The Big Read Chinese business & finance

How China has ‘throttled’ its private sector

Venture capital finance has dried up amid political and economic pressures, prompting a dramatic fall in new company formation

Eleanor Olcott and **Wang Xueqiao** in Suzhou SEPTEMBER 12 2024

For a place devoted to advancing knowledge of the human body, there are few signs of actual life in BioBay, a science park in Suzhou west of Shanghai.

In a five-storey tower that houses biotech and pharmaceutical start-ups, the only sound is a generator whirring away in the depths of the building.

Scores of its tenants have either moved out or closed down, and a funding crunch that has hit the sector means many offices have been left vacant. Opportunistic dealers emerged to snap up cheap computers and lab equipment to sell on in Malaysia or Indonesia, leaving their business cards scattered around. Many offices are caked in dust.

BioBay said it was "hoping to sublease" the empty spaces to new companies, but the lifelessness of the state-run park, once celebrated as a shining example of China's strides in cutting-edge science and technology, speaks to a broader trend in the country's venture capital industry.

"China used to be the best VC destination in the world after the US," says one Beijing-based executive, referring to the business of private investment in high-risk start-up companies.

Founders and investors harbour few hopes of a return to the glory years before the Covid-19 pandemic, when the likes of Alibaba and Tencent took advantage of rapid economic growth and the rise of the mobile internet to become globally significant technology companies.

"The whole industry has just died before our eyes," the executive continues. "The entrepreneurial spirit is dead. It is very sad to see."

The downbeat mood is reflected in the statistics. In 2018, at the height of VC investment, 51,302 start-ups were founded in China, according to data provider IT Juzi. By 2023, that figure had collapsed to 1,202 and is on track to be even lower this year.

Keyu Jin, associate professor at the London School of Economics, says the industry “has been critical to spur China’s entrepreneurial dynamism”.

“The outflow of global investment and the massive drop in the valuation of Chinese companies will impinge on the nation’s innovation drive,” she warns.

The crisis in the sector partly reflects the slowdown in the Chinese economy, which has been buffeted by the protracted Covid-19 lockdowns, the bursting of its property bubble and the stagnation of its equity markets. As bilateral tensions have risen, US-based investors have also largely pulled out.

But it is also the direct result of political decisions taken by President Xi Jinping that have dramatically changed the environment for private business in China — including a crackdown on technology companies regarded as monopolistic or not attuned to Communist party values, and an anti-corruption crusade that continues to ripple through the business community.

Desmond Shum, author of *Red Roulette* and a former real estate mogul, says the

Desmond Shum, author of Red Roulette and a former real estate mogul, says the party “has throttled the private sector”.

“Successful entrepreneurs . . . can expect to be closely monitored, unable to transfer money offshore and their transactions and public statements scrutinised,” he adds. “Their money is the country’s money.”

A building housing start-ups west of Shanghai is largely deserted after scores of start-ups housed there moved away or closed

The state-run park was once celebrated as a shining example of China’s strides in cutting-edge science and technology

The FT spoke to 11 executives at VC firms, including from state-run and private funds, as well as industry experts, academics and entrepreneurs. Most did not wish to be identified, as they are not authorised to speak on behalf of their investors, but all painted a bleak picture of what, at its peak, was the world’s most dynamic and cut-throat market for founders.

“Five years ago, the venture capital and private equity guys were masters of the universe. They were the most optimistic people in China,” says one industry insider.

“Now they’re depressed. You don’t see them any more.”

Founders like Jack Ma at Alibaba and Pony Ma at Tencent — the two are unrelated — inspired a generation of Chinese entrepreneurs seeking to mint a fortune by taking their companies public.

By the final quarter of 2020, the two companies were worth a combined $1.5tn.

That dream started to crumble in November 2020 after Beijing cancelled the IPO of Ant Group, a fintech company carved out of Alibaba, just two days before its shares were due to begin trading.

Jack Ma was hauled in by the authorities for what were termed “supervisory interviews”, kicking off a wider crackdown on the technology sector that underscored the unpredictability of investing in China.

Since then, the optimism that fuelled a generation of risk-taking entrepreneurs has been systematically eroded. “There is no good reason to start a company,” says one serial founder in Shanghai. “Why should we take the risk? We have had five years of lost start-ups.”

Many start-up companies sold equity to investors on the basis that they would buy back those shares if they did not list on the stock market or get acquired by a certain date. But a wave of failures has led VC firms to try to claw back assets from their insolvent investee companies through the courts.

> **Today, VC firms have to explain to the state why their companies failed and why they have lost the country’s money**

Chinese business publication Caixin reported in August that the country’s leading state-owned VC, Shenzhen Capital Group, has filed 41 lawsuits since 2023, of which 35 were against companies that had largely failed to go public by a set date and had not repurchased shares.

