



Asia-Pacific
Economic Cooperation

Seminar on Venture Capital and Start-up Companies

December 10-11, 2003 Beijing, China



ASIA-PACIFIC ECONOMIC COOPERATION

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Content

Summary Report	3
Program	10
Opening Remark	
Mr. Zhu Hong.....	13
Opening Remark	
Ms. Wang Lili.....	16
Venture Capital after the Bubble	
Mr. John T. Wall.....	24
How Can Venture Capital Flourish	
Mr. Chang Sun.....	30
Current Status and Opportunities for China Venture Capital Firms and Start-up Companies	
Mr. Gavin Ni.....	34
Solving the Mystery of Venture Capital --How a Process That Triumphs in the U.S. Can Succeed in China and other APEC Economies	
Mr. Ken Hagerty.....	42
Key Initiatives to Foster Venture Capital Development In Asia Pacific Developing Economies	
Mr. Richard Roque.....	49
The Importance of Structuring Exit Mechanism for Venture Capital – Case Study and Practical Solution	
Mr. Paul S. P. Hsu.....	54
Development Status of China’s Venture Capital Investment	
Mr. Shen Zhongqi.....	63
Implications of China’s Taxation Policies on Foreign-Invested Venture Capital Investment Enterprises	
Mr. Lu Yun.....	78
Efficient Capital Markets, Venture Capital Investments and Exits	
Mr. K. Thomas Liaw.....	81
Thoughts about Venture Capital Investment in China’s New and High-tech Industry	
Mr. Di Weiping.....	92
Foreign VC in China: Prosperity & Prospects	
Mr. Jingsheng Huang.....	102
Name List of Participants	104

Summary Report on APEC Seminar on Venture Capital and Start-up Companies

With the support of APEC TILF project, and organized by Department of International Trade and Economic Affairs, Ministry of Commerce of China (MOFCOM), APEC Seminar on Venture Capital and Start-up Companies was held successfully on December 10-11 in Beijing. Around 70 government officials, academics, representatives from APEC economies, and business people from China Venture Capital Association and enterprises attended the seminar. Mr. Zhu Hong, Deputy Director-General of the Department of International Trade and Economic Affairs of MOFCOM, and Ms. Wang Lili, Vice President of Industrial and Commercial Bank of China addressed the opening ceremony of the seminar. Mr. Zhang Shaogang, Division Director of the Department of International Trade and Economic Affairs chaired and made conclusion of the seminar. Speakers from government, universities, banks, venture capital associations and investment companies were invited to make presentations at the seminar.

Session I: Current Development and Practices of Venture Capital Industry

1. “Venture Capital After the Bubble”

- **By Mr. John T. Wall,
Chairman of Capital Markets Advisors, Inc.;
Former president of NASDAQ International Co. Ltd.**

The paper gives an overview on the development of venture capital market in US and what direction the market is heading after 2000 crash.

The paper articulates what ‘Bubble’ has affected investors, venture capitals, especially the psychology of the investors, which is unpredicted concerning the trend of the whole market. NASDAQ is the marketplace of choice for the majority of IPOs, especially for the majority of the venture capital backed IPOs since 1990s.

Although the deal size affected by the ‘Bubble’, VC investment level now goes steady with more venture-backed companies emerging. From the statistics, the number of active VC firms and total capital under management has been definitely on the ascending way. In sum, the market either for NASDAQ or the VC capital development will see a bright future.

2. “How Can Venture Capital Flourish”

- **By Mr. Chang Sun
Managing Director of Warburg Pincus Asia LLC**

Venture capital can flourish in a developing APEC economy if the right environment for investing and exit is created and maintained; VC firms can generate above-average IRRs; and government supports it with favorable policies.

The presentation gives detailed explanations of the necessary and sufficient conditions. Based on those conditions, “high returns” is the most important condition for VC development. Ride on fast growth, buy low and sell high, use leverage, and engineer turn-arounds are the ways to generate “high returns”.

Government also plays an important role in the VC development. Providing investment opportunities, creating/improving exit mechanisms, setting up preferential policies, and encouraging long-term capital into VC are the effective policies for the government to help VC development.

3. “Current Status and Opportunities for China Venture Capital Firms and Start-up Companies”

**- By Mr. Gavin Ni
President of Zero2ipo.com.Ltd**

The presentation gives an overview of the China Venture Capital in 2002 and 2003. The statistics show that the local Chinese VCs far outnumber foreign VCs, and VCs capital under management is much less than that of foreign VCs. Joint VCs have become an important force.

When it comes to the cooperation between foreign VC and local Chinese VC firms, the cooperation models are mentioned as follows: Cooperation Fund; Entrustment Management by either local VC management company or foreign venture capital management firms; virtual JV fund; JV fund in the forms of RMB, RMB-US\$ or US\$.

The paper also gives some cases on China VC deal, and predicts the opportunities for China Venture Capital Market in the next 5 years.

Seminar Session II Case Study on Start-up Companies and IPO

1. “Solving the Mystery of Venture Capital--How a Process That Triumphs in the U.S.

Can Succeed in China and other APEC Economies”

**- By Mr. Ken Hagerty,
President of Global Venture Investors Association, U.S.**

In today’s increasingly globalized economy, governments can no longer count on the comparative advantages their economy developed yesterday to support them tomorrow. An economy’s ability to discover and develop its comparative advantages is the bedrock of its economic viability in the global trading system. As we know,

American venture capitalists lead the world in discovering new business opportunities and spawning fast growing companies to exploit them, but the venture capital as practiced in the United States has been so difficult to export to other economies. The presentation outlines the reasons why the VC process in U.S. doesn't work in other places, and proposes strategy that APEC can follow for building American-style venture capital capabilities in other economies by giving American venture capital firms incentives to share their company creation expertise and knowledge with investors and aspiring venture capitalists in those economies. APEC should also encourage member governments to promote public and private institutional investment into American venture capital firms as a way of globalizing, and developing their economies, while earning excellent returns.

The presentation also gives the example of APEC Member Singapore and Israel to illustrate that economies that encourage investment into successful venture firms have much more success developing their own venture capital capabilities than those that focus only on attracting investments from VCs.

2. “Key Initiatives to Foster Venture Capital Development In Asia Pacific Developing Economies”

- **By Mr. Richard S. Roque**

**Chairman Emeritus of Hong Kong Venture Capital Association,
Principal of William E. Simon & Sons (Asia) Ltd**

There has been a growing awareness of venture capital as an important source of financing since the late 1990s. Venture Capital can play vital role as a catalyst to promote growth, structural change and development whilst at the same time enhancing cross border trade and investment amongst APEC economies:

1. Venture Capital/Private Equity can play an important role in transformation and development process of many APEC developing economies:
 - Venture Capital and Private Equity funds aim to nurture cutting-edge high technology enterprises at different phases of their growth cycle;
 - These funds also invest in Small & Medium Enterprises to enable them to emerge as formidable engines of growth and employment creation;
 - Buyout funds, expansion capital and distress debt funds are important players in restructuring state-owned enterprises;
 - Infrastructure funds and other industry funds assist in the development of certain vital sectors of the economy.
2. VC funds can also play an important role in fostering cross-border trade and investments amongst APEC economies. If properly managed and structured VC firms can act as catalyst to transforming these companies into emerging multinationals (MNCs) with a strong culture incorporating good corporate and business governance best practices;

There is therefore a real concern the industry may stagnate and fail to become an important engine of growth and innovation in APEC developing economies. In this regard, efforts should be made to re-energize the industry amongst APEC economies, such as to help upgrade VC skills, provide assistance in the development of Local Fund of Fund Entities (LFFE), broaden, deepen and further develop long-term capital markets. In addition, regulations that promote financial innovation and development of various financial instruments should be improved so as to provide flexibility for VC firms to manage its investments and in order to facilitate subsequent fund raising.

3. “The Importance of Structuring Exit Mechanism for Venture Capital - Case Study and Practical Solution”

- **By Mr. Paul S. P. Hsu,
Senior Partner of Lee and Li Attorneys-at-Law, Chinese Taipei**

In light of the trend toward liberation and globalization, it is of great importance for all APEC member economies to create a competitive environment that is compatible with the international standards and practice in order to further enhance the development of venture capital investment and start-up companies. As most new entrepreneurs and start-up companies emerge only with the help of initial equity input, usually in the form of venture capital, a mature capital market is important to facilitate the growth of start-up companies and also provides the necessary exit mechanism, which is vital for developing the venture capital industry.

For many investors and the firms U.S. PECC finance, the most desirable exit is an initial public offering (IPO). Other than IPO, other exit options for venture capitalists include merger and acquisition or private placements of the portfolios with third parties. The presentation takes Chinese Taipei for example to illustrate that the costs of inflexibility or complex rules would make the transactions become more costly and bar the efficient operation by recipients of funds.

Session III Regulatory issues on the Development of Venture Capital and Start-up Companies

1. “History, Current Status and Outlook on the Development of Chinese Venture Capital”

- **By Mr. Shen Zhongqi
Deputy Director-General of Department of Finance and Facilities,
Ministry of Science and Technology**

The presentation briefly gives the introduction of relevant policies and practice of venture capital investment in China. The concept of VC has appeared in China in 1985, since then, the concerned rules and regulations were enacted and VC institutions funded by government have emerged.

The presentation also analyzes the macro-situation of China's VC investment. China's venture capital investment has experienced rapid growth in 2000, and with downsizing in its developing speed and investment scale afterwards.

Along with the continued improvement in China's policy environment for venture capital investment, the constant improvement in the qualifications of professionals in the industry and the massive influx of overseas capital and talents, China's venture capital investment sector will enjoy a big expansion in the future.

2. "Taxation Reform in Support of Venture Capital"

- **By Mr. Lu Yun**

**Deputy Director-General of Department of International Taxation,
State Administration of Taxation of China**

It can be seen from the experience of countries around the world that venture capital investment plays an important role in expanding the financing channels of SMEs, overcoming the funding barriers against the industrialization of high and new technology, speeding up the transformation of high-tech results, and promoting the development of the high-tech industry. The current China's taxation policies lack more attractive incentives for foreign-invested venture capital investment institutions, and this has become one of the reasons behind the low percentage of venture capital in China at present.

In light of China's venture capital investment mechanism in a crucial development stage, since last year Chinese government has been discussing how to proceed from the characteristics of the venture capital investment mechanism and search for a more proactive tax incentive environment in order to promote the establishment of venture capital investment enterprises in China by foreign investors for purposes of undertaking venture capital investment activities. We are also thinking about making additions to the current tax incentive package and, in line with international experience, appropriately add to the tax incentives for venture capital investment institutions.

Session IV Prospective on Future Development on Venture Capital and Regulatory Reform

1. "Efficient Capital Markets, Venture Capital Investments and Exits"

- **By Dr. Kwoloong Liaw**

Chairman and Professor of Finance

Department of Economics and Finance

The Peter J. Tobin College of Business, St. John's University

The paper examines the linkages between venture capital financing, exit strategies and the capital market. A well-developed capital marketplace (that is transparent, liquid,

competitive and fair) is necessary for venture capitalists and limited partners to exit when they choose to, which in turn is essential to their supply of funding to startups.

The paper first reviews the current market environment in the United States. Second, the paper provides a review of the traditional exit strategies such as initial public offerings by the portfolio companies as well as merger and acquisition. A new exit approach, securitization, is discussed as well. Finally, the paper discusses the impact of Sarbanes-Oxley Act impact on venture capital market.

2. “Tentative Research on Venture Capital in High-tech Industry”

- **By Mr. Di Weiping**

General-Manager of Investment and Banking Department, China Development Bank

Also known as venture capital, venture capital investment has made remarkable strides over the past two or decades. Since the mid-1990s, various localities in China have resorted to the approach of establishing venture capital investment companies in their respective efforts to set up venture capital investment institutions similar to venture capital investment funds in other countries.

As an investment form fundamentally different from the traditional investment approach, venture capital investment has run into a number of problems in its actual operations in China: 1. The legal regime in connection with venture capital investment is still unsound in the sense that relevant national laws and regulations cannot be veiled as yet. 2. The reform of the financial market has lagged behind and there is a lack of diversified supply channels of funds. 3. There is no sound route of exit. In this regard, new thoughts and more efforts should be made to improve the environment of venture capital development: 1. Speeding up the effort to improve the regulatory and institutional framework for the venture capital market. 2. Overcoming the bottlenecks caused by undiversified venture investors and fettered sources of venture capital. 3. Changing the short-term behavior in the choice of venture capital investment targets.

Along with the continued optimization of the legal and policy environment and the continued improvement in the investment philosophy of all kinds of investment players, China’s venture capital investment sector will develop rapidly and play an indispensable role in the industrialization of high tech in China.

3. “Establishment of sufficient channels for fund sourcing of venture capital”

- **By Jingsheng Huang**

Managing Director of SAIF (Softbank Asia Infrastructure Fund)

In 2003, foreign VC in China is active in closing deals, which are larger than that of typical VC. The explanation is Chinese growing economy with the recession of world economy, and liberation of policies and legal environment are favorable for foreign VC in China. Another alternative explanation is from a fund life cycle aspect.

The presentation gives analysis on foreign VC in China in next 5 year and predicts that Chinese VC firms might face fund raising crisis and have hard time to compete with US VC firms. But if the government has the mind sight to fund the professional managed funds, then industry will have hope.

Program

Tuesday, December 9, 2003

Arrival and Registration

Wednesday, December 10, 2003

Opening Session:

Time: 9:00—9:40

Moderator: Mr. Zhang Shaogang Director
Department of International Trade & Economic Affairs
Ministry of Commerce, P.R.China

Opening Remark by **Mr. Zhu Hong**, Deputy Director-General
Department of International Trade & Economic Affairs
Ministry of Commerce, P.R. China

Opening Remark by **Ms. Wang Lili**, ABAC Member
Vice president of Industrial and Commercial Bank of China

Coffee Break

Time: 09:40—10:00

Session I Current Development and Practices of Venture Capital Industry

Time: 10:00—11:40

Moderator: Mr. Richard Roque
Chairman Emeritus, The Hong Kong Venture Capital Association
Principal, William E. Simon & Sons (Asia) Ltd

1. Venture Capital after the Bubble (30 minutes)

Speaker: Mr. John Wall, Chairman of Capital Markets Advisors, Inc.
Former President of NASDAQ International Co. Ltd

2. How Can Venture Capital Flourish? (30 minutes)

Speaker: Mr. Chang Sun, Managing Director Warburg Pincus Asia LLC

3. Current Status and Opportunities for China Venture Capital Firms and Start-up Companies
(30 minutes)

Speaker: Mr. Gavin Ni, President of Zero2ipo.com.Ltd

10 minutes discussion

Work lunch

Time: 12:00—13:30

Session II Case Study on Start-up Companies and IPO

Time: 14:00—15:40

Moderator: Dr. Kwoloong Liaw,

Chairman and Professor of Finance, Department of Economics and
Finance, The Peter J. Tobin College of Business, St. John's University

1. Solving the Mystery of Venture Capital--How a Process That Triumphs in the U.S. Can Succeed in China and other APEC Economies (30 minutes)

Speaker: Mr. Ken Hagerty, President of Global Venture Investors Association, U.S.

2. Key Initiatives to Foster Venture Capital Development In Asia Pacific Developing Economies (30 minutes)

Speaker: Mr. Richard Roque,

Chairman Emeritus, The Hong Kong Venture Capital Association
Principal, William E. Simon & Sons (Asia) Ltd

3. The Importance of Structuring Exit Mechanism for Venture Capital (30 minutes)
- Case Study and Practical Solution

Speaker: Mr. Paul S.P.Hsu, Senior Partner, Lee and Li Attorneys-at-Law, Chinese Taipei

10 minutes discussion

Coffee Break

Time: 15:40—16:00

Session III Regulatory issues on the Development of Venture Capital and Start-up Companies

Time: 16:00—17:40

Moderator: Mr. John Wall, Chairman of Capital Markets Advisors, Inc.

Former President of NASDAQ International Co. Ltd

1. History, Current Status and Outlook on the Development of Chinese Venture Capital (30 minutes)

Speaker: Mr. Shen Zhongqi, Deputy Director-General,

Department of Finance and Facilities, Ministry of Science and Technology

2. Taxation Reform in Support of Venture Capital (30 minutes)

Speaker: Mr. Lu Yun, Deputy Director-General

Department of International Taxation, State Administration of Taxation of China

3. Regulatory issues on the Foreign Venture Capital in China at present(30 minutes)

Speaker: Mr. Hu Jingyan, Director-General, Department of Foreign Investment

Ministry of Commerce, P.R. China

10 minutes discussion

Welcome Dinner

Time: 18:30—20:00

Tuesday, December 11, 2003(Day 2)

Session IV **Prospective on Future Development on Venture Capital and Regulatory Reform**

Time: 9:00—10:40

Moderator: Mr. Ken Hagerty, President of Global Venture Investors Association, U.S.

1. Efficient Capital Markets, Venture Capital Investments and Exits (30 minutes)

Speaker: Dr. Kwolung Liaw, Chairman and Professor of Finance

Department of Economics and Finance

The Peter J. Tobin College of Business, St. John's University

2. Tentative research on venture capital in high-tech industry (30 minutes)

Speaker: Mr. Di Weiping, General-Manager of Investment and Banking Department

China Development Bank

3. Establishment of sufficient channels for fund sourcing of venture capital (30 minutes)

Speaker: Jingsheng Huang, Managing Director of SAIF (Softbank Asia Infrastructure Fund)

10 minutes discussion

Coffee Break

Time: 10:40—11:00

Open Discussion and Conclusion

Time: 11:00—12:00

Moderator: Mr. Zhang Shaogang Director

Department of International Trade & Economic Affairs

Ministry of Commerce, P.R.China

Dialogue and Discussion among speakers, participants and officers from Chinese government agencies

Work lunch

Time: 12:00—13:30

Opening Remarks at the APEC Venture Capital Investment Seminar

Mr. Zhu Hong

Deputy Director-General

Department of International Trade & Economic Affairs

Ministry of Commerce, P.R. China

Distinguished guests,
Dear friends,
Ladies and gentlemen:
Good morning!

Let me, first of all, on behalf of the Department of International Trade and Economic Affairs of the Ministry of Commerce of the People's Republic of China, extend a warm welcome to all the friends and colleagues who are here for this APEC Venture Capital Investment Seminar. This event has benefited from the great support and sincere cooperation of various APEC member economies and the APEC Secretariat, for which I would like to express my heartfelt thanks. The Chinese Government has all along supported and actively promoted the APEC process and various activities. It is hoped that this Venture Capital Investment Seminar hosted by the Chinese side can make due contributions to the APEC's development in the field of venture capital investment.

As the largest forum for regional economic cooperation in the Asia-Pacific region, in its tumultuous history, the APEC has made important contributions to this region's economic stability, prosperity and growth, and achieved remarkable results. The APEC has always paid attention to the new problems in the fields of trade and investment, taken a series of convincing real action, and made unremitting efforts to promote the process of region-wide trade and investment liberalization and facilitation. This has also been an important reason behind the sustained vitality in the APEC regional economic cooperation exercise.

The APEC sets great store by the development of the high and new tech industry and paid close attention to venture capital investment which has a very intimate relationship with such an industry. At the APEC ministerial meeting held in Shanghai back in October of 2001, ministers agreed to include venture capital investment and start-up of companies in the "select measures designed to strengthen investment liberalization and business facilitation in APEC economies", and approved the guiding principle of the best practices relating to venture capital investment and business start-up. These results have promoted the cooperation in the area of venture capital investment in this region.

At this seminar, we will further explore the role of venture capital investment in APEC member economies, the challenges faced, and the mechanisms and legal

environment needed for the development of venture capital investment. We will also focus our attention on how to build a platform of the exchange between international capital and China's domestic venture capital investment projects and technologies, take a look at the relevant policies governing the entry of venture capital in the Asia-Pacific region into China and, by way of international cooperation, explore a venture capital investment development path suited to China's national conditions and compatible with international practices in order to promote the rapid and sustained development of China's venture capital investment and high and new tech industries.

Ladies and gentlemen,

In recent years, China's venture capital investment has undergone rapid development. According to statistics, there are over 250 venture capital investment institutions at present, involving over RMB 40 billion yuan of funds, and investment institutions and the scale of funds are growing at approximately 50% and 45% respectively annually. In the course of driving behind the upgrading of industrial structures, the progress of science and technology and the promotion of scio-economic development, venture capital investment has initially displayed its huge role.

We have noted that foreign venture capital occupies a significant role in the development of China's venture capital investment. Prior to the mid-1990s, foreign venture capital had become a major source of funding except government venture capital and once accounted for over 36% of the total amount of venture capital. Along with the expansion of domestic venture capital, although the share of foreign venture capital has declined, its share was approximately 20% in the year 2002, the absolute amount of foreign capital has rapidly grown and developed into one of the three pillars of venture capital investment in China.

The Chinese Government attaches great importance to the development of venture capital investment. The report of the 16th National Congress of the CPC pointed out that it is essential to "bring into play the role of venture capital investment and form capital operation and talent pooling mechanisms that promote scientific and technological innovation and start-up of companies". A number of documents issued by the State Council for purposes of promoting the development of high and new tech have also repeatedly stressed the important role of venture capital investment. In terms of specific policies, in 1999 seven ministries such as the Ministry of Science and Technology unveiled *Several Opinions on the Establishment of the Venture Capital Investment Mechanism*; in 2001 the Ministry of Foreign Trade and Economic Cooperation (now the Ministry of Commerce), the Ministry of Science and Technology and the State General Administration for Industry and Commerce jointly promulgated the *Interim Provisions on the Establishment of Foreign-invested Venture Capital Investment Enterprises*; and such localities as Beijing, Shanghai and Shenzhen have also unveiled a series of corresponding local regulations and provisions. The above policies have produced positive results in standardizing,

encouraging and fostering venture capital investment.

The development of venture capital investment in China has benefited from the establishment and improvement of an increasingly open socialist market economy system with Chinese characteristics, and from the rapidly growing national economy. This year, the Chinese economy has overcome the serious difficulties brought about by the SARS epidemic, and domestic investment, consumption and foreign trade have continued to display good momentum. Foreign trade and absorption of foreign investment have kept a good development momentum. In the first 11 months of the year, China's import and export trade has reached US\$ 760.9 billion, an increase of 35.8%; in a breakdown, exports stand at US\$ 390.3 billion, rising by 32.9%, and imports amount to US\$ 370.6 billion, a rise of 40.4%. In the first 10 months of the year, 32,696 foreign-invested enterprises have been newly approved, an increase of 17.99% as compared with the same period of the previous year; contractual foreign investment stand at US\$ 88.683 billion, rising by 33.75% year on year; and paid-in foreign investment amount to US\$ 43.556 billion, increasing by 5.81% year on year. At the same time, China's "Going Global" strategy has also scored preliminary results. In the third quarter of this year, China's investment growth rate and consumer goods retailing growth rate respectively stand at 31.4% and 8.6%, and the GDP growth rate reaches 8.5%, with the economic growth rate of the year as a whole expected to reach 8.5%.

Various effective domestic policy measures in China have provided a stable institutional guarantee for venture capital investment, and the long-run upward trend of the macro-economy have created a good economic environment for venture capital investment. In particular, China is now a full member of the WTO, and national treatment and the level of policy transparency will further improve. Against this background, venture capital investment will have great and unprecedented development in China. We expect venture capital in all forms to find their respective space and position in China's economic construction. We hope that more foreign venture capital will come to China and identify business opportunities in China's giant market.

Ladies and gentlemen,

At present, the global economy is developing and changing by the day. Economic globalization brought offered us both opportunities and challenges. We are faced with the arduous task of exploring the patterns and growth models for economic development in the new era. All of you present here are venture capital investment officials, experts and investors or entrepreneurs. It is hoped that this seminar will provide you with an opportunity of cooperation and exchanges and, more importantly, an opportunity for you to establish long-standing links, air your views and voices, and make joint efforts to explore effective means of developing venture capital investment and promoting economic development.

Finally I would like to wish this seminar a complete success.

