ISSN 1009-3095 Journal of Zhejiang University(SCIENCE) V.2, No.4, P.462-466, Oct.-Dec., 2001
http://www.periodicals.com.cn; http://www.zju.edu.cn;
http://lib.zju.edu.cn/English; http://www.zjupress.com

ON THE INSTITUTIONAL DEFECT AND ITS CORRECTION OF VENTURE CAPITAL IN CHINA*

DAI Zhi-min(戴志敏), YU Jin-jin(余津津)
(*College of Economics, Zhejiang University, Hangzhou 310027, China*)

Received Sept.18, 2000; revision accepted Mar.16, 2001

Abstract: With the emergence of Knowledge Economy, venture capital is playing a more and more important role in the high and new technology industry in China. The situation and problems of venture investment in China are analyzed in this paper which pointed out some problems that hinder the process of venture investment, and also, gave some suggestions to promote the development of venture capital.

Key words: venture capital, defect, institution innovation
Document code: A **CLC number:** F830.591

INTRODUCTION

With the emergence of Knowledge Economy and the reform of the science and technology system, from the beginning of its introduction in China, venture capital has been taken seriously by our government. The latest survey by the Venture Capital Research Team (VCRT) of the Ministry of Science and Technology of China in June 2000 showed that the venture capital is springing up vigorously in China. VCRT investigated 47 venture capital entities in the High and New Technology Development Zone of 25 provinces and districts, among which 83% was founded in 1999, 90% was state owned, only 2% had private equity and 8% was run by foreign capital. On the other hand, many sound high technology enterprises like Stone, Legend, Haier, Tsinghua-Tongfang, also set up venture capital companies solely or jointly to pursue high returns and diversify investment risks. The survey showed that all the venture-capitalized projects focused on high technology industries such as information technology, machinery and power-generation, bio-medicine, new materials, environment protection, new energy, etc. and that the percentage of the venture-backed companies staying in the seed stage, expansion stage and mature stage was 28%, 53.6% and 18.4% respectively. Some of them have even gone public.

Although China has made great progress in venture investment, the venture capital is still in the primary stage, many inevitable problems exist: (1) dislocation of the venture investment and simplification of the capital structure; (2) lack of true venture capitalists; (3) lack of standardization in the investment process; (4) lack of indispensable means of exiting for the investors; (5) lack of perfect law system. All these problems put our venture capital industry into a dilemma. In this paper, we will point out that the problems mentioned above is rooted in the fatal institutional defect existing in venture capital's in current phase. In fact, as for the venture capital, the key point is not the amount of the capital but the system upon which it depends.

THE ESSENCE OF VENTURE CAPITAL

Venture capital investment can be defined broadly as investment by professional investors in long-term, risky equity finance where the primary reward is an eventual capital gain, rather than interest income or dividend yield. Compared with common investment, the essence of venture capital investment can be listed as follows:

* Project (00BJY107) supported by Social Science Foundation of China.

First, venture capitalization is a kind of high-risk investment. Generally speaking, those developing high technology small enterprise (SME) will be selected by venture capitalists. But in western countries, up to 90% of the venture investment lose in the end due to the huge technology risks, market risks and management risks.

Second, venture capital will bring about high profit in return. Almost all venture capitalists will invest in rapidly growing high-technology enterprises, such as IT, Bioengineering, and so on. Once these enterprises succeed in the competition, the venture capitalist will get back several times, even hundreds or thousands times of the venture capital they invested. Moreover, the investors can get huge extra profits via venture capital's special way of exit.

Third, venture capital must be diversified so as to spread out the risks. Usually venture capitalists will invest in a group of projects so that they can use the profit of successful ones to offset the loss of failed ones.

Fourth, as a kind of long-term investment, in general, venture capital will be withdrawn from project after a period of 3 years to 7 years. Venture capitalists tend to add more venture capital into promising ventures. If there is a competition between venture capitalists and the venture-capital backed entrepreneurs, only those entrepreneurs who can provide the potentially highest profits will get the venture capital to sustain the running of the next stage. This is the so-called "Champion mechanism of management" (Masahiko, 2000).

