



Venture Capital in China: David Chao of DCM (Part 1)

August 4, 2009

David Chao is the co-founder and general partner of DCM. He has been active in the information technology industry since the 1980s. At DCM, he guides portfolio companies in formulating corporate and product marketing strategies, developing strong management teams and implementing domestic and international partnerships.

SM: Let's start by talking about your background. What experiences have shaped your thought processes?

DC: I am ethnically Chinese. I was born and raised in Japan. By definition I am a Chinese/Japanese, but I came here for high school and college, and did work between college and business school in both Japan and Asia. I am a product of three cultures. I am a Chinese/Japanese/American.

SM: When you were growing up in Japan, what was the relationship between the Chinese and the Japanese?

DC: Chinese in Japan are more like model minorities, very much like the way Asians are treated in the US. We tend to be shielded from the worst of the discrimination faced by African-Americans and Hispanics in the US, but we still get our fair share. In Japan most of the discrimination is towards Korean/Japanese, so the Chinese/Japanese get shielded a little bit, but then we get our own fair share. Being a Chinese in Japan is like being an Asian-American.

SM: It reminds me of a funny story. I had a client who had put a Korean guy as the head of Japan [operations]. I remember thinking, 'Why would you do that?'

DC: Although times have changed a lot, that would really depend on the industry. High-tech might allow it. I think that culturally there are times when I think I am Japanese, times when I think I am Chinese, and times when I think I am American. I am sure you go through this too.

SM: Mine is like 50/50 India and the US, with a pretty strong European influence as well. Those backgrounds shape us.

DC: Yes. It is pertinent to my career because I graduated in 1988. In October of 1987 we had Black Monday. I had a bunch of Wall Street jobs lined up and all the offers were rescinded. I

went back to Japan and worked for a company called Recruit, which is one of the largest advertising companies in the world. I then worked for Apple in Japan and later Cupertino.

I then decided that I wanted to go to business school. I was originally in a six-year med program at Brown, but I left that program because there was a bug in me to do something else. My family are largely entrepreneurial in Japan. Chinese living in Japan, particularly in my parents', uncles', and aunts' generation, could not get a job working for Sony or Toyota so they had no choice but to be entrepreneurs. They are a bunch of doctors, lawyers, or restaurant owners. It is very similar to the roles Jewish Americans and Italian Americans had to have when they came to the US.

For me to go to business school was different for my family. They did not know what it was about. My uncles would beat me up at Christmas when I would go back to Japan. They would ask me why I had to pay money to learn business. I have always had the black sheep thing going on.

I graduated from business school in the middle of the Gulf War. I was lucky enough to work at McKinsey in San Francisco and did projects in Asia as well. In January of 1995 there was the famous Kobe earthquake. My parents lived in Kobe. At the time I was in Vancouver working for a McKinsey client, and I flew back to Osaka. It normally would take an hour to go from Osaka to Kobe, but it took me 13 hours. It was three days after the earthquake and I had to go back because nobody could verify that my parents were alive.

That bus ride really changed my life. I was exposed to a lot of entrepreneurship because of my immediate family. I just kept looking at myself and I realized I had only worked for large companies. I had always wanted to be an entrepreneur but in so many ways I was comfortable being on a track. Luckily my friend saw my parents in a shelter on TV, so I knew exactly where to go. I was able to find my parents. At the end, however, that 24-hour process changed my life.

I kept saying, "If I were here, there is a 50/50 chance I would have died". When you talk to survivors, they talk about the regrets of the things they did not do while they were alive, as if they had died. That is when I realized I had to go do something. I could not stand on the railroad track any longer.

Venture Capital in China: David Chao of DCM (Part 2)

Thursday, July 30, 2009

SM: What was your next step after deciding that you could not stand on the railroad tracks any longer?

DC: I immediately resigned from McKinsey and started a company called Japan Communications Inc with three other co-founders. It is the first and largest mobile virtual network operator in Japan. It is a public company that is today in the \$200 million to \$600 million market cap range. While we were doing that company my wife and I had our firstborn son. She wanted to raise the kids in the US so we came back here.

My co-founder, Dixon, was an angel investor in Japan Communications. We got to know each other and lived in the same neighborhood in San Francisco. He had plans to raise a small venture fund and we decided to finish that up together. That is my history up to DCM.

SM: When did you start DCM?

