Climate-KIC Scout Report - China

Opportunities, barriers and strategies for start-ups

October 2014
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About this report

This study is part of the Climate-KIC Innovation Scouts program. Climate-KIC is Europe's largest public-private partnership, working together to address the challenge of climate change. An important part of Climate-KIC's efforts is to facilitate entrepreneurs in bringing new ideas and technologies to market that mitigate climate change. It does so by providing funding, training, and access to a network of academic institutions, governments, corporates, and investors.

As Innovation Scouts, we study (a) what makes entrepreneurial ecosystems work, and (b) the lessons we can learn from other programs that, similarly to Climate-KIC, aim to accelerate (clean tech) start-ups. We do so by collaborating closely with and interning at local key stakeholders, such as start-up incubators. Our results are shared with the rest of the world, thereby providing value for Climate-KIC, local stakeholders, and the world wide start-up community.

This document contains the key findings of the research performed in China from February – June 2014 and has a specific focus on the opportunities, barriers and strategies for foreign (cleantech) start-ups in China. In China we studied the studied Chinese and foreign start-ups, mainly in Shanghai and surrounding cities, complemented with Beijing, Shenzhen and the Special Administrative Region of Hong Kong. We did 43 qualitative interviews and met and spoke with many more people in the start-up scene at several events.

Our main findings are that the cleantech market in China is growing and there is a need for foreign technology and thus opportunities for foreign cleantech entrepreneurs to address this need. There are however also considerable barriers, including:

- Dealing with government
- Different business styles and ethics
- Finding and retaining good employees
- Difficult market
- Finding good investors

We will also elaborate on the strategies for entrepreneurs to overcome those barriers and increase their chance of success in China. In this report we will start with (1) a brief discussion of the Chinese ecosystem. We will (2) discuss the most important lessons learned and (3) present some interesting models to accelerate start-ups in China.

1. The Chinese Ecosystem

The Chinese market is strongly regulated by a large government that consists of many departments and layers that are not always harmonized with each other or even compete with each other for power. The national government acknowledges the environmental issues and has placed emphasis on reducing fossil fuel consumption and supporting R&D for clean technologies (Lewis, 2011). Three of the seven 'new strategic and emerging markets for 2011-2015' in the latest Five-Year plan are cleantech related (Yao Lu, 2012). Also in terms of capital, China is known as the world's largest commercial cleantech investor (Bloomberg New Energy Finance, Isola, & Zindler, 2013). However, the market for clean-tech is seen as fragmented; markets differ per region and first, second and third tier cities, i.e. the city's level of development. Most entrepreneurial and clean-tech activities take place in first tier cities, which results in a strong competition between firms. The third tier cities on the other hand are most in need for environmental innovation, but these are also least accessible for foreigners.

The judicial system is weak, and corruption is still widespread especially in third tier regions, but both are said to be improving. This contributes to the Chinese way of doing business on the basis of what is known as 'Guanxi', which is doing business based on network, relationships, respect and trust (Wang, 2007; Yau, Lee, Chow, Sin, & Tse, 2000). A foreign facilitator explained Guanxi is especially important because of the weak law system; "You need to have relations if you don't have the law".

Interviewees agree that there is money available for cleantech from rich individuals and VCs. They also say that finding good investors is not easy. We will go further into this and other barriers in the following sections.

2. Lessons learned

Below we discuss five lessons learned on barriers for entrepreneurs in China and the strategies they follow to overcome those barriers.

