

Q & A

Sebastian Mallaby on American-style Venture Capital in China

The financial journalist talks about the evolution of American venture capital in China — from its role in the rise of Alibaba to the split today over China's politics.

BY DAN XIN HUANG — JULY 24, 2022

*Sebastian Mallaby is a distinguished journalist and author and now a senior fellow for international economics at the Council on Foreign Relations in New York. Mallaby has contributed to a variety of publications, including *Foreign Affairs*, *the Atlantic*, *The Washington Post*, and *the Financial Times*, where he spent two years as a contributing editor. A graduate of Oxford University, he is a two-time Pulitzer Prize finalist and the author of five books, including most recently, *The Power Law: Venture Capital and the Making of the New Future*. In this lightly edited Q&A, Mallaby talks about the rise of venture capital in China, and its impact on the country's technology boom.*



Sebastian Mallaby.
Illustration by Lauren Crow

Q: Your book makes the argument that China's digital economy owes its success in part to the introduction of American-style venture capital. At the beginning, what was the opportunity for these VC firms in China? What problems did they face and how did they find success?

A: At the end of the 1990s, the internet boom [in America] was well underway. A lot of Chinese students on U.S. campuses saw what was going on and wanted to replicate that success in China. They wrote business plans that were modeled on U.S. online businesses that seemed to be working and sought capital for those business plans. Yet there was pretty much nobody in China that would extend venture capital investments to this kind of startup. There were some American players — notably [Shirley Lin](#), at the time a partner at Goldman Sachs in Hong Kong — who became interested in these plans and funded a handful of them, including

Alibaba. You can also look at Baidu, Tencent, Sina, Sohu, NetEase, EachNet, Ctrip — a lot of these early consumer-facing Chinese internet companies received American-style venture capital because the domestic financial system simply wasn't familiar with that kind of financing.

The central challenge was that under Chinese law, foreign investors were not allowed to own Chinese internet companies. They were classified as media companies, which restricted foreign ownership. That included venture capital investment because of its equity stake.

U.S. investors had to figure out a way around that obstacle, so they brought in

Silicon Valley lawyers who came up with this idea called the [Variable Interest Entity](#). The VIE structure created a Cayman Island holding company that had the ability to issue various kinds of stocks: preferred stock for the venture investors, common stock for the founders, equity options for the early employees. This was the standard practice in the U.S. but was not a familiar structure at all in China. We should remind ourselves that the concept of public equity was pretty novel in mainland China at this time. The Shenzhen and Shanghai Stock exchanges had just opened in 1990. Equity options for employees or preferred stock for investors were unheard of. By having this Cayman Islands entity, you could get around that obstacle.

At the same time, the Silicon Valley lawyers figured out a way of having essentially synthetic equity. The Cayman entity would have a subsidiary onshore in China which would then lend money to the Chinese internet company, but the loan would be cleverly structured so that it behaves like equity. The Chinese state neither blessed it nor condemned it. They were shown some draft documents, which Chinese officials looked at then returned with no comment. Western operators took that as a tacit approval. They were betting relatively small amounts of capital so they were willing to go for it.

BIO AT A GLANCE

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Joe Tsai speaking at the 2017 RISE Conference in Hong Kong – “the largest tech gathering in Asia”. Credit: Cody Glenn/RISE/Sportsfile via [Flickr](#)

In Alibaba's early days, [Jack Ma](#) didn't know what equity options were. But once he took the investment from Goldman Sachs, which came with this Cayman Islands structure that allowed you to use equity options, this tool quickly became central to his strategy. That's how he was able to hire [John Wu](#), the lead engineer at Yahoo, by offering him equity options and by giving him additional equity options with which to hire a whole team that would remain in Silicon Valley. This was a way of bringing in superior coding talent to build the early Alibaba

products. [Joe Tsai](#), who had been involved in Alibaba as an investor, decided to join the company completely based on equity options. He took an enormous pay cut, from \$700,000 a year to \$600 a year — not \$600,000, but \$600, less than 0.1 percent of what he made in salary terms — but it made sense because equity options promised to be valuable in the future if you believed in Alibaba as a prospect. That was the way that Alibaba became a world class company. In that sense, U.S. venture capital investment, which came with the ability to do equity options, helps explain the rise of Alibaba.

How did Chinese VCs develop over the years?

Before the late 1990s, there had been a little activity with Taiwan-based venture capitalists funding some mainland projects, but these were not particularly transformative. I regard that as the pre-history. Then from the late 1990s, you get the first wave of Western investment in Chinese internet companies with Goldman Sachs being the lead player.