Executives in the sector say that while such redemption clauses have been commonplace for years, especially in renminbi-denominated funds, few of them were enforced because there were always enough lucrative successes to more than cancel out the failures.

That calculus has changed, say several sector executives, who now find themselves under pressure from external investors — known in the industry as limited partners or LPs — to return capital. As a result, one Beijing-based investor says the sector has “turned into a debt-chasing monster”.

In most cases, firms know there is little hope of reclaiming their investment. “We know that few of the founders have the means to pay us back, but we need to show our government LPs that we have made an effort to get their money back,” adds another Beijing-based executive at a renminbi-denominated fund.

“You do not want to be accused of losing the government’s money,” says a third executive.

VC firms have laid off investment professionals and in some cases replaced them with lawyers or former judges to enforce the repayment terms. At law firms such as DeHeng and Zhonglun W&D, teams that previously worked on IPOs and buyouts have pivoted to advising on redemption clauses.

New start-ups face even more onerous terms. Two executives at renminbi-denominated funds, whose LPs are primarily local governments, say that it is no longer enough that the company is on the hook for repurchasing shares; founders must take personal liability for the debt.

“We require our founders to put their house and car on the line. In this market it is mandatory,” says one. These strict requirements mean the fund has had to reject good investments — including one profitable company with strong growth and customers — because the founder refused to be personally liable for the loan, the person adds.

Another executive at a state-run fund that invests in early-stage start-ups, says they have started checking founders’ assets, including bank deposits and property, to ensure they have the means to buy back shares.

Several firms have complained about their inability to track down founders who closed their companies and left China. To mitigate this, the executive at the state-run firm says founders with US citizenship now have to hand over the company chop — a rubber stamp widely used in China to authenticate documents — when a funding deal is signed, meaning the investor can take over if the boss flees.

Plaintiffs can ask the courts to impose restrictions on founders whose companies have reneged on their obligations, making it difficult for them to travel or find new jobs in China.

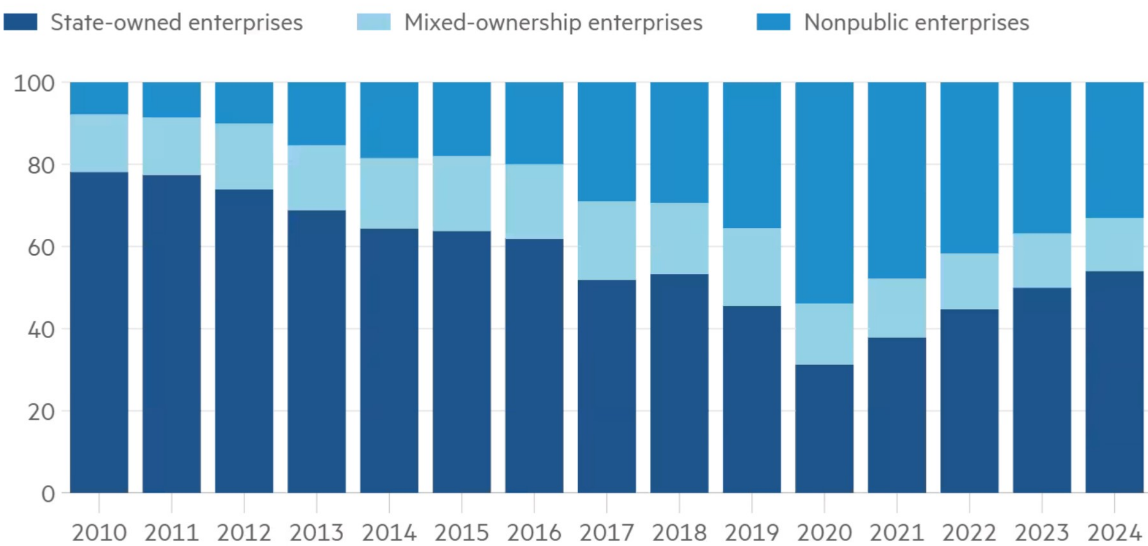
The pool of capital that VCs can tap into is also shrinking.

Foreign investors, wealthy Chinese, and corporate investors have been divesting or reducing their exposure to China, leaving state-backed players with an outsized role.

"In the past, US limited partners looking at Asia only wanted to meet China funds. Other markets like India struggled to get their attention," says one investor. "Today, we are like lepers. They don't want to touch us with a 10-foot pole."