Moving Ahead with Venture Capital Investment, Improving Financial Services and Promoting the Development of SMEs

--Speech at the Opening Ceremony of the APEC Venture Capital Investment Seminar

Ms. Wang Lili

ABAC Member

Vice president of Industrial and Commercial Bank of China

Distinguished guests:

Good morning.

I feel very privileged to have this opportunity to attend the Venture Investment Seminar organized by the APEC. The topic of my speech is Moving Ahead with Venture Investment, Improving Financial Services and Promoting the Development of SMEs.

During my 6-year tenure as the Chinese Representative at the APEC Business Advisory Council, SMEs have remained to be a central theme. We have had many discussions and offered many proposals, but the financing problem facing SMEs, as a world-wide phenomenon, has never been really properly addressed. Countries around the world have adopted many policies like fiscal subsidies, credit supplementation and policy loans. China has also resorted to a great many of measures, examples of which include the establishment of hundreds of guarantee institutions, great efforts to develop small and medium-sized commercial banks and the research into the possibility to introduce the second board stock market; as a result, some progress has been made, but much remains to be done. Acutely aware of the complexity and specialty of this problem, I would focus my attention here to how to move ahead with venture capital investment, improve financial services and better promote the development of SMEs and offer my opinions.

One. The role of SMEs and the financing difficulties facing them

The Communist Party of China (CPC) and the Chinese Government attach great importance to the development of SMEs and regard enhancing the competitiveness of SMEs as a strategic task that should be completed with great efforts at the present stage and even for a considerable time to come. A series of strategic decisions and measures have been unveiled in order to support the development of SMEs. The *Decision of the Central Committee of the CPC on Several Issues Concerning the Improvement of the Socialist Market Economic System*, approved by the 3rd Plenary Session of the 16th CPC Central Committee, stipulate that efforts should be continued to liberalize and rejuvenate state-owned SMEs, support the development of no-state SMEs, and encourage qualified SMEs to become stronger and bigger. The Decision

also emphasized the need to standardize and develop the primary board stock market and make proactive efforts to move ahead with venture capital investment and the building of the second board stock market.

In comparison with large enterprises, SMEs play a unique but important role in terms of offering services, adjusting industrial structures, adding to exports, promoting technological progress, creating job opportunities, maintaining social stability and balancing public expenditures and revenues. This has become consensus in a growing number of countries. In the past two decades since the inception of the reform and opening-up campaign in China, large state-owned enterprises have continued to occupy a very important role in the development of the national economy, but undeniably SMEs have taken up an increasingly larger share in the overall economy and turned into one of the main engines driving behind the nation's economic growth and prospects. At present, the number of SMEs in China has exceeded 8 million, accounting for 99% of the nation's total, with their total output, profits and taxes and exports respectively representing 60%, 40% and nearly 60% of the nation's totals. They have created 75% of job opportunities in cities and towns.¹

However, SMEs still face many difficulties in their development. For a long time in the past, China has in a lop-sided manner pursued extensive development in scale. As a result, the general public have a tendency of looking down upon SMEs to varying degrees; the social status of non-state operators have long been uncertain; and some contradictions that have consistently beleaguered the development of SMEs have for long found no solutions, with the financing difficulties facing SMEs representing a particularly protruding problem.

SMEs financing can be divided into equity financing and debt financing. Both have run into difficulties in practice.

Equity financing difficulties primarily arise from China's undiversified capital market structure, which offers narrow channels for equity financing and share exit. Given the high threshold of access to the capital market, it is very difficult for SMEs to be qualified for IPOs with the method of "bundled listing" that used to be resorted to in the early days of the capital market, and private SMEs are to a greater extent excluded from the capital market. Although planning for the second board stock market started very early, it has yet to be launched, and so most of high-tech SMEs still find it difficult to raise funds needed. Local property rights markets are still at a lower

¹ In the socially-accepted practice and the practice of supportive policy formulation, people from different walks of life have narrow and broad interpretations of SMEs. SMEs, in a broad sense, include medium-sized enterprises, small enterprises and micro enterprises. SMEs, in a narrow sense, do not include micro enterprises. It is generally believed that micro enterprises are those enterprises with legal-person status, individually-owned enterprises, partnerships and private individuals and household economic organizations, all only having eight or less employees. The State Statistical Bureau data used here are in the narrow sense.

level, and the venture capital market is yet to take shape; as a consequence, some venture capital has lost the route of exit.

The debt financing difficulties facing SMEs primarily take the form of difficulties to have access to bank loans, for reasons both relating to banks and SMEs themselves.

On the part of banks, because enterprises used to rely too much on indirect financing from the banking sector and ignore direct financing, non-performing loans (NPLs) of banks have piled up. In their efforts to move towards financial enterprises aimed at profit maximization, state-owned commercial banks face great operational pressures in connection with the need to reduce the ratio of NPLs. Historically the ratio of NPLs in loans to SMEs was on the high side; naturally it is difficult for SMEs to be the target of priority support. At the same time, in the face of a large number of SMEs in different locations and fields, banks find it hard to get to know their true financial standing and do not “feel comfortable” with loans to them. In addition, the formalities and costs associated with loans to both large and small enterprises are more or less the same whilst the differences of yields are very big. For the reason that loans to SMEs cannot offer attractive and reasonable returns, banks prefer to extend large loans to large enterprises and feel reluctant to make small loans to SMEs.

On the part of enterprises, many SMEs have historically been lacking in equity capital. In order to expand their business operations, they usually use working capital for purposes of technical renovation and plant building; as a result, they are short in working capital. SMEs have complicated ownership structures, and many of them engage in substandard business operations and exhibit big institutional risks. When making loans to them, banks need to bear greater “market risks” and “credit-worthiness risks”. Established only recently, most of the SMEs have yet to build stable business links with banks and do not have good track records. Some enterprises have weak awareness of credit-worthiness and generally default on or evade debts to banks; as a result, banks are “reluctant to lend” to SMEs. At the same time, SMEs find it difficult to offer qualified security or mortgage, and this has seriously hindered lending from financial institutions. Despite the fact that some SMEs guarantee funds have been set up throughout the country, the current number of such funds is still small and making it difficult to meet the needs of nearly 10 million SMEs country-wide. Furthermore these guarantee funds have only a small scale of capital and impose very demanding conditions on enterprises in need of guarantees; and so it is hard for SMEs generally to benefit from their support.

Two. Moving ahead with venture capital investment and expanding the equity financing channels for SMEs

In the early days of start-up and the growth period, SMEs face relatively high risks associated with a multitude of uncertainties and find it difficult to raise equity funds or long-term funds, while venture capital is dedicated to providing funds for the

development of such enterprises. Venture investment (or *risk* investment) is primarily to absorb venture capital from various kinds of investors, offer equity capital to high-growth high-tech venture businesses and provide managerial and advisory services to them, in hopes that when the invested enterprise has mature business activities, shares can be transferred to get greater returns on longer-term investment. The usual practice is to take the form of a venture capital investment company and a venture capital investment fund. After venture capital has made venture capital investment in SMEs, out of considerations of returns on investment and risks, it will have a greater inclination of offering specialized and sophisticated managerial and advisory opinions to enterprises and even participate in the actual operation and management of enterprises. When venture capital investment invests in SMEs, it pays greater attention to core technologies with market potentials. By way of “focusing on one area” and “differentiation” strategies, it embarks on a path different from that of enterprises, promotes the technological innovation of SMEs and facilitates the upgrading process of industrial structures.

As a matter of fact, as “incubators” and “engines”, venture capital investment has played a great role in promoting the development of China’s SMEs. As early as in 1985, the Central Committee of the CPC announced in the *Decision on the Reform of the Scientific and Technological Regime* that “venture capital investment may be established to provide support to the development of new and high tech which changes rapidly and involves greater risks”. Up to date, venture capital investment has been in existence throughout China for nearly two decades. In the past two years or so, overseas venture capital investment funds look favourably on China’s good investment climate and market prospects and have moved into China in great strides. In 2001, venture capital investment in China stood at US\$ 518 million, and in 2002, US\$ 418 million. In September 2003, it rocketed to US\$ 486 million, and the total value for the whole year may rise to US\$ 600 million. At present, the stock of venture capital in China has already reached RMB 40 billion yuan, involving over 300 venture capital investment institutions. In particular, since the launch of China Scientific and Technological SMEs Technical Innovation fund in June 1999, the fiscal authorities at the central level have cumulatively earmarked RMB 2.8 billion yuan in the form of grants and loans at subsidized interest rates and approved 3,749 projects, which have involved nearly RMB 30 billion yuan in investments from local governments and played a very big role in promoting scientific and technological SMEs.

However, as compared with the massive needs from SMEs at large, the current supply of venture capital investment in China is a far cry from the needs. In order to expand the scale of China’s venture capital investment market, it is imperative to adjust the current government-led venture capital investment operational mechanism, establish and improve the raising system of private equity capital, and foster highly-qualified venture capitalists; in this regard, what is the most important is to develop a multi-tiered capital market, improve the capital market structure, and enrich products

on the capital market. As a breakthrough and institutional innovation of the previous undiversified capital market, a multi-tiered capital market will facilitate the adjustment and innovation of China's fund-raising structure, break down the bottlenecks caused by financing difficulties facing SMEs, bring about long-lasting "prime driving force" behind China's economic growth, and serve as a landmark for China's economic development. In specific terms, I would like to make the following four recommendations:

First, introducing a market for the trading of SMEs shares. SMEs with less than 50 million circulating shares and high growth prospects should be listed on two stock exchanges and, without changes to the current regulations, listing criteria and listing examination procedures, separately monitored as a component of the current primary board stock market.

Second, setting up a government-sponsored venture capital market, which is devoted to the provision of private equity capital for SMEs in the early days of business start-up. SMEs financing companies, which specialize in SMEs property rights investment should be established on an experimental basis and function as the owners of financial resources—demanders of commercial banks and financial resources—bridges between and among SMEs. Not only do such companies transfuse funds into SMEs and own part of their property rights, but also provide talents and intellectual services required for the growth of enterprises by making use of these companies' managerial and financial experts.

Third, launching the second board stock market on the Shenzhen Stock Exchange so as to establish an effective route of exit for venture capital investment.

Fourth, fully mobilizing all walks of life to participate in venture capital investment activities. *Several Opinions on the Establishment of the Venture Investment Mechanism* issued by seven central government ministries, such as the Ministry of Science and Technology, encourages various kinds of investments, including governments at the local level, enterprises, financial institutions, private individuals and foreign businesspeople, to actively promote and get involved in the development of the venture capital investment undertaking. As for banks, as a natural outcome, venture capital has promoted innovation and capacity-building in connection with the client structure, asset structure, income structure and traditional services of commercial banks. Despite the fact that, as per the principle of separation of the operation of financial sectors, commercial banks are not yet able to move into the field of venture capital and conduct venture capital investment operations, they can offer more refined financial services to the development of venture capital, make investments on a proxy basis, serve as agent for venture capital equity transactions and settlements, provide depository services for venture capital equity, and make available funding support for venture capital investment companies and investment funds.

Three. Improving financial services and expanding the debt financing channels of SMEs

As Premier Wen Jiabao pointed out recently that SMEs, in particular private businesses, can play an important role in absorbing surplus labour and addressing the unemployment problem. The Chinese Government is still not doing enough in terms of strengthening the support of financial institutions for SMEs, in particular private businesses. In the days to come, while strengthening supervision and averting risks, efforts should also be made to beef up bank's support for these enterprises.

In order to address the debt financing difficulties facing SMEs, in the past few years, the banking regulatory authorities and various kinds of commercial banks have unveiled a number of credit policies designed to support the development of SMEs. The PBOC has extended RMB 15 billion yuan to small and medium-sized financial institutions as the re-lending amount to be used to support the development of SMEs, use the "window guidance" to guide each major commercial bank in its effort to strengthen and improve financial services and encourage commercial banks to intensify support for SMEs. These policies and measures have, to varying degrees, indeed alleviated the current financing difficulties facing some SMEs. Since the beginning of the year 2003, the PBOC has organized two dedicated surveys joined by some provincial PBOCs and relevant commercial banks on the lending extended by financial institutions to SMEs. The results of these two surveys show that the ratio of loans to SMEs in financial institutions has now reached 50%.

However, to thoroughly address SMEs' difficulties in obtaining loans, it still takes some more time. Commercial banks need to further improve their lending policies, take into account the developments in the venture capital market, constantly improve financial services for SMEs, alleviate the financing difficulties facing SMEs, and promote and support the development of SMEs.

First and foremost, commercial banks need to fully realize the huge development prospects of SMEs and their profound implications for the national economy, and enhance their initiative and creativity in the effort to strengthen and improve services for SMEs. It is imperative to gain an in-depth understanding about the problems that exist in the course of the development of SMEs, master the characteristics of their development, and formulate lending policies for SMEs. The needs for working capital of enterprises with good track records and more rosy prospects can be met by way of trade financing, closed-end loans and short term lending quotas. For those scientific and technological SMEs that have got the support from national tax authorities or funds, on the precondition that such enterprises have paid up their equity funds and that repayments can be ensured, matching loans can be extended. Based on SMEs' development needs like technical renovation, longer-term loans can be made in order to add to SMEs' stamina and long-term development capabilities.

Second, banks should actively tap financing lease activities and address the problems of insufficient mortgage and difficulties of getting guarantees facing SMEs.

Third, the government authorities should take the lead in establishing and improving the SMEs credit-worthiness regime and the credit-worthiness guarantee regime for SMEs financing. Banks should intensify lending support to SMEs on the precondition of making use of government guarantees, risk compensation, government subsidies of interest charges and guarantees from guarantee institutions and effectively reducing lending risks.

Fourth, banks may make full use of their advantages in terms of information, networks, talents and clients and offer financial advisory services to SMEs in areas such as investment, financing, conversion into shareholding enterprises, IPOs, mergers and acquisitions. Banks can provide a forum for communication between venture capital and SMEs and conduct financing promotion to SMEs with high growth prospects, high growth potential and financing needs and venture capitalists from at home and abroad.

In addition, there is the possibility of actively developing the corporate bond market and the long-term bills and notes market, appropriately develop local small and medium-sized financial institutions and expand private financing channels. The monetary policy implementation report of the third quarter released by the PBOC indicates that in the first nine months, the newly-added financing on the domestic financial market has reached RMB 2,973.4 billion yuan, among which loans account for 89.8%, or RMB 2,668.7 billion yuan, with indirect financing risks concentrating on loans. Great efforts should be made to develop the capital market, encourage enterprises to access direct financing, and appropriately provide outlets for bank loans; these are conducive to the alleviation of indirect financing pressures facing banks and of financing difficulties facing SMEs.

To promote the long-run development of SMEs and venture capital, it is also an urgent task on the part of the government authorities to further improve the market environment and, in fields such as legislation, taxation, investment and guarantees, intensify support for SMEs.

As the largest commercial bank in China, the Industrial and Commercial Bank of China (ICBC) has all along given top priority to SMEs lending operations. In 1998, its Head Office set up a small department for the management of SMEs lending. Since then a series of lending policies have been formulated and implemented in a bid to strengthen and improve financial services for SMEs and, in a timely manner, satisfy the reasonable needs for funds on the part of SMEs. By the end of 2002, the number of SMEs that the ICBC has extended loans to had reached 206,000, accounting for 93.64% of the total number of legal-person clients; and the outstanding balance of loans had amounted to RMB 1.25 trillion yuan, representing 48.64% of the total for

all the legal-person clients. In the year 2002, RMB 866.7 billion yuan in loans were made to SMEs, constituting 49.8% of the cumulative amount of loans made by the ICBC, with SMEs ranking as an important client group and an recipient of lending services of the ICBC. The ICBC has persisted in the principle of “paying attention to returns only instead of the size ownership structure”, formulated lending policies and credit rating criteria suitable for the characteristics of SMEs, and actively offered financing support for SMEs that conform to the nation’s relevant policies and possess comparative advantages. In light of the different financing needs of SMEs, the ICBC has lost no time in designing corresponding financial products, such as recycling loans which need one application only but can be used in cycles; loans that can be applied for at one time but can be repaid in instalments; account overdraft loans whose quota can be approved at a time and which can be withdrawn on demand; longer-term loans; and bank acceptance bills, letters of guarantee, discounting of bills and notes, letters of credit, and factoring. Taking into account the difficulties of obtaining guarantees for SMEs, the ICBC has actively developed guarantee categories and offered a wide selection of guarantee products for SMEs to choose from, examples include natural-person guarantees, taxi license security-backed loans, shop margin security-backed loans, inventory security-backed loans, foreign exchange guarantee loans, foreign shareholder guarantee loans and loans securitized on patents, franchises and enterprise equity. In order to enhance the efficiency of financing services and optimize the procedures of lending operations, the ICBC has appropriately decentralized the lending examination and approval rights and established the “green channel” for the rapid examination and approval of low-risk operations. The ICBC’s efforts to make greater lending to SMEs are by no means a contingent measure; rather they are based on its strategic considerations of long-term development. It is a long-term task to implement strategic adjustments to the mix of lending. In the days to come, we will, in a more proactive manner, speed up business innovation, expand business fields and actively promote the development of the capital market so as to make greater contributions to the development of SMEs.

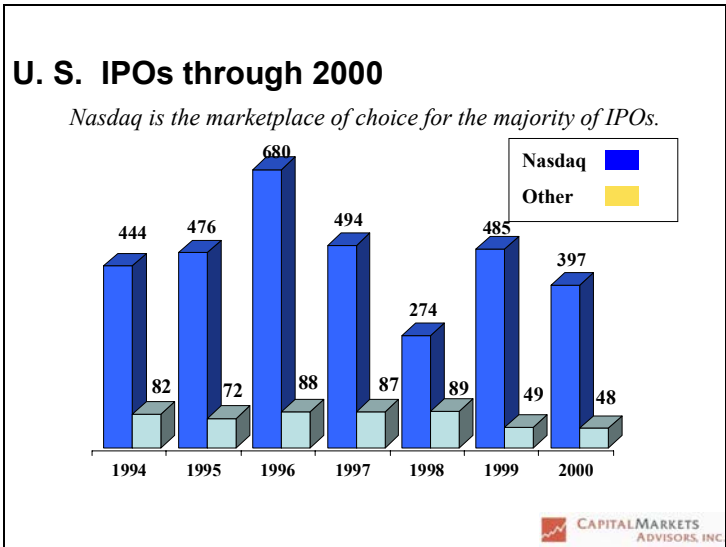
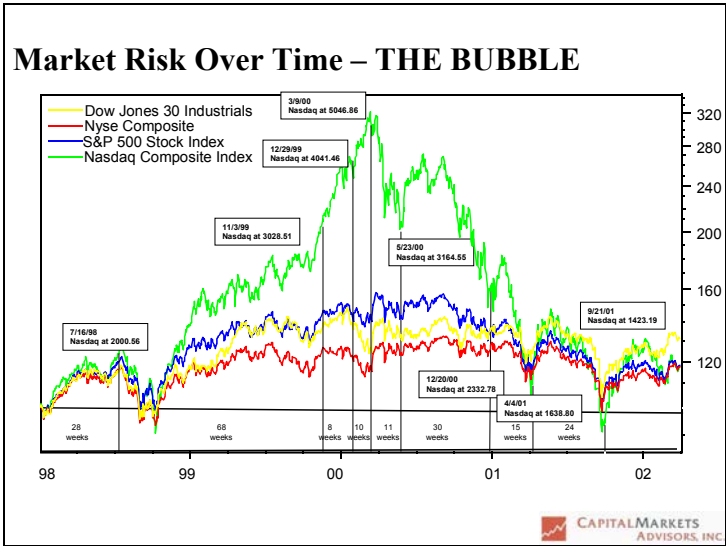
Let me conclude my speech by wishing this APEC Venture Investment Seminar a complete success.

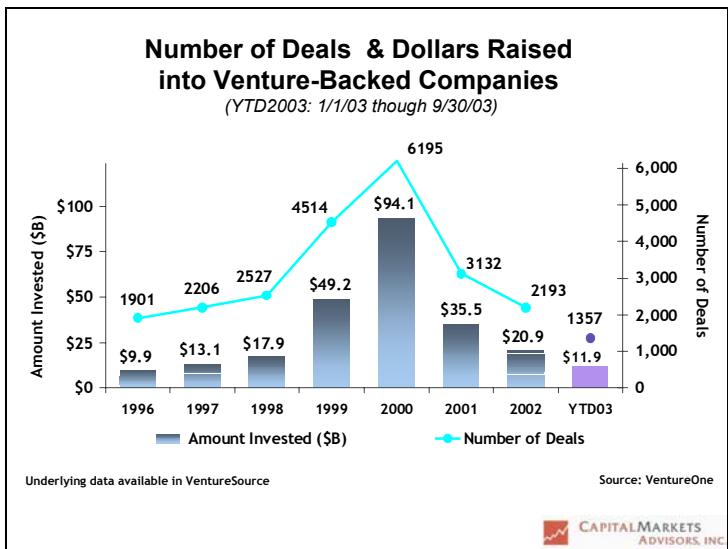
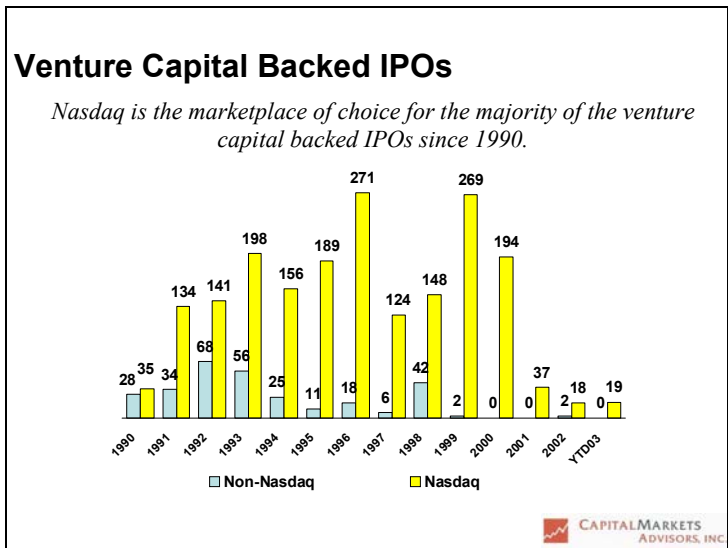
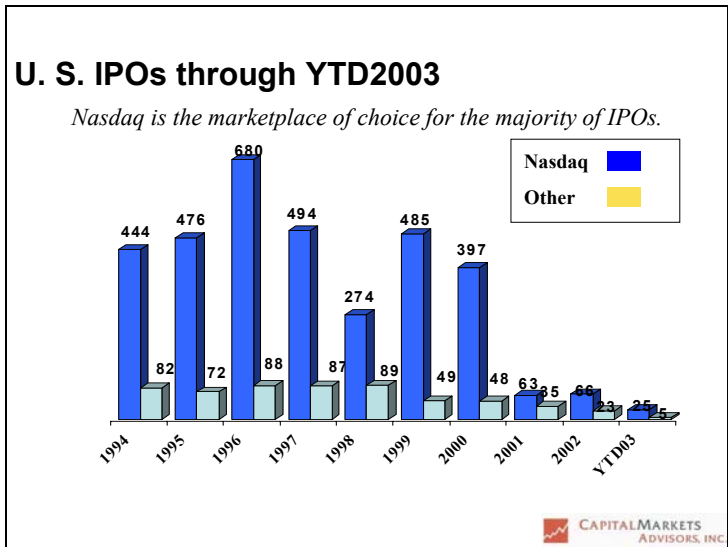
Thank you all.

