan, Indonesia, and Singapore – countries that have experienced economic growth that is similar to that in China[6]. Moreover, the Chinese educational system directs a large number of its students to programs in engineering and business at Chinese and US universities, laying the groundwork for its continued development and increasing dominance in world trade. It is not surprising that as a result of these developments, China has registered a surge in VC investments in recent years, primarily in the coastal provinces near Hong Kong (Nuechterlein, 2000).

Nevertheless, venture capitalists face a plethora of obstacles in China, because of which the returns on their investments are generally in single digits[7]. The low returns can be attributed to several factors: first, one has to remember that China has for several decades been under a Communist regime that curtailed entrepreneurial activity and has only recently opened itself to the West. As a result, it is often difficult to find experienced managers to run entrepreneurial companies. Second, the relationship between venture capitalists and the companies they fund is very different in China from that in the USA and Europe. Third, China does not have accounting and reporting standards, credit ratings, or a legal system that are as good as those in the USA. Finally, China's two most prominent stock exchanges in Shanghai and Shenzhen are still in their infancy, making it difficult for venture capitalists to exit their investments. We will discuss these issues in detail in Section 3.3.

3.1. The history of venture capital in China

China's venture capital industry was established in the mid-1980s, when the Chinese government decided that it should develop local high-tech industries (Xiao, 2002). However, initial attempts to create a flourishing high-tech sector were not very fruitful, largely because government officials and early venture capitalists lacked the necessary understanding and expertise and frequently channeled their efforts in the wrong direction. The failure of the China New Technology Start-up Investment Company, a well-known venture capital firm in China that went bankrupt in 1997, serves as a good example. But with continued support from the government and the private sector, China's venture capital industry overcame its sluggish growth and started to flourish in 1999 and 2000, a time period characterized by strong stock market performance and investor optimism not only in China but also in the rest of the world. According to incomplete statistical data, there were around 120 venture capital firms and 156 incubators in China in 2000 and Beijing, Shanghai and Shenzhen are emerging as the centers of the venture capital industry (Xiao, 2002).

The evolution of private equity in China was marked by the establishment of so-called "China Direct Investment Funds" (CDIFs). These funds were listed on the Dublin, London, and Hong Kong stock exchanges and were primarily targeted at institutional investors. Yet, because the stock exchanges recognized these funds as investment companies, they restricted their investments. As Bruton and Ahlstrom (2003) point out, the London Stock Exchange, for example, prohibited CDIFs from becoming majority shareholders in any of the ventures they invested in, restricted them from playing a significant role in the management of a funded firm, and barred them from investing more than one-fifth of their capital pool in any one firm. Bruton

et al. (1999) and Bruton and Ahlstrom (2003) note that – possibly as a result of these restrictions – CDIFs were largely invested in government-owned state or township/village enterprises (TVEs) throughout China, not in privately owned businesses. CDIFs typically did not focus on a specific industry. Instead, they provided interim financing for firms in a wide variety of industries and aimed to build relationships with large state enterprises which, in turn, frequently helped the CDIFs source investment opportunities in other affiliated firms. Xin and Pearce (1996) and Bruton and Ahlstrom (2003) review the relationship between Sino-Chem – a large state-owned firm that is in charge of building external import-export networks for the chemical industry in China – and a Western CDIF. They note that the collaboration between Sino-Chem and the CDIF serves as a good example for the aforementioned symbiosis. As part of their deal, the Western CDIF provided not only money but also managerial expertise to Sino-Chem. In return, Sino-Chem located a number of chemical-related deals and provided the CDIF with the necessary connections to government officials to ensure the success of those deals. Once a CDIF decided to follow through on a proposed deal, it typically entered a joint venture with the funded firm and the large state entity that sourced the deal (Xin and Pearce, 1996).

Yet, a frequent problem for CDIFs was that large state entities like Sino-Chem often kept the best deals for themselves and only offered the lower quality deals to the CDIFs. Despite the poor performance that CDIFs frequently suffered as a result, a large part of China's venture capital industry is still organized in the form of CDIFs. What has changed, however, is that most of the new investment funds are not listed on stock exchanges any more. Instead, they are organized as limited partnerships, as is typically the case for US venture capital funds (Bruton and Ahlstrom, 2003).

3.2 Recent developments in China's venture capital industry

Today, venture capital investments in China are coming from different sources like the government, state-owned enterprises, private firms, public companies, non-banking financial institutions, multinational corporations and foreign venture capital funds. As of 2000, foreign funded venture capital firms account for 8 percent of China's venture capital organizations and their presence and market share keeps growing. As a result, domestic investors increasingly compete with multinational corporations and foreign venture capital funds that possess abundant capital and superior project evaluation capabilities, for access to high-quality investments in China, most of them in the fast-growing technology sector.

Venture capital investments in China vary along several dimensions such as size, stage, voting control, duration, and location. Investments in industrial and service-oriented projects are typically less than $20 million, while investments in infrastructure projects can easily surpass the $100 million mark. Of the companies that receive venture capital financing, turn-of-the-millennium figures suggest that 28 percent are in the seeding stage, 53.6 percent are in the growth stage and 18.4 percent are mature-stage companies. Venture capitalists typically take passive equity stakes of 10-49 percent of effective voting control, require at least one out of five seats on the board of the investee company, and hold these stakes for an average of four to five years (Folta, 1999). Most foreign investments are made through funds located in Hong Kong, but venture capitalists from other Asian countries (primarily Japan and Singapore) as well as the USA and Europe also play an increasingly important role. A

majority of VC investments are made in China's Eastern regions. This is the case for both foreign funds, which typically see better investment opportunities in the industrialized coastal regions, as well as local Chinese VC firms themselves. While yearly statistics are not available, year 2000 figures suggest that among the latter, only seven were located in the West and 40 were located in the East. Finally, there is considerable clustering in terms of the industries that receive funding: about 90 per cent of all VC firms that invest in China specialize in and seek out investments in the high-tech sector (*People's Daily*, 2000).