Fifth, venture capital is a kind of equity capital but not loan capital. Seed-stage enterprises, except for ideas and technology, do not have enough assets to mortgage from traditional financial institutions. Venture capital can fill this gap by offering equity capital. Accordingly, the venture investor focuses on the prospects and the ability of the enterprise to grow rapidly and make profit and also hope to gain high profits by means of IPO (initial public offering) or private placement.

Sixth, venture capital needs good means of exit as agreed upon, after they get enough profit, venture capitalists will liquidate their equity in the venture-backed enterprises, which can easily get money from financial markets. Generally, there are three ways for venture investors to exit: IPO (initial public offering), private placement and share repurchase.

THE INSTITUTIONAL DEFECT OF VENTURE CAPITAL IN CHINA

Due to its special essence, venture investment needs a kind of new running system and organizational structure. According to North (1998), institution provides a framework in which people interact with each other. Institution is made up of informal constraints or institutional environment, formal constraints or institutional arrangement and mechanism of implementation. Institution is a whole set of rules, demands to be obeyed and standards of ethical action, which can restrain the individual's behavior effectively. Correspondingly, the institution of venture capital should be the sum of all the standards and rules that affect the running system of venture capital, including the regulations inside venture capital companies, the running mechanism of venture capital etc. Based on perfect market mechanism and relatively stable institutional factors, venture capital developed dramatically in western countries. While in China, due to the effect of the old investment pattern and that of the path dependence of traditional state owned enterprises (SOE), venture capital chose the government-oriented model naturally, hence the institutional defects come into being, which can be elaborated in four aspects below:

1. The defect of property right institution

The institution of property right is the base of all the institutions. North (1989) tells us that an effective property right institution is the key economy-promoting factor. Yet the effective institution of property right means the property right must be clear-cut at the beginning according to customs, rules or laws. But in China it is another story. Most of the venture capital companies are established by the government and raise funds by fiscal allocation (Table 1). But strictly speaking we cannot regard the government as the owner of the venture capital. Actually, the real owner of the property right is absent. Without the real owner of the property right, the venture capital companies fall into a state of ineffectiveness without exception. It is the famous transaction cost theory that transaction creates cost (Coase, 1990). In order to reach a transaction, the venture capitalist have to go through several phases such as selecting, negotiating, reaching agreement, implementing, and so forth, each phase resulting in different cost. In the Coase theory, if the transaction cost is positive, different original arrangement of property right will lead to different benefits. That is, property right must be clarified and pinpointed clearly at first so as to maximize the benefits. However the property right of the venture capital institute in China is so blurry that the maximization of benefits cannot be realized. Also, there is a typical example in America, the Small Business Investment Company (SBIC) set up by the American government in 1958, resulted in loss just because of the vague arrangement of property right.

Table 1 Survey of some venture capital companies in China

Name of company	Time of establishment	Authority	Source of venture capital	Asset (RMB)
Shenzhen High Science and Technology Venture Capital Limited Corp.	1998	Municipal Committee of Science and Technology	Fiscal capital: 0.5 billion Other corporation : 0.5 billion	1 billion
Science and Technology Venture Capital Limited Corp. of Guangdong Province	1997	Provincial Committee of Science and Technology	Fiscal capital, Guangdong Overseas Chinese Trust Corp.: 50 million	0.5 billion
Shanghai Science and Technology Venture Capital Limited Corp.	1993	Municipal Committee of Science and Technology	Fiscal capital, Shanghai Construction Bank, Bank of Communications, Baoshan Steel Corp.	0.3 billion
Science and Technology Venture Capital Corp. of Zhejiang Province	1993	Provincial Committee of Science and Technology, Provincial Department of Finance	Provincial Department of Finance, Municipal Committee of Science and Technology	60 million
High Science and Technology Venture Capital Limited Corp. of Jiangsu Province	1992	Provincial Department of Finance	Fiscal capital	0.65 billion
Shanghai Venture Capital Limited Corp.	1999	Shanghai Science and Technology Venture Capital Committee	Municipal finance, Municipal Committee of Science and Technology	0.1 billion
Beijing Science and Technology Venture Capital Limited Corp.	1998	Beijng city	Municipal government	0.5 billion

* Source: Shen Lijun, 1999. Venture Investment: operation, mechanism and strategies, Shanghai Yuandong Press.