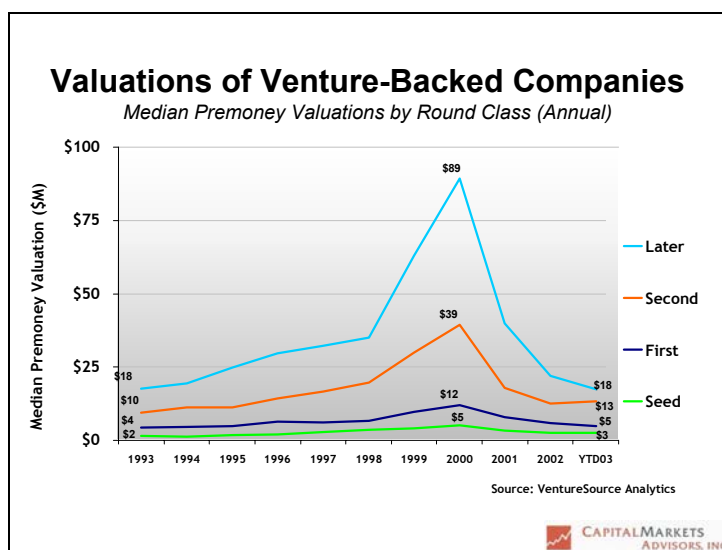
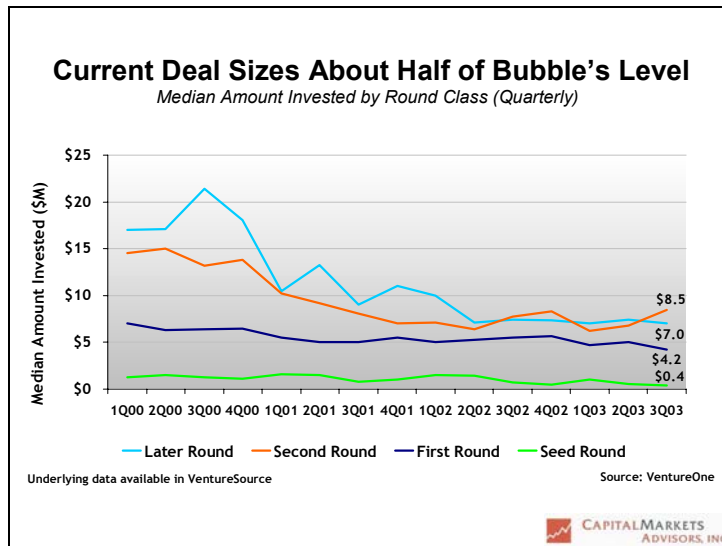
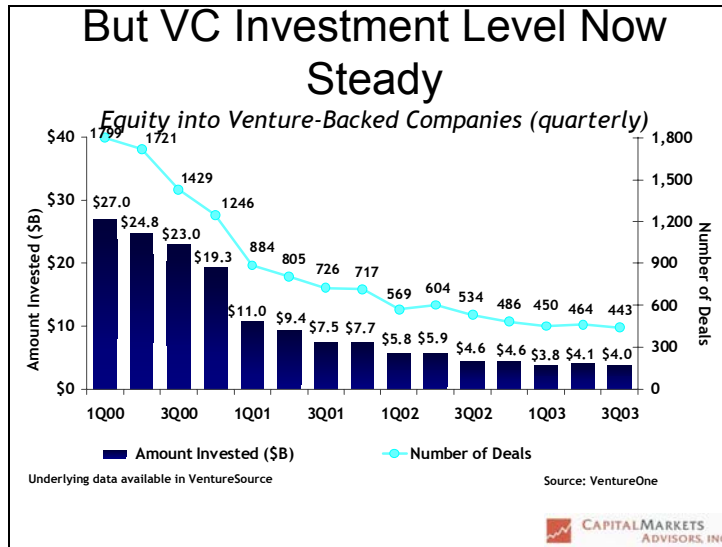
Venture Capital after the Bubble

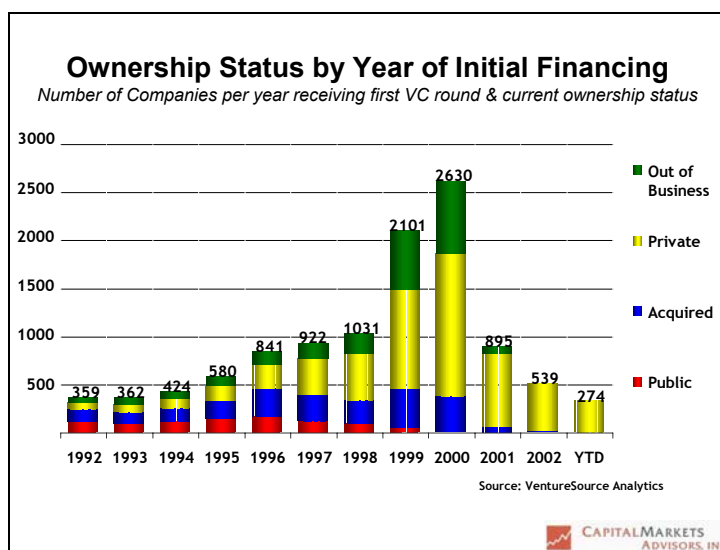
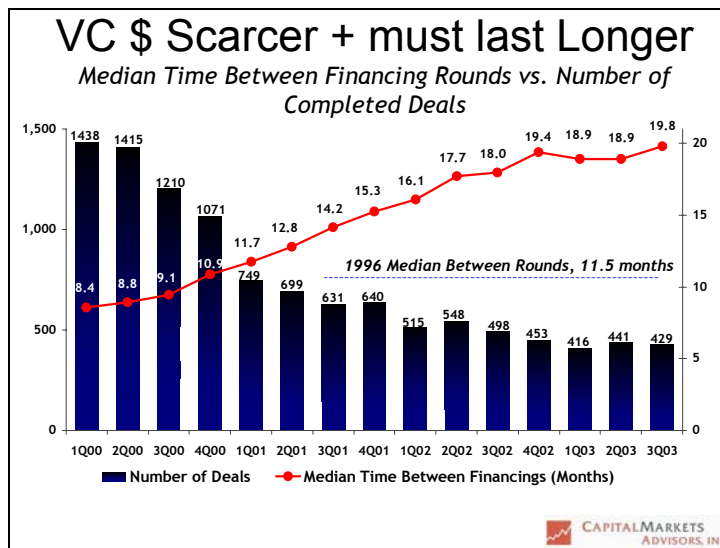
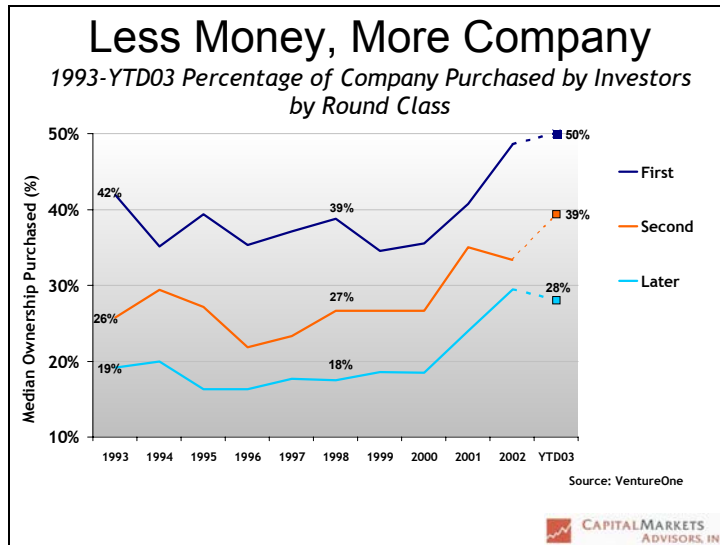
Mr. John T. Wall, Chairman of Capital Markets Advisors, Inc.
Former President of NASDAQ International Co. Ltd

Venture Capital after the Bubble
John T Wall, Chairman
Capital Markets Advisors, Inc.
December 10 and 11, 2003







Shareholders Lose Billions

Logos of companies that lost billions of dollars: Qwest, WorldCom, Xerox, Lucent Technologies, GE, Enron, Global Crossing, Computer Associates, Adelphia, and Motorola.

CAPITALMARKETS ADVISORS, INC.

Reforms - Accountability + Costs

- SEC requires CEO's to certify accuracy of statements
- Sarbanes-Oxley Act with heavy criminal penalties
- Exchanges tighten Corporate Governance Rules
- Accountants are limited in offering non-audit services and must comment on internal controls
- SEC creates Public Company Accounting Oversight Board
- COSTS – estimated Sarbanes Oxley Act will amount to \$3mil in added costs for midsize companies

CAPITALMARKETS ADVISORS, INC.


The US Venture Industry Has Grown

Number of Active VC Firms & Total Capital Under Management

Year	# Venture Firms	Capital Under Mgt
1970	28	\$1B
1980	87	\$3B
1990	386	\$32B
2002	892	\$253B

Source: 2003 NVCA Yearbook


CAPITALMARKETS ADVISORS, INC.



Investment Banking YTD Through 3Q03 Rankings by Dollar Amount Raised

Issuer Mkt Cap under \$1.5B — All Industries 1/01/03 – 9/30/03 IPOs Only			All Market Caps— All Industries 1/01/03 – 9/30/03 IPOs Only		
Lead Manager	# of Deals	Total Amt Raised	Lead Manager	# of Deals	Total Amt Raised
Credit Suisse First Boston	7	2,688.62	Credit Suisse First Boston	5	\$1,072.06
Citigroup Global Markets Inc	3	1,681.43	Goldman, Sachs & Co	4	1,011.01
Goldman, Sachs & Co	4	1,541.32	Friedman, Billings, Ramsey	4	\$117.28
Merrill Lynch & Co	6	1,451.57	Citigroup Global Markets Inc	3	754.09
Friedman, Billings, Ramsey	4	1,319.44	Morgan Stanley	4	630.06
Morgan Stanley	4	1,050.81	Sandler O'Neil & Partners LP	1	595.00
Banc of America Securities	2	937.11	Banc of America Securities	2	468.55
Lehman Brothers	3	786.60	Merrill Lynch & Co	4	462.81
Sandler O'Neil & Partners LP	1	596.00	Lehman Brothers	2	169.60
Deutsche Bank Securities	1	480.70	Keefe, Bruyette & Woods Inc	1	167.42
JP Morgan Securities Inc	2	393.30	Robert W Baird & Co Inc	1	148.78
Wachovia Capital Markets, LLC	1	339.73	Farris, Baker, Watts Inc	1	113.85
Robert W Baird & Co Inc	1	297.56	Wachovia Capital Markets, LLC	1	113.32
Jefferies & Co Inc	2	173.19	SG Cowen Securities Corp	1	104.48
Keefe, Bruyette & Woods Inc	1	167.42	Bear, Stearns & Co	1	90.00
CIBC World Markets	1	132.82	CIBC World Markets	1	66.41
Farris, Baker, Watts Inc	1	113.85	SunTrust Robinson Humphrey	1	59.34
SG Cowen Securities Corp	2	104.48	WR Hambrecht & Co LLC	1	30.80
Bear, Stearns & Co	1	90.00	Gunn Allen Financial Inc	1	10.00
SunTrust Robinson Humphrey	1	59.34	Advest Inc	1	9.00
48		\$14,387.30	41		\$7,043.81

Source: CommScan, LLC *Includes 144A Institutional Common Equity Placements, FBR raised more than \$707 million in 144A Institutional Equity Placements since 1/1/03.
Note: Excluding closed end funds, where FBR was Book Running Manager.



A Brighter TOMORROW

Since Year End-
Nasdaq up 46%, S&P up 20%, Dow up 17%

- Cost cutting measures showing results
- Companies report earnings up
- Companies start to show increase in sales and revenues
- Signs of increase in Technology spending
- Employment numbers are favorable

How Can Venture Capital Flourish

Mr. Chang Sun

Managing Director Warburg Pincus Asia LLC

VC Development: Necessary Conditions

1. Capital-starved, for-profit companies
2. Ambitious & competent management
3. Long term focused institutional LPs
4. Smart, professional VC managers
5. Growing M&A and capital markets

VC Development: Sufficient Conditions

1. Fast-growing or restructuring economy
2. Well-developed, transparent legal system
3. Deep and sophisticated financial markets
4. Free flow of capital & convertible currency
5. Supportive, efficient government

Most Important Condition:

HIGH RETURNS!

Why High Returns?

Venture capital's raison d'être is to provide risk capital to fast-growing businesses

Capital comes from long-term investors who seek returns superior to public markets

Without demonstrated ability to generate high returns, VC firms cannot survive, let alone flourish

Ways to Generate Superior Returns

- 1. Ride on fast growth**
- 2. Buy low, sell high**
- 3. Use leverage**
- 4. Engineer turn-arounds**

How Can the Government Help?

- 1. Provide investment opportunities**
- 2. Create or improve exit mechanisms**
- 3. Set up preferential policies**
- 4. Encourage long term capital into VC**

Provide Investment Opportunities

Continue pushing economic and financial reforms --

Create corporate and SOE divestiture opportunities for venture capital and private equity

Create or Improve Exit Mechanisms

Enhance listing rules to allow easier exit

Reduce no-sale period for founding shareholders

Permit founder/investor shares to be freely traded

Set Up Preferential Policies

Use policy incentives to encourage VC investments --

Quick and transparent foreign investment approval process

Tax abatement and government loans for VC-backed small businesses

Encourage Long Term Capital Into VC

Permit social security, pension & retirement programs to invest in VC funds --

Twin benefits of providing source of capital to VCs and allowing pension funds to diversify and achieve higher returns

Creates institutional investment community and helps develop financial products

Conclusion:

Venture capital can flourish in a developing APEC country if:

The right environment for investing and exit is created and maintained

VC firms can generate above-average IRRs

Government supports it with favorable policies

Thanks!

Q & A

Current Status and Opportunities for China Venture Capital Firms and Start-up Companies

Mr. Gavin Ni, President of Zero2ipo.com.Ltd

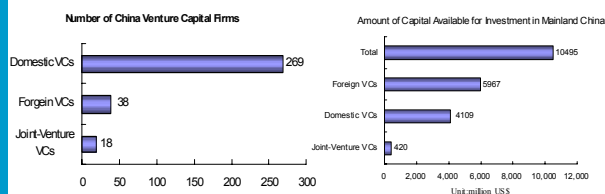


- ❑ *China Venture Capital in 2002 and 2003*
- ❑ Cooperation model between foreign VC and local Chinese VC firms
- ❑ Corporate governance in China VC deals
- ❑ Opportunities for China Venture Capital Market in the next 5 years



China Venture Capital in 2002 and 2003

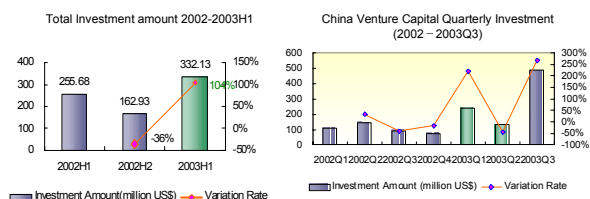
Number of VC firms and Capital Managed



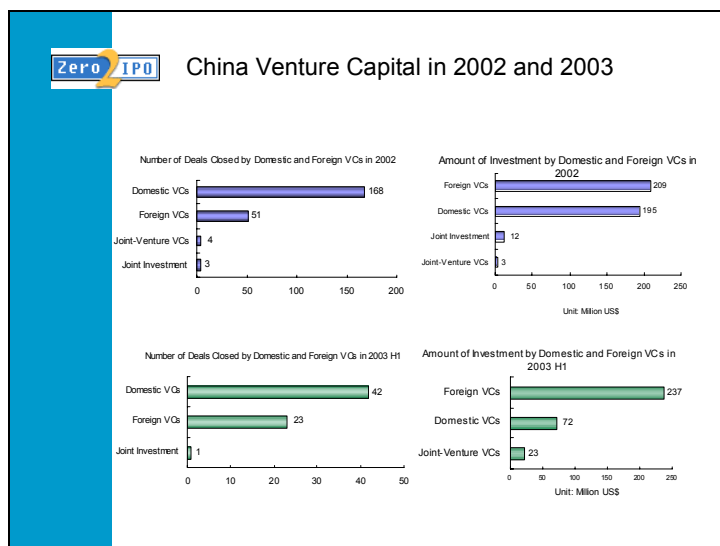
Local Chinese VCs far outnumber foreign VCs. Local Chinese VCs' capital under management is much less than that of foreign VCs. Joint VCs become an important force.



China Venture Capital in 2002 and 2003



China venture capital investment showed a rebound in the first half of 2003. Investment increased by a big margin in the first quarter while slipped sharply in the second quarter because of SARS. Zero2ipo predicts that the total investments in 2003 will exceed that of 2002 and reach US\$100 million.



Zero IPO China Venture Capital in 2002 and 2003

Industry Distribution of China Venture Investment in the First Half of 2003

Industry	Number of Investees	Number of Investees with Disclosed Investment Amount	Investment Amount (Million US\$)	Percentage
Telecommunication	14	11	163.94	49%
IT (narrow sense)	15	15	64.82	20%
New Energy	2	2	36.17	11%
Semiconductor	5	4	22.2	7%
Traditional	12	12	18.85	6%
Biotech/Medicine	8	8	11.64	4%
Photo electricity/ Machine electricity	4	4	6.41	2%
Environment	3	3	5.09	2%
Services	2	1	1.7	1%
Unknown	1	1	1.31	0%
Total	66	61	332.13	100%

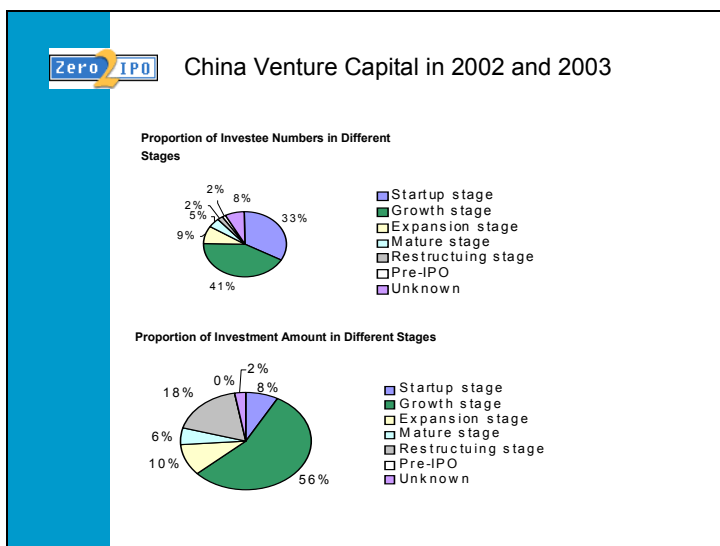
IT (narrow sense) includes: software, IT Service, Internet, Computer Hardware & Peripherals

Zero IPO China Venture Capital in 2002 and 2003

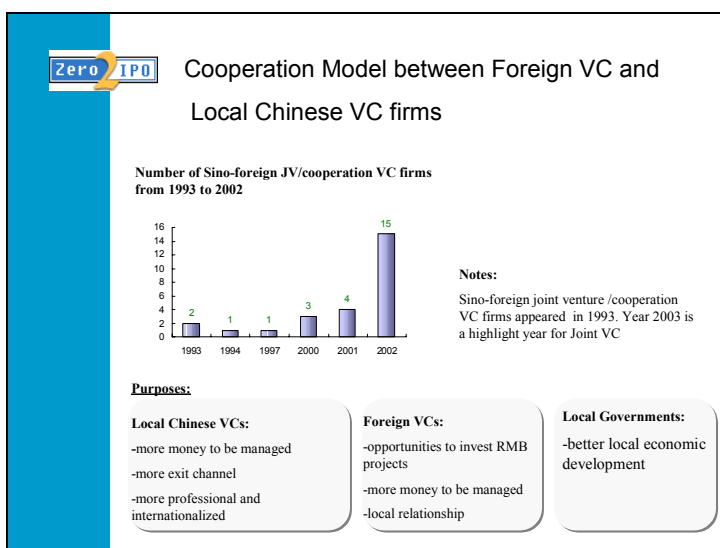
Geographical Distribution of China Venture Investment in the First Half of 2003

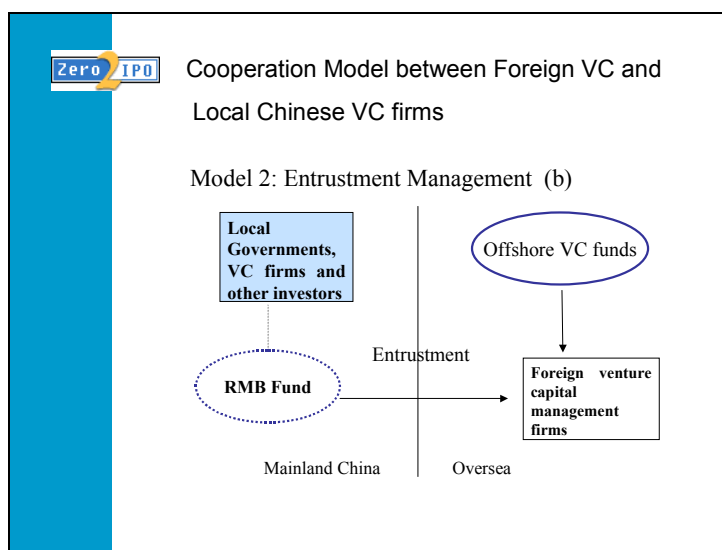
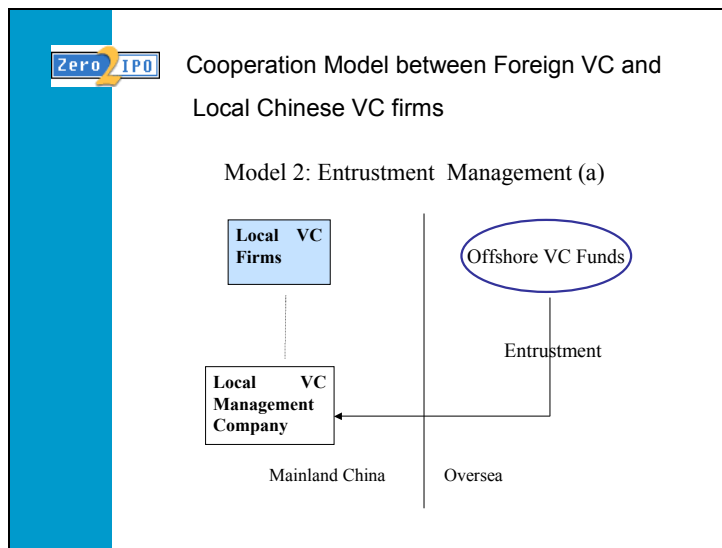
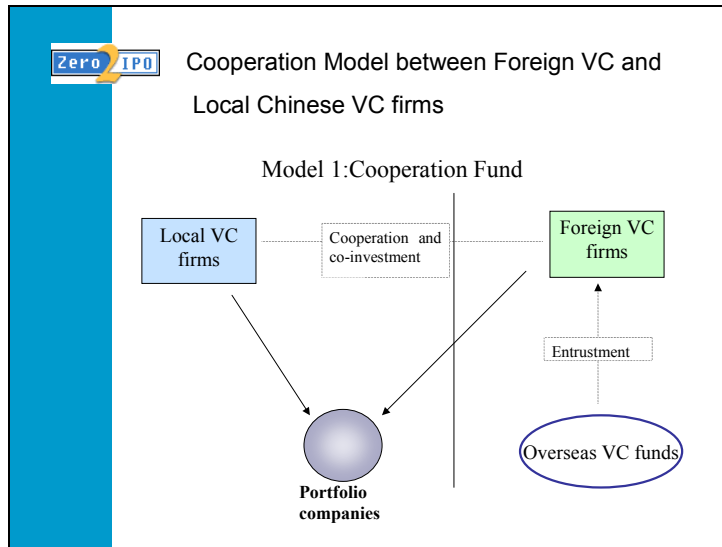
Region	Number of Investees	Number of Investees with Disclosed Investment Amount	Investment Amount (Million US\$)	Percentage
Shanghai	13	11	86.2	26%
Beijing	14	13	71.07	21%
Hongkong	2	2	61.7	19%
Guangdong	6	6	35.83	11%
Sichuan	1	1	15	5%
Shandong	8	8	12.73	4%
Shenzhen	8	8	12.55	4%
US	1	1	11.7	4%
Anhui	3	3	7.32	2%
Jiangsu	4	2	6.05	2%
Hebei	1	1	3.03	1%
Guizhou	1	1	2.42	1%
Qinghai	1	1	2.42	1%
Hainan	1	1	1.92	1%
Hunan	1	1	0.88	0%
Unknown	1	1	1.31	0%
Total	66	61	332.13	100.0%