DC: We started in 1996. Our first investment was a company in Japan which was the second round of Japan Communications Inc. I think that really put a stake in the ground for who we are and what we do. In 1996 the rule in Silicon Valley was to invest in companies within a 35-mile radius. By making that first investment while I was in Japan, we were a very different animal.

Our fundamental thesis was that we would invest in good technology companies and we had a definite affinity to good communications equipment companies as well as Internet companies. Those were companies like Foundry Networks, About.com, and network equipment companies like iPivot. Those were all companies we funded with the first fund.

We were also investing in Japan and China. We started investing in Japan in 1997. I was looking into China for two years before we made the first investment. China in 1999 was a bizarre thing to do for multiple reasons. The US market was so hot between 1998 and 2000 that very few people were getting on a plane to look for international deals.

The other thing that was interesting was that because of my background as an “overseas Chinese”, I was quite welcomed when we were looking at deals. One of my classmates, Hurst Lin, who is now one of our general partners in our Beijing Office, was the co-founder and for eight years the COO of SINA.com, which is the Yahoo! of China. We would ping each other during that period and it was quite obvious that things were also happening in China.

In 1999 there was a period during which entrepreneurs would come and say “Here is the price, take it or leave it in the next two days”. It was a great time to go to China because access to capital for entrepreneurs there was more limited.

SM: Was there access to capital for Chinese entrepreneurs at that time?

DC: Yes and no. The venture capital market in China has really only opened up in the mid 1990s. Business law came into effect in China in the late 1980s. The gates to do business really opened up in the early 90s. There was not very much access to capital. IDG was there in the early 1990s, but that was a slow process. There were firms like Walden and WI Harper that originally did a lot of Taiwan deals and then did a deal or two on China. In 1999 we made an investment in 51Job, which is the Monster.com of China.

SM: How did you find that deal?

DC: One of the founders is a CFO. Her name was Kathleen Chen and she was at a conference in the US. My partner Tom and I thought it was a good space for China. Recruit, the company I used to work for in Japan, was the largest offline and online HR advertisement company. I knew the space fairly well.

We visited the company in Shanghai and did a little bit of due diligence. We really liked the CEO and we decided to go for it. They were not the top company in the space, they were

probably number three, but they had the best team. They had the best strategy by far which was to combine offline and online. In 2004 they went public and went as high as \$1 billion-plus in market cap. We sold our position when they were around \$800 million market cap. Today it is hovering at \$300 million to \$400 million. We realized about \$250 million in return. We had invested about \$14 million. It was a big home run for our firm.

The first wave of Chinese IPOs were SINA, NetEase, and Sohu, which occurred in 2000. The bubble crashed and then the second wave was companies like 51Jobs and Shanda. They are either game companies or verticals.

It is really after 2005 that many firms in the US started paying close attention to China. That came in two flavors. There are companies like us who are long term and serious. There were a whole batch of companies who realized that the US market was not doing well and felt that a China strategy would look good on paper and help them raise money. That is the history of how we got started.

Venture Capital in China: David Chao of DCM (Part 3)

Friday, July 31, 2009 |

SM: What percentage of your deals are China or Asia deals?

DC: Today it's 40% to 45%.

SM: Does your Asia strategy include India?

DC: It is largely Japan and China. We do selective, opportunistic deals in Korea or India. We do have a deal in Korea right now. At the end of the day, venture capital is not the world's most scalable business. We felt that having strength in Japan, China and the US would allow us to be in the three largest GDPs and IT markets in the world. We felt that would allow us to get the most leverage.

If you look at the market caps of the top 30 Internet companies in the world, in terms of numbers it is fairly equally divided between the US, Japan and China. By market cap the US is 50% of that. China and Japan at 25% each. Overall, 96% of the top Internet companies in the world are in the US, China or Japan. It made a lot of sense for us to focus on those three.

SM: Given where you are today, and having seen China evolve over the past 10 years or more, what do you see in terms of sectors evolving and entrepreneurs maturing?

DC: The first time I went to China was with my father. He used to trade medical equipment between China and Japan. I went there in 1987 and what I saw was what most people still imagine China to be: a bunch of bicycles being driven around. It was quite clear back then that everything was about fundamental infrastructure. There was not much of the technology that you see in the Valley or in Japan.

I personally feel that when you look at the field of IT, the real pioneer and entrepreneur of that sector is Chairman Liu of what is now Lenovo. He did a pseudo-joint venture with the

government and started what is now the world's second-largest PC company. Those were different times, however.