3.3 A comparison between China and the West

Our earlier discussion has demonstrated that Western investors face a number of unique challenges in China. In this section, we aim to outline and examine the specific factors that have affected – and continue to affect – China's venture capital market and set it apart from its Western counterparts. A proper understanding of these differences should not only be beneficial to practitioners by helping them make better-informed investment decisions but also to academics who want to conduct further comparative research in this area.

3.3.1 Regulatory systems and capital market structure. In recent years, there has been considerable debate among academicians about what causes one country's capital market to develop differently from that of another country. While most of that debate has revolved around broader issues such as economic growth and firms' access to capital, a small but growing strand of the academic literature focuses on the venture capital industry in particular. An early study by Black and Gilson (1998) points out that one of the main factors that causes the VC industry to differ from country to country is the underlying structure of the country's capital market, i.e. whether it is bank-centered or stock-market centered. Stock-market centered countries typically have many banks that are small relative to large corporations. The stock markets in these countries tend to be well developed and corporate governance functions tend to be conducted via cross-holdings and interchanging board memberships among the corporations. Bank-centered countries, on the other hand, tend to have fewer but larger banks that make significant investments in the corporate sector and consequently play a central corporate governance role. In contrast to the US capital market, which is largely stock-market centered, the Chinese capital market is by and large bank-centered. European markets, in comparison, are somewhat mixed: the British and Irish capital markets are stock-market based whereas most Continental European countries have bank-centered capital markets (see Oehler *et al.*, 2006). As is typical in bank-centered economies, Chinese banks tend to hold significant stakes in local firms and frequently serve on their boards of directors, a practice that is unusual for US firms. As Bruton *et al.* (2002b) point out, one of the reasons why a nation is bank- or stock-market centered is the regulatory scheme employed by that nation. In China – as in many other Asian countries – regulators have traditionally encouraged banks to own equity in customer firms and to serve on the boards of directors of those corporations. Regulators in the US and other stock-market centered countries typically oppose such relationships.

Bruton *et al.* (2002b) further note that the Chinese regulatory system provides little support for stock market development. First, the financial reporting requirements in China are far less transparent than Western reporting standards (see also Backman, 1995), which makes it difficult for investors to monitor their investments. Second,

relative to the West, Chinese securities laws and their enforcement are comparatively weak, leaving shareholders with insufficient protection and inadequate means of legal recourse in the case that a company defrauds them (c.f. Allen *et al.*, 2002; Bruton *et al.*, 2002b).

Yet, these shortcomings hamper not only stock market investments. They provide an even bigger impediment for venture capitalists – an investor group whose success depends more than that of any other investor group on the ability to monitor and steer the firms they invest in.

3.3.2 Culture. Everyone who does business in a foreign country has to be aware of and responsive to that nation's culture. In the Western hemisphere, cultural differences between countries tend to be comparatively minor and businessmen and -women can typically adjust to another nation's culture without major difficulties. When setting foot into China, however, it is easy for Westerners to become overwhelmed by the cultural differences they suddenly face. These differences not only require personal adjustments in one's lifestyle and the way we interact and communicate with others while working abroad, they also necessitate substantial modifications in the corporate decision making process as many standards and routines that are taken for granted in the Western business world may not apply in China. Because the cultural differences between the West and China are so big, it comes as no surprise that both the academic and practitioner-oriented business literature has devoted extensive efforts into outlining and discussing them[8].

In a country like China, whose culture shows a strong collectivistic orientation, employees tend to share responsibility within an organization. That is, it is rare for an individual to be responsible for an activity; instead there is an emphasis on collective actions across all levels in a firm's hierarchy (Boisot and Child, 1988; Bruton *et al.*, 2002b). For Western business people, that means that negotiations and routine communications will rarely take place on a one-on-one basis, but will typically entail communicating with several individuals who share responsibility for a given task. This collectivistic approach is far reaching and, as demonstrated by Ueno and Sekaran (1992), even affects such areas as financial budgeting. In fact, teamwork has become such a standard in Chinese business culture that when individuals are taken out of a group and are asked to work alone, their performance tends to drop significantly (Earley, 1993).

3.3.2.1 Guanxi. *Guanxi* refers to the relationships and networks a business person maintains both within a firm and outside the firm or – when referring to the venture capital industry – the interconnections and relationships between venture capitalists and their related networks of investors, entrepreneurs, and other venture capitalists. According to Tsang (1998), *guanxi* can serve as a resource that can be called on when needed but also represents a liability when a favor is owed. When maintained and employed properly, *guanxi* with key individuals both inside and outside one's organization can be used efficiently to create value both for the venture capitalist organization itself as well as the firm it funds. Yet, *guanxi* networks take time to develop and require a venture capitalist to offer and provide benefits to the parties with which they aim to establish a close relationship.

Another characteristic of *guanxi* networks is that they are driven by unwritten social rules. While business transactions in the West are typically based on carefully worded contracts that are enforceable under a country's laws and regulations, China's

legal system provides comparatively little protection if things go sour. As a result, Chinese business partners rely more heavily on the social responsibilities that come with a well-maintained *guanxi* relationship.