If you go forward in time, there was a moment around 2005 when Silicon Valley companies woke up to how much headway the Chinese digital economy was making and they wanted to be a part of the action. A whole group of American VCs visited China in 2005. From that flowed multiple attempts to set up China operations that reported to, or were at least affiliated with, American VCs. The most famous would be Sequoia, which recruited Neil Shen to open up a China office based in Hong

Kong. There was another variation on that model where you had an individual Westerner, like [Gary Rieschel](#), who came to China working at SoftBank and saw what was going on. He decided to do a venture operation in China and found a Chinese partner who had American experience. Together they set up [Qiming Venture Partners](#).

The Chinese investors learned quickly how the American playbook worked, and eventually they didn't need the American input so much anymore. This Chinese-led wave of venture capital started from the late 2000s. Another phase after that, built on top of the basic venture capital model of doing Series A and Series B investments [typically the first two funding rounds of institutional funding for a start-up company], was acquiring the expertise to resolve some of the problems that might result from increased competition, i.e. if a lot of different contestants get funded in a particular space. The example I describe in my book is [Meituan](#) and Dianping, which were competing in food delivery. Mergers were thought to be extremely difficult to pull off in China, as neither founder would want to compromise and play second fiddle. But by the time of the Meituan-Dianping merger in 2015, there was a sophisticated investment banking world that was able to broker the agreement and persuade the two parties that they would be better off together than fighting one another. That was the big signal that the Chinese technology industry had come of age, that it was sophisticated and creating enormous amounts of wealth.



Neil Shen (left), and Gary Rieschel (right). Credit: Fortune Brainstorm TECH/Vivek Prakash via [Flickr](#), and Fortune Brainstorm TECH/Shawn Koh via [Flickr](#)

The Power Law Venture Capital and the Making of the New Future



Sebastian Mallaby

Sebastian Mallaby's *The Power Law: Venture Capital and the Making of the New Future* published in February of this year by Penguin Press. Credit: [Penguin Press](#)

At the time of the merger, Meituan became the biggest ever profit that Sequoia had made — even more than from Google. And when [Meituan](#) was overtaken, it was by [ByteDance](#) (parent company of TikTok). This was the period when China tech was not only catching up with the U.S. but by some measures overtaking it. The combination of an enormous internal market, the fact that the market was on a growth trajectory, and specifically an even faster *digital* growth trajectory — putting these things together, you had turbocharged returns for successful technology investments. China and the West were roughly equal between 2016 and 2018 in terms of number of unicorns, amount of venture capital being deployed, amount of venture capital profits.

After learning from the West, did Chinese VCs approach investing in China in a different way than their American counterparts?

Because the Chinese economy had developed so quickly, there were some incumbent industries that were quite well established in the U.S., which was not the case in China. Take hotels. There were opportunities in China to build really fast-scaling hotel chains. For a while, online education was another example. Online education is not particularly technologically sophisticated, so there were businesses which a Western VC would not have touched because there was not enough new technology in it. The reason Western VCs look for something that's very "techie" is that this is the way you disrupt incumbents, by discovering some new way of doing an old thing ten times better with the new tech. But in some cases in China, there was no old thing, so even without tech you could do it ten times better because the incumbent was some state-owned enterprise.

The other thing that was striking to me is that if you look at the list of the top Chinese VCs, there are quite a few women. The U.S. system is so male dominated. This is also partly to do with the speed with which China developed. By the time venture capital got going in China, it was the turn of the century and

women's status was a lot more advanced in China than it had been in 1970s America. Once American venture capital investing was dominated by men, they appointed each other to vacant slots and there was a real absence of women. China didn't have that problem very much.

MISCELLANEA

FAVORITE BOOK	<i>Men, Machines, and Modern Times</i> by Elting E. Morison
FAVORITE FILM	When We Were Kings
PERSONAL HERO	Nelson Mandela

“ You often hear people in the U.S. say, “We don't like platform monopolies in tech,” or “We don't like the addiction of teenagers to online gaming.” And yet we just sit around and talk about it, while China actually did something. ”

For most of the history of venture capital in the U.S., Silicon Valley dominated by a huge margin. That's breaking down a little bit now because of the ability to operate remotely, and the real estate in Silicon Valley is so expensive it's an incentive for companies to be founded elsewhere. But if you look at the data on where the partnerships are that raised the lion's share of venture capital dollars, the center remains in California. Whereas in China, there's a reasonably even split between Shanghai, Beijing, Hong Kong, Shenzhen, and maybe even Hangzhou. That's because venture capital got going in China at a time when communication technologies were more advanced than they had been in the U.S. in the 1970s and 80s. Everything from email to video calls existed when the Chinese VC world was developing, so there was a natural ability in China to be able to cope with geographic dispersion. In the U.S., the benefits of clustering in a world that was more primitive in communications technology were so strong that Silicon Valley dominated everything else.