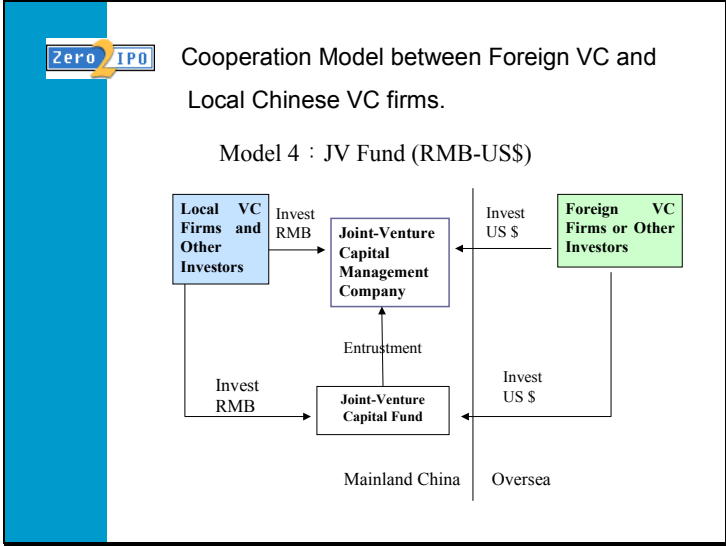
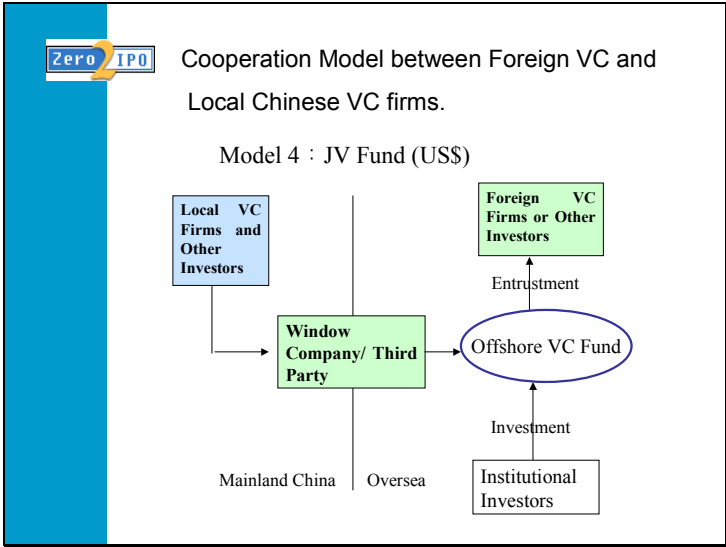
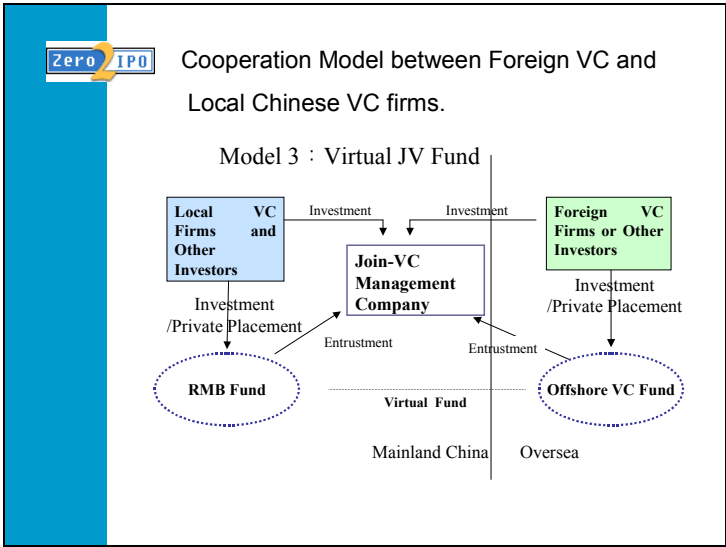
Guangdong doesn't include Shenzhen

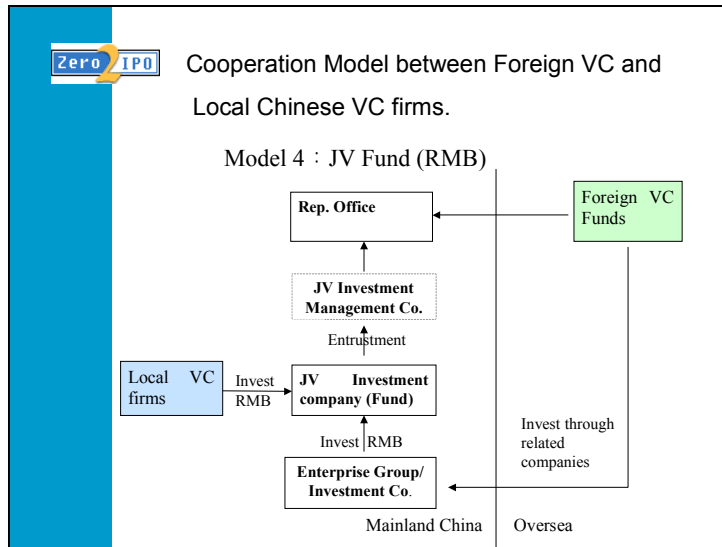


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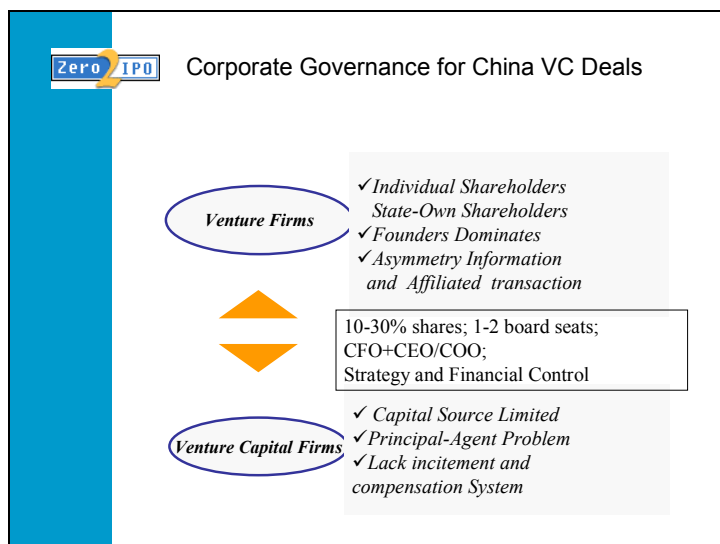






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- ❑ China Venture Capital in 2002 and 2003
 - ❑ Cooperation model between foreign VC and local Chinese VC firms.
 - ❑ *Corporate governance for China VC deals*
 - ❑ Opportunities for China Venture Capital Market in the next 5 years.

China VC Deal Cases



- Zero IPO**
- ❑ China Venture Capital in 2002 and 2003
 - ❑ The cooperation model between foreign VC and local Chinese VC firms.
 - ❑ Corporate governance for China VC deals
 - ❑ *Opportunities for China Venture Capital Market in the next 5 years.*

Zero IPO Opportunities for China Venture Capital Market in the next 5 years.

Macro Environment

- ✓ **High Growth:** China economy is most likely to keep a high growth over the next 5 years
- ✓ **Deregulation:** Under WTO agreements, China will further open its market.
- ✓ **Huge Domestic Market:** Go west, Rebuild North-east, CEPA
- ✓ **Better Stock Market:** Venture capital environment improves, better exit and fund raising channel



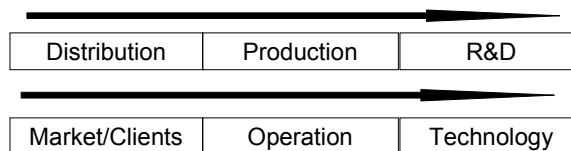
Opportunities for China Venture Capital Market in the next 5 years.

Industries

- ✓ Telecom/Mobile business
- ✓ IT (software and service)
- ✓ IC
- ✓ Health Care
- ✓ Media, Education
- ✓ New Energy, Environment Protection
- ✓ Others



Opportunities for China Venture Capital Market in the next 5 years.



•Successful Cases: Lenovo, Asainfo, Huawei, Netease

From a market oriented economy (Present) to a technology oriented economy (Future)!



Thank You!

Solving the Mystery of Venture Capital--How a Process That Triumphs in the U.S. Can Succeed in China and other APEC Economies

A Presentation by Ken Hagerty, President, Global Venture Investors Association, at the APEC Seminar on Venture Capital, Beijing, China, December 10, 2003

Summary

The purpose of my talk this afternoon is to suggest some reasons why venture capital as practiced in the United States has been so difficult to export to other economies. I will outline a strategy APEC can follow for building American-style venture capital capabilities in other economies by giving American venture capital firms incentives to share their company creation expertise and knowledge with investors and aspiring venture capitalists in those economies.

My proposed APEC strategy is to encourage member governments to promote public and private institutional investment into American venture capital firms as a way of globalizing and developing their economies, while earning excellent returns. I will use the example of APEC Member Singapore and of Israel.

This program will strengthen and globalize APEC economies by introducing a powerful new mechanism for discovering and developing their comparative advantages. It will also encourage more American venture capital firms to operate globally by helping them develop new sources of funding and new relationships and insights into business opportunities abroad, that they would otherwise ignore.

This strategy is founded on five propositions:

- ❑ An economy's ability to discern and exploit its comparative advantages is the bedrock of its economic viability in the global trading system.
- ❑ There is no more efficient mechanism for discovering and developing an economy's comparative advantages than the American venture capital process.
- ❑ Yet American style venture-backed company creation is rare, or totally missing, in most other economies today.
- ❑ This problem can be solved by providing incentives for American venture capital firms to share their specialized knowledge and expertise with investors in other economies.
- ❑ The Asia Pacific Economic Cooperation can play a key role in educating governments and investors abroad on the developmental benefits of encouraging investments into American venture capital firms.

An economy's ability to discover and develop its comparative advantages is the bedrock of its economic viability in the global trading system.

In today's increasingly globalized economy, governments can no longer count on the comparative advantages their economy developed yesterday to support them tomorrow. The unexpected rise of China as a manufacturing colossus, quickly moving up the value chain, has swamped the national industrial policies of many of its Asian neighbors. But this surprise is only one example of the stream of challenges and opportunities that constantly erupt in the global economy. Rather than relying on any fixed set of natural resources, goods or services that are profitable for the moment, the real prize for every economy is to develop a *process* that can allow it to change with the times. As Singapore's Prime Minister Lee Kuan Yew has said, "Being relevant to the world—and as the world changes being relevant in spite of those changes—is the business of living. The countries that make themselves relevant become better off. Their people become better off. Those who opt out suffer."

Every economy urgently needs private sector investment expertise and a willingness to deploy private resources to discover and develop its comparative advantages. But that knowledge is either extremely scarce or totally absent in nearly all developing economies. Most developing economies have a few large, government-related trading companies and utilities, followed by a mass of family owned enterprises. There is little or no globally competitive entrepreneurial sector in between. The question is where does the missing entrepreneurial expertise reside, and how can it be attracted to developing economies?

There is no more efficient mechanism for discerning and exploiting an economy's comparative advantages than the American venture capital process.

American venture capital firms are the world's best at discovering new opportunities and then systematically constructing dynamic companies to exploit them. Venture-backed companies in the U.S. are designed from the ground up to grow fast and compete successfully in global markets. As a group, venture-backed firms are much more successful than self-financed companies. And they often point the way for many more emerging companies. American venture capital has invented a series of entirely new industries, including biotechnology, the commercial internet, overnight delivery, personal computers, and big box retail stores.

Yet American style venture-backed company creation is rare, or totally missing, in most other economies today.

Many economies have recognized their need for a process to spawn growth companies. They have heard about American venture capital and have launched programs to try to develop their own venture capital industries. But failures litter the

landscape, even in sophisticated economies. The venture capital process doesn't seem to work in other places the way it does in the U.S. In Tokyo, an official of Japan's Ministry of Economy, Trade and Industry spoke for many economies when he told me, "We just don't have people in this country who can look at a stack of business plans and determine which of them has the best chance of success. We've tried doing that many times, and it hasn't worked."

The question is why? Why should a process that triumphs in the U.S. flounder in other economies? I believe a large part of the answer lies in a misunderstanding of the venture capital process as practiced in America.

The term "venture capital" itself can be somewhat misleading. Foreign officials, investors and entrepreneurs often mistakenly think the process consists simply of risk taking (venture) and providing money (capital). What is not well understood is that the success of America's venture capital firms depends almost entirely on two less visible factors: active, global, due diligence (research) before the investment, combined with continuous coaching of the portfolio firms' management after the investment. The absence of American style global due diligence and management mentoring explains the disappointing returns of many of the so-called "venture capital" initiatives in other economies. (See Attachment I for an outline of the American venture capital process.)

This problem can be solved by providing incentives for American venture capital firms to share their specialized knowledge and expertise with investors in other economies.

Even though American venture capitalists lead the world in discovering new business opportunities and spawning fast growing companies to exploit them, most U.S. VCs have little reason to share their knowledge outside their local area. The majority of American VCs prefer to be physically close to their portfolio firms so they can provide lots of hands-on help to management and still get home that night. And the legal/regulatory environment in most other economies deters them from operating there as well.

The force that can align the needs of American venture capitalists with the developmental needs of foreign economies is the American VCs' need to raise new funds. Most people don't realize how much time the majority of American venture capital firms have to spend soliciting new commitments of capital for their next fund. Famous, top tier venture firms regularly turn away investors, but eighty percent of America's venture firms have to work long and hard to round up their capital. Moreover, the venture capital market is cyclical, and for the last few years, fundraising has been a real challenge for many firms.

This fund raising imperative creates a significant opportunity for investors and

governments that would like to learn the American venture capital process. Experience has shown that economies that encourage investment *into* successful venture firms have much more success developing their own venture capital capabilities than those that focus only on attracting investments *from* VCs. Supplying capital to VCs allows investors to develop key relationships and knowledge while earning excellent returns. The experience Singapore and Israel illustrate this perfectly.

The Examples of Singapore and Israel

Beginning in the mid-80s, the Singapore Government became an active limited partner investor in American venture capital firms. In addition to learning the venture business from the inside and making spectacular returns on their investment, Singapore's government investment agencies developed close relationships with the top tier venture firms in the U.S. Eventually, by supplying investment capital to American venture firms, and developing close, personal relationships with them, Singapore was able to persuade nearly half of the top tier American VC firms to open up shop in Singapore and get them to train the next generation of Singaporean venture capitalists.

Israel was in more of a hurry. In 1993 they set out to spawn their own venture industry almost from scratch. The government put up \$80M and asked their Chief Scientist to recruit a group of people who could organize and lead Israeli venture capital firms. But instead of trying to go directly into the venture business--the mistake that has sunk most government-sponsored venture initiatives around the world--the would-be VCs from Israel came to the U.S. and partnered with American venture capital firms, using the funds supplied by the Israeli Government. With the Americans' help they learned how to perform global due diligence, and how to provide strategic and tactical advice to their portfolio companies. After five years they were allowed to buy back the Israeli Government's investment, and they were launched. In partnership with the American VC firms they were extremely successful. By 2000, the brand new Israeli venture capital industry raised and invested more than \$3 billion.

The experience of Singapore and Israel demonstrate that the key to jump-starting a viable venture industry is to supply capital *to* successful American venture firms rather than just trying to attract capital *from* them. American venture firms can be persuaded to share their vital knowledge and expertise--but only if doing so enhances their own success.

Fortunately, investing in venture capital for the long term can be extremely profitable. As the chart in Attachment II demonstrates, venture capital has been the institutionalized asset class with the highest earnings over the past twenty years. And this includes the low returns of 2000 - 2002.

The Asia Pacific Economic Cooperation can play a key role in educating governments and investors abroad on the developmental benefits of encouraging investments into American venture capital firms.

Proposed APEC Strategy:

- Produce symposia in the U.S. and abroad—co-sponsored by participating government departments, and agencies, and local VC associations—to introduce public and private institutional investors to the financial and developmental benefits of investing in American venture capital firms.
- Work with member economies to create policies and programs to develop their own venture capital capabilities and remove barriers to private equity investment.
- Recruit a team of global professional service firms to sponsor and market the program
- Develop an advisory council

Conclusion

Helping APEC economies develop their venture capital capabilities would dramatically enhance the economies of APEC's members. It would also generate significant goodwill with a series of constituencies that could be very helpful to APEC members in the future. These include:

- U.S. and offshore venture capital communities;
- Venture-focused global professional service firms, and
- Entrepreneurial oriented foundations;
- Governments of non-APEC economies.

See Attachments I & II

Attachment 1

SOLVING THE MYSTERY OF VENTURE CAPITAL Why a Process That Triumphs in the U.S. Flounders Abroad

Foreign officials, investors and entrepreneurs often mistakenly think the U.S. venture capital process consists simply of risk taking (venture) and providing money (capital). What is not well understood is that the success of America's venture capital firms depends almost entirely on two less visible factors: active, global, due diligence (research) before the investment, combined with continuous coaching of the portfolio firms' management. The absence of American style global due diligence and management mentoring explains the disappointing returns of many "venture capital" initiatives in other economies.

Key Elements of the American Venture Capital Company Creation Process

1. Pre-Investment Global Due Diligence

Evaluating: The Management Team; The Market & Projections; Competitors
Consulting: Experts in the Field; Existing & Potential Customers
Developing: A Joint Business Plan with the Entrepreneurs

2. Initial Capitalization & Help Securing Later Rounds of Funding

3. Post-Investment Management Coaching & Assistance

Providing Strategic Advice:

Selecting Board Members & Senior Staff

Marketing & Sales Strategies

Staffing & Outsourcing

R&D Programs

Financial Reporting & Corporate Governance

Senior Management Changes & Restructuring

Potential Strategic Partners

Introductions to Key Service Providers

Providing 'Best Practice' Templates (examples)

Forecasting Sales

Compensation & Evaluation

Benchmarking Performance

Budgeting Capital Requirements

Managing Turn Over

Corporate Safeguards

Recognizing Revenue

Reporting Results

Managing Cash Flow

Launching Products

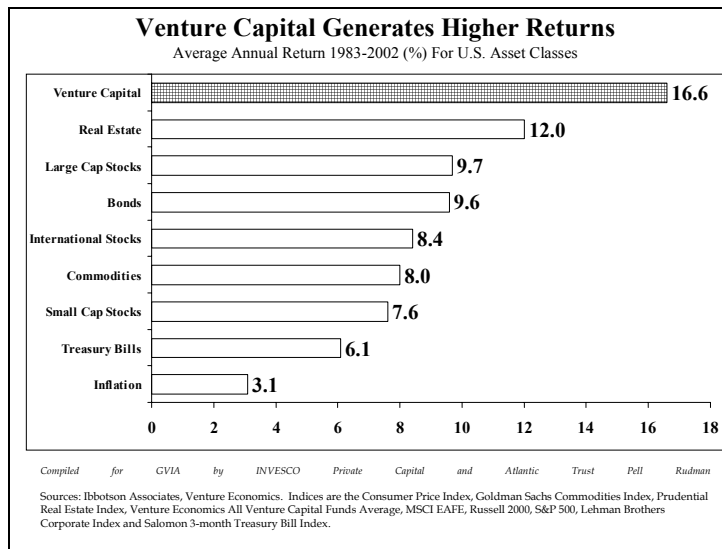
Managing Contracts

Managing Customer Relationships



Global Venture
Investors Association

Attachment 2



Key Initiatives to Foster Venture Capital Development In Asia Pacific Developing Economies

By

Richard S. Roque*

Chairman *Emeritus*, The Hong Kong Venture Capital Association

Principal, William E. Simon & Sons (Asia) Ltd.

The importance of venture capital as the force behind innovation and wealth creation in the US and other developed economies is well recognized. Many of the premier global corporations today have received their early stage funding from venture capital firms, such as Intel, Federal Express, Cisco, Microsoft and Compaq. The case for venture capital playing a similar role in APEC developing economies has not yet been realized in the same scale as in the West. Nevertheless, there has been a growing awareness of venture capital as an important source of financing since the late 1990s. With the steep collapse of the stock market that accompanied the bursting of the Internet bubble, interest in Venture Capital has waned. This situation is unfortunate as it neglects the vital role Venture Capital can play as a catalyst to promote growth, structural change and development whilst at the same time enhancing cross border trade and investment amongst APEC economies.

In this paper reference to Venture Capital ("VC") will focus on the broader definition often applied in Asia, which equates Venture Capital with Private Equity ("PE"). Although strictly speaking, Private Equity encompasses a much broader range of investment activities; the main categories being: venture capital; buy-outs, development/expansion capital, Pre-IPO/Late Stage Investing, Distressed/Turnaround Capital. Alongside these categories are the industry funds that specialize in specific sectors such as Infrastructure, Media and Telecommunications funds. In 2002, the distribution of the various categories of funds raised were as follows:

Types of Funds Raised				
Year	<u>2001</u>		<u>2002</u>	
Buyout	25%		38%	
Conventional Private Equity	17%		34%	
Technology	58%		28%	
TOTAL (amount raised)	(US\$6.1bn) 100%		(\$2.6 bn) 100%	

Source: Asia Pacific Equity Review

Private Equity can play an important role in transformation and development process of many APEC developing economies. For instance, Venture Capital and Private Equity funds aim to nurture cutting-edge high technology enterprises at different phases of their growth cycle. In addition, these funds also invest in Small & Medium Enterprises to enable them to emerge as formidable engines of growth and employment creation; buyout funds, expansion capital and distress debt funds are

* *The views expressed in this paper are those of the author and may not represent those of the institutions he represents.*

important players in restructuring state-owned enterprises; infrastructure funds and other industry funds assist in the development of certain vital sectors of the economy. In the case of China, most of what has been mentioned here finds application: given the current rapid growth, transition to a market economy, and the need to restructure huge debt problems at the state owned banks. In addition, China seeks to encourage growth of private enterprise, social stability, as well as to focus on certain sectors considered vital to the country; developing the VC industry will certainly help facilitate achievement of these objectives as well as provide a further lever to manage economic growth.

Moreover VC funds can also play an important role in fostering cross-border trade and investments amongst APEC economies. If properly managed and structured so as to foster development of business collaboration systems and networking across borders amongst users and providers of capital, VC firms can act as catalyst to transforming these companies into emerging multinationals (MNCs) with a strong culture incorporating good corporate and business governance best practices.

From an investment portfolio perspective, Private Equity is one component of the Alternative Assets that is generally considered a high-risk asset class, to which a small allocation of 1% to 5% of total assets is made. A higher return of 500 basis points or more than the public markets return is typically expected from this asset class. Amongst the major Alternative Assets, the historical returns achieved by PE in North America and Europe over a 10-year period ending 2002 has been estimated at 15% p.a. net return according to a recent survey compiled by Goldman Sachs and Russell Investment Group. This compares with 9% and 10% for real estate in North America and Europe over the comparable period and 7% and 13% for hedge funds in North America and Europe over a 5-year period.

