PitchBook Data, Inc.

John Gabbert Founder, CEO

Nizar Tarhuni Vice President, Institutional Research and Editorial

Dylan Cox, CFA Head of Private Markets Research

Institutional Research Group

Analysis

Max Navas
Analyst, Venture Capital
max.navas@pitchbook.com

Kaidi Gao
Associate Analyst, Venture Capital
kaidi.gao@pitchbook.com

Data

Collin Anderson
Associate Data Analyst

pbinstitutionalresearch@pitchbook.com

Publishing

Designed by **Julia Midkiff**

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Contents

Note: Throughout this note, China is defined as mainland China. Hong Kong refers to Hong Kong as an autonomous Special Administrative Region of the People's Republic of China.[1]

Examining US Investments in China

Escalating US-China tensions exert downward pressure on cross-border capital flows

PitchBook is a Morningstar company providing the most comprehensive, most accurate, and hard-to-find data for professionals doing business in the private markets.

Key takeaways

- During the past two decades, when venture first experienced rapid growth in China, the introduction of capital and resources by USD funds made US investment into China's VC market mutually beneficial for both sides. US investors benefited financially from tapping into a country with high growth potential, a massive population, and expanding mobile internet adoption. Meanwhile, the Chinese market was able to accelerate domestic technology development with nondomestic capital injection.

- The breakout of USD and RMB funds is unique to VC in China.[2] USD funds have constituted an active investor base for unicorn-style internet companies, enabling US investors to put significant amounts of capital into startups with high growth potential.

- Amid heightened US-China tensions and the US government's increased scrutiny of US investments into Chinese startups operating in strategically important or sensitive sectors, we expect to see RMB funds play an even larger role in these sectors, including semiconductors and artificial intelligence.

- The number of annual US LP commitments has closely followed the trend of China VC deal activity with US investor participation. After a record high of 107 commitments in 2018, participation waned, culminating in a six-year low of 31 commitments in 2022.

- Just 40 US-headquartered firms have elected to launch dedicated investment vehicles to participate in China VC deals. While it will become even more difficult for firms to launch China operations due to recent economic and political developments, for those US GPs already investing in the Chinese VC market, the Biden administration's latest executive order will hasten the evaluation of their China VC investment strategies, but it will not have as much of an impact as one would expect.

1: "Government Structure," GovHK, September 2022.

2: To ensure consistency and conciseness, in this note, we characterize venture funds in China that are denominated in Chinese yuan, or renminbi, as RMB funds. Similarly, VC funds that are denominated in US dollars are referred to as USD funds.

Introduction

In the realm of global economics, few relationships have garnered as much attention and speculation as that between the US and China. At the nexus of this complex dynamic lies the China VC market, a potent source of innovation, economic growth, and historically strong returns. The China VC market has experienced a meteoric rise, transforming itself from a regional powerhouse into a global juggernaut. Its evolution has been driven by a mix of government support, a high-growth tech ecosystem, and a wave of entrepreneurial enthusiasm. US investors have flocked to the China VC market, recognizing the immense potential for returns and the opportunity to capitalize on its fast growth.

In recent years, however, the tensions between these two global giants have introduced new hurdles and a new level of uncertainty into the minds of US investors, fundamentally altering the calculus of their participation in the China VC market. Even before the recent US executive order limiting VC investment into certain sectors in China, the flow of capital between the countries had been put through a series of hurdles. Questions now loom large in the minds of US investors as to the viability of continued investment into the market. These uncertainties have ignited a significant re-evaluation of US investor participation in the China VC landscape.

This note delves into the historical deal activity within China and the multifaceted impacts of US-China tensions on US investor participation in the China VC market. It will explore the evolving macroeconomic and regulatory landscapes, the changing risk perception, and the strategic recalibrations taking place within the minds of US investors. Through a comprehensive analysis, we aim to shed light on the ways in which geopolitical tensions are reshaping the investment landscape and the strategies employed by US investors in China.

History and deal activity

Venture capital initially emerged in China as a foreign concept. Compared to in the US, where VC originated in 1946,[3] venture is a relatively nascent asset class in China, burgeoning only within the past two decades. In the 1980s and 1990s, the Chinese state and regional governments played an active role in supporting VC's domestic development; however, real growth and rapid expansion in the VC industry did not materialize until the late 1990s and early 2000s, with nondomestic VC firms actively participating in dealmaking activity and taking full advantage of access to overseas exit channels that were not readily available to their domestic counterparts.[4] While access to public exits was constrained for domestic VC firms in China, nondomestic VC firms were rewarded financially for taking their Chinese portfolio companies—specifically those that operated in the internet sector—to IPO overseas. This imbalance led to the Chinese state launching its own stock exchanges within the country.[5] Over time, the country built out the economic structure necessary to nurture and facilitate VC development. Starting with the "open-door" policy introduced by Deng Xiaoping in 1978, and with subsequent initiatives such as nondomestic direct investment and the introduction of special economic zones, China gradually embraced the influx of nondomestic capital. The country's staggering annual GDP growth through 2019, ranging from 6% to upwards of 14%,[6] coupled with an unprecedented speed and volume of new business creation,[7] helped fuel the domestic capital market and attract global investors.