SM: What year did he start?

DC: It was in the early 1980s.

SM: Was the government playing the role of venture capitalist?

DC: Most of those projects back then were inter-related with the government. From the pure venture capital perspective, as we know it in the Valley, the first wave occurred when SINA and NetEase went public in 1999. The entrepreneurs of those companies are now returnees. In China they are called turtles, because turtles go out, lay eggs, and then come back again.

If you look at the first 10 China IT companies that went public, almost all of them are returnee CEO companies. Today that ratio is down to 50%–60%. The first wave was all the sea turtles. The second wave, which is now reaching another peak, is being driven by a mix of sea turtles and local entrepreneurs. In the past, the only way for these companies to exit was NASDAQ or a Hong Kong exit. Local entrepreneurs, while they would still like to go public on NASDAQ, now have a strong domestic market. Going public in Shanghai is now a good option, maybe even better. The market is changing from the sea turtle generation to the second generation, which is a mix of the two.

Long term, what we will see are local entrepreneurs dominating over time. There will still be room for people who go to Japan, Europe or the US to be educated.

Venture Capital in China: David Chao of DCM (Part 4)

Saturday, August 1, 2009 |

SM: I am intrigued that I have not heard you speak about bootstrapped entrepreneurship in China. It has been a very strong outsourcing destination for the manufacturing industry for several decades. There must have been a solid bootstrapped entrepreneurship ecosystem during that period, right?

DC: In China there is a whole other world of traditional businesses. These are bicycle factories, solar panel factories, and other manufacturing facilities. There are tons of bootstrapped companies that have done well and gone public abroad and domestically.

That sector was not really a focus for venture capitalists until 2007. The margins are low, along with all the traditional reasons venture capital should not go into those kinds of businesses. However, the rising tide lifts all boats. Your economy is rising 10% year after year, plus you have a booming local stock market. One of the great things about venture capitalism is that worldwide, people are greedy. Instead of investing in a good technology company that will take seven years to gestate, why not triple your money quickly by investing in a bicycle factory or a lettuce farm?

Those are the kind of deals that many VCs, including some very good US brands, started making in 2007 and 2008. Obviously the market crashed last year, so traditional businesses' return expectations have gone down significantly. But there was still that two-year period during which everyone went crazy over these traditional businesses. Many of them were companies that had bootstrapped for a long time and built themselves over a period of years.

SM: What is the story of the semiconductor manufacturing industry?

DC: Long term, everyone knows that China will be a major player. The result so far is a big question mark. In China, SMIC was the first modern fab. We were investors in it and we exited with solid profits. What is interesting is that there are lots of old generation fabs in China, not the cutting-edge 45nm, but the 13's and 25's. Many of them are also older IBM or Motorola fabs that were made years ago.

The issue is that those older fabs are no different than any other factory. They add value from a volume perspective but not from a technology perspective. The US has a lot of restrictions on sending cutting-edge semiconductor technology from the US to China. One of the challenges fabs in China face is how to get the best equipment to be ahead of the curve. Even today, the best fabs in China are a half generation behind the cutting edge in the US.

There is also another ecosystem, the professional service side, which in China is not as mature. There are always IP issues as well. Taiwan has its own issues around that. Is China on a good trajectory in the semiconductor industry? Yes. Has it caught up to Taiwan? No, and it probably won't for another 10 to 15 years.

The other side of semiconductors is fabless chip design. I think that on the digital side China is one generation behind. On the analog side we have a company called Analogix, which makes HDMI and display port chips. The CEO is a Chinese guy who started the company in the Valley but 80% of the employees are in Beijing, and he lives on an airplane back and forth. Is that a China deal or a US deal?

Venture Capital in China: David Chao of DCM (Part 5)

Sunday, August 2, 2009 |

SM: India has remained the IT back office. The best product company out of India is Zoho, which did \$60 million last year as a fully bootstrapped company. That seems to be the best India has done in terms of product and innovation.

DC: We were the seed and first investors in Sling Media, which has three founders, one of whom is Bhupen Shah. We had our entire R&D center in India. Sling sold \$40 million in the first year and we sold it to EchoStar in the second year. It was definitely a major consumer electronics product and was sold for \$400 million. It had a huge Indian operation.

SM: That model is very common. The architecture and key design decisions were done in the Valley, so the innovation is truly in the Valley. Where is the innovation at in China?