2. Lack of perfect principal-agent relationship inside the venture capital company

The government supplies the venture capital but dose not manage it; that is to say, the owner of the venture capital is not the manager of it, thus the problem of principal-agent relationship comes into being. Because both parts of the transaction are under the situation of asymmetric information, it is common that the adverse selection and moral hazard arise. In fact, inside the company of venture capital in China, what the principal and the agent really pursue is not the same thing at all. The principal or the government expects to make full use of venture capital to promote the development of high-technology industry greatly so as to realize the maximization of social welfare. While the agents, for their own interests, are more concerned about the stable profit they could gain at present or in future (Daniel, 1996). What is more, the agent gains the profits without undertaking the risks of failure. In such case, the government can take two steps to solve the principlal-agent problem, which are supervision and incentive. On one hand, the supervision can prevent the agent from doing harm to the principal and on the other hand the incentive can constrain the behavior of the agents by enlarging their cost of breaking the contract. In practice, the supervision includes many ways, e. g. to restrict the limit of the agent's right and to supervise the action of the agent by certain supervisory committee. And incentive can be done by bonus, shares, stock options, positional consumption, honor and some other ways. But these two kinds of measures have not been put into practice inside the venture capital institutes in China, which results in the low effectiveness even no effectiveness. However, in America, the institution of LP (limited partnership) gives us a good example of how to coordinate the relationship between the manager and the investor. LP undertakes limited responsibility, supervises the behavior of the GP (general partnership), but is not involved in the day-to-day management. As for GP, it is concerned about the future profits of the fund and bears unlimited responsibility of law and property at the same time (Liu, 1998).

3. Lack of effective mechanism of supervision

It is known that venture capital runs with great uncertainty. The agreement reached between the venture capitalist and venture-backed enterprise is somewhat a contract of uncertainty. In view of this, urged by the desire of getting money, high-technology enterprises that own much private information will usually hide the potential problems and enlarge their advantages. This kind of situation of highly asymmetric information will certainly bring about the problem of adverse selection. Apart from it, due to the unpredictability, it is impossible for the venture capitalist to list all the events that will happen in the future. This is why many venture capitalists remain very active in the firm's management to prevent the opportunism of the managers. On the other hand, monitoring the implementation of contract costs a lot. Without proper incentive mechanism, how can we encourage the management to carry on supervision? Without effective supervision mechanism, how can we cut down the running risk of venture capital? Therefore, setting up an effective mechanism of supervision is put forward as a most important strategy for venture capital companies in China.

4. Lack of satisfactory running mechanism

As mentioned above, the venture capital company needs an entire set of inside running institutions. And it should have the capability of appraising risks of venture projects reasonably so as to draw sound strategies to reduce risks. After several years of practice, western countries have developed the comparatively perfect running procedure and reasonable system of project valuation. The running process is made up of many stages including investigation, valuation and negotiation, reaching agreement, supervision, etc. And valuation models can do the project valuation system. Generally, these models include many indexes. The indexes cover almost all aspects of the company (the scale, the market, the enterprise culture, the quality of the entrepreneur, the management-labor relationship, the organization structure, and so forth), which are changing day by day in New Economy (Jin et al., 2001). In contrasting to this, venture capital in China lacks both perfect running mechanism and sophisticated venture capitalists. In a few words, the defect of the running institution in a venture capital company lies in the defect of the running process and project valuation system.

SUGGESTIONS: INNOVATING INSTITUTION OF VENTURE CAPITAL IN CHINA

Now we can draw the conclusion that the institutional defect of venture capital has greatly hindered the development of venture capital in China. And compared with overseas venture capital institutes, those in China are so small, weak and chaotic. Facing sharper and sharper competitors coming into China, what we should do is to develop the venture capital of our own, innovating the institutions to sustain themselves in the world marketplaces. On this account, some efforts are recommended below.