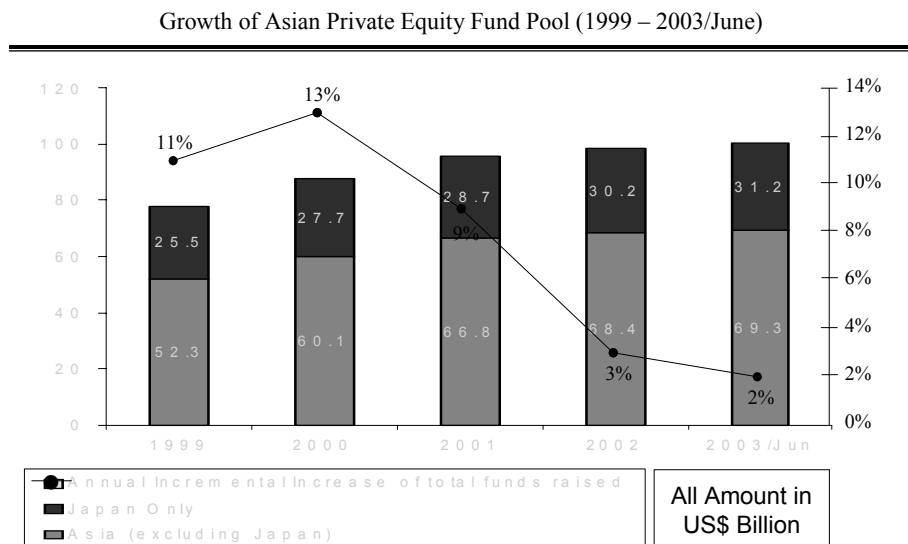
Alternative Investing Annual Returns

	North America	Europe
For 10-years to 2002		
Private Equity	15%	15%
Real Estate	9%	10%
Hedge Fund*	7%	13%

*Note: For 5-year period

Source: PrivateEquityOnline.com; 6th "Global Report on Alternative Investing by Institutions"
- survey compiled by Goldman Sachs International and Russell Investment Group

In order to achieve such superior returns, Venture Capital firms are required to provide a number of Value Added services aside from Capital such as: strategic advice, network of relationships, endorsement of the company to the investment community and more recently operational expertise. In short, Private Equity firms act as the catalyst for transformation to a professionally run corporation. The Venture Capital industry in Asia is relatively young compared to North America and Europe, this is one reason why no definitive track record of investment returns has yet been achieved. Compared to the US and Europe where the industry began in the late forties and the early sixties respectively, the industry in Asia only really took off in the early nineties. It is envisaged that Private Equity returns in Asia will be forthcoming as the industry grows and the regulatory, legal framework and capital markets mature. The issue however facing many APEC developing economies is the sharp decline in new funds raised for Private Equity during the last 3 years. There is therefore a real concern the industry may stagnate and fail to become an important engine of growth and innovation in APEC developing economies. To a certain extent, the lack of track record as well as the short experience over the last 10 years, together with the recent problems of the Venture Capital industry in the US and Europe has dampened the appetite from traditional suppliers of funds to the Venture Capital funds operating in APEC developing economies and other emerging markets. Given that the industry is still relatively young and has not reached critical mass, there is a real risk that waiting for the “track record” as basis for renewed investment in Private Equity could lead to a circular problem ending in stagnation of the industry in many APEC developing economies.



Since VC plays an important catalytic role in development and structural reforms in a developing economy, efforts should be made to re-energize the industry amongst APEC economies. There is a need for a new torchbearer to lead the industry forward

and increase the pace of growth and development. The economics is relatively straightforward; it is well known that many APEC economies have significant large foreign exchange reserves so that the combined total is over US\$ 1.0 trillion. In this respect, a joint effort could be launched amongst APEC members and between government and private sector aimed at deploying a very small percentage of these funds, say 0.5% to provide seed capital to accelerate development of the APEC region and local VC industry. To execute this strategy properly requires ensuring that the funds are spread over a sufficient number of qualified and professionally run Venture Capital funds to ensure a critical mass for the industry to achieve sustainable growth. One way of best achieving this would be for government to work closely with major International Private Equity Specialists ("IPES") such as Fund-of-Funds, consultants and multilateral development institutions who are skilled at identifying good managers, nurturing and coaching venture capital funds and instilling best practices in them. The essential element being the management team that will run these funds and it is important that they are of the highest integrity, possess strong management skills and preferably battlefield experience including many failures (as long as they have learned invaluable lessons from them). To upgrade VC skills and ensure a steady supply of quality VC professionals, a local Venture Capital training centre and institute could be established or alternatively a regional institute, which has the advantage of providing a setting to facilitate collaboration and networking to develop amongst VC professionals from each APEC member economies.

IPES could also provide assistance in the development of Local Fund of Fund Entities (LFFE) that could support development and upgrading of local VC firms. There are various structures that have been used elsewhere for LFFE to leverage on the seed capital provided and tap the international capital markets for part of the funds raised for investment. For instance, a European government recently decided to jump-start the VC industry given that there were few active local players and the industry was a fraction of the size of other developed markets. In this case, the government invited an IPES to establish a LFFE and dedicated Euro 45 Million to the fund with the balance of Euro 105 million raised from institutions through a listing of this fund in a European stock exchange. This LFFE will now invest in between 10 to 12 venture capital funds operating or to be set up in the country, providing up to 50% of the capital to each fund.

In addition, IPES can create opportunities to encourage top VC firms around the world to partner with local VC firms. In effect what is proposed is a public-private sector initiative tapping international private equity expertise in order to "apply global investment practices to regional and local investment situations", and achieve "Zhong Xi He Bi" as the Chinese adage goes.

There is also a conscious effort by many APEC developing economies to broaden, deepen and further develop their long-term capital markets. Concomitant with the strategy above, regulations should be relax to allow local long term capital players such as pension funds, provident funds and insurance companies to take reasonably small positions of 1% to 5% of total assets in private equity. The best way to do this

whilst achieving both diversification and lower risk would be through investing in the LFFE.

Aside from promoting Venture Capital companies and capital, measures are needed to transform the environment to be more conducive to VC investing. First of all is improving the rule of law and enhancing regulatory framework for protection of investors. In addition a high priority needs to be given to improving regulations that promote financial innovation and development of various financial instruments so as to provide flexibility for VC firms to manage its investments and in order to facilitate subsequent fund raising. The establishment and/or further development of a second board for younger promising companies will also help develop the VC market, as it provides an alternative exit market. In addition, the development of institutions that promote transparency and disclosure, high standards of corporate governance, entrepreneurship and the right business culture will go a long way in facilitating venture capital investing.

The Importance of Structuring Exit Mechanism for Venture Capital

– Case Study and Practical Solution

Mr. Paul S. P. Hsu

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Professor of Law, National Taiwan University

I. Preface

After the 1997 financial crisis in the Asia-Pacific region, one of APEC's efforts is to promote the development of start-up companies and venture capital in the knowledge-based economy. In this regard, APEC member economics must establish and facilitate access to efficient capital markets, both public and private, to ensure that capital will be available to finance the growth of a company at all stages. Thus, creating a conducive environment for start-up companies will also require a number of measures, including lowering the cost for starting and sustaining subsequent growth of companies, liberalizing government regulations and reducing probable bureaucratic processes. However, as most new entrepreneurs and start-up companies emerge only with the help of initial equity input, usually in the form of venture capital, a mature capital market is also important to facilitate the growth of start-up companies.

An ideal capital market is comprised of five tiers:

- (i) Angel funding;
- (ii) Venture capital;
- (iii) Pre-IPO funding;
- (iv) Stock exchange and OTC market; and
- (v) Other financial instruments to serve as intermediaries between suppliers and recipients of capital.

Based on the above, Chinese Taipei continued to propose 1 the APEC Best Practice Guidelines for Enhancing the Financing Chain for SMEs at Different Growing Stages at the 15 th APEC Ministerial Meeting. The Guidelines were endorsed by the APEC Ministers and serve as a model for future development of all Asian economies. (please refer to the attachment)

More important, a comprehensive and efficient capital market also provides the necessary exit mechanism which is vital for developing the venture capital industry.

II. Exit Mechanism

Among the key considerations in investing in venture capital funds are the presence of a high-quality management team, potential business opportunities and deal flow

activities that could enhance the valuation of the venture capital fund and a friendly and transparent legal infrastructure for venture capital investments, including the likelihood of a realistic exit from the invested company. According to a report on “Venture Capital in APEC Economies” submitted to APEC by U.S. PECC in April 2003², a major concern of investors in venture capital is liquidating their position in start-up firms, the so-called “exit”. For many investors and the firms they finance, the most desirable exit is an initial public offering (IPO). Although second-board markets are opened in a number of economies within the Asia Pacific region, these markets lack liquidity and transparency, but nonetheless continue to function.

Furthermore, according to *The 2003 Guide to Venture Capital Asia, 2002*, “For VC investors hoping for exits on public markets, the outlook in Asia has always been difficult. But although public listings remain in short supply, the story has improved considerably over the past years. The Internet bubble produced several sizeable offerings, and deals funded in the post-cash buyout era have now begun to move to the checkout counter.”

Other than IPO, other exit options for venture capitalists include merger and acquisition or private placements of the portfolios with third parties. It was also reported in *The Guide to Venture Capital Asia, 2003* that “Despite the downturn in M&A activity, trade sales have become an increasingly viable exit route as mergers and acquisitions have grown into an acceptable corporate strategy for Asia’s conservative, family-dominated business community. Of the top 10 exits in 2001-2002, almost all were done through an acquisition rather than a listing.”

III. Case Study

Taking the IPO market in Chinese Taipei for example, as of the end of 2002, among the 1,041 public companies listed on the Taiwan Stock Exchange and the OTC market, 266 public companies were listed with the support of the venture capital firms, representing 25.6% of all listed companies or 47.81% of all listed companies engaging in hi-tech business.

Nevertheless, in comparison with the listing rules in the United States, it is both costly and time-consuming for a company to go IPO under the prevailing listing rules and regulations of Chinese Taipei. Specifically, the regulators conduct merit review, including on-site due diligence for all IPO applications. A company (with the exceptions of defined hi-tech companies) cannot be listed if failing to meet, among others, the profitability test. A start-up company cannot be listed on the main board, but the secondary board which usually lacks liquidity and transparency.

Given those constraints, in the past, when an Internet company seeks an IPO, the shareholders of a local company would often exchange their shares with an offshore holding company in order to have the offshore holding company listed on a foreign

exchange, such as NASDAQ. The restructuring and migration of a local company to a foreign jurisdiction for an offshore IPO is usually costly and time-consuming.

The laws applicable to the exit mechanism impose the following major legal constraints:

- (i) A venture capital firm in Chinese Taipei can only be established in the form of a corporation (a company limited by shares), having no fixed term of existence. The legal framework of limited partnership commonly adopted by most venture capital firms in the United States is yet to be developed.
- (ii) Under the Company Law of Chinese Taipei, before a corporation can be incorporated, the paid-in capital must be fully paid up by the subscribers. Shares of a private company cannot be issued at below par value and any contribution of capital in-kind (e.g., in the form of technology) other than cash must be valued by an independent appraiser with the approval of the regulators. The issuance of preference shares is highly regulated. The amendments of corporate registrations are required for any subsequent increase or decrease of capital of the company. Only under limited circumstances is a company allowed to repurchase shares from shareholders, subject to restrictive limitations.
- (iii) A company is prohibited from returning capital to its shareholders unless in the case of a capital reduction or dissolution and liquidation with approvals of the regulators. Capital reduced can only be returned to the shareholders on a pro rata basis. Dividends can only be declared in cash once a year; no interim distribution of dividends is permitted and stocks held in the portfolio cannot be distributed to the shareholders as dividends.
- (iv) Although there are many merger and acquisition cases in process as a result of the promulgation of Financial Holding Company Act and Corporate Merger and Acquisition Act, the rules governing tender offers, hostile take-overs, especially involving foreign investors need to be further improved. In addition, the tax rules regulating taxation on merger and acquisition activities are unclear.

The difficulty in applying for IPO, and the inflexibility and inefficiency for structuring venture capital investments in Chinese Taipei have caused the exit mechanism for venture capital investments in Chinese Taipei, to be not impossible, but costly and time-consuming. Chinese Taipei has promulgated the corporate governance rules applicable to listed companies to enhance disclosure, accountability and transparency for the protection of minority shareholders. However, Chinese Taipei would need to continue to further amend/promulgate laws and regulations to loosen or lift the unnecessary legal constraints, such as to further amend the Company Law and to enact the Limited Partnership Law, with the objectives of not making the funding in venture capital viable and also making all possible exit mechanisms available for venture capital investments for the furtherance of the development of

start-ups and venture capital investments in Chinese Taipei.

IV. Conclusion

It is observed that with sufficient flexibility from regulators and tax authorities, most barriers deterring investments can be overcome. The costs of inflexibility or complex rules would make the transactions become more costly and bar the efficient operation by recipients of funds. Markets with less complicated regulations and a stable political and economic environment would likely be the ones to attract venture capital funds in the future. Having in place clean exit channels is essential for a venture capitalist to make a long-term commitment in a market. The proper role of government is to provide the infrastructure needed for the industry to develop. The legal framework governing the development of venture capital in any APEC member economies need to be improved and flexible enough to lower the transaction cost and attract investments. In light of the trend toward liberalization and globalization, it is of great importance for all APEC member economies to create a competitive environment that is compatible with the international standards and practice in order to further enhance the development of venture capital investment and start-up companies.

Attachment:

Best Practices Guidelines for Enhancing the Financing Chain for SMEs at Different Growing Stages (The Guidelines were endorsed by the APEC Ministers at the 15 th APEC Ministerial Meeting and served as a model for future development of all Asian economies.)

Best Practices Guidelines for Enhancing the Financing Chain for SMEs at Different Growing Stages

Mr. Paul S. P. Hsu

Background

In the past, APEC members recognized the important role start-up companies and small and medium enterprises ("SMEs") played in promoting economic growth. Through the recent development of their economies, APEC members further recognize the need to support SMEs at different growing stages, so that these SMEs can adapt themselves to a fast-changing economy. In this regard, the establishment of financing mechanisms for SMEs at different growing stages is essential for maintaining dynamic business and financing activities, encouraging innovation and entrepreneurship, and enhancing economic growth and prosperity in the APEC region. Additionally, with wide diversity among APEC member economies, finding the best ways to financially facilitate SMEs at different growing stages is crucial to enhancing the competitive position of the APEC region. Therefore, the establishment of best practices guidelines for enhancing financing chain for SMEs at different growing stages is one of the top priorities for APEC member economies.

APEC members aspire to the following best practices guidelines for enhancing the financing chain for SMEs at different growing stages:

1. Equity Funding and Debt Funding

The initial funding for SMEs at the start-up stage is angel funding, i.e. funding from families and friends. When SMEs seek external funding, the following equity and debt funding are the major sources of aid. Thus, they are of particular importance to SMEs.

(1) Equity Funding

- Member economies are encouraged to expand the venture capital industry through providing appropriate incentives and ensure that sufficient capital is injected into the venture capital industry.
- Member economies are encouraged to establish clear policies to facilitate innovation and R&D funding so as to encourage start-up companies as well as SMEs.
- Member economies are encouraged to seek to develop, attract, and retain management professionals to develop the venture capital industry and to foster the establishment and growth of start-up companies and SMEs.
- Member economies are encouraged to establish or strengthen government funding programs tailored for start-up companies and SMEs.
- Member economies are encouraged to improve the transparency, efficiency

and stability of their investment environment, minimize any obstacle to investments, and encourage foreign direct investments.

(2) Debt Funding

- Member economies are encouraged to facilitate SMEs in building their business credit histories to better position themselves for loan opportunities.
- Member economies are encouraged to equip SMEs with the skills to apply for loans, such as the preparation of business plans and loan proposals.
- Member economies are encouraged to establish a new mechanism or improve the efficiency of any existing mechanism for valuing both tangible and intangible assets as collateral for loans.
- Member economies are encouraged to establish a database of financial institutions that are more willing to lend money to SMEs.

2. Capital Market

A strong and robust capital market reflects a sound and healthy economy. When global investments are channeled into capital markets, the capital markets can be employed as a powerful tool to finance SMEs at different growing stages. Thus, an efficient and dynamic capital market is essential for individual member economies to create value and accumulate wealth, and is crucial for economic growth in the individual APEC member economies.

- Member economies are encouraged to facilitate access to capital markets by providing timely listing mechanisms and lowering listing costs.
- Member economies are encouraged to establish an efficient system for the disclosure by listed companies in consideration of corporate transparency principles.
- Member economies are encouraged to adopt flexible listing alternatives and requirements as necessary to encourage the growth of companies in different industries or sectors.
- Member economies are encouraged to make information about listing alternatives and requirements readily available to SMEs and equip SMEs with the skills to apply for listing.
- Member economies are encouraged to provide access for foreign businesses to the capital market to maintain and enhance international liquidity.
- Member economies are encouraged to build a capital market infrastructure using know-how, innovative processes and technology to facilitate listing, transactions, and disclosure in capital markets.

3. Corporate Governance

Many companies in Asia are family-run, and their ownership is kept within the family. The financial crisis in Asia revealed that such ownership and management

might prove to be a weakness in the corporate governance of such companies. Moreover, the rapidly changing technology and globalization of the market have led to fierce competition. Accordingly, companies need to establish a sound corporate governance environment. Thus, it is essential for APEC member economies to enhance transparency, integrity, and accountability to ensure the appropriate administration of corporate governance in the APEC region.

- Member economies are encouraged to enhance the legal, regulatory and institutional framework to reinforce disclosure, accountability and transparency of companies in the APEC region.
- Member economies are encouraged to require disclosed information to be independently audited based on high standards of accounting.
- Member economies are encouraged to enhance the performance of corporate management teams for managing corporate affairs on a day to day basis.
- Member economies are encouraged to enhance the training and education of directors, shareholders, regulators, professionals and investors for establishing market integrity.
- Member economies are encouraged to facilitate an adequate representation of independent non-executive directors on the boards of listed companies or companies having widely spread shareholdings
- Member economies are encouraged to reinforce the rights and duties of independent non-executive directors to provide independent judgments.
- Member economies are encouraged to support companies to establish mechanisms for evaluating the performance of boards and of individual directors.
- Member economies are encouraged to promote the sustained soundness of financial status of companies as well as their transformation into socially responsible enterprises.

4. Securitization

It is important to promote dynamic economic activities by encouraging a diversity of financing activities and the innovation of financial products. Thus, securitization is the inevitable trend in APEC economies.

- Member economies are encouraged to facilitate securitization by lifting legal and practical obstacles, and providing reasonable tax and accounting mechanisms.
- Member economies are encouraged to promote securitization by providing a more efficient system for the perfection of transfer of receivables and security interests.
- Member economies are encouraged to establish a value appraisal system to determine the value of both tangible and intangible assets for the purpose of securitization.

5. Merger and Acquisition

In response to fierce global competition, the convergence of industries and fast-changing marketplaces, merger and acquisition activities have grown at an increasing pace. To enhance corporate competition and facilitate the integration, synergy or re-allocation of corporate resources, APEC member economies need to improve the merger and acquisition environment.

- Member economies are encouraged to facilitate mergers and acquisitions by establishing an efficient legal framework, reducing transaction costs and time, as well as providing appropriate tax incentives.
- Member economies are encouraged to support mergers and acquisitions, while also establishing an environment that fosters fair competition.
- Member economies are encouraged to develop strategic alliances and joint ventures to combine the efforts of allied companies to achieve common goals.

6. Restructuring and Bankruptcy

Restructuring and bankruptcy is a system to help companies to overcome financial difficulties, to protect creditors' and investors' interests and to prolong the continuance of business. In this regard, restructuring and bankruptcy are also regarded as the systems to accept business failures, encourage entrepreneurship and give enterprises chances to restart their businesses.

- Member economies are encouraged to streamline restructuring and bankruptcy proceedings for the timely protection of creditors' and investors' interests.
- Member economies are encouraged to ensure participation by creditors, debtors and related third parties in restructuring and bankruptcy procedures by providing them with regular opportunities to receive information about their situations and to share information.
- Member economies are encouraged to enhance the functions of courts and other relevant government agencies in respect to restructuring and bankruptcy proceedings.
- Member economies are encouraged to cooperate with other member economies to establish a mechanism for cross-border bankruptcies.

7. Financial System

To maintain economic growth in the APEC region, APEC member economies shall ensure that their respective financial regulatory and legal frameworks are not stifling domestic or international competition, or otherwise inhibiting market development. Therefore, financial regulations in individual member economies

should encourage a diversity of financial services and products to meet market needs.

- Member economies are encouraged to reduce bureaucracy and enhance the efficiency of the financial industry.
- Member economies are encouraged to increase financing activities by non-banking institutions, such as finance companies.
- Member economies are encouraged to facilitate innovative financial products to promote the diversity of financial activities.
- Member economies are encouraged to make technology accessible to the market participants to allow them to engage in financial activities as efficiently and safely as possible.
- Member economies are encouraged to enhance fair competition in markets by deregulating unnecessary restrictions and establishing fair competition mechanisms.
- Member economies are encouraged to facilitate the education, training and recruitment of financial experts.

Development Status of China's Venture Capital Investment

Mr. Shen Zhongqi, Deputy Director-General,
Department of Finance and Facilities, Ministry of Science and Technology

Part One

Introduction of China's Relevant Policies for Venture Capital Investment

One. Review of early policies for venture capital investment

- In 1984, the Scientific and Technological Development Research Center of the previous State Commission of Science and Technology cooperated with the SPRU research institute of the UK Sussex University in a joint study of high-tech development in China. UK experts indicated that China would have to establish a venture capital investment regime in order to develop the high and new tech industry.
- In 1985, the *Decision of the CPC Central Committee and the State Council on the Reform of the Scientific and Technological Regime* put forward the concept of venture capital investment for the first time in China.
- In 1996, the Standing Committee of the National People's Congress adopted and approved the *PRC Law on the Transformation of Scientific and Technological Results*.

Two. Early practice of venture capital investment in China

- In line with the spirit of the above documents, some local governments have made active experiments; Shanghai, Zhejiang, Jiangsu, Guangdong, Shanxi, Chongqing, Xi'an, Tianjin and Shenyang, in the period 1992-1997, successively established government-invested venture capital investment institutions.

Three. Research into and formulation of recent policies on venture capital investment

- In 1997, the State Commission of Science and Technology established a Venture Capital Investment Policy Research Group
- In 1998, the CPPCC put forth a bill on the establishment of China's venture capital investment regime, or Bill No. 1.
- In 1999, based on the instructions of the State Council, the Ministry of Science and Technology, in cooperation with other ministries/commissions, unveiled *Several Opinions on the Establishment of the Venture Capital Investment Mechanism*, or the seven-ministry document.
- In 2001, the Ministry of Foreign Trade and Economic Cooperation, the Ministry of Science and Technology and the State General Administration of Industry and Commerce jointly promulgated the *Interim Provisions on the Establishment of Foreign-invested Venture Capital Investment Enterprises*
- In 2003, revisions were made.

Four. Relevant policies of local governments

- Many local governments attach great importance to venture capital investment and have formulated some specific policies based on their own situations in order to promote the development of venture capital investment locally. These policies can be summarized as follows:
 - First, relaxing establishment conditions;
 - Second, offering tax preferences or fiscal subsidies (refunds);
 - Third, giving access to foreign investors (lower conditions);
 - Fourth, matching of investment;
 - Fifth, establishing parent funds following the model of the YOZMA fund ;
 - Sixth, establishment of structure in the limited partnership approach (Beijing)

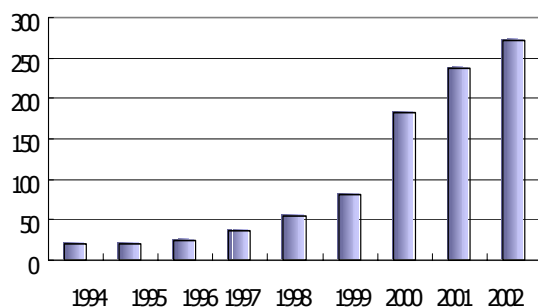
Part Two

Analysis of the macro situation of Venture Capital Investment in China

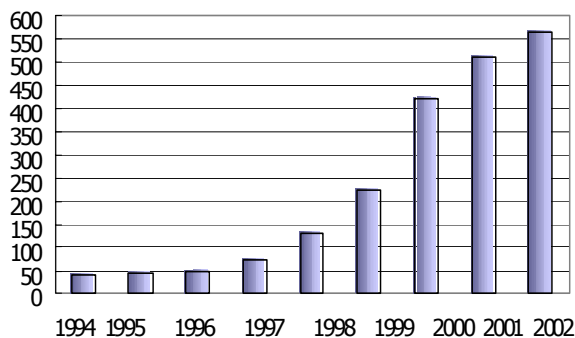
Development of venture capital investment in China

- The development of venture capital investment in China has roughly gone through four stages:
- The start-up stage before 1996
- The small growth stage between 1997 and 1998
- The rapid growth stage between 1999 and 2000
 - the seven-ministry document gave a strong boost to the development of the venture capital investment undertaking, with the number of venture capital investment institutions in the year 2000 rising by a big margin.
- The adjustment stage after 2001
 - the indefinite postponement of the second board stock market and the international environment have resulted in a slow-down in the development speed of venture capital investment in China after 2001.
- At present the number of venture capital investment institutions of various kinds in China has reached around 300.