The extent of the *guanxi* network that is required for a firm to become successful is difficult to establish. As documented in a case study by Mann (1997), having a handful of top executives and central government officials in one's *guanxi* network is not enough. Many of the first Western venture capital firms that entered China failed because they believed that *guanxi* with a few top officials in the Chinese government would be sufficient to guarantee their success. But this is not what *guanxi* is about: the network has to be very broad-based to be beneficial. The main reason why such a vast network is needed lies in the aforementioned lack of a proper legal and administrative framework (Luo, 2000). With many of China's laws in flux and open to ambiguous – and in some cases – paradoxical interpretations, the wider the *guanxi* network and the more personal relationships and favors one can call on, the less likely it is that one encounters a bad surprise such as a zoning law conflict or a tax audit. With venture capital being one of the youngest and thus least regulated industries, the absence of a basic legal infrastructure to support and regulate a planned investment is particularly problematic. As a result, venture capitalists are particularly well advised to establish a broad *guanxi* network before entering the Chinese market and to continue to maintain it once they have established a presence. Finally, because the success of a venture capitalist firm depends not only on its own *guanxi* network but also on the *guanxi* networks of the firms they consider funding as well as the managers they plan to employ, it is important for a venture capitalist to be able to judge the *guanxi* of other firms and individuals – a task that entails much more than the due diligence Western VC firms typically conduct before making an investment or hiring a key professional[9].

3.3.2.2 The venture capitalist/entrepreneur relationship. Another difference between the Chinese venture capital industry and that in the USA lies in the relationship that venture capitalists maintain with the entrepreneurs they fund. Sahlman (1990), for example, notes that in the USA, venture capitalists tend to structure deals in order to maximize returns while minimizing agency risks. He points out that although US VCs commonly view the VC firm and its portfolio companies as two separate entities, they share the goal of growth and profit maximization with the funded firm's management (Bruton *et al.*, 2004). A venture capitalist intent on entering China, however, has to be aware that his goals may be fundamentally different from those of the entrepreneur and Chinese government departments with influence over the firm (Bruton *et al.*, 2002b).

Backman (1995) and Weidenbaum and Hughes (1996) examine standard buyer/seller relationships in Asia and note that they are much closer than in the West. Their results are in line with an earlier study by Kao (1993), who points out that when a Chinese entrepreneur enters into a business deal, he is not just interested in the economics of the contract, but also in the relationship it represents. Indeed, Chinese businessmen generally anticipate that their commercial dealings result in more than a formal legal relationship – they expect their business partners to provide them with personal and equity links and extended interconnected networks (Gerlach, 1992).

Bruton *et al.* (2002b) argue that this collectivistic perspective affects venture capitalists as well. When examining the interactions between venture capitalists and

the CEOs of the firms they fund, Bruton *et al.* (2002b) find that, in the West, the time a venture capitalist spends in face-to-face contact with the firm's CEO generally varies with the perceived risk of the funded venture. That is, the riskier a firm is perceived to be, the more time the venture capitalist will devote to monitoring his investment (Sapienza *et al.*, 1996; Bruton *et al.*, 2004)[10].

In contrast, Chinese venture capitalists frequently maintain contacts not only with the CEO, but with a wider range of top and mid-level managers. In line with the concept of relational ties that we discussed earlier, the time the venture capitalist spends with these parties is largely driven by his desire to build and maintain a relationship instead of economic or risk-related considerations. The invested time is not wasted, however: on one hand, the venture capitalist stands to gain from the network he develops by securing potential follow-up business (e.g. funding requests for future acquisitions by the firm or referrals to other firms that may require financing); on the other hand, the personal accountability that results from the personal ties he maintains with the firm's managers can help overcome some of the regulatory shortcomings that still exist in China.

Indeed, after conducting extensive interviews with venture capitalists in East Asian countries – many of them in China – Bruton *et al.* (2004) find that effective monitoring in these countries is only possible if a venture capitalist builds personal relationships with funded entrepreneurs. They argue that as a result, Western venture capitalists have to be aware that the time, effort, and costs they will have to spend in an effort to monitor a firm effectively will be significantly higher in China than what they are used to in the West. This is in line with earlier findings by Bruton *et al.* (2002b), who show that the number of years the funded venture has been in the VC firm's portfolio is negatively related to the amount of time the venture capitalists devote to the funded venture in the USA and Europe. On the other hand, they document that the factors are unrelated in China.

Finally, venture capitalists have to be aware of government intervention that may affect their interactions with the firm (Peng *et al.*, 2001). Steinfeld (1998), for example, points out that with a population of over one billion people, China is concerned that as the state sector shrinks, a rise in unemployment could create social instability. As a result, Chinese firms are often encouraged by the state to maximize employment and production (Bruton *et al.*, 2002b). Thus, without careful oversight, firms can end up with larger than expected payroll expenses and an overproduction of goods that could result in unsellable inventory.

3.3.3 Selection of the firms to fund. The criteria based on which a venture capitalist will evaluate a firm and decide whether or not to fund it differ significantly between China and the West (Bruton and Ahlstrom, 2003). In Western countries, a firm's business plan typically serves as the primary document based on which a firm is evaluated and the risk of the investment is judged. In China, a firm's business plan represents only one piece of the puzzle. Aside from its evaluation, venture capitalists typically collect and analyze information from various other sources before they make their investment decision. The procedures venture capitalists typically follow in China are outlined below.

3.3.3.1 Initial screening. Venture capitalists in the West typically have a screening mechanism in place which they employ in their initial evaluation of all new proposals (Bruton and Ahlstrom, 2003). Such screening mechanisms are usually based on both

historical and forecasted financial and accounting information as well as a number of pre-specified risk factors that the venture capitalist will look out for. By employing these somewhat standardized screening criteria, venture capitalists are able to quickly discard proposals that they view as too risky or otherwise unappealing and to focus their efforts on what they regard as the most attractive proposals. While venture capitalists in China employ similar screening mechanisms, they typically include a number of additional criteria that are based on the regulatory and institutional environment and often require subjective judgments. Since there is no preset formula that can be employed to evaluate the ever-fluctuating risk of regulatory impediments or the possible malevolence of government officials that a firm may face, a venture capitalist has to be well experienced and needs to work with the right people to evaluate and – if possible – circumvent such risks.