DC: Five years ago there was almost zero deal flow on technologically innovative companies. Now it is about 9:1. Out of every ten deals we see, one is reasonably innovative. In the US it is nine innovative businesses and one copy cat.

Do I have faith that the 9:1 will become 7:3 in the next 20 years? I do. It has largely to do with the fact that the VPs of companies today are locals to China and will one day start their own companies and be architects of the next generation. Consumer electronic giants will continue to emerge, and they are going to have their own R&D. They will go through the same cycles the big Japanese companies went through.

It will not be as fast as people think it will be. There are a couple reasons why. Compared to Japan it will be a bit faster because culturally, Chinese are more entrepreneurial than Japanese society. At the same time, Japan took 20 to 30 years. It will still take China 10 to 20 years.

SM: Was Japan really going through the same phenomenon? It was a bit far back.

DC: A lot of people forget there was a point in time when every car on the road was a Cadillac and every memory chip was National. Over time companies like Toshiba and Honda emerged. Honda is an entrepreneurial company. They were pushed by the government to not do cars, but they did it anyways.

I think we have a very western notion and historical bias that everything the US did was fundamentally innovative. An article from the 1860s I read was really interesting. The British were complaining about this barbaric place called America where people copied and violated every patent on cotton farming, railroad engineering, and everything scientific. If you change the name from Britain to the US, and the US to China today or Japan in the 1960s, it would be the exact same phenomenon.

We tend to make the US into realm of absolute innovation. It may be that to a degree in the tech space, but even the world's first cell phone was a European invention. With that background in mind, when you look at Japan, it has certainly innovated by making things smaller and more portable.

SM: Which is huge innovation and a complex engineering achievement.

DC: I think that culture exists today in Japan. They have an innovation engine. What is the one core competence that China has which will drive innovation? One answer is scale. We are investors in a couple of big Internet companies. China has the largest number of Internet users already. We are investors in Xiaonei.com, the Facebook of China. Softbank recently invested \$400 million in this company and we dominate in the student and white-collar market.

If you combine the mobile access and people getting into the system, and the database 51Job has for employment opportunities, the numbers of the largest player in Japan or Monster.com look like peanuts. When you dig into how they do it and architect it, they have an ingenious way of making it really cheap. They are not buying AS400 or expensive Sun/Unix machines. They are innovative at working on a shoestring budget.

Right now people do not see that as much. My hunch says that in the future anything that has to do with scale, that works, and has a good product will likely come out of China or even India. That is how they are trained.

SM: It is scale and price. Those two countries cater to extremely price-sensitive markets, the kind that the western world has no experience of. That is where they have to come up with original solutions.

DC: I could be wrong, but I think there are definite innovations coming there.

Venture Capital in China: David Chao of DCM (Part 6)

Monday, August 3, 2009

SM: Seeing where it has been, where is innovation in China going?

DC: In the cellular space they did it right by relying on open technologies, and innovation will continue there. They did not have anything native, so they had to rely on Motorola and Nokia, as well as an OS like Symbian. That gave way to SMS, which became a global standard. PC penetration is still low, but mobile penetration is greater. Innovation will come as that penetration occurs in ways that helps people pay bills and live their lives.

Certainly there is potential around the design side of semiconductors. It is probably 10 years out there. On the Internet side the “me too” will continue.

SM: That is OK. Some degree of concept arbitrage on the Internet is good. All these verticals that are successful in the US have to exist there as well. If entrepreneurs do not see the obvious, then what the hell are they doing?

DC: There is one sector with Internet where I think China has done phenomenally and uniquely well. That is online games. If you look at the revenue generated by online games in China, they are larger than Internet advertising dollars. People can't afford to buy the Xbox, Wii or Playstation. People would rather go to Internet cafés, pay a dollar, and play an online game for a few hours.

The first generation of online Chinese games were licensed games from Korea. Over the next 10 years many of the innovative online games are going to come out of China.

SM: China now has to educate an enormous population in a different way than they have so far. It is becoming very clear that it would help the Chinese to learn English.

DC: We have one associate in the Beijing office who has never left China yet his English is incredible. In China there is no real historical reason for English being able to be learned natively, yet you have all these heroes and role models that learn English and benefit from it. China has an interesting dichotomy where on the one hand they feel as if they succumb to learning English they are admitting that the US is a superpower, but at the same time they are practical entrepreneurs and they know it is necessary.

