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Chinese tech faces an innovation reality check as the economy cools and start-ups stumble

Even after a banner year for venture capital funding, some investors predict that as many as 90 per cent of Chinese tech start-ups are doomed to fail

The sheer size of the Chinese marketplace is no longer enough to keep a struggling tech company afloat

Topic | China technology

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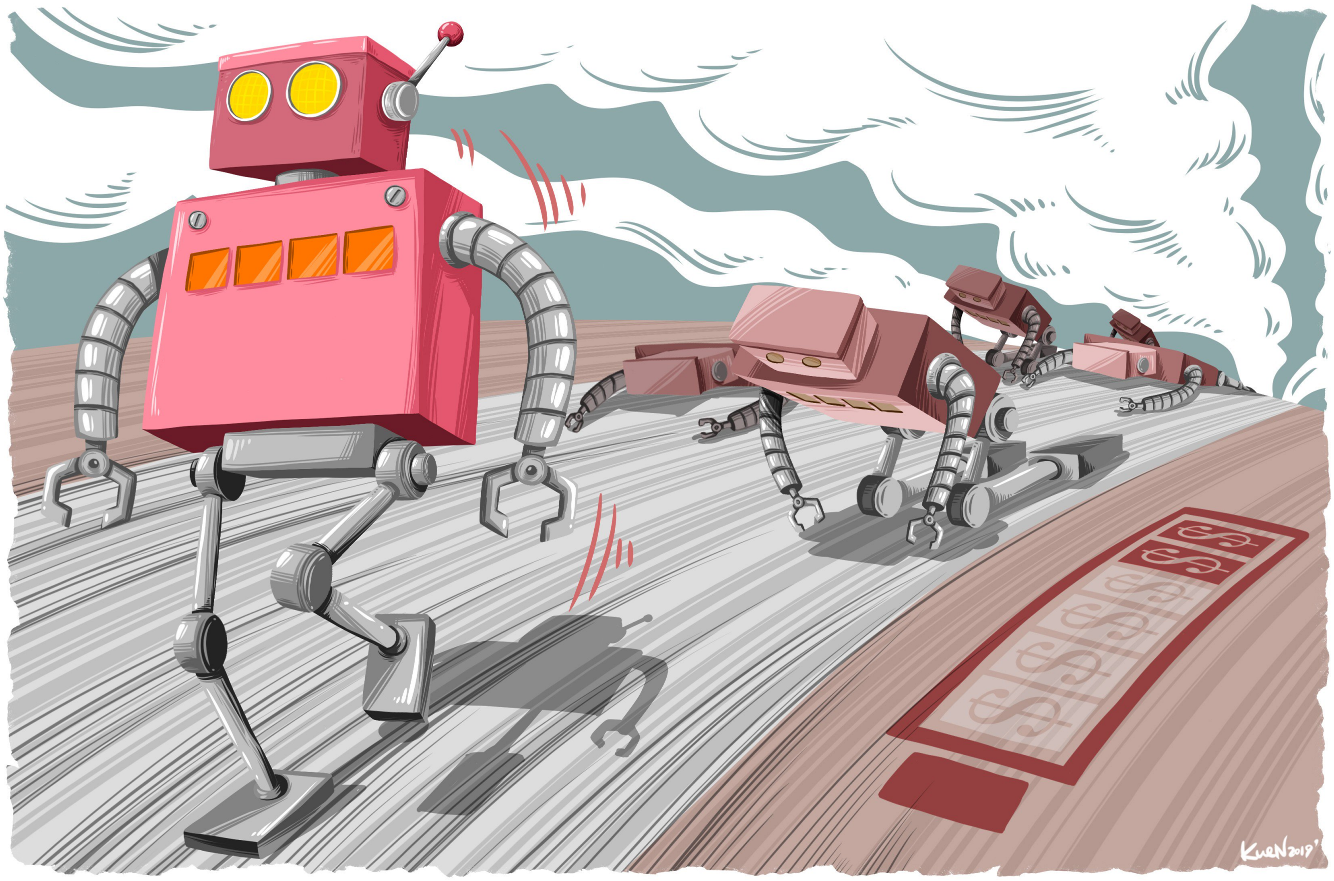

The slowing Chinese economy may be claiming some unexpected victims: without its robust engine, many tech start-ups relying on China's fast growth for success are being cast out.

Despite healthy capitalisation, investors are finding that some companies' underlying technologies may not be as innovative as hoped. And even after a banner year for venture capital funding in 2018, some investors predict that as many as 90 per cent of Chinese tech start-ups are doomed to fail.

