



China's Innovation Advantage

Sramana Mitra, 08.07.09, 6:00 AM ET

In my efforts to gauge the state of entrepreneurship and venture capital around the world, I recently spoke with David Chao, general partner at DCM, about China. Chao belongs to a select group of early investors who started looking at China as far back as 1997, when Silicon Valley VCs would not consider deals beyond a 35-mile radius of Sand Hill Road.

"The venture capital market in China really only opened up in the mid-1990s," Chao says. "Business law came into effect in China in the late 1980s. 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 in China. In 1999, we made an investment in 51Job, which is the Monster.com of China."

51Job went public in 2004 and saw its market cap top \$1 billion. DCM sold its position when 51Job's market cap was around \$800 million and realized about \$250 million in return. "We had invested about \$14 million. It was a big home run for our firm," Chao reminisces.

It is really only after 2005 that many VC firms in the U.S. started paying close attention to China. That came in two flavors. There are companies that were long term and strategic investors in China. Then there were a whole batch of companies that realized that the U.S. market was not doing well and felt that a China strategy would look good on paper and help them raise money.

So what is going on in China these days in terms of innovation and entrepreneurship?

Chao poses a leading question: "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, 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 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. My hunch says that in the future anything that has to do with scale will likely come out of China or even India."

My observation: It is scale and price. Those two countries cater to extremely price-sensitive markets, the likes of which the Western world has not experienced. That is where they have to come up with original solutions. Think about the price point needed for chips and smart phones to be viable in the Chinese and Indian mass markets. I can tell you, it ain't the iPhone price point.

Chao agrees and adds: "There is one sector 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."

What about education as a business opportunity, I ask. "It is great. Vocational schools are on fire because not everybody gets to go to school," Chao says. "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."

Chao also thinks that China will breeze past the U.S. in clean-tech innovation. "There are fewer regulations in China. If Menlo Park were going to put a smart-energy grid 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 one, as is the use of LED lights to reduce energy requirements. That may lead to innovation."

Chao also observes a bright future for Chinese e-commerce. "E-commerce is finally booming. This is noteworthy because in the U.S. 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 on retail in China. In the U.S. and Japan, good retail brands were not born online. In China there are brands which are capturing good market share which were born online."

And finally, Chao also forecasts a boom in chips. "Semiconductors are going through a down cycle right now, but I think they will come back," he says. "At the end of the day, when you have the largest scale consumer electronics company in China, demand for semiconductors will return."

[Read my interview with David Chao.](#)

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