VC and Tech: An interview with Dr. Kai-Fu Lee of Innovation Works and Peter Liu of WI Harper Group

Dr. Kai-Fu Lee and Peter Liu, two of the leading figures in promoting innovation and venture capital investment in China, shared the following perspectives on entrepreneurship, investment trends and new projects in an interview conducted by Dr. Martin Haemmig.

Dr. Kai-Fu Lee is the founder of Innovation Works, which incubates new Chinese high-tech companies and mentors next-generation Chinese entrepreneurs. Focused on internet, mobile internet and cloud computing, Innovation Works, which started up in 2009, will prototype some 20 new ideas each year and attempt to spin off three to five independent companies.

Prior to founding Innovation Works, Lee held senior positions at a number of major technology companies, most recently that of President of Google, Greater China, whose market share doubled during his tenure.
Peter Liu is widely regarded as a pioneer among venture capitalists in Asia with more than 20 years of experience in venture capital. In 1993, he founded the WI Harper Group, one of the earliest venture capital franchises in Greater China, which now manages more than US$500 million in committed capital. In 1985, Liu co-founded Walden International, currently a firm with US$1.7 billion under management. Liu has personally invested in more than 100 high-tech companies in Greater China.

Dr. Martin Haemmig is Senior Advisor on Venture Capital for Stanford University (APARC-SPRIE) and an Adjunct Professor at CeTIM in Switzerland. He specializes as international innovation and commercialization researcher, lecturer and advisor on the globalization of venture capital.

**Martin Haemmig:** What is the current state of entrepreneurship in China?

**Peter Liu:** The market opportunity for Chinese venture capital is as large as I’ve seen it since I started investing in Greater China 25 years ago. The domestic market is booming, and there is a great deal of funding looking for qualified projects. However, I would make a clear distinction between traditional venture capital and true formation-stage start-ups. Venture capital in China today consists of first or second institutional financings of companies. These companies are typically post-product and often post-revenue and profitable as well. For entrepreneurship, which I define as venture creation, the infrastructure in China is still emerging. For instance, in the US, the angel financing network is estimated at 260,000 participants, and Silicon Valley’s best-known companies, such as Apple and Google, were funded by angels. In China, on the other hand, the angel and seed investor network is highly fragmented, and many former VC funds have moved into the growth equity market where large funds of US$500 million to US$1 billion-plus invest in consumer goods and industrial products. These investments have limited, if any, technology content.

**Kai-Fu Lee:** In addition to the funding gap for seed-stage investments, there are three other trends that are prohibiting Chinese entrepreneurs from reaching their potential. First, the next generation of Chinese entrepreneurs will largely be born, raised and educated within China, in contrast to the last wave of Chinese entrepreneurs who largely were educated in North America and Europe. This new crop of CEOs will require some coaching to groom them into more well-rounded managers. Second, there continues to be a large fear of failure among China’s top engineers. I suspect that this is common in emerging markets, and China is no different, although there may be some cultural issues that place an even greater emphasis on joining a well-known company. Finally, the combination of these structural barriers creates a situation where start-ups are starved of capital, mentorship and top engineers. In sum, I believe
that technology start-ups in China are both less expensive and more risky than in the United States or Europe.

**Martin Haemmig**: How does the current market influence your strategy?

**Peter Liu**: The global economic crisis of the past few years has reinforced the need for investors to manage risk in their portfolios. At WI Harper, we have redoubled our focus on finding first institutional investments in technology-related companies in telecom, media and technology (TMT), cleantech and health care. When we looked at the TMT sector, we were both amazed at the market opportunity in next-generation Internet and concerned about the structural challenges required to build these companies. Last fall, Kai-Fu came to us with an exciting prospect of building a unique platform to capture this opportunity in a low-risk manner. We were intrigued, and after some discussion and refinement, announced what became Innovation Works in September.

**Kai-Fu Lee**: China is entering its third phase of growth in the online software market, which will be dominated by the Internet, mobile Internet and cloud services sectors. China now has 338 million Internet users, more than any other country in the world, and there are more than 222 million mobile Internet users nationwide. E-commerce usage has grown by four times in the last four years. Propelled by the simultaneous explosion in mobile Internet and e-commerce, the opportunities are unbelievable. While China may seem like a market ripe for the taking by global Internet giants, there are major differences that open the gates for Chinese domestic firms to ultimately succeed. Those differences include demographics, usage habits and government regulations. As a result, the major Internet companies have faced uphill challenges in building their China presence, and domestic firms have an unprecedented, rare and valuable opportunity to capture this upside with a customized product and business model that fits China's distinct market. I believe that this opportunity will exist for the next three to five years, which is what prompted me to launch Innovation Works in late 2009.

**Martin Haemmig**: Can you briefly describe Innovation Works? Is it an incubator? A seed fund? Recruiting service? CEO leadership program?

**Kai-Fu Lee**: It's all of the above. As we have discussed, the infrastructure for early-stage companies is lacking in each area that you mention. Innovation Works is focused on starting companies today that will capture today's market opportunity rather than funding far-reaching projects that will take years and years to develop. For us to capture the near-term opportunity, we need to bring a full platform to market that fills all of the gaps in venture creation. This starts with finding high-potential CEOs and building world-class technical teams and ends with a captive funding vehicle — Innovation Works Development Fund — that seeds new companies until they are prepared to receive a Series A investment from an
institutional investor.

**Peter Liu:** We spent many hours to identify the proper structure for Innovation Works and realized that we needed to separate operating capital from investment capital. One of the lessons learned from incubator platforms funded in the 1990s was that mixing these two pools of capital can create significant challenges for management teams — for instance, deciding between spending US$500,000 to hire a new development team versus spending the same US$500,000 to seed a new company.