- **Dealing with government.** A combination of a dominant government and unfavourable regulation makes dealing with government one of the most important barriers for entrepreneurs. A strategy mentioned by the majority of the interviewees is to start the business and only deal with government when you absolutely have to: *"When you are very small you should not start to bother with that otherwise you can spend hours on meeting the administrative stuff"* (foreign entrepreneur). The unclear and sometimes conflicting regulation creates a 'grey area' that companies can use to their advantage. Entrepreneurs can solve the lack of information on regulations and how to do things by talking to other entrepreneurs or getting support form consultants. However, entrepreneurs will discover most as they move along: *"Rather than anticipating problems, you just wait for them to happen and once they happen, then you are in firefighting mode. To me it's very much like the wild west going on."* (foreign entrepreneur). Industry and government are big potential clients for cleantech companies. Although in most sectors there is no choice but to deal with government, industry would entail the lowest barriers as this Chinese facilitator explains: *"Selling to government is impossible because they always buy from the same supplier, regardless of the price or quality. It is not a free market. The only way is to sell to the government suppliers, who will sell it to the state controlled companies."* Thereby corruption is a bigger problem in dealing with government according to foreign entrepreneurs.

- **Competition and different business styles and ethics.** Interviewees state that the Chinese competition is very hard; *"The competitors here may come up with something that you cannot even imagine, Because it's outside of your knowledge, you thought this is how far this will go but no, it will go further."* That is why the foreign entrepreneurs say they don't compete with Chinese in the same market but try to find a niche. On the other hand, most entrepreneurs are not too concerned with a little competition since the market is big enough to share. Thereby being copied can also be a good sign as *"it validates the idea"*, a foreign entrepreneur states. The different business styles and ethics are sometimes difficult to understand for foreign entrepreneurs. When a company wants to do business in China they traditionally have to invest a lot of time in building Guanxi, i.e. networks, relationship, respect and trust. The personal bonds and agreements are worth more than contracts that sometimes are seen more as guidelines for cooperation. *"A contract is seen as something temporary, if the circumstances change and the agreements are no longer beneficial, chances are they don't keep to the contract"*, says a foreign facilitator. To build a network and relationships requires patience and usually dinners, drinks and gifts. Patience is also important when it comes to the more obvious barriers for foreigners; the cultural and language barriers. A good Chinese partner or team member is also said to be important to be successful in China. For instance in understanding the indirect communication as is often used in China.

- **Finding and retaining good employees.** Finding and retaining talent is the number one management challenge for Chinese and foreign companies in China (Fernandez, Xu, Zhou, Puyuelo, & Li, 2013). In the interviews foreign entrepreneurs state that they struggle to find good staff because they don't know where to look and resumes are hard to judge. Moreover, the general level of education is lower and talented candidates prefer to a secure job with the government or a large (state owned) company. Interviewees indicated that personal and professional networks are an important source of human resources. There is a common conception that staff will leave for a slightly higher salary somewhere else. 'Lack or career progression' and 'Seeking a new challenge' are however more important reasons to leave according to Hays (2012, P.3). As an employer *"You have to think differently about how you promote people, how you deal with titles and pay raises on the basis of growth."* (foreign recruitment expert and entrepreneur). The work style is also different from what western entrepreneurs are used to. *"People have a 'don't look up'-mentality. They don't take ownership or initiative. They will never do something that was not asked, because they are afraid they do something wrong."* (Entrepreneur). Foreign entrepreneurs say that they have to invest considerable more management time in their Chinese employees to get the same value from them.

- **Difficult market.** Although the government acknowledges the environmental issues in China, one of the main barriers for cleantech mentioned in the interviews is that the Chinese customer does not care about the environment. "*Water and energy is too cheap here to be a problem*", says a foreign cleantech entrepreneur. Thereby Chinese customers generally have a short term vision as this foreign entrepreneur explains: *"It is hard to sell big solutions in China, they always go for the small and easy fix."*. According to different interviewees opportunities arise when industry has to meet certain regulations for which they need clean technologies. Promising technologies are those that align with the government's 5-year plan. Entrepreneurs and facilitators say that it is best to find a niche. Some segments of the market are however not mature enough to focus on solving a specific problem. A foreign entrepreneur explains he needs to *"offer many different types of products and solutions together as opposed to in the U.S. where startups are able to capture something in a very narrow space for a specific problem"*.