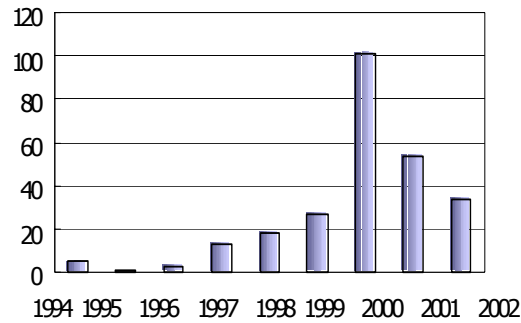
Comparison of total number of venture capital investment institutions countrywide



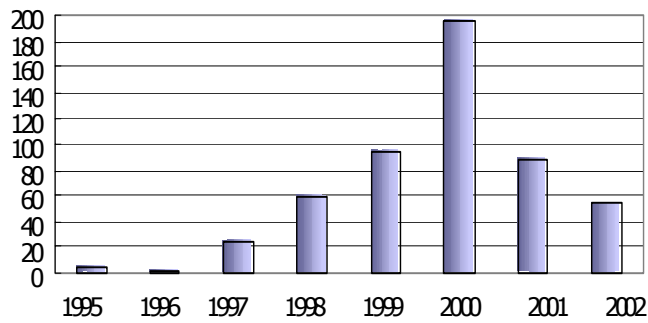
Changes of stock venture capital countrywide



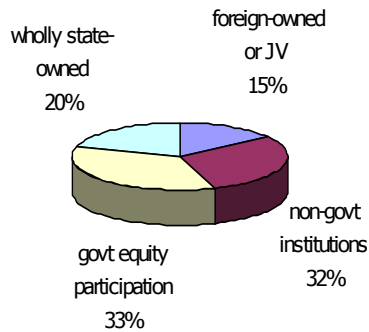
Comparison of number of newly-established venture capital investment institutions over the years



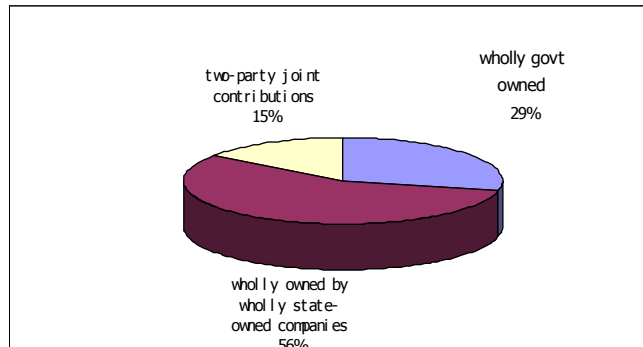
Year-by-year comparison of newly-added venture capital countrywide



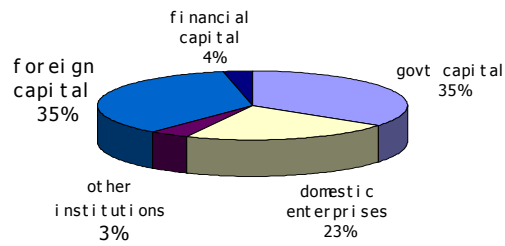
Distribution of nature of venture capital investment institutions



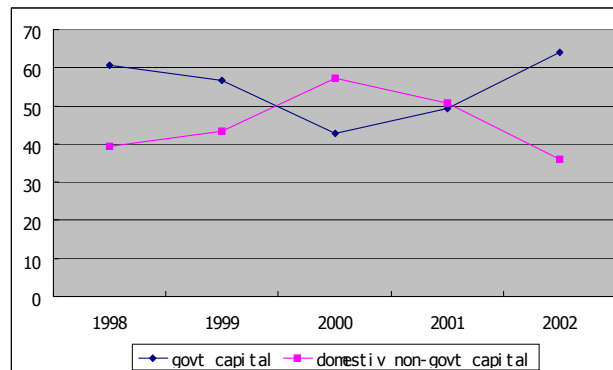
Composition of nature of wholly state-owned venture capital investment institutions



Composition of venture capital investment countrywide



Composition and trend lines of venture capital investment increases in recent years (excluding overseas funds)



The development of venture capital investment in China experienced a relative stagnation (I)

- After rapid development in 2000, venture capital investment in China experienced decreases in development speed and investment scale by different margins in 2002:
- 1. Development speed of venture capital investment obviously slowed down
- The growth rates of institutions and capital were as high as 115% and 70% in 2000. In 2001, they fell to 29% and 22% respectively, and in 2002, they dropped further to 11% and 9%.

The development of venture capital investment in China experienced a relative stagnation (II)

- 2. The enthusiasm of private capital participation dropped slightly
- After 2001, non-government institutions and non-government funds started to account for lower percentages. In 2000, among the newly-added venture capital investment institutions, non-government institutions represented 39%, while this ratio further dropped to 30% in 2002. In the year 2000, among the newly-added venture capital, the ratio between domestic non-government funds and government funds was 4:3, while in the year 2002, it further dropped to 1:2. What is even more worse is that some non-government institutions have had no choice but to close down or no longer engage venture capital investment activities.

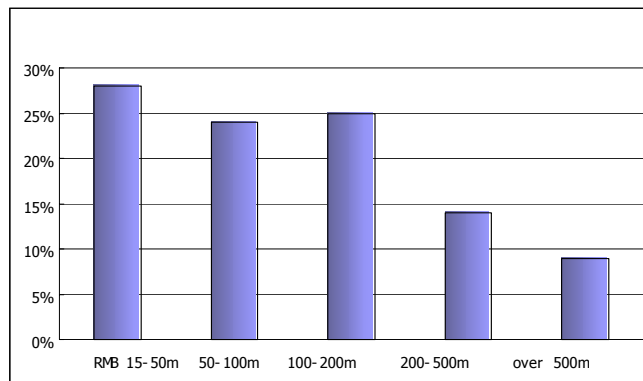
The development of venture capital investment in China experienced a relative stagnation (III)

- 3. The investment appetite of venture capital investment institutions have dropped slightly and stand on the verge of investment downslides
- After 2001, the investment appetite of venture capital investment institutions, in particular non-government institutions, became noticeably weaker. Before 2001, non-government institutional investment was rather active, but in 2002 nearly 1/3 of non-government institutions made no investment.

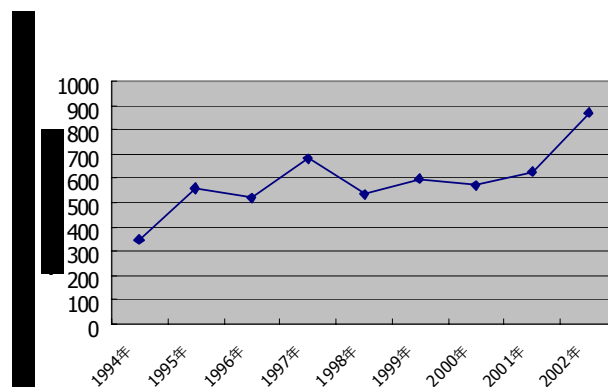
Part Three

Analysis of the Venture Capital Investment Situation

Distribution of fund management scale of venture capital investment institutions
--on average each fund manages RMB 200 million yuan



Changes in venture capital investment intensity 1994-2002



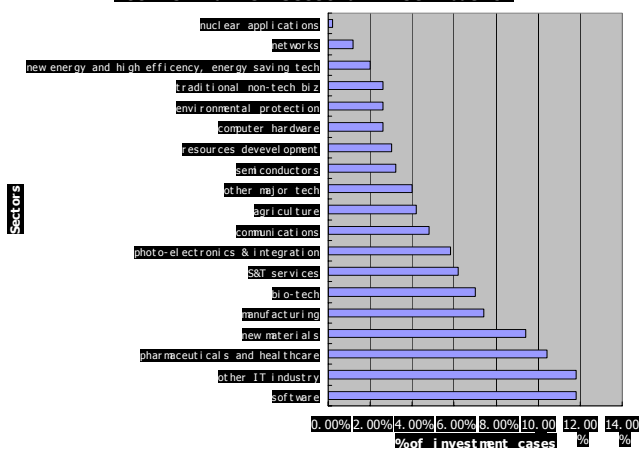
Average intensity noticeably increased in 2002

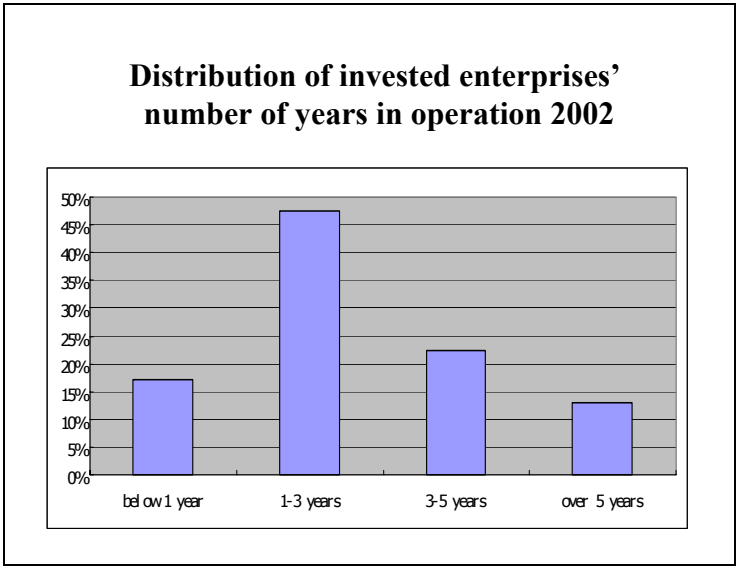
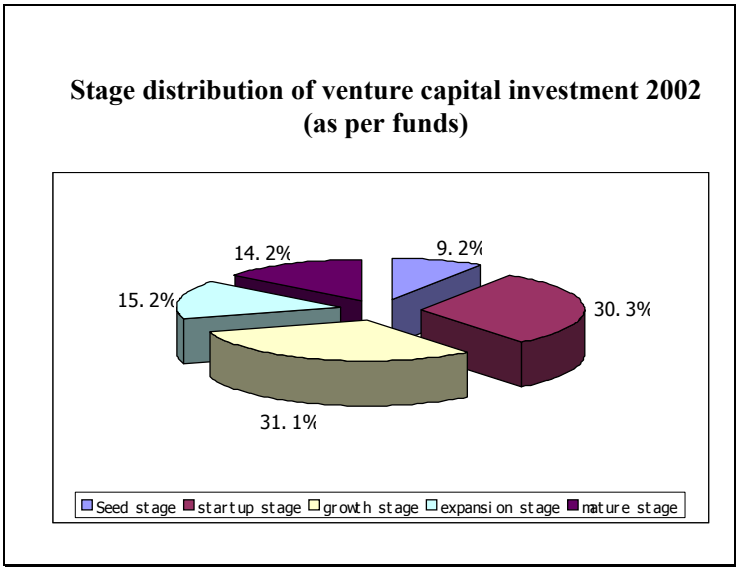
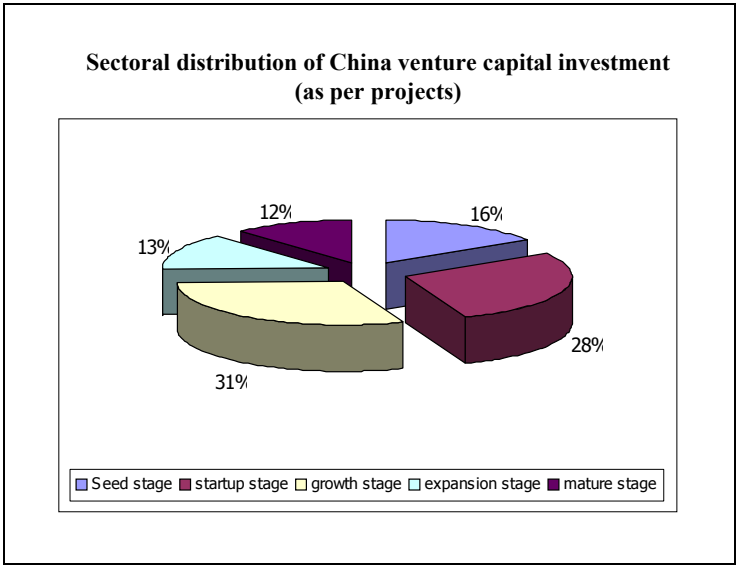
- Given that there is no normal way out, venture capital investment institutions find it difficult to realize the increase in value of capital through share transfer. To ensure a certain level of returns, these institutions can only invest in some relatively mature projects so as to obtain dividends. Hence a noticeable increase in the investment scale.

Major trends of venture capital investment in China

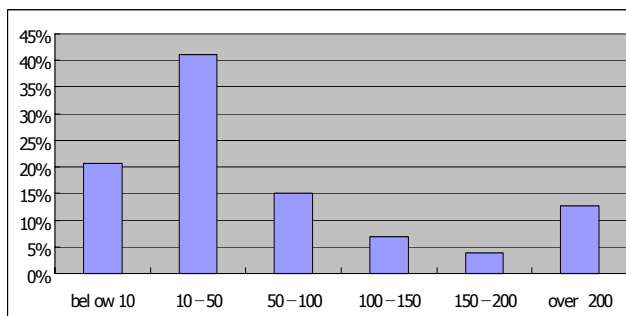
- First, investing mainly in the high and new-tech industry;
- Second, investing mainly in relatively early projects;
- Third, investing mainly in enterprises relatively smaller in scale;
- Fourth, the operational situation of invested enterprises is basically good; and
- Fifth, venture capital investment activities mainly concentrate on economically-developed provinces and cities.

2002 China VCI Sectoral Distribution



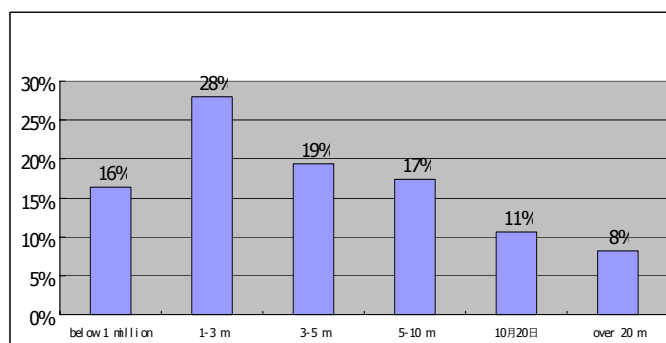


Distribution of invested enterprises' number of employees 2002



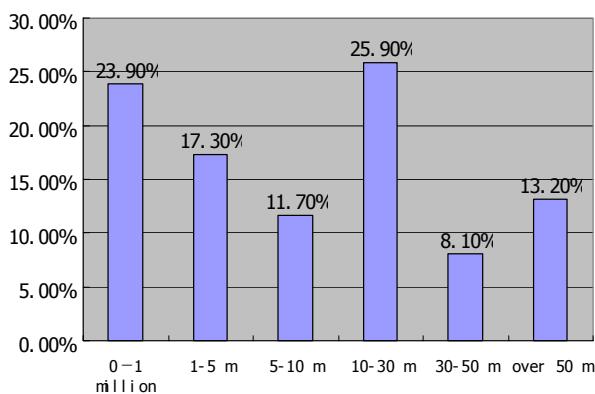
Distribution of scale of each investment by China VCI institutions 2002

--on average investment intensity=RMB 8.7 million yuan

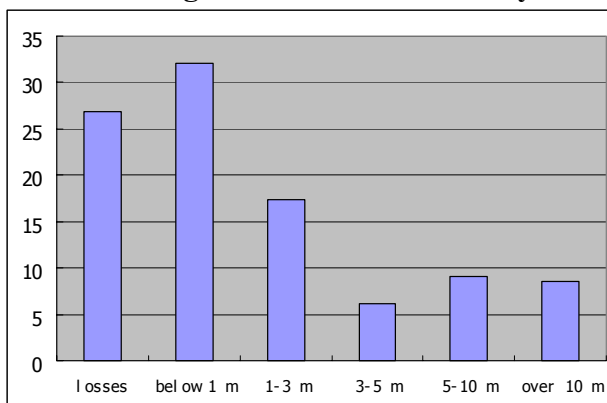


Distribution of income in invested enterprises 2002

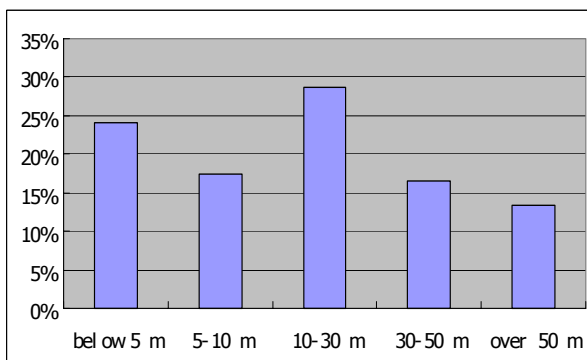
--on average annual income=RMB 25 million yuan



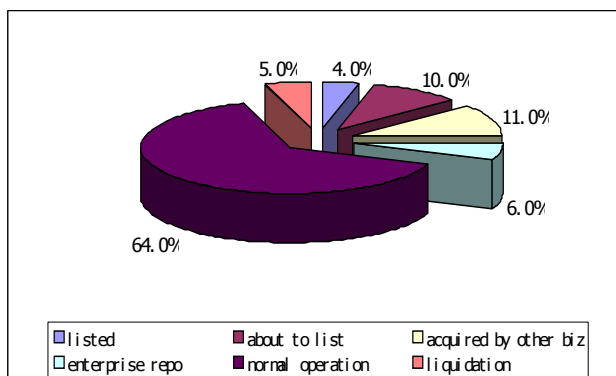
Distribution of profit distribution of invested enterprises for the year 2002
 --on average about RMB 1 million yuan



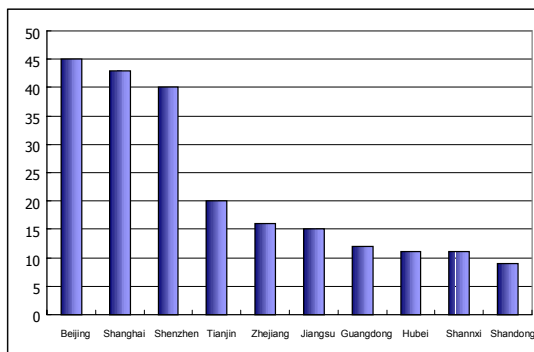
Distribution of paid-in capital of Invested enterprises 2002
 --on average scale=RMB 30 million yuan



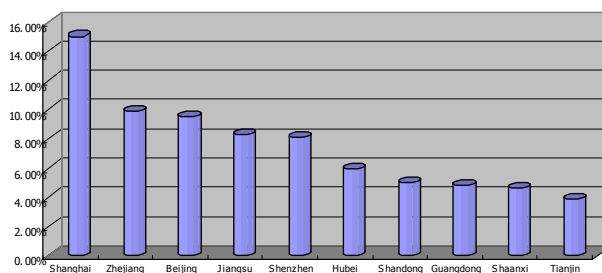
VCI Institution Performance Analysis: Operations of Invested Enterprises



**Top 10 localities in order of no. of VCI institutions
2002**



**Top 10 localities in order of VCI projects
in China 2002**



**Top 10 domestic VCI institutions in order of
fund management scale**

Shenzhen VC Investment Group Co. Ltd.	30
Shanghai VC Investment Co.	14.5
Shandong High & New-tech Investment Co. Ltd.	12
Shanghai Lianchuang Investment Management Co. Ltd.	9.5
Shanghai Science & Tech Investment Co.	9.2
Guangdong Yueke VC Investment Group Co. Ltd.	8.8
Beijing Science & Tech VC Investment Joint Stock Co. Ltd.	8
Jiangsu High & New-tech VC Investment Co.	7.2
Tianjin Bohai Rim VC Investment Management Co. Ltd.	7
Heilongjiang Chenneng HIU High Tech VC Investment Co. Ltd.	6.3

Part Four

Prospects of Venture Capital Investment in China

Policy barriers facing venture capital investment (I)

1. Lack in an effective route of exit
 - Because legal-person shares cannot be traded on China's securities market, venture capital investment cannot exit from such a market; corporate mergers and acquisitions have to be done through cash purchase instead of share swaps, thus adding to the difficulties, which makes it difficult for venture capital investment in China to capitalize on corporate M&As and exit.

Policy barriers facing venture capital investment (II)

2. Lack in corresponding laws and regulations

At present, establishment and operation of venture capital investment institutions are primarily governed by the *Company Law*, but this law promulgated in 1993 was only intended for manufacturing and trading enterprises and in many ways is no longer suitable for venture capital investment institutions that conduct capital operation as their core businesses. This legal framework is hugely different from international practices, unhelpful for absorbing the investment in China by overseas institutions, and even unhelpful for domestic venture capital investment institutions to develop according to their own patterns.

Policy barriers facing venture capital investment (III)

3. Less than reasonable tax regime
 - In tax arrangements, a considerable number of countries regard a venture capital investment institution as a kind transparent organization. That is, returns on investment are distributed to all the parties as per their agreement; the venture capital investment is not a tax payer, but all the investors pay their respective tax (or are exempt from tax) based on their own status after obtaining returns on investment.
 - However, China regards a venture capital investment institution as an ordinary tax payer and requires it to pay the income tax, thus greatly reducing the attractiveness for institutional investors.

A look ahead at China's policies for venture capital investment

1. Further bringing into play the role of the inter-ministry leading group
2. Improving the diversified capital market and establishing an effective route of exit
3. Formulating provisions on the administration of venture capital investment institutions
4. Formulating specific tax policies
5. Starting as soon as equity injection into tech SMEs so as to better guide overseas funds and private funds
6. Encouraging various localities to establish venture capital investment parent funds

Development prospects of venture capital investment in China(I)

The development of venture capital investment in China has met with some problems and the policy environment is less than desirable. However, given China's sustained economic growth, the good performance of some Chinese enterprises on the NASDAQ market and the quicker steps of a considerable number of Chinese enterprises to be listed overseas, there is some attraction for foreign capital to enter into China's venture capital investment sector. In addition, the five-ministry document released by agencies like the Ministry of Commerce and the Ministry of Science and Technology have offered legal guarantees. It can be predicted that the entry of overseas venture capital will witness a big increase.

**Development prospects of venture capital
investment in China(II)**

Along with the continued improvement in China's policy environment for venture capital investment, the constant improvement in the qualifications of professionals in the industry, and the massive influx of overseas capital and talents, China's venture capital investment sector will enjoy a big expansion.

Implications of China's Taxation Policies on Foreign-Invested Venture Capital Investment Enterprises

Mr. Lu Yun, Deputy Director-General

Department of International Taxation, State Administration of Taxation of China

Good morning!

Let me make a brief analysis of the implications of China's taxation policies on foreign-invested venture capital investment enterprises (hereinafter referred to as the FIVCIE).

It can be seen from the experience of countries around the world that venture capital investment plays an important role in expanding the financing channels of SMEs, overcoming the funding barriers against the industrialization of high and new technology, speeding up the transformation of high-tech results, and promoting the development of the high-tech industry.