3.3.3.2 Obtaining financial and accounting information. Accounting standards and auditing practices in China and the West are strikingly different. In Western countries, accounting and auditing practices have evolved to provide potential investors with as much insight into a firm's past performance as possible and to make it transparent to all outsiders. Because a firm's financials are an important criterion on which venture capitalists base their funding decision, particularly for later stage ventures, financial transparency is key to making informed investment decisions (Wright and Robbie, 1996; McGrath, 1997; Bruton and Ahlstrom, 2003).

Chinese accounting standards, on the other hand, do not provide the same level of transparency that venture capitalists have become accustomed to in the West. While Chinese venture capitalists also prefer to fund firms that have a proven track record and strong financials, the information they have to work with tends to be very different from what disclosure rules mandate in the West.

Following decades of Communist rule, China's accounting standards are primarily designed to assist firms in production planning, not asset valuation (which is their primary purpose in the West). Another problem that Chinese venture capitalists have long complained about is the fact that regulations are often confusing and are not properly enforced (Becker, 2000). Taken together, these factors make it very difficult for venture capitalists to obtain financial information that is reliable and useful, a problem that they typically do not face in the West.

3.3.3.3 Due diligence. In Western countries, once a firm passes a venture capitalist's initial screening, the venture capitalist proceeds with due diligence, which includes a careful assessment of the desirability and value of an investment in the firm as well as a rigorous examination to confirm the information the firm provided to the venture capitalist (Fried and Hisrich, 1994; Bruton and Ahlstrom, 2003). When venture capitalists first entered China, they typically proceeded with little or no due diligence. While the "goldrush mentality" of early VCs may have led to some carelessness, it was also caused in large part by the lack of a proper support system that was needed to carry out proper checks (Mann, 1997; Bruton *et al.*, 1999).

In fact, as Bruton and Ahlstrom (2003) point out, obtaining accurate and reliable information is still a problem for VCs today. Although the Chinese government has implemented some regulatory reforms to bring the Chinese accounting system up to Western standards and make information better accessible, the Chinese capital markets still lack transparency. Bruton and Ahlstrom's (2003) discussion is consistent with earlier findings by Boisot and Child (1988, 1996), who argue that information is

tightly controlled in China. They point out that under the central planning system, bureaucrats and business people control almost all of the information that is required to properly understand the market and local regulatory environment and that they only share that information in exchange for favors or kick-backs.

3.3.3.4 Knowing an entrepreneur's background. Aside from performing a quantitative analysis of a potential investment, Western venture capitalists frequently spend a considerable amount of time on "people research", that is, evaluating the entrepreneur or the team of entrepreneurs who applied for funding (Tyebjee and Bruno, 1984; Bruton *et al.*, 1998a). Bruton and Ahlstrom (2003, p. 243) quote the legendary venture capitalist Arthur Rock, who once observed "Nearly every mistake I have made has been in picking the wrong people".

Given the aforementioned difficulties that venture capitalists face in China when trying to obtain and validate company information, ensuring the reliability and honesty of the applicant is particularly important. Yet, conducting personal background checks or monitoring an entrepreneur is hampered both by legal and cultural barriers (Lubman, 1999; Becker, 2000). Bruton and Ahlstrom (2003) review earlier studies by Goa *et al.* (1996) and Wank (1996), and conclude that in the Chinese culture, it is almost impossible to find individuals of responsibility who are willing to share information with someone they do not have a relationship with. To overcome this problem, venture capitalists are well advised to build an extensive *guanxi* network that will allow them to acquire the information they need to evaluate and monitor the entrepreneur.

3.3.4 Monitoring of the firm. Once an investment decision has been made, VCs have to stay informed about the firm's performance through regular supervision and monitoring. In Western countries, VCs typically conduct their monitoring activities through a membership on the firm's board of directors (Sapienza, 1992; Fiet, 1995; Bruton and Ahlstrom, 2003). Before entering China, VCs should be aware that a VC investment will not necessarily guarantee them a board seat (Low, 2002). Moreover, even if they do obtain a board seat, it typically does not provide them with the same benefits they enjoy in the West. After conducting extensive interviews with venture capitalists who entered China, Bruton *et al.* (2004) note that information is often withheld from the board, and the influence of outside directors remains weak. In addition, they quote several venture capitalists who invest in China and report that it is not uncommon for the minutes of board meetings to be written before the meeting has actually started, complete with ready-made quotes from that venture capitalist. To avoid these problems, venture capitalists frequently seek to protect themselves by adding extensive minority protection clauses to their investment agreements (Bruton and Ahlstrom, 2003) even though their eventual enforcement is often difficult in the face of underdeveloped regulatory institutions, a comparatively weak court system, and insufficient commercial code.

Because many of the traditional means of monitoring that are common in Western countries may be futile in China, it is crucially important for venture capitalists to form a close personal relationship with the entrepreneur and to gain his trust. Once they have developed such a relationship, they are much more likely to obtain the information they require and can feel more assured that the information is indeed accurate. As such, the relationship and communication between venture capitalists and the entrepreneur is similar to that between other parties in the Chinese culture. That

means that, unless the venture capitalist manages to enter the entrepreneur's trusted circle, he will be considered an outsider and his access to information will be severely restricted (Goa *et al.*, 1996).

3.3.4.1 Monitoring and the board of directors. In the USA and other Western countries, venture capitalists typically have a strong impact on the governance structure of the funded firms in their portfolio (Sahlman, 1990; Bruton *et al.*, 2002b). As noted earlier, this includes occupying one or more seats on the firm's board of directors, which enables them to keep an eye on the activities of the funded firm (Rosenstein, 1988; Sapienza, 1992; Fried and Hisrich, 1994, 1995; Fried *et al.*, 1998; Bruton and Ahlstrom, 2003).