We quickly realized that, in China, you need the capital to do both. Our solution was to build a co-founding vehicle in Innovation Works Ltd. with a funding vehicle in Innovation Works Development Fund. The first group makes the operating decision and becomes a co-founder, and the second group makes the investment decision based on financial returns.

**Martin Haemmgig:** Innovation Works seems to be quite a new concept indeed. What has gone most smoothly so far, and what have been your biggest challenges in launching this new platform?

**Kai-Fu Lee:** Operationally, the smoothest part of our process has been our recruiting of top-tier engineers to Innovation Works. Technical talent is the lifeblood of our company, and we already have more than 60 of China’s best engineers, including many programming champions, and we are increasing our plans and estimates now. The Chinese educational system does a good job of ranking those with the highest “horsepower,” so we know we have a tremendously talented team. We have also launched several high-potential development projects based on the input from my team, our industry partners and me.

These projects address a few of the gaps that we see in the Chinese Internet and mobile Internet market. We are using both quantitative and qualitative analysis to prioritize our projects, and we have made good strides in building a solid process and a robust pipeline of projects.

The ongoing challenge — and I think the one that will most impact our eventual success — is our ability to recruit high-potential CEOs to lead and grow these companies. When we started, that was very difficult. But now that we have established teams and projects, we are making solid progress, and we expect to have three to five CEO-caliber people on board by mid-year. I also see several young engineers who will have CEO potential in several years. I can provide mentorship, talent and funding, but ultimately, these companies need leaders.

**Peter Liu:** We have seen tremendous support from our industry partners from around the world, which just shows how much Innovation Works can contribute to China. We have also supported Kai-Fu’s operations by sharing some of our best practices, and we work very well together.

Kai-Fu has been an advisor of ours for many years, so we already had a good
deal of familiarity. This model is truly revolutionary in China and, in my opinion, our biggest challenge is the unknown — we have no idea what new opportunity or challenge lies around the corner.

An interview with Joe Tian, DT Capital Partners

Joe Tian is a founding partner of DT Capital Partners, which provides growth capital to early- and expansion-stage companies in the consumer, technology, industrial and energy/clean energy sectors in China.

EY: What do you view as the biggest opportunities and challenges for the VC industries here in China today?

Joe Tian: There are more and more investment opportunities encouraged by the Chinese Government, in a variety of sectors, which are facilitating the economy’s continuous growth. In particular, substantial opportunities are emerging in the consumer and cleantech arena. We see a lot of opportunity in the consumer sector for years to come, as consumer spending is strongly encouraged by the Chinese Government. Currently, it only accounts for less than 40% of China’s GDP, versus 60% to 70% in developed countries. So the Government has also put a lot of emphasis on clean energy and cleantech. The biggest challenge, in my view, is how the VC players can better work with good companies across the country and across different industries. Often, VC players have a lot of overseas experience but lack deep knowledge of the local environment, and therefore, they may be unable to work with local investees seamlessly to create win-win scenarios. However, this challenge is also an opportunity: if you are fully committed to China VC industries and really dig in very deeply, you can build a comprehensive network across different industries and different regions, and you will see substantial opportunities.

EY: In China, both US dollar funds and RMB funds are facing very fierce competition. What’s your view about these two funds and their effect on the landscape of the VC investor in the future?

Joe Tian: Many fund managers, including DT Capital, started as purely US dollar funds but are now starting to manage the RMB funds as well. This is mainly because investee companies demand the RMB investment, and RMB investors could potentially have a higher return from the robust A-share market in China. Our US dollar fund and RMB fund will coexist for the foreseeable future. Ultimately, the two funds will become one once the RMB becomes fully
convertible. Until then, however, there will likely be some potential conflicts because you have the two sets of LPs. But VCs like DT Capital have very clear guidelines on managing US dollar and RMB LPs. Because we can invest in both US dollar and RMB, we can continue to maintain a competitive edge in terms of capturing attractive opportunities and thus continue to deliver good returns for both types of LP.

EY: How is DT’s investment strategy evolving in response to current changes in the exit environment, the economy and technology here in China?

Joe Tian: We try our best to capture the mega-trends in China. A big part of that is looking at what the Government is promoting. We’ve done this in cleantech, for example, by investing in WuXi SunTech Power. If the Government has a strong opinion on a certain industry or a specific direction and we feel there are good returns to come out of it, then we start really diving in. That’s been our strategy before, and it will continue to be our investment strategy going forward. Go with the trends and not against them.

Second, we are very local. Most of our team has studied and worked in the US, but most of my partners have been back in China more than 10 years. We already re-plugged in. We have set up 10 offices and local teams across China. Many good companies prefer talking to you face to face, so we are always there when needed. It’s also important to establish good relationships with local governments, and they want to see that you are part of the community.

EY: Looking ahead 5 to 10 years, what does the optimal VC fund look like in China, in terms of the fund structure and composition of the LPs?

Joe Tian: I think Chinese industry will continue to grow rapidly. Specifically, there will be more significant billion-dollar funds and also funds specializing in specific industries. The industry as a whole will engage more professionals due to the large amount of due diligence work to be done. Some will be headquartered overseas, some will manage RMB funds domiciled in China. Local RMB fund managers are growing rapidly, thanks to Shenzhen’s ChiNext and the A-share SME board. The most competitive VC players, in my view, are those that integrate foreign and domestic LPs — firms with great local connections but also managers that are experienced with the best international practices.