Increased scrutiny and a potentially disastrous investment rule change have made the financial backers of China’s Internet sector very nervous. George W. Russell reports

Illustrations by Tree Tree Tes

The great firewall of China

1986
The first known email from China is sent from the Institute of High Energy Physics in Beijing to CERN, the nuclear research organization in Geneva.

1988
China Academic Network (CANET) links Chinese scientific researchers with the outside world.

1990
CANET registers the top-level .cn domain with InterNIC.

1994-95
China expands commercial Internet access through equipment installed by Sprint.

1995
Internet subscription base reaches 5,000, mostly scientists, government entities and universities.

Chinanet, the main provider, halts processing of new subscribers due to official concerns over access to information.

Washington irritates Beijing by putting Chinese-language Voice of America transcripts online.
On 17 October, the curtain rose on the historic Zhengyici Peking Opera Theatre in the Xicheng district of Beijing. But rather than traditional or revolutionary productions, the performers were Internet start-ups and their founders. Like ponies at a horse show, entrepreneurs were put through their paces, performing short pitches for nine new ideas in front of potential mentors and investors.

They ranged from the well-received Piktochart, a graphic design website for nonprofessionals, and SuperClass, a teaching software, to less popular ideas such as college-dating service LuRenJia and Kwestr, a social network that awards badges to users who complete a list of tasks.

This was the much-anticipated annual Demo Day for Chinaccelerator, a group of angel investors in Beijing that offers start-up ventures investment of up to 40,000 yuan, as well as professional (and emotional) support, in exchange for a 4 to 8 percent equity interest.

In Shanghai, TechYizu, an Internet start-up community organization, held its annual Demo Day in June amid similar fanfare. The seven candidates there included Aimifan, an online food delivery website, and Tuiping, a brand monitoring and management service.

“Judging by the warm reception and the hot venture capital money flowing in, I’d say that investors are still very interested in Chinese tech,” says Lucas Englehardt, an American in Shanghai who cofounded Aimifan, and who is now CEO of BloggerInsights, a research company.

Once derided for its commitment only to faithful duplication, the Internet industry in China has emerged as a major incubator for a range of new online products, services and concepts. China has one of the world’s fastest-growing Internet economies. According to Connie Gu, an analyst at Bocom International Securities in Hong Kong, industry watchers expect the segment to have grown by 65 percent by the end of this year.

**Plunging confidence**

However, the Internet sector is bracing for a sharp downturn. The tech community is worried that authorities are about to embark on another anti-Internet crusade, designed to weed out political dissent and social discord, but also likely to smother commercial enthusiasm for the Internet industry.

In addition, the Chinese government has perturbed investors by making noises about curbs on indirect foreign investment in Chinese Internet companies. Meanwhile, regulators in the United States have begun investigations into possible accounting irregularities that may entangle Chinese Internet stocks, including several market leaders listed on American exchanges such as the Nasdaq.

The net result, observers say, is a loss of investor confidence. “I believe the effect is negative in general,” says Echo He, senior vice president and analyst at Maxim Group, an investment management company in New York. “First, investors see increased risks in Chinese stocks,” He says. “Also, more rules and restrictions would likely hurt the service quality and user experience of Chinese Internet companies. This would further translate into weaker growth and profitability.”

On 30 September, a spokesperson for the State Internet Information Office, a regulatory body under China’s cabinet, said in a statement carried by the official Xinhua that...
News Agency that Internet rumours spread through social networks were “malignant tumours” that harm social stability. Internet users were urged to abide by laws, while Internet companies were encouraged to more closely monitor and police content.

From 15 to 18 October, the Communist Party central committee held a meeting in Beijing to discuss the use of micro-blogs, one of the most popular forms of instant messaging and widely used by China’s more politicized youth. “The meeting signals that China’s government is exploring measures to rein in domestic social media,” says David Bandurski, editor of the China Media Project at the University of Hong Kong, which monitors the Internet in the mainland.

Markets spooked
Executives at more established Chinese Internet companies acknowledge that investor sentiment has fallen sharply in recent months. “We’re definitely seeing a major deal slowdown,” said one senior executive based in Beijing. Start-ups have also declined sharply in the third quarter of 2011, he added.

Chinese Internet companies listed overseas are already feeling the repercussions of regulatory scrutiny: The average China Internet stock listed in the U.S. fell almost 30 percent in September.

On 29 September, rumours surfaced that the U.S. Department of Justice is reviewing allegations of accounting fraud at several companies, including Nasdaq-listed Sina Corporation, owner of the Twitter-like Weibo service in China, and Baidu.

Robert Khuzami, enforcement director of the Securities and Exchange Commission, confirmed to Reuters that there was an investigation but did not name any individual company, sparking a general sell-off of Internet stocks.

“When the market gets spooked, there is a flight to lower-risk stocks and Internet stocks are assumed to be high risk,” says Jonathan Masse, a money manager at the Californian company Baocuian Capital Management, which invests in Chinese technology stocks.