In the USA, an average board is composed of six people and venture capitalists directly hold an average of 41 percent of the board seats (Kaplan and Strömberg, 2003), giving them a strong influence on the firm. In contrast, Chinese firms tend to have considerably larger boards of directors, often comprising ten or more people (Xianjie, 2007). One reason that board size is limited in the West is to expedite the decision-making process (Bruton *et al.*, 2002b). Furthermore, in Western countries, small board structures with limited insider representation can alleviate potential agency problems that are likely to arise if the firm's managers pursue their personal interests, overlooking the interests of the firm's shareholders (Sahlman, 1990). In contrast, in Chinese firms the board of directors fulfills more than a monitoring function. Given China's collectivistic culture, boards are often designed to include and build relational ties with all major stakeholders in the firm (Bruton *et al.*, 2002b).

At least from a Western perspective, the practice of having such large boards has frequently been criticized. On one hand, it tends to lead to an inefficient decision process because with more people involved there tends to be more disagreement among the parties. At the same time, as Tam (1999) and Bruton and Ahlstrom (2003) point out, Chinese boards tend to have less power over the firm, typically receive little information from the firm's management, and tend to be composed to a much larger extent of internal rather than external members. Moreover, an outside director who is on a Chinese board typically has comparatively little say, whereas external board members in the West usually have the same influence as internal board members. This preference for *internal* versus *external* board members can ultimately heighten rather than reduce agency problems in Chinese firms.

3.3.4.2 Retaining majority control. In Western countries, when a high-tech company approaches a venture capitalist it is well understood by both parties that the company will continue to own and have control over the techniques, products and market opportunities it has developed, while the venture capitalist provides the capital that is required to pursue those opportunities (Xiao, 2002). If and when the company turns profitable, each party will then enjoy capital returns that are proportional to their investment. Nevertheless, Chinese managers have frequently demanded that they retain voting control in their firm irrespective of whether the amount the venture capitalist contributes to the venture exceeds their own investment[11]. Xiao (2002) argues that the primary reason for this behavior lies in traditional Chinese thinking and the belief that one loses control over a firm by giving up voting control.

3.3.4.3 Information asymmetries. Information asymmetries can pose a real problem for venture capitalists, and particularly so in China where – as our previous discussion revealed – access to timely and accurate information can often be difficult. Xiao (2002)

notes that serious problems can arise for VCs who invest in high-technology firms, and refers to a number of examples where company management monopolized information sources and provided falsified information to investors, particularly if the firm was facing financial difficulties. While securities fraud exists all over the world, he notes that it is particularly persistent in China. Arguably, the fear of losing face, which is common among many Asian cultures, contributes to the temptation to withhold unfavorable information from outside investors or even other managers and the board of directors.

Xiao (2002) further posits that in China, some business managers deliberately conceal their company's weaknesses and exaggerate its strengths during negotiations with venture capitalists. He notes that there are numerous examples where such dishonesty has soured the relationship between the two parties and has led to (often unfruitful) legal actions and, not surprisingly, denials of additional capital infusions.

3.3.4.4 Exclusionism. High-tech companies in China, particularly those run by locals, tend to practice exclusionism. That is, they frequently refuse to approach outside investors even if they are in need of additional capital. If they eventually do approach a venture capitalist because their capital shortage has become too severe, then they will typically remain distant, skeptical, and secretive, which makes it hard for venture capitalists to establish a basis for cooperation (Xiao, 2002).

3.3.5 Value added to venture firms. In Western countries, venture capitalists not only provide capital, but also add value to the firms they fund by giving them timely advice and protecting them from taking excessive risks (Bygrave, 1987; Zider, 1998; Bruton and Ahlstrom, 2003). While venture capitalists aim to provide the same services in China, local firms are only slowly getting accustomed to the fact that an outside investor would want to get so involved in their firm. Before the advent of private equity experts in China, foreign investments tended to be made by China experts or internationally known individuals. As noted by Bruton *et al.* (1999), for example, one of the first venture capital funds that targeted China was raised by Henry Kissinger. These early investors were generally passive investors and provided little or no advisory services in addition to their capital.

3.3.6 Management quality. Through a series of interviews with Western venture capitalists who conduct business in China, Bruton and Ahlstrom (2003) find that a frequent concern raised by venture capitalists is that the level of managerial sophistication is comparatively low in the firms they fund. As a result, the advice they provide to a firm's management is somewhat rudimentary and frequently involves educating senior managers on fundamental things such as accounting formats, valuation, and cash flow management. In contrast, in the USA, venture capitalists often provide advice at a somewhat higher level, offering operating and strategic guidance and connecting the firm with customers and suppliers (Fried and Hisrich, 1995; MacMillan *et al.*, 1988; Bruton and Ahlstrom, 2003). Venture capitalists contemplating entry into the Chinese markets are therefore well advised to set aside a fair amount of time and resources to provide basic training to their Chinese counterparts before proceeding with strategic or operational counseling.

3.3.7 Keeping face. There is also a striking difference between China and the West in the manner and frequency with which venture capitalists interact with the CEOs of the firms they fund. In the USA, communications between the two parties tend to be fairly informal and typically take place during regularly scheduled meetings (Fried and

Hisrich, 1995). However, in China venture capitalists have to follow a particular code of conduct and must deal appropriately with the firm's managers to uphold their "*minzi*", i.e. their face or respect (Bond, 1988). That is, venture capitalists can advise managers but have to do so in a manner that will allow the managers to maintain face.