Has it become more challenging for VC firms operating in China to get reliable information on the Chinese companies they want to invest in?

These days just about all venture capital investments in China are done by people who are based in China. The Western investors are people who are investing into venture capital funds. They might be from a university endowment or a fund of funds perhaps, but it's not like somebody based in the U.S. is investing in a startup in Shenzhen or Shanghai. Communication between these LPs, the limited partners who are capital allocators, and GPs, the general partners who actually make the startup investments, is fine. Of course lockdowns make it tricky to have meetings so you have to do it online, but they can talk to each other on Zoom. Other than that, for much of the last two years mobility within China was pretty

good. It's been very hard to get in and out of the country, but quite easy to move around inside the country.

Even before COVID, however, there was a clear shift of decision-making authority away from the Westerners and toward the Chinese nationals. The Westerners obviously understand the local conditions much less well. What they could contribute was a general understanding of how you do venture capital but by 2010, Chinese investors understood that perfectly well and they didn't need the Western input anymore. If you look at Sequoia China, when it first started out in 2005 they were getting a reasonable amount of guidance and input from Sequoia in California. But by 2010 or soon after, it didn't really need Western input so much because they understood how to do it. If you look at Qiming, Gary Rieschel, the American co-founder, was important in the beginning, but he left China after some years because he recognized that he didn't have as much to contribute anymore [on the individual deal level]. That is true across the board.

What are some of the criticisms against VCs in China?

One criticism you hear is that venture capital dollars don't always go to the socially most helpful fields, and in some ways, the Chinese government's restrictions on some of the tech companies that were originally started with VC money in the last couple years shows you that they are sympathetic to this idea. You often hear people in the U.S. say, "We don't like platform monopolies in tech," or "We don't like the addiction of teenagers to online gaming." And yet we just sit around and talk about it, while China actually did something. There's a jealousy of the decisiveness of Chinese action and so for people who are critical of the way that VCs allocate dollars, the China model has some attraction.



Premier Li Keqiang speaks at the opening session of the annual meeting of China's National People's Congress (NPC), March 2022. He was quoted as saying that "We will promote the development of venture capital," during his opening remarks.

Credit: Ng Han Guan/AP Photo

The counterargument is that when somebody — whether it's the government or regulators — starts to say, "Here is what VCs should and shouldn't back," it is going to change the way that VCs think about the next 10, 20, 50 projects that they invest in. They're going to be thinking, "Okay, what is within the government's acceptance zone and what isn't?" Let's say you've already funded a marketplace for food delivery, but then somebody has the bright idea that you could use the same marketplace idea and apply it to the hiring of software talent. In a

world where there's no government second guessing, you might say, "Great, that sounds like a good idea, let's do it." But in a world where there is government second guessing, you might say, "What would the government think about that?" Would it be draining software talent from existing national champions that really need the software programmers? If these software coders come on this marketplace platform and end up doing freelance jobs for companies that the government doesn't necessarily support, would that cause the government to close down the marketplace? Perhaps there's too much risk here and so they're not going to back it. In unpredictable ways, government guidelines will inhibit the choices that these VCs make in the future, and a lot of innovation comes from VCs stumbling sideways into ideas and opportunities that nobody can foresee in advance.

Given this government crackdown on private-sector firms, how are foreign VCs viewing China today? Is the heyday over?

There is a real split in that question. On the one hand there are Western investors who say, “China has delivered amazing returns in the last 15 years. It is still an economy that — although slowing down — is growing much faster than the rest of the world. It is a sophisticated place with lots of talented people who are ambitious and entrepreneurial and working really hard. So this tech ecosystem is going to continue to be successful. There is so much momentum built in, and I still want to invest there.” That’s one view amongst Western investors about China.

“ **It is good economically to have cross-border flows of products, people, ideas, and money because it makes for a more efficient economy, but it is also good because it makes for contacts between Chinese and American people and that reduces suspicion. That is an important thing when it comes to avoiding a war.** ”

The other view is that politics is going to make it really complicated. And the politics is not just what the Chinese government may think about particular tech sectors, like online education falling out of favor or video games having their usage restricted for teenagers. It’s bigger than that. The political risk is that because of heightened geopolitical competition between China and the U.S., both governments are going to restrict cross border flows of capital. If you are a Western investor, specifically an American investor, and you put money into a Chinese venture fund, there is a risk that three years later, before any of your bets have paid off, the U.S. government comes to you and says, “Listen we don’t like that, we don’t want you to be putting money into China tech because it’s assisting China in developing products and services that will help them to compete against the U.S. That is not in our national interest.”