China's private sector has been losing ground to state-owned enterprises in recent years

Share of total market capitalisation of top 100 listed firms, by ownership (%)



End-year values except 2024 = June
Source: Peterson Institute for International Economics

Three separate venture capital executives estimated that state-run funds now accounted for around 80 per cent of capital in the market. "The state is taking over the industry in an age of anti-corruption," says one Chinese expert on innovation, who declined to be named. "It is contradictory to the VC spirit of engaging in high-risk and high-potential ventures."

"In a portfolio of 10 companies, you would expect one or two to be a mega success and the rest to die. But now VC firms have to explain to the state why their companies failed and why they have lost the country's money," the expert adds.

Limited partners are also increasingly requiring fund managers to guarantee returns, creating a bias towards lower-risk investments. Two executives at renminbi-denominated funds say state LPs had over the past couple of years asked fund managers to guarantee annualised returns of between 6 and 8 per cent.

In the past, US limited partners looking at

Several firms say they are now mostly looking at companies in manufacturing, regarding them as less risky. In 2023, advanced manufacturing companies

Asia only wanted to meet China funds. Now they don't want to touch us with a 10-foot pole

working on new energy, integrated circuits and new materials accounted for over 30 per cent of start-ups founded, according to IT Juzi — a marked change from previous years, when biotech, consumer technology and education topped the charts.

Beijing's efforts to cut what it views as excessive salaries in finance have also reduced the incentive for high-risk but potentially high-reward investments. State limited partners have either mandated that fund managers either cap their salaries at the Rmb2.9mn (around $407,000) annual limit that has been more rigorously enforced this year at state-backed financial institutions, or slash management fees by half, according to several people with knowledge of the matter.

Many funds are downsizing. Source Code Capital, an investor in ByteDance, let go of 50 of its 150 staff last year, while the big-name funds HongShan (formerly Sequoia Capital China) and Hillhouse have also cut back their China offices, according to people familiar with the matter.

Source Code, HongShan and Hillhouse declined to comment.

The person at the renminbi-denominated Beijing firm says that bosses are either laying off staff, reducing pay or creating working conditions that are so unpleasant that people leave voluntarily, thus avoiding the need for expensive severance payments.

"This industry used to be a 10,000lb gorilla. Now we're slimming down to the size of a chimpanzee," says another executive based in Shanghai.

The rapid contraction of an industry that helped make China a technological superpower will hamper future innovation, experts say.

Sebastian Mallaby, a senior fellow at the Council on Foreign Relations and the author of a book on venture capital, says "the debt mindset" that has taken hold means "fewer experiments in cutting edge science and technology that could push China to the technological frontier".

Jin, at the LSE, says it is not just the amount of capital "but the strategic expertise of investors, their global connectivity and managerial knowhow that benefit these companies".

Even sectors outlined by Beijing as critical to national security are now struggling to attract investment. Financing for biotech and pharma start-ups fell by 60 per cent in 2023 from its 2021 peak of Rmb133bn, according to IT Juzi.

Entrepreneurs are increasingly building companies without raising outside capital, rather than agree to onerous terms. "There are still founders doing start-ups. But they are literally bootstrapping the company, borrowing money from friends and family or taking out loans," says the Shanghai-based venture capitalist.

He added that a lot of these entrepreneurs are catching the wave of cross-border ecommerce, using Chinese manufacturing prowess to build cheap consumer electronic products that then sell on Amazon, Shein or Temu.

Pedestrians in Shanghai's Lujiazui financial district. Investors have been divesting or reducing their exposure to China, leaving state-backed players with an outsized role © Qilai Shen/Bloomberg

While a funding chill has hit most areas of tech, several venture capitalists mention humanoid robots and electric flying vehicles as two areas gaining traction, after Beijing singled them out for support in recent policy documents.

But several say the path to monetisation remains elusive. The robots are still far from replicating human dexterity and speed, while the Chinese military's strict control of domestic airspace precludes the widespread commercial adoption of flying taxis.

flying taxis.

Many of the funds that emerged during the rapid growth of the 2010s are now looking overseas and trying to convince their investors that they have the skills to make money outside their original market.

HongShan, Hillhouse Investment, 5Y Capital, ZhenFund, DCM Ventures, Linear Capital, Shunwei Capital, Genesis Capital and Qiming Venture Partners have either increased investments overseas or are more actively scouring markets like the US and Europe for deals, according to public filings and multiple people familiar with the matter.

Linear Capital founder Harry Wang acknowledges there are still VCs "trying to piece together the best offerings from different countries" for collaborative innovations. The other firms did not respond to requests for comment.

Another executive in Shanghai says "people are voting with their feet" and questions whether China venture capital will ever come back.

He adds that he has little option but to remain given his team and investments are all in China. "I am like the Titanic, flying the flag as the ship goes down."

Additional reporting by Ryan McMorrow in Beijing