C’est la VIE
The technology sector in China has also become entangled in a recent controversy involving a company structure known as a variable interest entity. The VIE structure is often used for investing in Chinese industries where foreign direct investment is prohibited or limited, such as telecommunications, media, the Internet and education.

The VIE circumvents the rules by first setting up a domestic company with Chinese founders who typically hold the necessary permits and licences to operate the business. The Chinese founders then invest, along with foreign investors, into an offshore holding company, often based in Caribbean tax havens such as the Cayman Islands or the British Virgin Islands.

Finally, the holding company separately establishes a wholly owned subsidiary in China to enter into captive contractual arrangements with the domestic company. “This provides the holding company with the control over the domestic company that it would have received had it been permitted to hold a direct ownership interest in the domestic company,” says Steve Xiang, a corporate partner with the Weil, Gotshal & Manges law firm in Shanghai.

The legality of VIEs in China has always been a grey area, so companies had been working under the assumption that authorities would continue tolerating the structure.

But in September, the Economic Observer, a Beijing financial weekly news bulletin,
reported that the China Securities Regulatory Commission plans to prohibit or restrict the use of VIEs, citing an internal CSRC memo it had obtained in August. That prospect will almost certainly discourage investors, experts say. “The risk is very high if the structure has to change,” says Gu of Bocom International.

Tucker Grinnan, regional head of Asia telecommunications and media research at HSBC in Hong Kong, cites an ulterior motive for the government’s potential change of heart: “The [Internet] sector is out of favour and there are indications that the Chinese government investigations of the VIE structure used for most of these Nasdaq listings are designed, in part, to encourage them to list in China instead.”

Peter Schloss, chief executive officer of Internet broadcaster Allied Pacific Sports Network and a former chief financial officer of Tom Online when it was listed on the Nasdaq, says many doubt whether the SEC would continue to allow consolidation of VIE financial statements under FASB Interpretation No. 46 Consolidation of Variable Interest Entities if the VIE structure continues to be questioned under Chinese law.

“The VIE structure is not only a mechanism by which foreign ownership restrictions are avoided, but also a mechanism which has allowed entities that are not subsidiaries under PRC law – and U.S., Cayman Islands and BVI law for that matter – to be consolidated under U.S. GAAP for income statement purposes,” says Schloss. “Without the ability to consolidate the financial performance of the operating entity, the VIE structure is meaningless.”

**Room for opportunity**

To be sure, the turmoil in China’s Internet industry is not bad news for everyone. The upside is that valuations of new or untested companies are low, making them juicy targets for larger companies. Baidu, for example, has been taking advantage of jittery start-up investors to go on an acquisition spree. So far this year, the company has bought China’s leading travel website, Qunar, and acquired stakes in Leftbrain, an online ratings operator, and e-book retailer Fanshu.

Meanwhile, Tencent, which provides Internet and mobile phone services such as the QQ instant-messaging service, bought a stake in Kaixin001, China’s fourth-largest social-networking site.

Baidu and Tencent are among China’s largest Internet players and some analysts believe they probably have little to fear from authoritiesthe increasing regulation, such as [those] on VIE entities, will have more impact on yet-to-be-listed companies,” says Gu. “Existing companies will most likely enjoy the status quo.”

Back at the Beijing opera house, the mood is sanguine. “I basically don’t care about stock markets,” says Cyril Ebersweiler, a French Internet investor in Beijing who cofounded Chinaccelerator. Most of the companies he deals with are years away from a potential listing.

Ebersweiler says, in his experience, there is no shortage of enthusiasm for Chinese Internet ventures among the country’s entrepreneurs. “[There will be] more start-ups, with more maturity in the handling of the investment process.”

The financial infrastructure for start-ups is also growing, he adds. “[I definitely have seen the creation of more funds or micro-funds, so things are heating up],” he says. “Even our Chinaccelerator programme model has been duplicated.”

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**2005**

Censors target specific pages within domains based on blacklisted keywords; Chinese politics, religion and pornography sites banned

Baidu opens on the Nasdaq at US$66, far above its IPO price of US$27, and closes at US$122.54 on its opening day

**2008**

Censorship peaks before Beijing Olympics. Website of The New York Times, unblocked for years, is banned; the BBC, almost always blocked, is permitted

**2009**

Sina launches Weibo, its micro-blogging platform

Pew Research Center survey finds 80 percent of the Chinese public think Internet access should be controlled and 85 percent think the government should be responsible

**2010**

Eager foreign investors snap up Chinese Internet IPOs such as Youku, founded by former Sohu president Victor Koo, although some, such as SkyMobi and MecoxLane, prove disappointing

**2011**

State Internet Information Office, a regulator, says online “rumours” are “malignant tumours” that harm social stability

Tencent launches English micro-blogging service as part of international strategy