According to GSM Association, a nonprofit organization representing global mobile network operations, as of 2018, the number of unique mobile subscribers in China reached 1.17 billion, representing 82% of the country's population and almost doubling the 2010 figure of 43%.[8] In addition, 69% of the population owned a smartphone.[9] As of 2022, the unique mobile subscriber count further ascended to 1.29 billion with an 87% penetration rate, and 81% of the total population were smartphone holders.[10] With a vast majority of one of the world's most populous countries being connected via smartphones, the Chinese market's embrace of digital transformation presented a unique and promising opportunity for venture investors favoring high-growth models. The combination of rapid economic growth, middle-class expansion, emphasis on tech innovation, and across-the-board mobile adoption contributed to a rise in consumer-tech companies, a group that drew attention from US investors and subsequently became a major venture segment in China during the past decade.

3: "VC History," Venture Forward, n.d., accessed September 1, 2023.

4: "The Rise of Venture Capital Centres in China: A Spatial and Network Analysis," ScienceDirect, Geoforum, Fenghua Pan, Simon X.B. Zhao, and Dariusz Wójcik, October 2016.

5: Ibid.

6: "GDP Growth (Annual %) - China," The World Bank, n.d., accessed August 7, 2023.

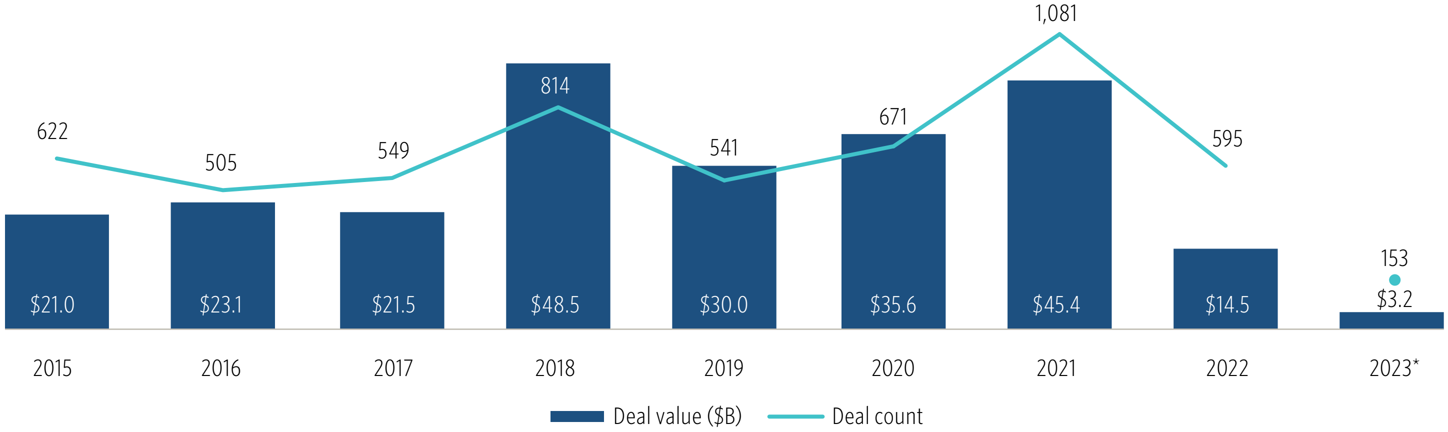
7: "New Businesses Registered (Number) - China," The World Bank, n.d., accessed August 7, 2023.

8: "The Mobile Economy China 2019," GSM Association, March 2019.

9: Ibid.

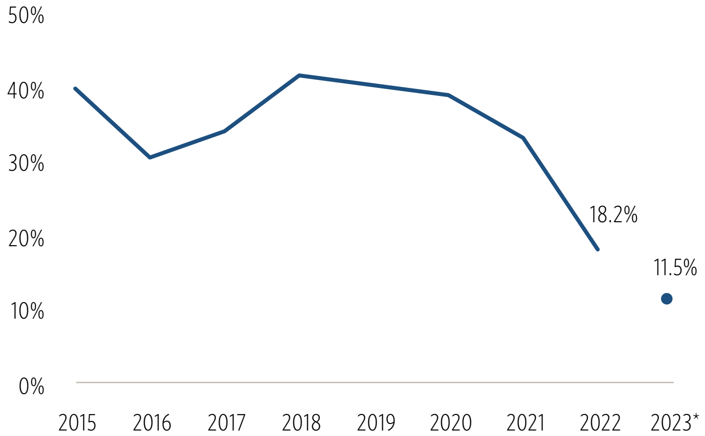
10: "The Mobile Economy China 2023," GSM Association, March 2023.

VC deal activity with US investor participation



Source: PitchBook • Geography: Mainland China
*As of July 12, 2023
Note: Firms with US parent entities or secondary office locations in China are included in the US investor scope.

Deals with US investor participation as a share of all VC deal value



Source: PitchBook • Geography: Mainland China
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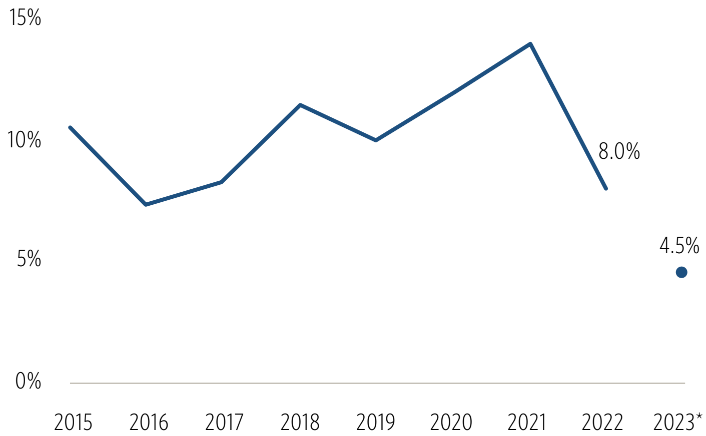
Deals with US investor participation as a share of all VC deal count



Source: PitchBook • Geography: Mainland China
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US investors, both LPs and GPs, have played a prominent role in the development of the Chinese venture market. Deal value in China with US investor participation peaked in 2018, with a record $48.5 billion being deployed to the regional market. The immense growth rates and record-setting round sizes led by technology startups captured significant US investor capital. Four of the largest VC deals in China—Ant Group's $14.0 billion Series C round in 2018, DiDi Global's venture-growth rounds in 2016 and 2019, and Meituan's Series F round in 2017—included US investors. In fact, there were as many as 33 US investors that committed capital to those rounds, illustrating the trend of US investors injecting significant capital into high-growth tech startups that are close to making an exit.