3.3.8 A lack of service professionals. How well the venture capital industry can flourish in a given country depends on a variety of factors. A thriving economy, a sound legal system combined with proper law enforcement, and a strong entrepreneurial spirit are only some of the necessary ingredients. In addition, a proper cooperation between venture capitalists and the firms they fund requires various intermediaries such as lawyers who are well trained in both local and international law, accounting firms that provide auditing functions and consulting services to ensure that the funded firm follows local accounting standards and, if necessary, can prepare accounting statements in an internationally recognized format such as GAAP, and assessment centers that can aid venture capitalists in the assessment and valuation of proposed projects and can arrange contacts between capital seekers and capital providers. Unfortunately, it is still common for venture capitalists to struggle to find intermediaries who offer these services. As Xiao (2002) points out, the lack of assessment centers can cause several problems, including incorrect assessments of a project's value, a lengthy investment cycle, and additional investment costs. Moreover, the agencies that do exist are generally profit-seeking, which compromises the objectivity and validity of their assessments. As a result of the weak infrastructure in China, venture capitalists frequently find themselves in a situation where they have to juggle multiple parallel tasks such as searching for possible investment opportunities, assessing them, avoiding legal risks, assisting the funded firm in properly following accounting standards, and eventually helping the firm go public via an initial public offering. In light of these factors, Xiao (2002) points out that venture capitalist firms not only play the role of investors, but also become assessors, investment bankers, and lawyers. In some cases this will not only overwhelm the venture capitalists but will also take their attention away from their main duties, such as monitoring the firm and arranging contacts with potential buyers and suppliers.

3.3.9 Limited sources of capital. There are a number of studies in the financial literature that document a clear relationship between firms' access to venture capital in a given country and economic growth in that country (see, for example, Oehler *et al.*, 2006). In China, government funding continues to account for a large portion of venture capital investments. Using 2003 figures, for example, the Chinese Venture Capital Institute (CVCI) estimates that investments made by the Chinese government accounted for approximately 48 percent of the total venture capital investments made in the country (Sood, 2004). In contrast, comparable figures for the USA suggest that in 2003, government funding accounted for only 8.3 percent of total start-up funding (Liu, 2005). Although the CVCI estimates that there are about six trillion *renminbi* (yuan) in consumer savings, it finds that only a very small fraction of that amount is invested in high-tech firms. In addition, insurance companies and social security funds are not permitted to invest in the venture capital industry. Sood (2004) notes that, as a result, the scale and diffusion of venture capital activity in China remains limited and Chinese firms continue to have a large unmet need for start-up financing. In recent years, the central government has encouraged local governments to establish state-owned

venture capital funds. This has somewhat helped reduce the shortage of funds, particularly among China's high-tech firms, but a significant shortfall still remains.

3.3.10 Venure capitalists' investment preferences. Folta (1999) notes that venture capital is often referred to as private equity, because the recipients of VC funds tend to be companies that are not yet listed on a stock exchange. In Western countries, a majority of the funded firms are in an early stage of development, whereas their Chinese counterparts are frequently established firms that seek capital for various types of expansion projects. Such expansion projects tend to involve the introduction of technologies aimed at reducing costs or boosting productivity. While these technologies tend to be relatively new they have usually already been tested – and have proved to be effective – in economically more advanced countries.

In 1995, only 1-2 percent of all venture capital investments in China were made at the seed stage, to finance product development or other R&D expenditures, well before a product even exists or a company has been formed. In contrast, about 30 percent of all investments went to start-up firms, 65 percent went to expansion projects, and the balance went to buy-outs (Aylward, 1998; Folta, 1999).

3.3.11 Venture capital mechanisms are not yet fully developed. Venture capital investments in the West typically have an equity component, that is, they are either made in the form of an equity infusion or involve debt instruments and preferred shares that are convertible into common shares at a fixed price in the future. In contrast, venture capital firms in China tend to use loans to provide funding. As a result, a proper and objective equity valuation system has not yet been developed (Sood, 2004). In addition, Liu (2005) notes that a regulation enforced by China's State Administration of Foreign Exchange (SAFE) in early 2005, known as "Document 11", restricts foreign capital flow in and out of China and makes it difficult for Chinese entrepreneurs to raise funding in international stock markets. The venture capital industry has expressed serious concerns about this new regulation since it makes it more difficult for VC firms to exit their investments by means of an initial public offering. In response, the central government is currently deliberating a series of laws and regulations, such as the Venture Capital Law and the so-called Regulations on Start-up Funds, which will put into place a proper legal framework for the venture capitalist industry. In addition, the government makes considerable efforts to ease the exit of venture capitalists by reforming its stock markets (Liu, 2005).

3.3.11.1 Insufficient protection of intellectual property rights. Another issue that poses a serious problem for venture capitalists and makes them unwilling to invest in riskier trial-stage projects is the insufficient protection of intellectual property and immaterial assets. While the government also works on reforming the laws in this area, their enforcement continues to be weak and additional reforms as well as stricter enforcement are undoubtedly needed.

3.3.11.2 Other regulatory hurdles. In 1995, the Chinese government announced plans to "revitalize the country through science and education". Yet, despite the crucial role that venture capital plays in the financing of high-technology firms and thus the commercial implementation of scientific achievements, venture capitalists tend to operate without proper protection by the law (Xiao, 2002). In fact, China's existing legal structure contradicts much of the operational rules that venture capitalists abide by. For example, the Company Law of China requires a minimum number of shareholders as well as a minimum investment of 100,000 *renminbi* per shareholder. Compared to

Western laws, which tend to be fairly lax in this respect – allowing venture capital companies to be run by a few partners and to be registered with little capital – these requirements are quite restrictive. Another legal hurdle that affects venture capitalists is that China's Company Law prohibits outside investors (including venture capitalists) from making investments that exceed 50 percent of a company's total net assets (Xiao, 2002). Xiao (2002) notes that from the perspective of venture capital firms, such restrictions are irrational and are not in line with common international practices. He argues that by setting such limits, the Chinese government prevents companies from seeking adequate funding and forces them to forego potential growth opportunities, which may require larger external capital infusions.

Moreover, China's tax laws deter capital investments from offshore funds, taxing their gains at higher rates than those of domestic funds. This is in contrast to most Western countries, whose tax laws either encourage venture capital investments from offshore funds or at least treat them equally[12].