"The market is going through a severe selection process," said Weijian Shan, chairman and CEO of PAG, a Hong Kong-based equity firm managing US$30 billion. "Only those with true technology and an understanding of risk control are able to survive."

The Chinese tech industry has impressed global investors since the dramatic rise of Baidu, Alibaba Group and Tencent in the past decade. Fearing missing out again, venture capital has been pouring into the younger generation of start-ups in hi-tech sectors such as e-commerce and financial technology, helping create a roster of Chinese unicorns – companies valued at more than US$1 billion – that dwarf those from other countries.

Alibaba is owner of the *South China Morning Post*.

Most Chinese start-ups had thrived, however, not because of cutting-edge technologies but through a business model that primarily built and sold everyday apps, from online payments to bike sharing, investors said.

Job-hopping in China's tech sector dashed by economy [1]

"To call the technologies world leading is an overstatement," said Jialong Liu, general manager of credit card business at China Merchants Bank, which works closely with online payment providers. "What made these enterprises successful has been the large Chinese market."

In other words, China still lacks the deep repository of innovation know-how for fundamental tech breakthroughs compared with countries such as Israel, Japan and the US.

As a weakened economy can no longer support start-ups as it did in the past decade, Chinese companies face a hard reality: stand on the quality of their technologies or fail. The moment of truth is dawning on an industry that has in recent years been touted as a miracle and a source of domestic pride.

The Chinese market is now experiencing what legendary investor Warren Buffett once observed: "It's only when the tide goes out that you learn who has been swimming naked."

Globally, tech innovation is seen as a powerful force that can thrust China into a role of technological dominance. The issue has since become a major concern for Washington and governments around the world that it helped trigger US President Donald Trump's trade war against China last year.

The US has attempted to thwart Chinese tech advancement through various means. The Trump administration blocked Alibaba's purchase of US payment service provider MoneyGram early last year and rejected the acquisition of US telecommunications company Qualcomm by Singapore-based Broadcom to prevent technological leaks to Beijing.

In the race to dominate the next-generation 5G technology in cellular communication, the US moved to cut off business with ZTE last year and sent the large Chinese telecoms equipment maker to the brink of bankruptcy.

The fierce competition has pushed Huawei, a 5G developer and the world's second-largest smartphone maker, into the spotlight's glare. The Chinese company and its US subsidiary are facing a slew of charges over alleged violations of US business sanctions. Its chief financial officer, Meng Wanzhou, has been indicted and awaits a Canadian court decision on her extradition to the US, while Europe and other parts of Asia are under pressure to sever business relationships with Huawei, with Washington citing espionage concerns.

Ironically, while much of the world is moving to contain China's tech ambitions, domestically, investors are questioning the nature of companies' innovations.

Cracks have begun to show, with a number of recent flops catching investors off guard. The once high-flying bike-sharing operator Ofo, whose short-lived success was fostered by the large Chinese population, is an example

The success of the bicycle-sharing company Ofo was short-lived. Pictured are Ofo bikes in a vacant lot in Zhengzhou, Henan province, in May 2018. Photo: Reuters

Founded by five cycling enthusiasts at Tsinghua University in 2014, Ofo's valuation shot up to US$1 billion less than two years after its launch in 2015. Membership rose to a whopping 200 million at its peak but the business model, which has high operating costs, could not be sustained. After pulling in as much as US$2.2 billion in venture capital and attempting an ambitious expansion outside China, Ofo pulled out of Australia, Austria, the Czech Republic, Germany, India and Israel in July and laid off most of its US workforce.

It left its lead investor, Alibaba, which led a US$866 million funding round only a year ago, Hony Capital and Citic Group holding the bag.

Some attribute Ofo's collapse to Mobike, a better-funded competitor that was launched the same year. But Mobike, bought by Chinese food-to-taxi app giant Meituan Dianping in 2018 for US$2.7 billion, is also in trouble. In early March, it applied to surrender its bicycle-sharing licence in Singapore, its latest attempt to pull out of overseas markets.

"We have seen too much capital chasing too few good ideas," said China Merchants Bank's Liu. "So when they saw a seemingly good idea, all the money rushed in and lots of it was lost quickly."