During the past two decades, especially when venture initially experienced rapid growth in China, firms that primarily operated out of USD funds served an important function connecting capital, talent, technology, and business models across the two sides of the Pacific Ocean. The introduction of resources and capital helped facilitate investment, and, as time went on, turned US investment in China into a win-win situation.

USD and RMB funds: Two distinct investment styles in China

The breakout of USD- and RMB-denominated funds is a prominent and unique feature of VC in China. Rather than speaking about VCs with broad strokes, when referring to an investor, regional market participants specify the currency in which a fund is denominated. This is mainly because, over time, the two types of funds have gradually developed and evolved into their own styles of investing, including different industry sector preferences, risk tolerances, fund sizes, and LP types. The distinction between USD and RMB funds partly helped US investors navigate some of the challenges in entering the Chinese private market, enabling them to put large swaths of capital to work in select industry sectors with high risk/reward potential.

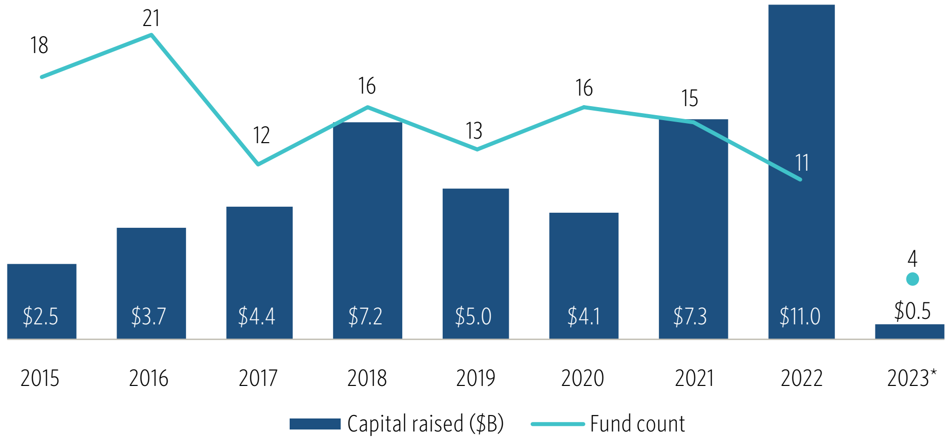
The domestic Chinese venture ecosystem benefited from nondomestic capital injections, which accelerated the pace of internet technology development as well as the growth of venture-backed companies in China. When venture was first taking off in China, many of the first wave of high-growth internet companies were backed by US investors, including sophisticated institutions that were more open to high risk/return deals because they had been in operation long enough to have been through multiple market cycles. US LPs have historically been a preferred source of capital among Chinese GPs because they are oriented to long-term relationships and are purely driven by financial returns. The latter characteristic stands in contrast with Chinese state and regional government LPs, a group that actively allocates to RMB funds, because they typically have other investment objectives and mandates that are not financially driven and could lead to conflicts of interest with USD funds.

With lucrative financial return prospects and an abundance of internet companies looking to thrive and dominate the Chinese market and beyond, US investors were motivated to allocate and wire funds across the border. Some of the largest and most established VC firms, including Sequoia Capital, IDG Capital, and Lightspeed Venture Partners, opened offices in China. Leading accelerator programs also jumped on the trend, planting roots in China to access the regional talent community. For instance, Plug and Play Tech Center launched its China office in 2015 and has since extended its accelerator program to more than 1,700 startups in the region.[11]

11: "Plug and Play China," Plug and Play Tech Center, n.d., accessed September 1, 2023.

Setting up USD funds in China does not necessarily equate to having a majority US LP base. While some GPs operate on USD funds because most or all of their LP base is from the US, others may choose to set up USD funds even if there is minimal US presence in the fund's LP base. Investing out of USD funds in China offers several benefits for certain deals. To start with, for companies that are planning on expanding globally, Chinese GPs tend to prefer investing in those businesses via USD vehicles so that, down the road, it is easier logistically to bring overseas investors on board for follow-on rounds and to go public on nondomestic stock exchanges. In addition, USD funds tend to have more recognizable global branding. In the venture world, where name, prestige, and a successful track record matter, USD funds with a more well-known brand name bring instant credibility from potential global co-investors.