Take the Shenzhen-based drone manufacturer DJI, which has the lion’s share of the commercial drone market in the U.S. but is viewed with [suspicion](#) by the Pentagon. That is an example where Western capital was part of the money behind DJI. And that’s something that some Western investment firms worry about. At the minimum there will be reputational risk. At the maximum the U.S. government may come down and say you’ve got to divest that. Political risk takes these different forms. Whereas one faction in the Western investment community believes the China is still where you want to be involved in, another faction is looking at the war between Russia and Ukraine, looking at the fact that tension with China appears to be high, and just saying, “This is not something that we would want to bet on.”



DJI's booth at CES (Consumer Electronics Show) 2016 held in Las Vegas, Nevada. Credit: Maurizio Pesce via [Wikimedia Commons](#)

Is one of those factions more prominent or outspoken than the other?

It’s funny that you put it that way. I would say that the pull back from China faction is more outspoken, but the silent majority is still investing. The momentum is important. A lot of what makes technology companies and startups work is that you just have a big group of people who are experienced in building startups. They’ve done it before. They’ve been working at a big company like Alibaba or Tencent or Meituan, and they’ve seen it scale from the inside. It’s really exciting when it takes off and they want to do it again. So now they’ve left that company and they’ve got both money and experience, and they want to use it to help build new companies, either by founding them or by backing them as angel investors or

being a board member or a consultant or maybe being hired. How did Alibaba get going? It was by hiring that guy John Wu from Yahoo, who came to be the CTO of Alibaba. Jack Ma was entrepreneurial enough to go to the U.S. and make that hire. But it's obviously more convenient if you can make lots of hires like that within your own country. The point about China is that it has been so successful for two decades in generating fantastic startups that have become unicorns. There is just a large number of people who experienced that transition and who will want to do it again. That is an enormous advantage. If you are an investor, it makes sense to keep betting on ecosystems that have that momentum.



Jack Ma speaking during the session 'Enabling eCommerce: Small Enterprises, Global Players', at the annual meeting of the World Economic Forum in Davos, 24th of January, 2018. Credit: World Economic Forum/Ciaran McCrickard via [Wikimedia Commons](#)

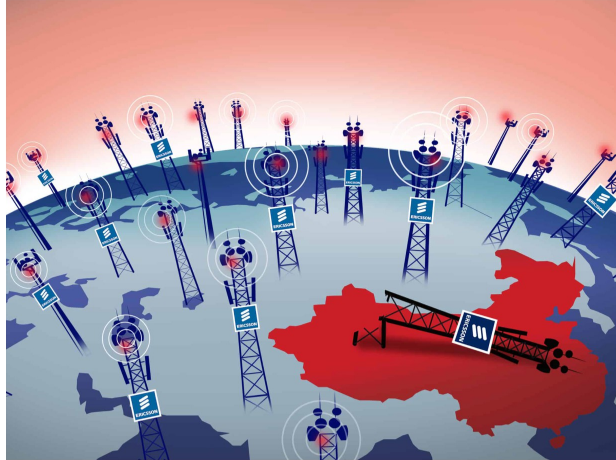
There's been greater scrutiny from policymakers in Washington and Europe on investment flows going into China. Are these efforts important and necessary or misguided?

One has to face the fact that technology is a facet of national power. Geostrategy requires governments to care about the strength of their technology sector relative to the technology sector of a potential military rival. The U.S. and China clearly are potential military rivals. It is inevitable therefore that the Chinese government will want to develop its own technology industrial base as a facet of national power, and it is inevitable that the United States will do the same thing in rivalry against China. What I hope is that we don't spiral into that [Thucydides Trap](#) if we can help it. Where it is possible to maintain commercial interchanges, I am in favor of it. It is good economically to have cross-border flows of products, people, ideas, and money because it makes for a more efficient economy, but it is also good because it makes for contacts between Chinese and American people and that reduces suspicion. That is an important thing when it comes to avoiding a war. I am hopeful that it will be possible to say, for example, there are certain kinds of tech that have a military use, and then there are other kinds of tech, such health-tech, where we should collaborate.



Dan Xin Huang is a contributing writer for *The Wire*. He has reported from China and Central Asia, and his work has appeared in *Foreign Affairs*, *Guernica*, *The New Republic*, *Pacific Standard*, and *The Village Voice*. He previously worked as a reporter for *The Wall Street Journal* in New York. [@Huangplan](#)

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Q & A



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