Compare this to how English education is handled in Japan, where they teach kids grammar very early, yet they do not speak it very well. In China they have less to lose if they mispronounce a word. There are so many different dialects and accents in Mandarin and in China that people have a more open attitude towards butchering a word or two. China is like New York, as long as you can speak it they will accept you. Japan is like Boston. If you don't have that New England accent people will treat you a bit differently.

SM: What about education as a business opportunity?

DC: It is great. Vocational schools are on fire because not everybody gets to go to school. There are some schools focusing on Cisco networking certificates while others are about fixing cars. Partly because of the one-child policy, parents are willing to work hard and help pay for their kids' education. China has always had a history of making education important and scholars are celebrated culturally.

SM: Are you investing in anything in the education sector?

DC: We have one company, Oriental Standard, which helps outpace vocational schools to match them with jobs. 51Jobs has a training division that actually acts as these schools. That is our exposure to education. There are firms that do invest in the actual vocational schools.

SM: I think online education is underexplored from an entrepreneurial point of view.

DC: In Korea there was a school specifically for high school kids to practice and train for college applications, like a finishing high school. In Korea and Japan that is big business. A company in Korea took the best teachers from those finishing schools, put them online, and charged for it. It is a billion-dollar market cap company. There is a huge opportunity there for students who are too busy or remote to attend those classes in person.

Venture Capital in China: David Chao of DCM (Part 7)

SM: Was there something I should have asked you but didn't?

DC: I would like to add some thoughts on innovation. I think in certain cleantech markets, China might be ahead of the curve. There are fewer regulations in China. If Menlo Park were going to put a smart energy grid storage in place, residents would most likely vote against it. In China the government says it is going there and that's it.

I think that there will be some cleantech deployments that China might experience earlier and faster. Wind power is certainly in that sector, as is the use of LED lights to reduce energy requirements as China has energy restrictions. That may lead to innovation.

There are some very interesting areas in China today. E-commerce is finally booming. This is noteworthy because in the US e-commerce exploded at the same time as did Internet content. The infrastructure was not in China for that to occur, so content came first. People did not have credit cards or a UPS, but in the last year and a half it has exploded.

This is going to have an interesting impact in retail in China. In the US and Japan, good retail brands were not born online. In China there are brands which are capturing good market share which were born online.

Semiconductors are going through a down cycle right now, but I think they will come back. At the end of the day, when you have the largest scale consumer electronics company in China, demand for semiconductors will return.

I also think that social networking is going to play a unique role and will grow rapidly. Facebook opened its API, and you have SNS games on top of Facebook or Hi5. Until that opened up, developers in China could only make games for China. Now the floodgates have opened. There are game development companies in China making more money on Facebook games than domestically. If you look at labor costs in China and India, combined with the fact that these are not rocket-science applications, I can see a world where in three years the dominating players will be Indian and Chinese companies.

SM: My hope is that some entrepreneurs are going to use those principles and apply them to education. HotChalk is doing that and has created a social media community for teachers, parents and students. They have great traction. They are getting into schools without banging on the doors of school administrators.

DC: I think they absolutely will. I think MIT has almost all of their classes online. That is phenomenal. Kids will literally find ways to learn more there than paying \$5,000 to a community college. I feel bad for a lot of faculty around the world. It is a plus and minus for them.

SM: If they learn from the MIT faculty, they will be able to teach better. It is better than the blind leading the blind.

DC: Good ones will emerge and have a bigger audience. I completely agree.

SM: What kind of deals are you looking for these days?

DC: I have gone through the sectors we are looking at. We are looking more closely into Series A/C deals. In the last cycle when the bubble popped it was more tech-driven, and this one is more broad. Our portfolio is doing great because of our diversification. One of the interesting phenomena we encountered in 2002 to 2004 was that there were a lot of Series C/D being done at Series A prices. People think that is a great bargain, but our experience is that it is not the case. At the end of the day is the that team drives performance. When you have a group of really smart people who know they have to work incredibly hard for three to four years, and then they realize that they have to do it again for another three to four years, it is hard. We would rather focus on new ideas because it is all about how fresh and smart the team is.

SM: I have worked a lot of turnarounds during my consulting career and I know exactly what you are talking about.

DC: Some succeed, but you need 10 times the energy. Most fail.

SM: This has been a very interesting discussion. Thank you for taking your time.