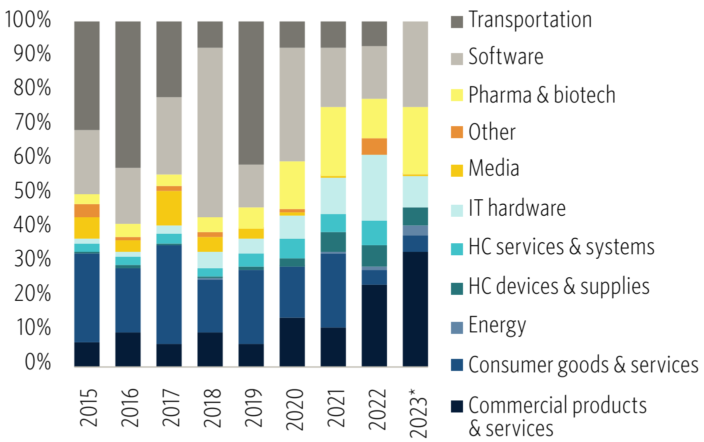
VC fundraising activity by US-headquartered firms



Source: PitchBook • Geography: Mainland China and Hong Kong
*As of July 12, 2023
Note: This chart includes Hong Kong-based funds. Firms with US parent entities or secondary office locations in China are included in the US investor scope.

During the rapid expansion of mobile internet in China, USD funds exerted profound influence and propelled the development of the Chinese private market. USD funds in China have established a track record of numerous successful investments that ended up generating outsize financial returns. To some of the most well-known venture-backed businesses in China, including ByteDance, Baidu, Shein, Meituan, and Pinduoduo, USD funds typically represent an active investor base. These GPs include US-headquartered VC firms with an office presence in China, such as Matrix Partners China.

Share of VC deal value with US investor participation by industry



Source: PitchBook • Geography: Mainland China
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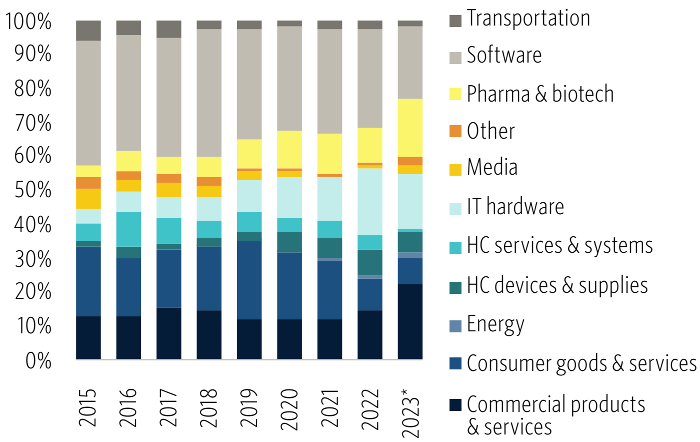
Share of VC deal count with US investor participation by industry



Source: PitchBook • Geography: Mainland China
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USD and RMB funds typically pursue investment opportunities in different industry sectors, which is important in regard to US investor participation in the Chinese market. USD funds tend to invest in internet software companies as well as advanced technology industries such as artificial intelligence, virtual reality, and Web3. Those advanced technology sectors are attractive to USD funds primarily because of a large total addressable market and their outsize return potential. RMB funds, on the other hand, have developed their own investment theses and styles, taking a localized approach following the introduction of VC into China, and have generally been more involved in sectors where growth is relatively slower but steadier. Such deals could be highly profitable with large profit margins but often require extended investment timeline horizons. While RMB fund involvement in tech unicorns has been minimal, it would be inaccurate to overgeneralize and claim that RMB funds are less successful than their USD counterparts. In fact, a large number of IPOs were backed by RMB funds; however, few of those companies are as well known as Alibaba or Meituan.

The LP base has been an important difference between USD and RMB funds as well. US institutional investors constitute an important part of the LP structure of USD funds in China, especially due to the differing risk tolerances of US investors. While it would be overgeneralizing and inaccurate to claim that USD funds are more comfortable taking higher risks than RMB funds, in the past, USD funds have been more active in deals in select industries with large growth potential that require heavy upfront capital injection at an early stage, when the return potential remains unclear. This pattern has led to USD funds being much larger, enabling US LPs to put large amounts of capital to work in a single commitment, while capturing the risk profile desired by US LPs.

Now, US LPs are generally taking a more cautious approach to committing and deploying capital to the Chinese VC market. Starting from a couple quarters ago, many USD funds in China, especially those with smaller AUMs, have encountered a series of challenges, mostly prominently with layoffs, pay cuts, and a lack of highly investable, good-quality deals. Overall, the recent decline of USD funds within the Chinese venture market adds to the challenges that US LPs already have with maintaining or increasing their China exposure.

Challenges and the current market environment

Regulatory challenges to US investment in China

Economic and political developments in the US and China have recently ushered in an era of tempered US investor participation in the Chinese VC market, but the market has long proved challenging for the broad base of US investors. While recent focus has been on the Biden administration's executive order, challenges to active US investment in China have not been one-sided, though the cross-border investment has been heavily impacted by government regulations.

China

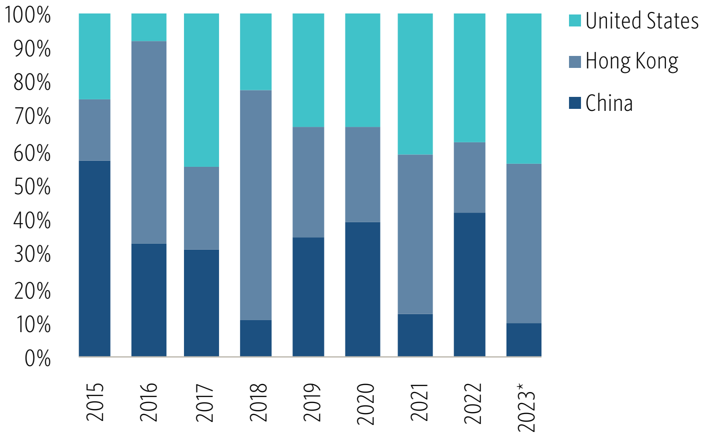
One such hurdle is the Chinese government's crackdown on tech companies that began in 2020, pumping the breaks on startups looking to enter the public markets via IPO. In February 2021, China's State Administration for Market Regulation issued its anti-monopoly guidelines for the platform economy, finalizing the draft law released in November 2020 aimed at price fixing. The guidelines restricted technologies using data and algorithms to manipulate market data.[12] The Chinese government's crackdowns further expanded to more than two dozen of China's leading tech companies and played a role in the restructuring of Alibaba, as covered in our recent analyst note Chinese Tech Conglomerates' Split Expected to Shake Up VC.