3.3.11.3 Inadequate exit channels. The return that a venture capitalist firm derives from its equity holdings generally does not depend on dividends but on the ability to sell its shares in a given company by means of an acquisition or an initial public offering (Xiao, 2002). To exit an investment via either of these requires a well-developed and liquid capital market which China still lacks. In addition, while the USA and many European countries have established stock exchanges that are specifically geared towards high-tech companies by offering laxer listing requirements[13], the A-share markets in China make no distinction between the listing requirements for traditional firms and those for high-tech start-ups, making it difficult for venture capitalists to exit their investments by means of an IPO in one of the local markets. Yet, exiting an investment by means of an IPO tends to be the most profitable venue for venture capitalists. *Venture Economics* (1988) reports that every $1 invested in a firm that later has an IPO will generate a profit of $1.95, whereas every $1 invested in a firm that is acquired only generates a profit of $0.40 (see also Gompers and Lerner, 1999). Additional market reforms are certainly needed before IPO exits become a viable alternative in China, not the rare exception. At the time of writing, we are not aware of any plans by Chinese regulators to establish a separate exchange for start-up firms or to implement high-tech friendly listing policies on its existing exchanges, but given the developments that have taken place in many other countries around the world, it is likely that such reforms are being considered.

Even for successful ventures, exiting remains a big problem. Proper securities laws, regulations, and accounting standards that help regulate the venture capital industry are in the process of being developed, but few are already in place (Peng, 2000). As mentioned earlier, most of the firms that list on China's stock exchanges are state-owned. But even for privately owned firms, it is ultimately up to the government whether or not it allows the firm to be listed. The central government typically views a venture-backed firm as having sufficient financial resources and regard it as unnecessary that the firm raises additional capital via a stock offering. Instead, government officials generally argue that the funds raised via a stock listing should be directed towards state-owned enterprises that are in desperate need of restructuring (Wentao, 2007). Consequently, firms that utilize internationally sourced capital are generally not considered for local listings and their venture capitalists either have to look for strategic buyers or help the firms list on a foreign exchange such as the

NASDAQ. With overseas listings being subject to stringent regulations, exiting by finding a strategic buyer or having the firm itself buy back the stock tends to be the preferred exit mechanism. Venture capitalists contemplating an investment in China should be aware that this lack of appropriate exit channels may present a major hurdle down the road and that it may prevent them from realizing the returns that they are accustomed to in the West.

4. Governmental promotion and the future of China's venture capital industry

Governments play a predominant role in the growth of the VC industry. One way in which they can assist entrepreneurs and venture capitalists is by providing an adequate infrastructure such as strong intellectual property rights protection. Because many entrepreneurs start out with an asset pool that consists only of intangible assets such as patents and copyrights, it is very important that there is adequate enforcement to protect these entrepreneurs from potential copyright or patent infringements by third parties. The USA is widely viewed as having one of the strongest patent protection systems in the world and has taken on a lead role in the World Trade Organization in encouraging other countries to adopt similar protection. In China, intellectual property rights are either poorly enforced or not enforced at all, often due to corruption among the local police forces or government officials (Liu, 2007). Given China's inadequate protection of intellectual property rights, combined with a poorly developed market infrastructure and a comparatively weak research and development capacity, some venture capitalist firms have decided to stay away from high-tech investments altogether and invest in low-tech industries instead (Zeng, 2004; Liu, 2005). While the Chinese government has taken some steps to improve the situation, a lot remains to be done.

Over the years, the Chinese government has increasingly recognized the potential of venture capital and has embraced the concept of a knowledge economy. As a result, it has begun introducing a series of policies aimed at encouraging the growth and development of the venture capital industry. In 1999, the State Council issued the "Decision to Develop High Technology through Innovation and Industrialization", which helps expedite the growth of the VC industry by developing the capital markets and providing incentives for venture capitalists to invest in high-tech industries (Xiao, 2002). Later that year, the State Council issued "Opinions on Establishing a Venture Capital Regime", in which the government identified emerging industries and the high-tech sector as the key drivers behind the growth of an information-based economy. The document highlights that information technology, biotechnology, and advanced manufacturing technologies will be the main recipients of government funding. Lastly, the government recognized that it has to better develop and support the venture capital industry if it wants to spur technological innovation among small and medium enterprises (SMEs).

Another issue that has received increased attention from the government is the development of a legal framework to support the venture capital industry. Various policies and laws have been introduced to support the development of the high-tech and venture capital industries. Furthermore, the government is becoming increasingly aware that it has to provide venture capitalists with better exit venues by better developing its capital markets (Nuechterlein, 2000). In addition to the significant role

that the central government plays in this process, local governments have also become increasingly involved in promoting and implementing VC-friendly policies, largely under the guidance of the central government's macro-policies.

Moreover, in 2001, the Chinese government passed a law that allows for the formation of foreign-managed domestic currency venture capital funds, making it easier for venture capitalists to raise funds for their investments within China (Sood, 2004). In addition, the Chinese government has recently passed legislation that will make it easier for foreign investors to enter the Chinese venture capital market as it reduces the minimum required capital for VC funds from $100 million to $10 million.

After years of slow development, the venture capital industry is now emerging strongly and a promising future is likely on the horizon. While some shortcomings remain, the gradual changes in governmental policies that have recently been implemented have provided a much stronger foundation on which the venture capital sector can grow. This has also benefited China's economy itself: with venture capitalists investing in a broader range of industries and becoming more eager to invest in high-tech ventures, China's economy is becoming increasingly diversified, making it a stronger and more stable power both in the region and in the world.

5. Conclusions

China has been on the radar of international investors for several years. While institutional and individual investors are increasingly adding Chinese stocks to their portfolios, few have dared set a foot in China's venture capital market. The concerns are justified: many venture capital investments have underperformed. In addition, venture capitalists frequently face numerous cultural and regulatory hurdles that make it difficult to monitor their investments. Yet, as China continues to open itself to the West and tries to adopt Western business practices, it is likely that VC investments will become increasingly appealing.