In light of China's venture capital investment mechanism in a crucial development stage, since last year we have been discussing with the relevant authorities such as the Ministry of Commerce and the Ministry of Science and Technology how to proceed from the characteristics of the venture capital investment mechanism and search for a more proactive tax incentive environment in order to promote the establishment of venture capital investment enterprises in China by foreign investors for purposes of undertaking venture capital investment activities.

Foreign-invested venture capital investment involves three layers: foreign investors, FIVCIEs and the receipt of investment by FIVCIEs. When and if an FIVCIE resorts to the contracting investment approach, that is "establishing no management and operating structure but contracting with a venture capital investment management company to carry out day-to-day management and operating activities", this field may also include venture capital investment management companies.

The different layers mentioned above will enjoy the following different tax treatment in the current taxation policies:

1. In accordance with the stipulations as contained in Article 19 of the *Income Tax Law of the People's Republic of China on Sino-foreign Joint Ventures and Wholly Foreign-owned Enterprises* and Article 18 of the *Implementing Rules of the Income Tax Law of the People's Republic of China on Sino-foreign Joint Ventures and Wholly Foreign-owned Enterprises*, the dividends obtained by foreign investors from FIVCIEs and the dividends obtained by FIVCIEs from within the territory of China are exempt from the income tax;
2. In accordance with the stipulations of Article 5 of the *Income Tax Law of the People's Republic of China on Sino-foreign Joint Ventures and Wholly*

Foreign-owned Enterprises, the income of FIVCIEs except dividends, including the yields from share transfer and the provision of management advisory services, the corporate income and the local income tax will levied respectively at the rate of 30% and 3%. According to the stipulations of Article 7 of the *Income Tax Law of the People's Republic of China on Sino-foreign Joint Ventures and Wholly Foreign-owned Enterprises*, the income obtained in special economic zones by FIVCIEs in special economic zones is subject to the corporate income tax at the rate of 15%; and

3. As per the stipulations of Article 4 of the *PRC Sino-foreign Equity Joint Venture Law*, in the registered capital of an enterprise with investment from FIVCIEs, if the ratio of foreign investment is not lower than 25% of the total capital, the enterprise with such investment is entitled to relevant preferential treatment of FIEs.
4. Following the stipulations of Article 1 of the *PRC Interim Rules on the Business Tax*, activities of providing venture capital investment management advisory services are subject to the business tax at the rate of 5%.

The current taxation policies lack more attractive incentives for foreign-invested venture capital investment institutions, and this has become one of the reasons behind the low percentage of venture capital in China at present. In the entire chain of venture capital investment, the current tax incentives primarily focus on the provision of tax incentives for high-tech manufacturers or services providers with foreign investment, with examples including preferences in the form of lower income tax rates for specified regions and sectors, periodic tax exemption and reduction preferences, and tax exemption and reduction preferences for software development and integrated circuit manufacturers.

However, we have also noted that, as shown by international experience, for high-tech SMEs in the early or growth stages, direct provision of tax incentives for venture capital investment institutions will also provide a noticeable boost to the development of high and new tech SMEs and projects. The reason is that before scientific and technological SMEs can enjoy income tax preferences accorded to them, what they need more is strong funding support so that they can rapidly develop and obtain returns on investment. Nevertheless, high risks associated with pioneering investment have resulted in a situation in which they will face many difficulties when trying to obtain bank loans in the current financial framework. As a consequence, a dynamic venture capital investment operating mechanism is all the more important.

We have also been thinking about how to provide tax payment procedural facilities for venture capital investment institutions in the present tax legislation framework. On June 4, 2003, the State General Administration of Taxation issued the *Circular on Several Taxation Issues on the Payment of the Corporate Income Tax by Foreign-invested Venture Capital Investment Companies* (Guoshuifa [2003] No. 61), in which clarifications were made in connection with several issues relating to the

payment of the corporate income tax by FIVCIEs, and thus the tax payment uncertainties on foreign investment in the venture capital investment have been greatly reduced. Article 3 of the *Circular* stipulates that, when a venture capital investment enterprise of a non-legal person status is established, there is the option of each investor respectively declaring and paying the corporate income tax, or the venture capital investment enterprise applying for centralized declaration, calculation and payment of the corporate income tax based on the stipulations of the tax law. In addition, foreign investors, which have not established any venture capital investment management and operating structure but has contracted with a venture capital investment management enterprise or another venture capital investment enterprise to carry out the day-to-day investment and operating activities, may declare and pay the corporate income tax as foreign enterprises that have no management structure and/or premises. These are all very favourable stipulations for foreign investment in the venture capital investment activity within the scope allowed for in the current tax legislation.

We have noted that direct provision of tax incentives for venture capital investment institutions will have greater spill-over effects. We are thinking about making additions to the current tax incentive package and, in line with international experience, appropriately add to the tax incentives for venture capital investment institutions.

These ideas include:

1. In accordance with the mandate given by the State Council, after we have reported and got the approval from the State Council, stipulations will be made to apply reduced income tax rates for venture capital investment institutions; and
2. In light of the important role of venture capital investment management companies under the contracting investment approach, we are thinking about establishing some specific tax incentives for venture capital investment management operations in terms of the business tax and the corporate income tax in order to encourage experienced management personnel from abroad to come to China and set up venture capital investment management companies and raise the managerial techniques and level of China venture capital investment sector.

We hope to be able to offer clearer tax incentives for venture capital investment in a bid to move ahead with what is emphasized in the political report of the 16th National Congress of the CPC, that is “bringing into play the role of venture capital investment and forming the capital operation mechanism that promotes scientific and technological innovation and venture investment”.

Efficient Capital Markets, Venture Capital Investments and Exits

By

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Executive Summary

The paper examines the linkages between venture capital financing, exit strategies and the capital market. A well-developed capital marketplace (that is transparent, liquid, competitive and fair) is necessary for venture capitalists and limited partners to exit when they choose to, which in turn is essential to their supply of funding to startups. The paper first reviews the current market environment in the United States. Second, the paper provides a review of the traditional exit strategies such as initial public offerings by the portfolio companies as well as merger and acquisition. A new exit approach, securitization, is discussed as well. Finally, the paper discusses the impact of Sarbanes-Oxley Act impact on venture capital market.

1. VENTURE CAPITAL INVESTING

Venture capital (VC) firms make equity investment in entrepreneurial companies. The financiers recoup their investments when the portfolio companies either go public or sell out to other corporations. The VC market includes the merchant banking subsidiaries of large institutions such as investment banks, bank holding companies, industrial companies, and insurance companies. The VC industry also has many specialized investment entities formed principally to make VC or private equity investments. A private VC fund typically raises its capital from a limited number of sophisticated investors in a private placement, and has a life of about 10 to 12 years. The investor base consists of wealthy individuals, pension plans, endowments, insurance companies, bank holding companies, and foreign investors. VC firms receive income from two sources, the annual management fee and profit allocation of the fund. The fund's main source of income is a capital gain from sale of stock of the portfolio companies.

A VC fund passes through four stages in its life. The first stage is fundraising. The second stage is to carry out investment. After sourcing a perspective deal, satisfactory due diligence leads to an investment, the company then becomes a portfolio company. The next stage, which lasts until the closing of the fund, is to help portfolio companies grow. The final stage in the life of a VC fund is its closing, which provides exit for limited partners.

It is well documented that venture capital-backed companies had approximately twice the sales, paid almost three times the federal taxes, generated almost twice the exports, and invested almost three times as much in research & development as the average non-venture capital-backed public company, per same amount of assets.

It has also been shown that in addition to its well-understood role as the driving force for high technology advances, venture capital financing was responsible for innovation across a broad spectrum of the U.S. economy, including biotechnology, consumer products, retailing, construction, transportation, industrial, financial services and forestry.

2. MARKET OVERVIEW AND A BRIEF HISTORY

The U.S. has a well-developed VC market. Venture capitalists funded more than 8,200 transactions for a total of more than \$100 billion in 2000. In 2001, funding from VCs totaled \$41 billion. Due to several years of stock market slump, data in 2002 and 2003 indicate a slowdown in VC funding. Table 1 lists venture investment by year, from 1997 to Q3 2003.

Table 1 Venture Capital Investment in United States Companies
As of 09/30/2003

Year	Average per deal (\$ Millions)	Deals	Investment (\$ Millions)
1997	\$4.66	3,250	\$15,160
1998	5.11	4,203	21,473

1999	9.68	5,684	54,995
2000	12.96	8,208	106,391
2001	8.76	4,691	41,082
2002	6.99	3,028	21,296
2003	6.36	2,022	12,865

Source: Venture Economics/NVCA.

Active VC investors include U.S. Venture Partners, New Enterprise Associate, Sevin Rosen Funds, ComVentures, Battery Ventures, Venrock Associates, Warburg Pincus, Flagship Ventures. Recently, most of the funding has been in the areas of software, retailing and distribution, telecommunications, medical devices and equipment, biotechnology, IT services, and networking and equipment. Healthcare, financial services and business services received very little money.

Performance of Private Equity Investments

VC investment is high risk, high return. Historically, VC investing has enjoyed a very high rate of return. As shown in the following table, VC investing (All Ventures) enjoyed a 26% return per annum over a 10-year period. However, poor economy and illiquidity has negatively impacted on the returns to VC investors in recent years. On average VC investors lost 27% of their investments in the past year. Investors in later stage lost substantially more (-45.1%).

Table 2 Venture Economics' US Private Equity Performance Index (PEPI)
Investment Horizon Performance as of 6/30/2002

Fund Type	1YR	3YR	5YR	10YR	20YR
Early/Seed VC	-26.1	-21.7	47.9	35.7	19.8
Balanced VC	-13.6	-16.5	18.6	21.4	13.9
Later Stage	-45.1	-22.0	7.3	19.5	14.3
All Venture	-27.4	-20.0	24.2	26.2	16.1
All Buyouts	2.6	-6.1	0.6	8.8	12.1
All Private Equity	-6.9	-9.9	6.1	14.2	13.8

Source: Thomson Venture Economics/NVCA

Historical Development

Private equity investing has existed in one form or another in every society in which there has been significant commercial activity. One interesting historical example was documented in Levin (1994). It involved the financing of a private fire department by Marcus Licinius Crassus in Julius Caesar's Rome. His business agents and firefighters would rush to the site when a building caught fire. If they believed the building was worth saving, the agents would offer to buy it for cash at a

substantial discount. If the owner of the property turned down the offer, they would leave without rescuing the building. If accepted, Crassus' firefighters would then attempt to save and repair the building. Crassus made substantial profits.

With the industrial revolution in the 19th century, banks became the main source of business financing. Venture capitalists shifted to funding the type of companies that lacked access to bank financing. They frequently provided equity capital as the necessary underpinning for a bank loan. The players were mostly amateur venture capitalists such as wealthy individuals and entrepreneur's friends. However, as the scale of business and the capital needs escalated, VC became more institutionalized. In England, merchants had emerged as the principal providers of the private risk capital. English merchant banks helped finance the U.S. industrial revolution and provided a model for U.S. merchant banking development.

The development of professional venture investing in the U.S. began in the 1940s. The VC market was given a big burst when the Small Business Investment Act was enacted in 1958. Under the Act, the small business investment companies (SBICs, licensed by the Small Business Administration) were armed with tax-advantaged status and government lending leverage. The Act also permitted banks to invest in SBICs. The entry of banks into the VC business in the late 1950s and the growth through 1960s and 1970s was a key link in the formation and development of a professional and institutionalized VC industry as it is today.

The VC industry first developed on a large scale in the 1970s. In the early 1970s, many VC funds had a capitalization of \$10 – \$20 million, raised from wealthy individuals, endowments, and foundations. These venture groups targeted small and often early stage technology companies. In the late 1970s, several factors added new sources of capital to the VC industry. First, the Labor Department clarified that investment in a VC fund could be prudent for a private pension plan. Secondly, insurance companies began to provide a significant portion of VC funding. During the same period, the traditional investors remained active.

By the 1980s there was an enormous increase in funding the private equity market. The major driving force behind the surge was the hot IPO market. Many VC backed companies went public and returned investors many times over the money invested just several years back. This allure of high returns attracted many new investors. The investment in VC reached a peak in 1987. After 1987, money flowing into VC funds declined. The combination of three factors contributed to the downturn. Since early 1970s, as more money flooded into the VC market, the number of venture firms exploded. Some of the VC professionals did not have the fundamental skills to succeed. Furthermore, there was too much money chasing too few good deals. The failure of VC to provide investors returns comparable to that in the early 1980s resulted in a decline in VC funding in the late 1980s.

In the early 1990s, the amount of money raised by VC funds each year was significantly lower than the 1987 peak. However, the IPO market in 1991 – 1992 again improved returns for many funds and hence improved fundraising aspects. VC was making a comeback by the end of 1992. Since 1992, the amount of money raised by venture capitalists has steadily increased, and surpassed the 1987 peak in

1995 – 1997. The amount continued to rise, as shown in Table 1, until 2001.

3. INVESTING STRATEGY

VC is high risk, high return investing. In pursuit of high returns while managing risk, VC professionals need to understand that many deals fail due to poor strategic planning and a lack of vision. Too often VC fund managers get bogged down in details, ignoring the big picture. Venture capitalists need to define their goals and source the myriad of prospects in order to find a good match with the best financial and strategic edge, before engaging in a costly and time-consuming evaluation process. Once this phase is completed, most VC firms evaluate potential investments based on four fundamental criteria: management, marketing, products and financial opportunity.

Risk Factors

VC investing is subject to a high degree of risk. The evaluations criteria outlined are to assess value as well as the risk involved. First, an early stage company has a limited history of revenue producing activities. Its operations are subject to the difficulties frequently associated with the growth of a new business and the competitive environment in which the company operates. Furthermore, the new business generally needs strong strategic alliance partners. In addition to other benefits, strategic alliance will also help create name recognition that is an important factor in marketing any product or service. Without such partners, the growth of the company may not proceed as planned.

New products and technological changes present a big uncertainty. This is especially true when investing in a high tech company. The market evolves with the rapid and frequent changes in technology and customer preferences. The company's growth and future financial performance will depend on its ability to develop and introduce new products. Failure to anticipate or respond to the changing market environment will adversely affect the company's potential. There is no assurance that any new products will be successfully developed or achieve market acceptance, or that competitors will not develop and market products that render obsolete the company's products.

A new startup's success is critically dependent upon a few key personnel. Retention and recruitment of quality team is essential to the success of the company. Long-term employment contracts that defer a portion of the compensation over time and contain noncompete provisions, stock options, phantom stock, and other profit-sharing schemes have been used to a certain degree of success. The company needs to attract additional talented individuals in order to carry out its business plans.

Before long, the company may need additional financing. The required additional investment will have a substantial dilution effect. VC usually has to accept the dilution, because there is no public market for the company's securities yet. Typically, the share certificates acquired by VC will bear a legend on the back of the stock certificate referring to sell restrictions:

The shares represented by this certificate have not been registered under the Securities Act of 1933, as amended, and may not be sold or transferred in the absence of an effective registration statement under the said Act, or an available exemption thereunder and under applicable state securities laws.

Also, stop transfer instructions will be noted in the company's records with respect to these shares. VC needs to be prepared to accept the liquidity risk.

4. EXIT STRATEGIES

The exit strategies are planned when the VC is making the front-end investments. This is important because the actual exit strategy executed may require cooperation from some shareholders who may not be in agreement with the pricing or timing. Therefore, it is important for VC to have obtained certain contractual rights to control its exit. For this purpose, VC wants to insist at the front end that the portfolio company and its other shareholders sign an agreement which gives the VC control over issues such as the timing of IPO, selection of underwriter, and right to demand additional SEC registrations subsequent to the IPO. When the VC is the majority shareholder, it will insist to have drag-along agreements that give it the right to find buyers for all or part of the portfolio company's stock. However, if the VC is a minority investor, it will often want take-along right to sell alongside management and other shareholders.

VC's exit strategy includes taking the portfolio company public or selling the portfolio company to another company. The IPO approach could further involve a post-IPO registered offering or SEC Rule 144. Whereas, selling out to another company can be structured as exchange for the acquirer's stock, cash, or for a combination of cash and debt instruments. Table 2 lists venture capital backed IPOs in the United States from 1995 to 2002.

Table 3 Venture Capital Backed IPOs in United States
As of 09/30/2003

Year	Companies	Amount Raised by IPO (\$Millions)	Total Valuation Placed on Company by IPO (\$Millions)
1995	209	\$9,564	\$39,831
1996	281	14,664	75,272
1997	140	5,495	25,635
1998	78	4,735	21,690
1999	271	25,080	158,411
2000	261	27,660	141,241
2001	41	3,489	18,004
2002	24	2,473	8,992
2003	12	974	3,907

Source: Venture Economics/NVCA.

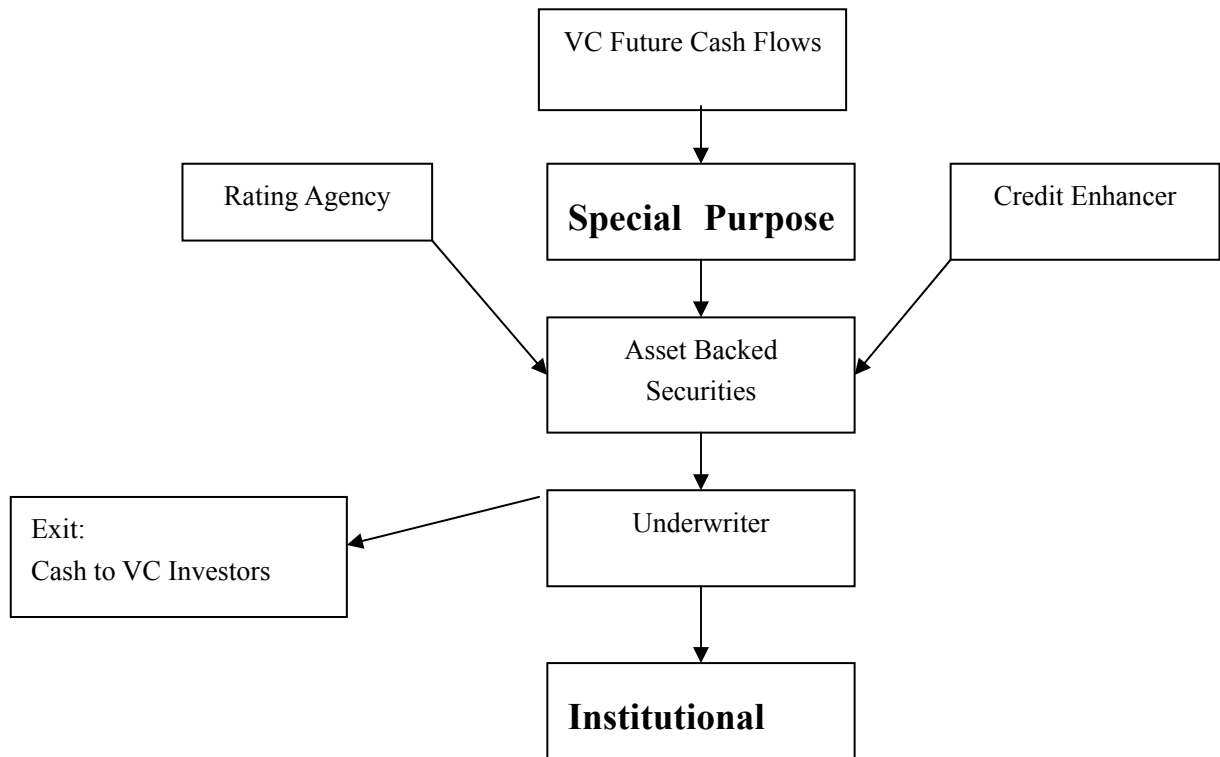
If VC's exit is through a public offering, there are several methods for reselling the restricted securities. Restricted securities can be sold via a subsequent private sale or a public offering registered with the SEC. After the IPO, the portfolio company is a 1934 Act reporting company and hence may qualify for short-form registration statements which allow the portfolio company or its holders to sell securities with less delay and less expense than a full-blown S-1 registration statement. Once the portfolio company has completed its IPO, VC and other holders can sell their restricted securities without filing an SEC registration statement if all SEC Rule 144 requirements, such as volume limitation, holding period, and SEC notification, are met. Effective April 29, 1997, the holding period requirements for the resale of a limited amount of restricted securities are one year. Rule 144 previously required a two-year holding period. In addition, under amended Rule 144(k), non-affiliates of an issuer may sell unlimited numbers of restricted securities if at least two years have elapsed since the acquisition of such securities from the issuer or an affiliate of the issuer. Rule 144(k) previously required a three-year holding period.

Alternatively, VC could sell the portfolio company to, or merge with another firm for the acquirer's stock, notes, and/or cash. If the acquirer's stock is paid to VC and other holders as principal consideration, the transaction can be regarded as a tax-free reorganization. In addition, under the post-reorganization continuity-of-interest doctrine, VC and other shareholders of the portfolio company as a group must intend to hold the new securities for long term. Hence, from a tax standpoint, VC and other shareholders are not free to sell all of the new shares received in a tax-free reorganization. When debt instruments are used as part of the consideration to VC and other holders of the portfolio company, the IRS installment rules allow tax deferral on a pro rata portion of their gains until the debt instruments are paid.

The slowdown in the stock market in recent years has resulted in a financial picture painted not just with diminished portfolio value but uneasiness in determining when value can—if ever—be extracted from limited partner arrangements. The complex market of asset-backed securitization (ABS) has been touted as a remedy for ailing private equity investors. ABS vehicles have the ability to package the risk associated with future cash flow from a VC investment, in this case future receivables expected from a LP investment, and sell it to ABS investors. The result is an exit strategy for the private equity investor, albeit at an extreme discount.

The process of securitization of future cash flows expected from a VC investment is depicted in Figure 1:

Figure 1: Basic VC Securitization Structure



As shown in Figure 1, VC investors put the expected future cash flows from VC investments to the special purpose vehicle (SPV). Credit enhancement is added via over-collateralization, senior/subordinate tranche, or via bond insurance. Major U.S. bond insurers are MBIA, AMBAC, FGIC, and FSA. Rating agencies such as Moody's and Standard and Poor's often provide a rating to the newly created ABS. The newly created ABS provides several major advantages:

1. It provides an exit for VC investors.
2. It provides transparency in valuing these future cash flows.
3. It broadens the investor base, from the VC limited partners to those who purchase the ABS.
4. It enhances liquidity. VC investors' interests are themselves quite illiquid. With ABS, these new securities can be traded in the market.
5. It potentially increases the supply of money in the VC market and hence lowers the costs to startups that rely on VC funding.

Securitization for VC cash flows can be difficult to arrange, as the expected cash flows are quite heterogeneous. However, it is a new approach that has potential. The following table provides an illustrative timetable for investors to go through the process.

Table 4: An Illustrative ABS Timetable

Steps	Timetable
VC cash flow analysis	30 days
Setting up a special purpose vehicle and developing a legal structure	Rating agency due diligence 45 days
Investor due diligence	Private placement memorandum 60 days
Presentations to investors	Finalizing rating 90 days
	Price deal
	Closing 120 days

5. SARBANES-OXLEY ACT AND VENTURE CAPITAL

The main impact of the Sarbanes-Oxley Act on venture capital operations will be its effect on directors of public companies and companies that are in the process of going public. The act generally applies to companies that are issuers. For instance, the prohibitions on loans to executive officers and directors would apply to a company immediately upon filing its S-1 or other form of IPO registration statement. Likewise, all of the auditor independence and audit partner rotation provisions would apply immediately.

Other Sarbanes-Oxley provisions apply immediately upon a company's filing of a registration statement, but will have no effect on a company until its registration statement became effective or it begins trading on an exchange. These provisions include the CEO/CFO certification requirements because those requirements apply to periodic reports which a newly public company would not have to prepare until some time after it became public. Provisions such as those related to insider trading prohibitions during pension plan block-outs and revised insider trading reporting would have no meaning for a company until it actually became publicly traded. Similarly, the requirements as to disclosure of financial experts and internal controls and procedures would apply according to the SEC's rules only after a company had a reporting obligation.