Additionally, the passing of China's Data Security Law (DSL) that took effect in November 2021 empowered the Chinese government to create a "hierarchical data categorization system in accordance with the importance of the data to China's economy," according to a report from Orrick.[13] The law also established security obligations for data processors and penalties, such as mandated remedial measures, for violating the obligations. The DSL led to the Chinese government restricting DiDi Global, a China-based publicly listed company on the New York Stock Exchange, from registering new users during their investigation of cybersecurity risks and ultimately contributed to DiDi Global's delisting from the exchange in June 2022.[14] As a result, listing on nondomestic exchanges became a larger concern for Chinese startups and compounded investor wariness of the Chinese government's speedy intervention in the VC asset class. While broader global public market declines have certainly impacted new public listings, there has been a significant decline in Chinese startups listing on US exchanges, falling from around 18 listings each year between 2018 and 2021 to just three listings in 2022. Despite recent signaling that the Chinese government is ready to ease restrictions, these crackdowns increased the risk profile of investing in Chinese startups for fear they could come under scrutiny and be unable to exit, thereby stifling liquidity, reducing fund returns, and disincentivizing the deployment of capital.

In making the road to exit more challenging for companies, these crackdowns had a distinct impact on US investors and USD funds with US LPs. Because many of the largest IPOs were completed on US exchanges, including the recent listing of DiDi Global, the route to future large-scale IPOs overseas became less clear. This significantly increased the risks of investment in China, limiting the returns for both GPs and LPs.

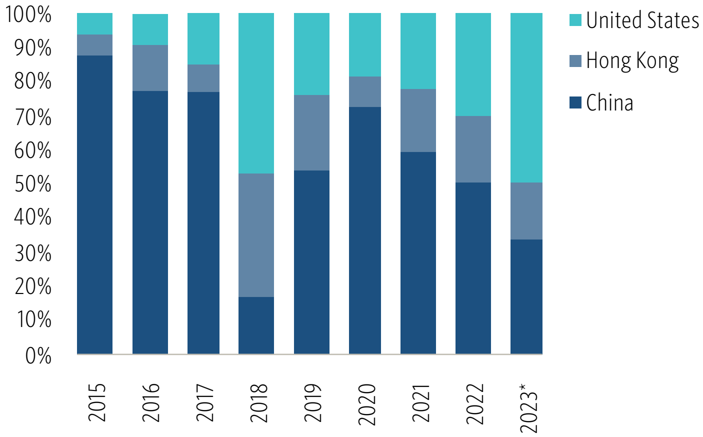
12: "China Issues New Anti-Monopoly Rules Targeting Its Tech Giants," Reuters, Cate Cadell and Brenda Goh, February 7, 2021.
13: "China's New Data Security Law: What International Companies Need to Know," Orrick, Xiang Wang, et al., September 23, 2021.
14: "China Investigates Didi Over Cybersecurity Days After Its Huge IPO," Reuters, Tony Munroe, et al., July 2, 2021.

Share of VC IPO exit value by listing region



Source: PitchBook • Geography: Mainland China
*As of July 12, 2023
Note: This chart includes exits only for known exchanges.

Share of VC IPO exit count by listing region



Source: PitchBook • Geography: Mainland China
*As of July 12, 2023
Note: This chart includes exits only for known exchanges.

VC IPO exit value ($B) by listing region

	2015	2016	2017	2018	2019	2020	2021	2022	2023*
China	$4.3	$5.8	$11.1	$10.0	$24.2	$48.9	$20.8	$5.9	$0.6
Hong Kong	$1.4	$10.3	$8.3	$62.1	$21.5	$33.4	$74.1	$2.8	$2.7
United States	$1.9	$1.4	$15.9	$20.9	$23.0	$40.4	$66.1	$5.3	$2.5

Source: PitchBook • Geography: Mainland China
*As of July 12, 2023
Note: This table includes exits only for known exchanges.

VC IPO exit count by listing region

	2015	2016	2017	2018	2019	2020	2021	2022	2023*
China	28	27	41	6	38	71	51	5	2
Hong Kong	2	5	4	13	15	9	16	2	1
United States	2	3	8	17	17	18	19	3	3

Source: PitchBook • Geography: Mainland China
*As of July 12, 2023
Note: This table includes exits only for known exchanges.

Another hurdle is China's economic environment, which had previously been a draw for US investors looking to capitalize on China's high growth. China's official GDP growth target of 5% for 2023 sits well below the highs seen in prior decades. Several major banks, including Barclays, Morgan Stanley, Nomura, and UBS have trimmed or downgraded their forecasts for China's real GDP growth, citing the property downturn as well as weakened external demand and policy support.[15]

Moreover, confidence in China's economy continues to waver amid dampened public market activity, rising youth unemployment, and the country's growing debt issue stemming from lending to regional Chinese governments, real estate developers, and other developing nations. JPMorgan Chase estimates overall debt within China has "reached 282 percent of the country's annual economic output," more than the "average of 256 percent in developed economies [...] and 257 percent in the United States."[16] Tested investor confidence in the prospect of strong returns via public markets, as well as defaulting debt, has contributed to the pullback in US investors from the Chinese VC market. This pullback will likely remain until markets show a significant rebound.