- **Finding good investors.** Even though there is a lot of capital in the market, foreign entrepreneurs state that getting funding is still difficult because there are many bad investors and investors are risk averse. It has become more popular among the new rich to invest in start-ups, they are however unexperienced, have unrealistic expectations and their interest is not always in line with the companies best interest. The more experienced investors prefer to invest in Chinese companies or later stage companies with a proven technology and market abroad. A Chinese investor in cleantech agrees and says *"Later stage is better. You should have at least formed a team, with a Chinese who understands the Chinese market. And have a high entry barrier for others, so it's not easy to duplicate your technology."* In addition, there are also many bad investors

3. Interesting models to support start-ups

There are roughly three types of incubators and accelerators in China; government/university incubators, private Chinese incubators/accelerators and foreign incubators/accelerators. The government and university incubators are not known for their leading way of supporting start-ups. They do have a lot of resources and are able to offer their start-ups many things for free. That means start-ups get overfunded and as a result there are many 'living dead' that are kept alive by the incubator but would not survive otherwise. One good thing about them is that they tend to have the best relationships with relevant government departments, which is important to make company registration a smooth process and to find out about new government funding possibilities.

The private Chinese incubators, such as Boji Science Park and Ming Innovator generally have a classic real-estate model. That means they are inherently interested in the start-ups' success, since they are dependent on their rent. Private incubators have the advantage to be able to guarantee a bank loan for their start-ups. Something government incubators cannot, since their assets are public good.

With six locations People Squared is presumably the most successful co-working space in Shanghai. The diversity of the companies and the strong sense of community is what attracts entrepreneurs to People Squared. When they are about to open a new location they select people from the waiting list and involve them in the remodelling of the space to give them a sense of ownership in the space from the start. One of the People Squared locations hosts Chinaccelerator.

Chinaccelerator is the first and still one of the few mentorship-driven seed-funding programs in China. The original model was to help international startups to go after the Chinese market, but that did not work because the Chinese market was too difficult for foreigners to go after. Now they help both Chinese and foreign teams that focus on the Chinese and international markets. The accelerator is especially well connected with and supported by the foreign startup community in Shanghai.

The same founders of Chinaccelerator later founded Haxlr8r when they realised that the cost of trying to do a hardware startup had tremendously decreased. Tech and hardware had become so cheap that a similar accelerator model could be applied. Haxlr8r is based in Shenzhen, because cheap hardware manufacturing is so readily available.

AsianBiz is one of many consultants offering office space and consulting services to foreigners that want to set up their business in China. They provide services in company registration, accounting and tax, HR and recruitment, visa issues and other types of consulting.

The Honk Kong Science park runs an incubator and a soft landing centre. The third phase of the incubator focusses on supporting cleantech businesses. The soft landing centre offers services (including serviced office space, fundraising support advice) especially for foreign entrepreneurs that want to explore the opportunities for their tech business in Hong Kong, China and the rest of Asia.

The Hong Kong Road

Hong Kong is seen as the gateway to China because it does not have many of the barriers that exist on the mainland. Hong Kong is a Special Administrative Region (SAR) of China and home of many holding companies of Chinese wholly owned foreign enterprises (WOFEs). According to foreign entrepreneurs and facilitators the WOFE is by far the easiest way to register a company in China as a foreigner. The combination with a Hong Kong Special Purpose Vehicle (HKSPV) has a couple of benefits over a company registered in the mainland of China:

- Ease of managing funds. As opposed to other foreign accounts, funds can be moved between the WOFE and HKSPV easily for about five percent transfer cost.
- Tax benefits. The tax rates on earnings outside Hong Kong is zero percent. Earnings from the WOFE can be sent to the HKSPV, thereby avoiding China’s 25% income tax.

Doing business in Hong Kong is also easier than on the mainland according to entrepreneurs and facilitators in Hong Kong. Setting up and closing a business in Hong Kong is inexpensive, easy and quick; there is a strong rule of law which resolves most issues around violation of contracts and IP infringements; and cultural and language barriers are less because Hong Kong is so international and English is an official language.

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