Comparing China and US unicorns

	China			US		
	No. of Deals	%	Avg. valuation (US$b)	No. of Deals	%	Avg. valuation (US$b)
Internet/eCommerce/O2O/Games	49	52.7	4.47	45	28.8	4.52
AI/Big Data/Robotics/Software	13	14	1.75	62	39.7	2.28
Fintech	7	7.5	3.11	16	10.3	3.87
Old economy	12	12.9	1.89	11	7.1	5.62
Hardware/Semi	5	5.4	4.21	6	3.8	4.26
Auto/Machine	3	3.2	2.86	2	1.3	11.25
Healthcare/Biotech	4	4.3	2.63	14	9	2.99
Total	**93**	**100**	**3.51**	**156**	**100**	**3.58**

Source: Credit Suisse estimates, CB Insights SCMP

Unicorns are companies valued at more than US$1 billion.

Other Chinese unicorns have also crashed. Aiwujiwu, an online property listings platform, ceased operations at the end of January and is being liquidated, according to news reports. Founded in March 2014, the firm had five funding rounds in 18 months, obtaining US$305 million and a valuation of US$1 billion. GGV Capital and Hillhouse were among the major investors.

Another online property platform, Pinganfang.com, founded by the Ping An Insurance Group in 2014, folded on January 11.

The collapse of Aiwujiwu and Pinganfang suggests that the "property plus financing plus internet services" business model may be failing in China, according to a March report by the research firm CB Insights.

Even in the most promising subsector, financial technology, or fintech, the ground is littered with victims.

Can China's tech industry innovate its way to leadership? [2]

Online lender Modai, which translates as "magic pocket", collapsed late last year and is being investigated by financial regulators. Individual investors who provided US$149 million are likely to get little or none of their money back.

Peer-to-peer lending platforms, which match people with money to spare with borrowers, have taken off in China and ballooned to nearly 3,500 lenders in 2015. By the end of 2017, there were more than US$167 billion in loans outstanding. Fraught with defaults and fraud, the entire sector has been turned upside down.

"Fintech has become this hot catchphrase," said Shan, the equity firm CEO. "But many companies that claimed to be fintech have turned out to be risky and fraudulent."

Even the largest growth companies are not immune. China's ride-hailing operator Didi Chuxing, which in December was valued at US$56 billion, reported losses in the hundreds of millions last year, and its planned IPO has seemed to fizzle.

Despite the failures, China continues to be the hottest area for venture capital. Overall, Greater China – China, Taiwan, Hong Kong and Macau – completed US$107 billion in venture deals last year, according to data provider Preqin. Seven of the world's 10 largest deals announced in 2018 were China-based companies.

In the biggest-ever fundraising by a private company, Ant Financial – the operator of Alipay, China's largest online payment system – secured US$14 billion in venture capital last June. Investors included such international heavyweights as Singapore sovereign funds GIC and Temasek; Malaysian sovereign fund Khazanah Nasional Berhad; the Canada Pension Plan Investment Board; and US private equity firms Warburg Pincus, Silver Lake and General Atlantic.

Venture capital deals completed in China with company valued at US$10 billion (2017 - 2018)

Portfolio company	Deal date	Stage	Deal size (m)	Post-money valuation (m)
Ant Financial Services	Jun-18	Series C/round 3	14,000 USD	150,000 US$
JD Finance	Jul-18	Series B/round 2	13,000 CNY	20,022 US$
Beijing Bytedance Technology	Oct-18	Pre-IPO	4,000 USD	79,000 US$
Didi Chuxing	Dec-17	Unspecified round	4,000 USD	56,000 US$
Meituan-Dianping	Sep-18	PIPE*	1.500 USD	52,700 US$
Shanghai Lujiazui International Financial Asset Exchange	Dec-18	Unspecified round	1,330 USD	38,000 US$
Beijing Kwai Technology	Apr-18	Unspecified round	400 USD	20,000 US$
Bitmain Technologies	Aug-18	Pre-IPO	1,000 USD	15,000 US$
Pinduoduo	Apr-18	Series C/round 3	3,000 USD	15,000 US$

Sources: Preqin *Private investment in public equity SCMP

China remains a hot area for venture capitalists.

The budding trend, however, is worrisome.

"There is too much capital in China. In reality, 90 per cent of the firms will be gone in another five to 10 years," said Joe Tian, founding partner of DT Capital, a Shanghai-based investment firm.

The window is closing for Chinese start-ups to rely on the sheer massive size of the domestic market to thrive.

"We need better entrepreneurs with better imaginations," said China Merchants Bank's Liu. "The most important thing Chinese entrepreneurs need today is a real ability to innovate."

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