Finally, China's government has deployed massive amounts of capital into government guidance funds, which the Center for Security and Emerging Technology describes as "public-private investment funds with a dual mandate to produce financial returns and further the state's industrial policy goals."[17] By 2021, more than 1,800 guidance funds managing an estimated $1.5 trillion USD were operating in China.[18] The strategic goals of these funds can conflict with those of US and Chinese domestic investors who may be strictly focused on financial returns.

In addition to the participation of guidance funds in Chinese VC funds raising concerns for US investors, the Chinese government's Negative List for Foreign Investment Access prohibits nondomestic investors from deploying capital in 31 different industries and fields, including telecommunications, internet news services, and preschool through higher education.[19] The Negative List has been updated multiple times, further increasing investor wariness that new industries could be included in a nondomestic investment ban. Government guidance funds working in tandem with industry-restricted investment has created a minefield for US investors to effectively deploy capital and realize returns from the Chinese VC market.

US

Similarly, the US government has created several hurdles that US investors must clear in order to effectively participate in the Chinese VC market, including narratives of de-risking away from China, congressional scrutiny of historical investments, and most recently, the Biden administration's executive order addressing US investments in certain national security technologies and products in China.

15: "China's Economy Is in Trouble. Here's What's Gone Wrong," CNN, Laura He, August 23, 2023.
16: "Why China Has a Giant Pile of Debt," The New York Times, Keith Bradsher, July 8, 2023.
17: "Understanding Chinese Government Guidance Funds," Center for Security and Emerging Technology, Ngor Luong, Zachary Arnold, and Ben Murphy, March 2021.
18: "The Promise and Pitfalls of Government Guidance Funds in China," Cambridge University Press, The China Quarterly, Yifan Wei, Yuen Yuen Ang, and Nan Jia, April 19, 2023.
19: "China's Negative List for Foreign Investment Access," China Briefing, December 28, 2021.

The G7 Summit took place in Japan in May 2023, and the resulting communiqué detailed the participating countries' pledge to de-risk and diversify away from China in an effort to remain economically resilient and vibrant.[20] This represents a positive deviation from the prior narrative of decoupling but does not alleviate investors' worries about the extent to which the US government will limit cross-border flow of capital and business. Several firms, including GGV Capital and Qualcomm Ventures, have been investigated for their investment in the Chinese VC-backed AI startups Megvii Technology and SenseTime, though no action has been taken to date.[21]

The most notable hurdle is the Biden administration's latest executive order, announced in early August 2023, restricting US investment in Chinese companies developing products in the semiconductors and microelectronics, quantum information technologies, and artificial intelligence sectors.[22] This order will curb new investment into Chinese-headquartered startups, as well US-headquartered startups owned by Chinese nationals, developing technologies in these fields. While the ban will not be enforced retroactively, any deal closed after its effective signing date of August 9, 2023, will be void or require divestment. For GPs that may have included some of these sectors within their investment theses, modifying their strategy could impact their targeted return profiles and leave LPs questioning whether they had made the correct decision committing to their funds. The executive order also includes the flexibility to modify the sectors covered.

Effect of regulations on US investment in China

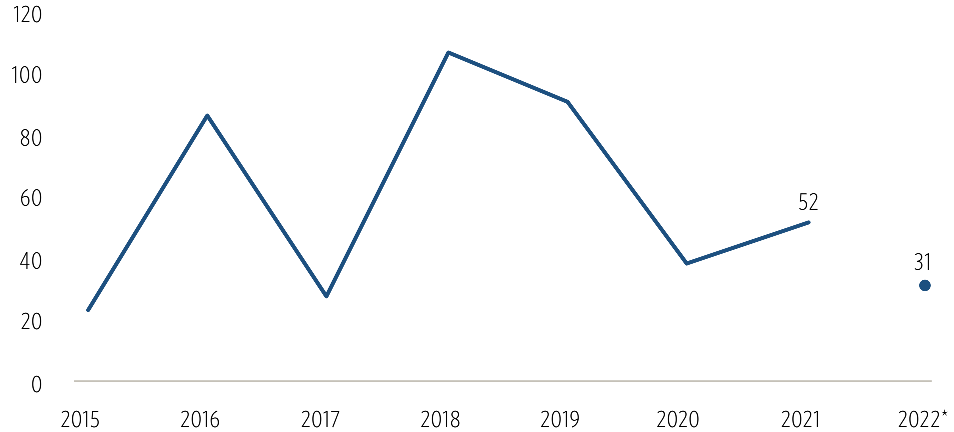
These more recent challenges impacting US investment in China will have a broad but varied effect. As mentioned earlier, historically, both LPs and GPs have benefited from the win-win situation in China over the past two decades. LPs have been able to further diversify their portfolios into more managers and geographies, and GPs have been able to able to expand their investment strategies to appeal to wider groups of LPs for a market with high risk and high returns.

LPs

US LPs have looked to invest in China because it has provided a different risk/return profile than what is found in the US market. Larger LPs have also been able to put large chunks of capital to work in large funds, in a less-crowded investor market than what they experience domestically. These factors drove US LP interest in China, though the increased risks and fewer USD fund closures have made continued investment more challenging. During the past few quarters, Chinese GPs have been experiencing severe headwinds trying to secure capital commitments from US LPs, particularly from institutional investors, and many have looked elsewhere for capital commitments.