1. Weakening government's function of supplying capital but strengthening its function of supplying institution

It has been proven by practice that the government's overdoing in venture capital will cause rent-seeking and ineffectiveness (Li, 2000), because the government should be the "gatekeeper" and "judge" in economy but not other matters. From now on, we should weaken government's function of supplying capital but strengthen its function of supplying institution.

The government should change its role from main venture investor to equity partner and at the same time private capital should take the main position in this field. The government should provide institutions, as public products, to overcome the "market failure". Here, we should clarify the property right as the first step; otherwise, there must be coming problems in the running cycle of a venture capital company.

2. Innovating the financial system of venture capital industry

First, to accelerate the innovation of the financial system of venture capital, we should let private capital enter the venture capital industry. According to statistics, the deposits of residents rose to 6000 billion RMB in 1999. These owners of private capital have clear property rights and strong desire to increase it. Absorbed as major fund of venture capital, private capital will surely be of much help setting up an effective running mechanism of venture capital. Second, we should implement a deregulation policy, let insurance funds and pension funds enter the venture capital. In fact, in developed countries, insurance funds and pension funds played important roles in venture capital. Third, the banks should improve their traditional business and valuation system to sustain the development of promising SME. Finally, we should introduce foreign venture capital into China, learn from them at the enterprise level and foster sophisticated investors of our own.

3. Setting up and perfecting the mechanism of exit for venture capital

(1) Set up a second stock exchange second board as soon as possible. As we have known, the second board is the main exit of venture capital, which differs a lot from the main board in many aspects, such as the requirement of revelation, the process of due diligence, the rules of trading, etc. Foreign countries and districts have already set up their second board, such as NASDAQ, AIM, GEM, EURO-NM and so on. We should set up the second board of our own and make it perfect gradually.

(2) To establish the property right markets for venture capital enterprises. Although the second board is the major exit for venture capital, it is impossible for all of the venture company's equity to be traded in the second board. So it is worth establishing share exchange markets especially for venture capital enterprises in property right exchange markets (i.e. OTC market).

(3) Improving the business quality of intermediaries and standardizing their actions. Only when all those mentioned above have been done, can we set up the complete exit channels for venture capital in China.

4. Promulgating venture capital law as soon as possible

Although China has issued some laws, say, "Law of Securities", "Law of promoting the transformation of technology fruit, PRC", none of them was made especially for venture capital. Thus venture capital loses the base of law in its operation. We suggest that laws on venture capital should be issued as soon as possible and specific rules of its management should be made in advance. All these rules, concerned with tax, limit of capital, share exchange etc, should be different with those of general companies. For instance, favorable tax policy should be implemented to promote the development of venture capital in China.

References

Coase, R., 1990. The Enterprise, Market and Law. Shanghai Shanlian Publishing House, Shanghai, p.23 – 45.

Daniel, W. Browmly, 1996. Economic Interest and Economic Institution. Shanghai Shanlian Publishing House, Shanghai, p.176 – 178.

Jin Xuejun, Yu Jinjin, 2001. The effect of knowledge economy on the management and labor relations. *Journal of Zhejiang University (SCINECE)*, **2**(1): 114 – 118.

Li Haihong, 2000. The Government and Market on the Development of Venture Capital, Investment Research (5th, ed.). p.30 – 34.

Liu Manhong, 1998. The Venture Capital: Innovation and Finance. People's University Publishing House, Beijing, p.315 – 317.

Masahiko Aoki, 2000. The Information and Governance Structure in Silicon Valley. Economy Publishing House of China, Beijing, p.178 – 180.

North, Douglass C., 1988. The Rise of Western World. Xueyuan Publishing House, Beijing, p.45 – 67.

North, Douglass C., 1989. The Property Rights and the Country, Reform and Development (2nd, ed.). 480p.

Shen Lijun, 1999. Venture Investment: operation, mechanism and strategies, Shanghai Yuandong Press. 270p.

Venture Capital Research Team (VCRT) of Ministry of Science and Technology of China, 2000. On the Situation and Strategy of Venture Capital in China, Chinese High Technology Industry Newspaper, July 5, p.1.