For the time being, however, investors have to be aware of the disparities that set the Chinese VC market apart from Western markets. Our study outlines the key differences that Western investors should be aware of. First, unlike in the West, venture capital investments in China require a high level of personal oversight and close relationships with insiders and outsiders of the funded firm. Formal mechanisms such as occupying a seat on the board of directors and including protective clauses in the funding contract – tools that are often used in the West to ensure that VC funds are used properly and can be monitored – may not be sufficient in China. Due to a lack of sufficient control mechanisms such as accounting, auditing and financial regulations, venture capitalists have to remain in close contact with the insiders of the funded firm to be constantly informed of the firm's performance.

Second, while Western investors are used to periodically receiving timely and accurate reports on a company's financial situation, the reporting standards in China often focus on production figures rather than on financial performance which hampers the effective monitoring of the firm's well-being. As a result, if a firm does have financial difficulties there is a good chance that they will only become transparent when it is already too late. Indeed, gaining access to current and reliable information about the firm is almost impossible unless close personal ties with the firm's management exist and are continuously cultivated. Even the board of directors

typically has limited power and control as Chinese managers tend to be reluctant to disclose information to anyone they do not know well.

Lastly, government restrictions and the lack of well-developed financial markets make it difficult for venture capitalists to realize a return on their investment. While an initial public offering tends to be the preferred exit method in the West, venture capitalists doing business in China are more limited in terms of exit venues. As a result, typical exit strategies in China include selling the funded company to another local firm or listing it on a foreign exchange.

Given these differences, it may take years if not decades for China's venture capital market to be at par with Western standards. Yet, there is little doubt that China's rapidly growing economy holds many promises. Venture capitalists who are capable of establishing early contacts and gaining experience in this new environment, are likely to emerge successful in the long-run. While there is no substitute for practical hands-on experience, we hope that our study provides important insights into the differences between the venture capital markets in China and the West for those contemplating to take their first step into the Chinese market.

Notes

1. See Chinadaily.com, "China now 4th largest economy", July 4, 2006 (quoting data released by the World Bank).
2. Ernst & Young's Venture Capital Advisory Group reports that in 2004 approximately $20.4 billion were invested in 2,067 deals in the USA, compared to $1.5 billion in 286 deals in the UK. Venture capital investments in China increased to $1.3 billion in 2004, putting it in third place behind the UK (see Ernst & Young, "Renewal and new frontiers – global private equity: venture capital insights, report 2004-2005").
3. See CNNMoney.com, "Venture capital investing in China reaches $480.1 million in second quarter of 2006, doubling from last year", September 6, 2006 (citing data contained in the "China quarterly venture capital report" released by Dow Jones VentureOne and Ernst & Young).
4. A recent *Business Week* article (*Business Week*, 2006) reports that Focus Media Ltd, an operator of elevator and supermarket flat-screen TV advertising signs, saw its shares go up by 112 percent within only six months of its July 2005 initial public offering on the NASDAQ. Similarly, the shares of Baidu.com, a Chinese-language search engine, rose by more than 145 percent in the first five months after its August 2005 IPO.
5. See Oehler *et al.* (2006), who compare the venture capital markets in Europe and the USA. Despite a slow start for the VC industry in much of continental Europe, the study documents that changes in tax laws, the establishment of transnational stock exchanges targeted at young start-up firms, and several other initiatives by the European Union and local governments have caused the European VC markets to flourish in recent years. As a result, they have become more comparable to the US market, not only in terms of size, but also with respect to organization, deal structure, and VC-firm interaction.
6. See *The Economist* (1998), which notes that "the four Chinese states – China, Taiwan, Hong Kong, and Singapore – have often fared better in terms of stock market and currency performance than other Asian countries", and Nuechterlein (2000), who notes that in 1997, "ethnic Chinese accounted for less than 4% of Indonesia's population, but controlled more than two-thirds of its economy".
7. Lau (1999) and Nuechterlein (2000) argue that venture investing in China is no simple task. They note that the country has no legal system to protect foreign investors, that business

transactions operate through an "old boys'" network and that venture capitalists find it very difficult to exit their investments because the government – with few exceptions – only lists state-owned companies on its stock exchanges. In addition, Lau (1999) recites an interview with Peter Brooke, chairman of Advent International, one of the world's largest VC firms, who notes that the returns on his Chinese VC investments are typically in the lower single digits and points out that the firm mainly invests in China due to the size of its population.

8. For some of the seminal works in this area we refer the interested reader to Hamilton and Biggart (1988), Adler (1991), Orru *et al.* (1991), Biggart and Hamilton (1992), Ueno and Sekaran (1992), Boisot and Child (1996), and Jiang (2006).
9. For related discussions, see also Wank (1996), He (1997), Pohndorf (1997), Standifird and Marshall (2000), and Bruton and Ahlstrom (2003).
10. Bruton *et al.* (2004) conduct a series of interviews with venture capitalists in East Asia. They find that monitoring activities in these countries require venture capitalists to build close personal relationships with funded entrepreneurs. They argue that, as a result, the time, effort and costs spent on monitoring will be higher in almost all Asian countries when compared to the West.
11. Note that China's Company Law prohibits any single foreign investor from owning more than 50 percent of a firm's shares (we discuss this law in more detail below). Thus, our example here refers to a situation in which the venture capitalist owns more equity than the founders/managers, with third parties owning the rest.
12. Our paper addresses only the most significant legal challenges affecting venture capitalists in China that we are aware of and is by no means exhaustive. For additional information on the legal framework governing venture capitalist investments and an update on recent steps the Chinese government has taken to reform its laws, we refer the interested reader to Lubman (1999), Ahlstrom *et al.* (2002), Bruton *et al.* (2002a), and Liu (2005).
13. See, for example, the NASDAQ in the USA, the Neuer Markt in Germany, or the pan-European Euronext exchange headquartered in Paris.

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