20: "G7 Hiroshima Leaders' Communiqué," The White House, May 20, 2023.
21: "U.S. Venture Firms' Deals in China Tech Investigated by Congress Panel," The Wall Street Journal, Kate O'Keeffe and Berber Jin, July 19, 2023.
22: "Executive Order on Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern," The White House, August 9, 2023.

US LP commitments to China VC funds



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The number of annual LP commitments has closely followed the trend of China VC deal activity with US investor participation, with 2018 setting a record high of 107 commitments and participation waning after that, culminating in a six-year low of 31 commitments in 2022.

Several institutional LPs announced plans to divest from or stop new investments in Chinese equities, including the Teacher Retirement System of Texas, the University of Chicago, and the Robert Wood Johnson Foundation.[23] However, we have also seen LPs remain steadfast against this pressure. California Public Employees' Retirement System (CalPERS) made a statement in June 2023 that it has "no plans to divest from Chinese assets";[24] reinforcing its 2022 decision to commit $48.0 million to two HongShan (previously Sequoia Capital China) funds. While there have been preliminary discussions by legislators to restrict US LP commitments, no legislation has been passed to date.

GPs

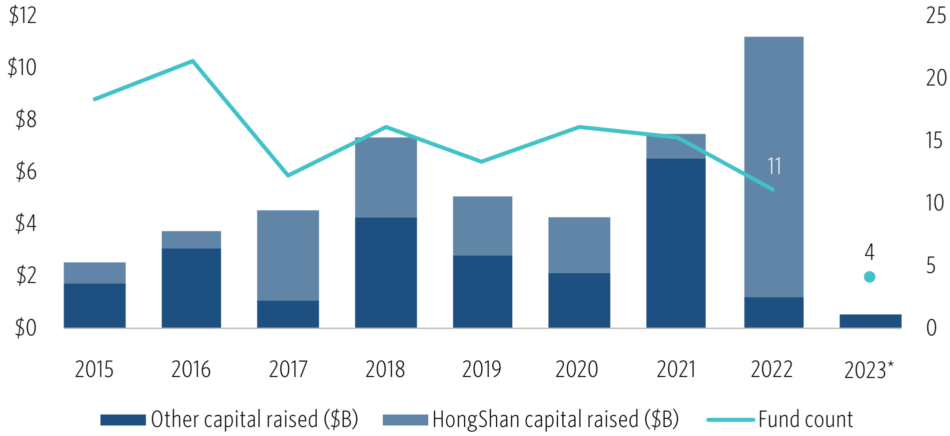
Just 40 US-headquartered firms have elected to launch dedicated investment vehicles to participate in China VC deals. Mounting pressure has made the risk of expanding operations into China even greater for US GPs, and few have done so in recent years. China's border closings during the COVID-19 pandemic, coupled with slowing economic growth and the US government's increased scrutiny of historical investments, has led to fewer VC funds closed and caused many US-headquartered firms or those with subsidiaries or secondary offices in China to re-evaluate their China strategies.

Excluding HongShan and Sequoia Capital, China VC fundraising activity by US-headquartered firms has seen a fairly steady decline in terms of capital raised since 2018. Firms that have long been operating in China have been able to consistently

23: "U.S. Pension Funds, Universities Face Pressure Over China Investments," Nikkei Asia, Jack Stone Truitt, July 2, 2023.
24: "America's Biggest Public Pension Has No Plans to Pull Investments From China as Others Flee," The Daily Caller, Will Kessler, June 9, 2023.

raise funds at larger sizes, but younger firms have struggled to clear the many hurdles in front of them. Of the 40 US-headquartered firms that have raised China VC funds since 2015, just seven expanded their strategies to include China and raised their first China-VC-dedicated fund since the onset of the pandemic in 2020, including B Capital Group, MiraclePlus (formerly Y Combinator China), and Pegasus Tech Ventures. Since 2020, this subset of VCs has captured $540.3 million in commitments across their debut funds, accounting for just 2.4% of the total $23.0 billion committed to all Chinese VC funds raised by US-headquartered firms.

VC fundraising activity by US-headquartered firms (HongShan versus other)



Source: PitchBook • Geography: Mainland China and Hong Kong
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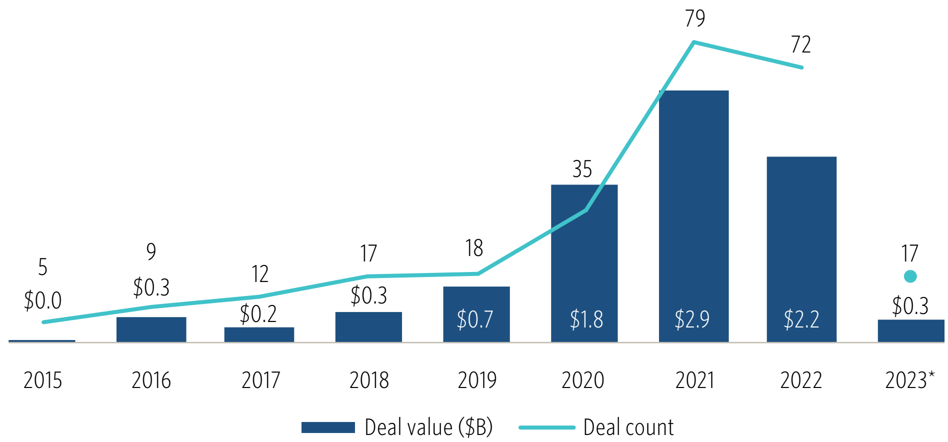
Note: This chart includes Hong Kong-based funds. Firms with US parent entities or secondary office locations in China are included in the US investor scope. HongShan includes all of Sequoia Capital's fundraising in China.