The stock exchanges and NASDAQ require an audit committee composed of independent directors for companies once they list, but not upon the filing of a registration statement. However, most companies in the IPO process would need to begin planning for these requirements immediately and would probably want to disclose the composition of their board and board committees in their IPO prospectus, if possible.

Both the New York Stock Exchange (the "NYSE") and NASDAQ are

amending their listing requirements to reflect the Sarbanes-Oxley Act and in response to recent corporate governance concerns.

Thoughts about Venture Capital Investment in China's New and High-tech Industry

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Since the 1980s, the wave of the new technological revolution, as pioneered by the development of such new and high-tech sectors as information technology, bio-engineering and new materials, has generated a great impact on the whole world. Given the new and high-tech industry's high growth nature and its huge penetration into traditional industries, various national governments have placed it high on the agenda of a country's survival and development and offered support. In the 1990s, along with the sustained growth of the U.S. economy and the arrival of the new economy era driven by technological innovation throughout the globe, competition between and among countries and regions have also shifted to competition of overall national strengths featuring new and high technologies. Considering that the new and high-tech industry has by and of itself sectoral characteristics and development rules, financial innovation has, as a result, appeared in different forms, with the most notable example being venture capital investment.

One. The evolution and status quo of venture capital investment

Also known as venture capital, venture capital investment has made remarkable strides over the past two or decades. The most representative country in this connection is the United States, where it is a mode of investment designed to offer equity capital support and operation-related advisory services to fast-growing small business start-ups. In the early days, venture capital investment did not have any close relationship with the development of science and technology as an industry; rather, it is a new form of investment that has gradually appeared and developed, driven by the pursuit for maximum returns on investment. Starting from the late 1960s, in a noticeable move, venture capital investment concentrated onto newly emerging science and technology industries. In the 1980s, the field of new and high technologies became the main destination of venture capital investment, while it accounted for less than 1% of investments in non-technology traditional industries. As a result, at the present day, venture capital investment is often referred to as investments in the new and high-tech industry. In the past two decades or so, a period during which venture capital investment has experienced a fast growth in developed countries, the U.S. is a leader much ahead of Europe and Japan: in 1999, the value of venture capital investment funds in the U.S. reached US\$ 80 billion, while the scale of such funds in Europe was less than half of the U.S. figure for the same year. The boom of venture capital investment has resulted in the fact that, since the 1990s, the U.S. has been farther ahead Europe and Japan in a multitude of scientific and technological fields and scored higher speeds and quality of economic growth. In this whole process, the U.S. economy has also entered into the phase of

the new economy.

As a developing country, China began to see, in the late 1980s, a host of venture businesses with self-developed new and high technologies as core competences. More than 10 years later, China has initially put in place a policy environment in which the National Torch Program serves as the leading dragon and governments at various levels support local high-tech venture businesses. So far over 100 venture business service centres and science and technology parks, based on the country's 53 new and high-tech industry zones, have been established. At present, a wave of competition for the establishment of China's "Silicon Valley" is also on the rise country-wide. More than a dozen of cities, like Beijing, Shanghai, Shenzhen, Guangzhou, Xi'an and Chongqing, have successively announced their own plan to build into "China's Silicon Valley" or "Western China's Silicon Valley". All of these developments have, judging from the perspective of efforts to search for ways of institutional innovation in China's science and technology administrative regime, provided a strong boost to the expansion of new and high-tech business start-ups. The new and high-tech venture industry is initially in place throughout the country.

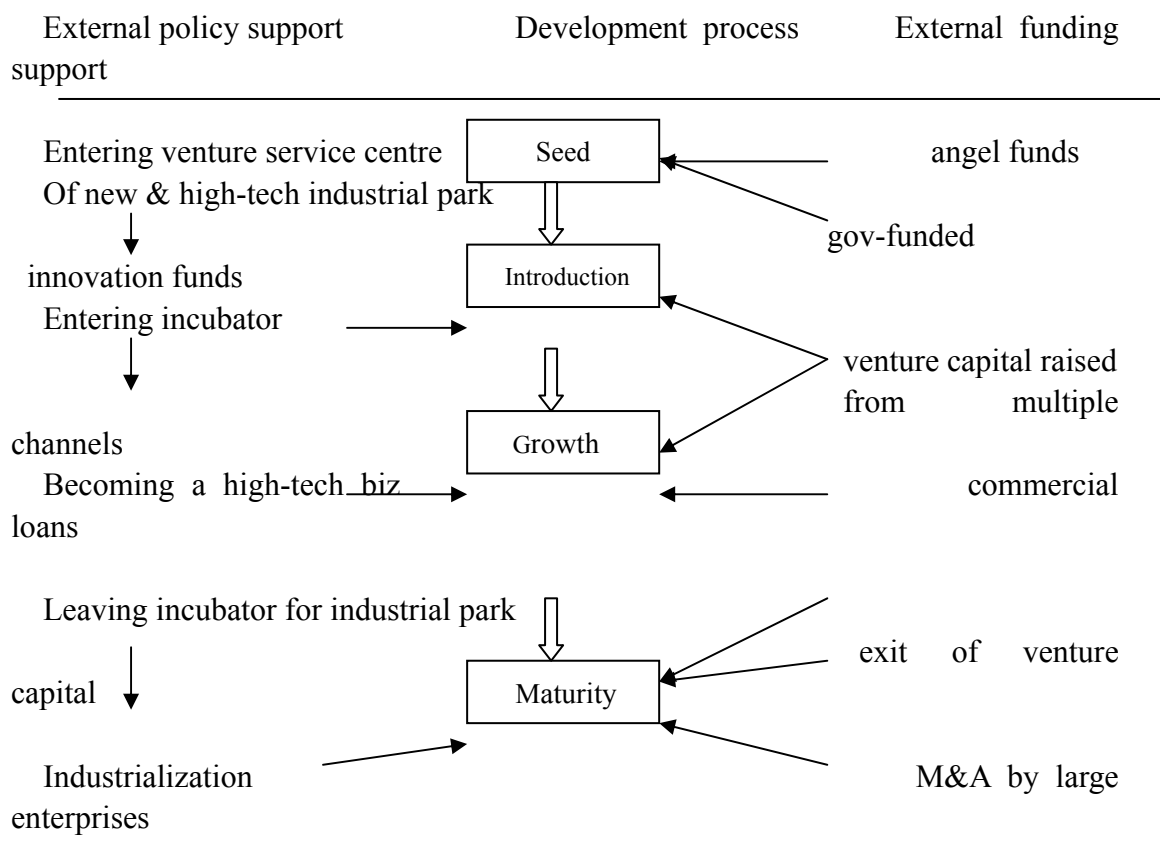
Ever since the mid-1990s, at a time when there were no corresponding laws and the market environment, various localities in China have resorted to the approach of establishing venture capital investment companies in their respective efforts to set up venture capital investment institutions similar to venture capital investment funds in other countries; as a result, such companies operated as a privately-placed investment fund have supported the development of new and high-tech venture businesses. By the end of 2000, there had been nearly 200 venture capital investment institutions of various forms in China, with their total investment capital exceeding RMB 30 billion yuan. At the same time, venture capital investment has received strong support from governments at various levels; the establishment of a venture capital market, designed to facilitate the exit of venture capital, has been put on the agenda for quite some time and has undergone extensive and in-depth theoretical and operational assessment. The National People's Congress and relevant government authorities have made uninterrupted efforts to conduct research into, and draft, the *Investment Fund Law* and the *Administrative Methods on the Industrial Investment Fund* to standardize and facilitate the operations of venture capital investment.

As an investment form fundamentally different from the traditional investment approach, venture capital investment has run into a number of problems in its actual operations in China; such problems that exist in both the regulatory and market environments have hindered the development of venture capital investment. These problems are primarily manifested in the following areas: (1) The legal regime in connection with venture capital investment is still unsound in the sense that relevant national laws and regulations cannot be veiled as yet, which has affected the standardized operation of venture capital investment and added to the operational risks associated with venture capital investment; (2) The reform of the financial

market has lagged behind and there is a lack of diversified supply channels of funds, thus hindering the effective application of scientific and technological results and the industrialized development of technology; and (3) There is no sound route of exit.

Two. New thoughts about the development of new and high-tech venture capital investment

The process from new and high-tech ventures to the industrialization of high technology is a gradual one. In this process, the regulatory environment and the modes of support in terms of investment and financing needed in each and every phase are not uniformly the same(see Figure 1). The ultimate purpose of new and high-tech ventures is to achieve industrialization. The process from ventures to industrialization is completed by a regime supported by various kinds of innovation, such as technological innovation, the innovation of the science and technology administrative regime, and the innovation of the investment and financing mechanisms, in which they support and have organic links with one another.



(Figure 1) The development process of venture capital investment businesses

(One) Speeding up the effort to improve the regulatory and institutional framework

for the venture capital market

In the past we used to regard the input of funds and routes of exit in the industrial development of new and high-tech as the starting point in the research into venture capital investment. Undoubtedly this is a problem that demands an urgent solution. However, if one places more emphasis on the research into the financing and operation of venture capital purely from the standpoint of inputs, then he will, without ever noticing it, ignore the problems that beleaguer the market environment of venture capital investment. In turn, lack in uniform regulations represents an important reason behind the difficulties that stand in the way of the development of China's venture capital market. An imperfect regime of laws and regulations will lead to an ambiguous positioning of the substantive legal status of venture capital investment, and without the restraint, protection and guidance from regulations in relation to the operation of venture capital investment companies, the line between the investor and the invested in venture capital investment cannot be clearly defined and will lead to great transactional costs on the venture capital market. As a consequence, the first and foremost problem in the development of China's venture capital investment sector is to improve all kinds of relevant laws.

Judging from the legislative situation relating to venture capital investment outside of China, it is very necessary to formulate specific regulations suitable for the development of venture capital investment, and also to include clear-cut and uniform provisions regarding the venture capital market in relevant economic regulations. For instance, in the U.S., venture capital investment companies mainly operate in the form of limited partnerships. Since this method can effectively combine the interests of managers and major investors, it has evolved into a mainstream approach of venture capital investment. Nevertheless, in China, the provisions of the current Company Law exclude registration in the form of a limited partnership and thus greatly impede the development of China's venture capital investment.

Meanwhile, it is also essential to establish an institutional framework governing small and medium-sized new and high-tech enterprises and the venture capital investment market. Its main components should include the following aspects. First, the venture capital investment corporate governance should be established and improved in order to strengthen the incentives and restraints for the managers; at present, such innovative instruments as stocks and stock options may be introduced to improve the incentive and restraint mechanism in venture businesses. Second, there is need to increase the safety of venture capital investment contracts and reduce default risks. On one hand, it is possible to implement a mechanism of phase-by-phase investment and regular reviews in order to revise judgement on the value of venture businesses; on the other, venture capital investment institutions should introduce comprehensive guarantee and limitation clauses so as to ensure there are stipulations and requirements governing the operation and management of venture businesses. Third, a micro-level monitoring mechanism should be established and improved for the

venture capital market. In a bid to monitor risks, it is imperative to bring into full play the role of accounting, auditing and asset assessment institutions and minimize the level of asymmetric information and moral hazards in venture businesses so that the value of science and technology businesses can be reasonably reflected on the venture capital market.

(Two) Overcoming the bottlenecks caused by undiversified venture investors and fettered sources of venture capital

Of the funds available for venture capital investment in China, 80% comes from government inputs. Overseas experience in regard to the development of the venture capital market has shown that the approach of relying upon the central or local government's direct participation in the development of venture capital investment is generally unsuccessful, and that it has more often than not led to inefficient use of funds and moral hazards in venture businesses. For this reason, in the course of developing China's venture capital investment players, the excessive involvement on the part of the government should gradually be weakened, and proactive efforts made to foster market-driven venture capital investment players.

Given that it is still difficult for China's private capital to become a main player of venture capital investment in the short term and that the development of venture capital investment funds is still subject to the restrictions imposed by policies and regulations, as a contingent measure, at the present stage a possible solution could be to encourage existing financial institutions (including both policy and commercial banks) to offer their funds and large enterprises (especially listed companies) to get involved in venture capital investment.

International experience indicates that the primary sources of funds for venture capital investment are mutual funds, insurance funds and various kinds of private-placement funds; however, taking into account the imperfections in China's laws and regulations relating to investment funds and in the market itself, it is still hard to resort to the fund market to satisfy the needs for funds in venture capital investment in the short term. On the other hand, the savings rate in China is at a very high level, and the outstanding balance of savings deposits in banks is growing in a sustained and rapid manner. At the current stage, the only effective channel is to make use of the intermediation role of the existing financial institutions for purposes of meeting the demand for funds for venture capital investment. Having said that, due to the special nature of venture businesses, to fulfil the requirements for liquidity and safety, banks usually are not ready and prepared to move into this field. Currently an issue high on the agenda is thus how to make full use of the role of banks to both satisfy the financing needs on the part of small and medium-sized venture businesses and to the requirements of risk prevention in the operations of banks.

1. To bring into play the guiding role of funds from policy banks.

Presently the difficulties facing small and medium-sized enterprises (SMEs) in having access to funds constitute an extremely salient problem. In addition to their effort to continue and support state-owned large and medium-sized enterprises, state-owned banks and various kinds of small and medium-sized banks need to sustain the steady growth of China's national economy; it is thus necessary to have a diversified pool of market players and offer financial support to small and medium-sized private enterprises, in particular new and high-tech venture businesses. Statistics show that this year private investment has decreased by 18% year on year, a full indication that private SMEs are still mired in great financing difficulties and that this has evolved into a "bottleneck" in China's financial system. Along with the changes in the country's industrial structures, guided by the central government's guiding principle of "rejuvenating the nation through science and technology", the new and high-tech industry and private SMEs have grown into a new growth engine driving China's economic development, a new priority of China's industrial policy, and a priority field that state-owned policy banks should actively provide support for.

The major task on the shoulders of policy banks is to capitalize on their own comparative advantages, and to guide and lead funds society-wide to be inputted into industrial sectors that enjoy the state's priority support. Take China Development Bank (CDB) as an example. In terms of the direction of its lending activity, loans are primarily extended to finance energy, communications, urban construction and other infrastructural investments, in a move to alleviate the constraints caused by "bottlenecks" at a time of there is a shortage of such infrastructure in an effort to drive behind economic growth, pull up domestic demand and promote the sustained, healthy and steady development of the national economy. In light of the new industrial structures, CDB should expand its policy lending facilities for priority industries and support innovative SMEs in their development. Such measure can embody the guiding role of funds from a policy bank and help with the inflows of commercial funds, and also meet the requirements of business expansion on the part of CDB. Looking back at the policy banking experience in developed countries, we can see that policy banks have changed with the changes in the domestic economy and made continued efforts to adjust their industrial policies so as to satisfy the needs of economic development. For example, based on Germany's industrial policy and requirements regarding the support for economic development and equal employment in different time periods, the Deutsch Bank for Rehabilitation and Development has made adjustments of its lending priorities in a timely manner. In recent years, supporting the development of German SMEs has remained to be an important business field for the DBRD.

2. A feasibility study of active involvement by commercial banks in venture capital investment.

It is, more often than not the case, that, in the early days of business start-up, venture

businesses are not qualified to meet the credit-worthiness track record criteria needed to obtain bank loans. At a time when there is no diversified financial market, the contradictions in the sense that small and medium-sized venture businesses have no way to secure financing and that it is difficult for traditional lending from banks to support venture businesses, have never been effectively resolved. The nature of commercial banks and the characteristics of venture businesses have given rise to the level of difficulty for commercial banks to be actively involved in the field of venture capital investment. Back in the year 2000, the People's Bank of China (PBOC) issued a document that requested each and every commercial bank to establish a SMEs lending department for the purpose of promote and support the start-up of SMEs. Given that China's SME venture businesses are faced with such problems as a low level of management, a small scale of investment, a low level of credit-worthiness and difficulties in getting mortgage-backed loans, as shown by the actual situation, the effectiveness of such operations in each bank is still very limited. How to overcome the constraints imposed by such a bottleneck has become a crucial factor for commercial banks in their in-depth involvement in the venture capital investment field.

In light of the current conditions in China, there are mainly two feasible participatory models. One is the integrated incubation and lending model, whereby a commercial bank extends loans to the finance company affiliated with a well-performing conglomerate, which will in turn provide guarantees for such a loan and invest in and foster venture projects within the conglomerate. The other is the third-party guarantee model, whereby a guarantee institution set up by the government offers guarantees for the venture loans made by a commercial bank to an SME. These two models can make it possible for commercial banks to be readily and actively involved in venture capital investment financing.

3. A feasibility study of large companies actively getting involved in the venture capital investment field.

With the gradual formation of China's market economy, a large number of enterprises of different ownership structures have, one after another, been successfully listed on the stock market or restructured; as a result, they have pooled from the capital market funds for the sustainable development of these enterprises themselves. However, with the arrival of the new economy era, China's industrial structures have changed greatly, and many enterprises find that their previous core business activities have shrunk and profitability decreased. As a result, if the funds sourced from the capital market were to be inputted into the previously-contemplated industry, it would be impossible to ensure high profitability, and there will even be a risk of losses. A considerable number of large enterprises, especially listed companies owned and controlled by the state have entered into a critical period of industrial upgrading and structural adjustments; consequently the use and efficiency of funds has turned into an issue that demands immediate attention. On the other hand, many small and

medium-sized high-tech start-ups, due to the current and policy and institutional restrictions and market imperfections, cannot get the support of financial capital; this has seriously hampered the industrialization of new and high-tech projects and prevented them from developing competitive edges. Under this game condition, support for the development of high-tech businesses and industrial upgrading of state-owned enterprises can be linked in the pursuit for a solution. In other words, so long as there is a suitable environment, large enterprises, in particular those listed on the stock market, are fully qualified as the centrepiece in the venture capital investment field.

The basic idea for large enterprises to use financial capital and support the development of new and high tech is that these enterprises, in particular those listed on the stock market, have rather sufficient flows of funds, which could be cash flows generated by issuing stocks (direct financing) and obtaining longer-term bank loans backed with enterprises' own assets (indirect financing); a host of modes, such as establishing venture capital investment fund companies through equity participation, developing technology venture capital investment projects collaboratively and making direct investments in technology venture capital investment projects in the phase of stable development. The specific modes are as follows:

- (1) A large enterprise may establish a venture capital investment fund or investment management company, in which the enterprise has a controlling or minor stake, and choose its venture capital investment target based on its own experience in developing new and high tech. If the enterprise thinks that a high-tech venture company has better prospects, such a company can be directly included in the large enterprise itself and become a branch or subsidiary.
- (2) A large enterprise may cooperate with institutions of higher learning and institutes of scientific research in the development of new and high-tech venture projects. The usual practice is that the large enterprise will offer funds while institutions of higher learning and institutes of scientific research contribute technology. Based on the enterprise's needs, new and high tech with real value can be developed so as to achieve the enterprise's technical and industrial upgrading.
- (3) A large enterprise may, by way of mergers and acquisitions, take a controlling interest in some small and medium-sized high-tech companies that have moved into the stable growth phase in the course of venture capital investment, with stable prospects and incremental cash flows. The enterprise may capitalize on its own managerial expertise and sales channels, further develop relevant technologies, and ultimately achieve industrialization so that these technologies can become the enterprise's new growth area, promote its technical and industrial upgrading, and realize the enterprise's maximum value.

As can be seen from the above analysis, the approach of large enterprises get

financing from financial markets and support the development of new and high tech is fully capable of evolving into a relatively effective mainstream method of venture capital investment provision and conducive to a greater role of private capital in venture capital investment and to the alignment with internationally-accepted practices.

(Three) Changing the short-termist behaviour in the choice of venture capital investment targets.

A look at the practice of China's venture capital investment in the recent years shows that there are a large number of venture capital investment companies with short-termist investment behaviours. Such behaviours are mainly manifested in two aspects. One is that a high percentage of venture capital investment funds are entrusted with money managers and channelled into the stock market for purposes of snatching short-term extra profits. The other is that the recipients of venture capital investment are mostly venture businesses on the verge of an IPO and already in the mature phase, in hopes that, in the wake of such IPOs, stocks in possession can be sold as soon as possible and get profits from a huge price difference. Such a short-termist approach can be better characterized as venture speculation instead of venture capital investment. At the current stage, in the development of China's new and high tech, what is lacking first and foremost is "high-tech seeds", without enough of which it will be very hard to talk about more new and high tech items for industrialization. In the absence of a large number of "venture" experiments, it is also difficult to pick and choose a sufficient number of new and high-tech projects with industrialization prospects. Most of the venture companies qualified for an IPO are in the industrialization phase; as a consequence, investment in these companies has lost the function and features of venture capital investment.

There are a multitude of reasons behind such short-termist behaviours. The reason can be that, due to the imperfections in the overall investment and financing regime and in the corresponding laws and regulations, venture capital investment companies cannot make a longer-term judgement and decision on the overall investment prospects. It can also be because of the less than desirable mechanism for the exit of equity investments in the sense that, without the technology board or the second-board market, the OTC transfer of equity shares is very difficult, as a result of which venture capital investment companies flock to projects that can be listed on the primary board. For these reasons, the primary solution to the present problem of short-termist investment behaviours is to improve the overall policy and market environments for the venture capital investment sector, introduce the second board market as soon as possible, and improve the exit route for the investments in venture businesses, so that new and high-tech business start-ups can really be supported. Such short-termist speculative behaviours should be overcome at the current stage.

Based on the above analysis, we have reason to believe that, along with the continued

optimization of the legal and policy environment and the continued improvement in the investment philosophy of all kinds of investment players, China's venture capital investment sector will develop rapidly and play an indispensable role in the industrialization of high tech in China.

Foreign VC in China: Prosperity & Prospects

Mr. Jingsheng Huang

Managing Director of Softbank Asia Infrastructure Fund

Brief Introduction of SAIF: www.sbaif.com

- Set up in 2001
- Fund I: US\$400 million. LP is Cisco Systems, Inc.
- Investment Strategies
 - ▶ Region: countries in Asia
 - ▶ Fields: value chains for diff nets
 - ▶ Stages: profit expansion or early stage with strategic partners
 - ▶ Scale: each single investment is US\$5-50 million

SAIF's Investment Regions



- Level one: focus countries
- Level two: Increasing investment
- Level two: diversification of investment portfolio
- Level three: searching for large projects

Investment Priorities of Softbank Asia: Sectors & Portfolio Firms

IT service	broadband/media Services providers: Service	Sify	AsiaNetcom	New tech	
	Application developers: application	SHANDA	盛大网络		MDC
	Basic software/services: software		SEVEN		
	Basic hardware: hardware	Centela	Belwave		博康集团
	Component suppliers: component	摩比技术 (Mobi)			
Uno				SkyPilot Network, Inc.	

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Foreign VCs in China in 2003: Second Spring?

- In 2003, Foreign VC is active in closing deals
 - ▶ Large size deals
 - ▶ Higher profiles
 - ▶ CVCA: organized with > 50 VC foreign VC firms
- Typical explanation in China
 - ▶ Growing economy -> growing market
 - ▶ Liberation of policies and legal environment
- An alternative explanation from a fund life cycle
 - ▶ "Last bubble" in 1999-2000 -> capital to current VC funds
 - ▶ Slower speed of investment since 2000 so still have much capital
 - ▶ Pressure for capital reduction by LPs. Pressure for management fees

Foreign VC in China in next 5 years: fund raising crisis

- Few VC funds in China have proven records
 - ▶ Have well-published money making cases
 - ▶ But few FUNDS prove high returns for their investors
- Fund raising cycle in 2004 to 2006
 - ▶ Bets on 2004-2005 IPO windows to generate records
 - ▶ Hard time to compete with US VC firms
 - ▶ Foreign LPs are NOT yet ready to take China risk
 - ▶ So many current foreign VCs may phase out
- Is China's domestic capital ready to save the VC industry?
 - ▶ There is capital, but still policy and legal hurdles
 - ▶ Early experiments
 - ▶ Could China save China's VC industry?

APEC Seminar on Venture Capital and Start-up Companies

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