Expanding operations in China has been a high hurdle for many firms due to the risks and costs involved as well as the difficulty sourcing deals and completing due diligence without a dedicated team within the country. In 2021, B Capital Group announced its China expansion plan after spending the previous "five years investing across Southeast Asia [and] building the right team with expansive knowledge of China" prior to the COVID-19 lockdowns, tech crackdowns, and economic slowdown.[25] It ultimately took the firm nearly two years from the fund's announcement date to reach the final close of $234.7 million.

However, any shift these challenges may have will likely not have as significant of an impact on China's ecosystem as one would expect. China VC deal activity with US investor participation within the included sectors accounts for a fraction of the total deal value and count and has declined in recent years, suggesting that curbing new investment into these sectors may not be too difficult. US investor participation in semiconductor deals peaked on a deal value and count basis in 2021 and has since declined. On an annual basis, semiconductor deal activity accounted for less than 15% of all China VC deal activity with US investor participation.

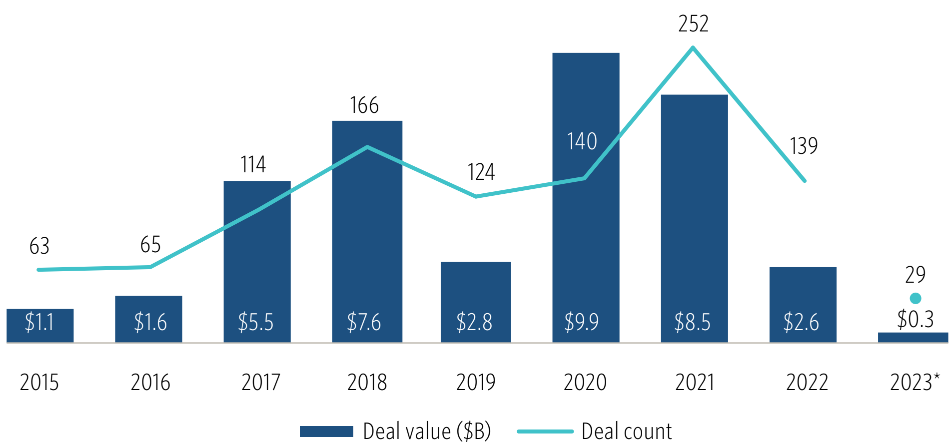
25: "B Capital Group Announces China Expansion and New Partner," B Capital Group, March 31, 2021.

Semiconductor VC deal activity with US investor participation



Source: PitchBook • Geography: Mainland China
*As of July 12, 2023
Note: Firms with US parent entities or secondary office locations in China are included in the US investor scope.

AI & ML VC deal activity with US investor participation



Source: PitchBook • Geography: Mainland China
*As of July 12, 2023
Note: Firms with US parent entities or secondary office locations in China are included in the US investor scope.

Outlook and expectations

The recent economic and political developments have made establishing a presence in China even more arduous, such that the anticipated opportunity cost for US firms partnering with Chinese nationals may be better spent engaging with their respective domestic markets or other developing ones. We expect the 2023 China VC deal activity with US investor participation to land at a nine-year low, followed by a decade low in 2024. US investors that are still interested in investing in China are taking a step back to re-evaluate their strategy while closely monitoring the ongoing market dynamics.

As noted previously, pullback of US capital may not necessarily lead to a significant void in China's VC market. Chinese GPs have already been establishing contact or engaging with investors from other parts of the world, including the Middle East and Southeast Asia, to supplement their capital needs. The August 2023 expansion of BRICS, the bloc founded to challenge a world order dominated by the US and its Western allies, to six more nations, including Saudi Arabia and the United Arab Emirates, will further strengthen the flow of capital and limit the impact of US investor pullback.[26] In addition, domestic LPs, particularly state and regional governments in China, constitute an LP base that can wield substantial capital for the regional venture ecosystem. Going forward, we expect to see RMB funds play an increasingly important and dominating role in China's domestic dealmaking and fundraising scene against the backdrop of tested US investor confidence and heightened geopolitical uncertainty.

While Biden's executive order leaves US LP fund commitments exempt, the permeating narratives of de-risking and diversifying have created pressure for LPs to take a more cautious approach to committing to China-based funds. Over the past two decades, US LPs have developed strong relationships with Chinese GPs, and if the diversification and returns desired are being realized, there may be enough incentive to deploy capital into the market. For Chinese GPs that have cemented their relationship via a strong track record and proactive communications, US LPs are likely to be more open with re-ups than adding a brand-new manager based in China to their portfolio.

The geopolitics between the US and China continue to evolve and have already impacted investor participation in the China VC market. However, it is a complex landscape that demands a nuanced approach. As both nations navigate their differences and seek common ground for fostering and maintaining a mutually beneficial relationship, there remains hope that the cross-border investment environment will stabilize and offer new avenues for cooperation. US investors must continue to assess the risks and opportunities, adapt to changing circumstances, and, above all, remain engaged with the Chinese VC market to harness its vast potential in the long term.

26: "BRICS Welcomes New Members in Push to Reshuffle World Order," Reuters, Carien du Plessis, Anait Miridzhanian, and Bhargav Acharya, August 24, 2023.