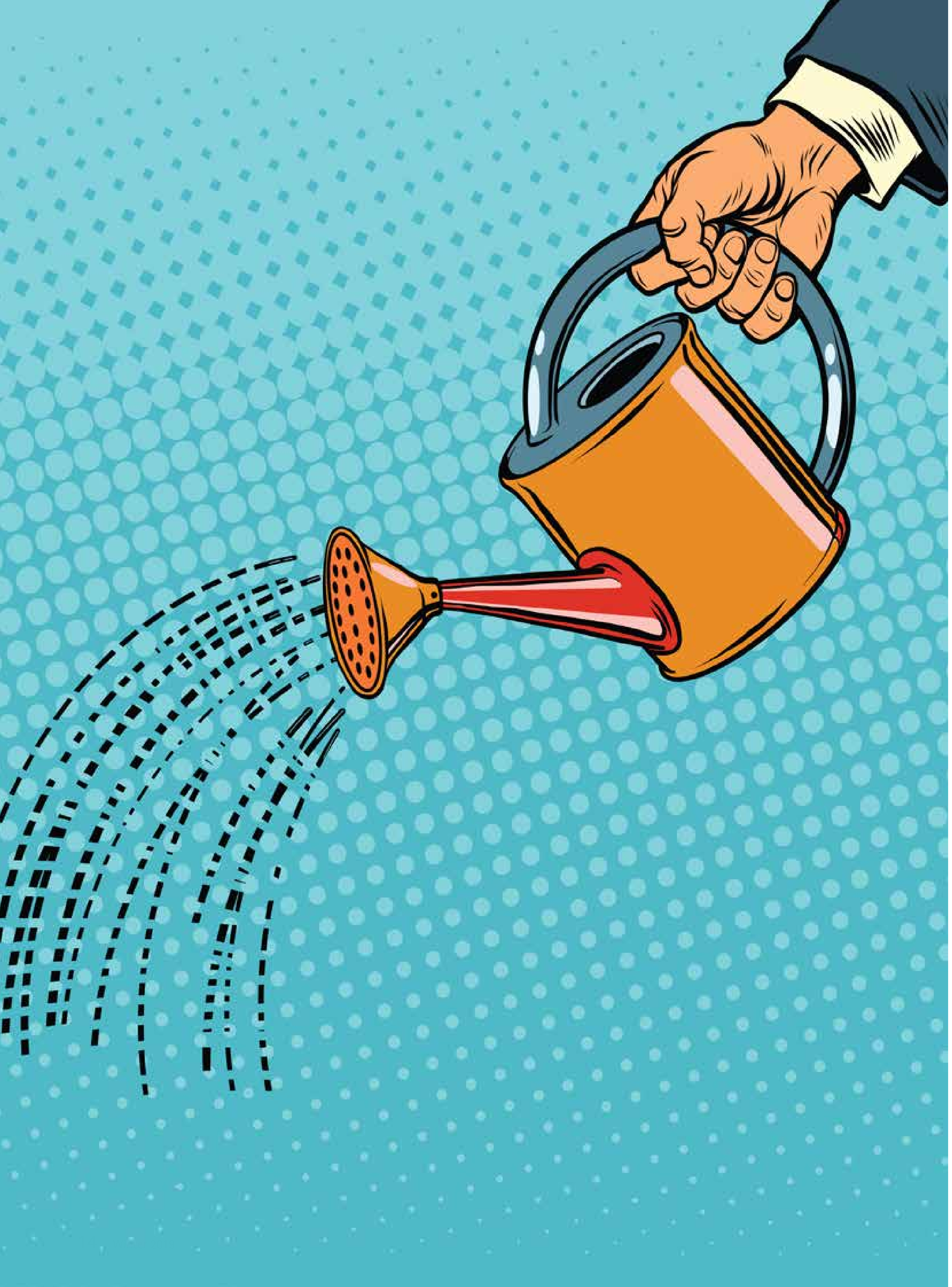
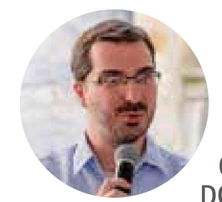
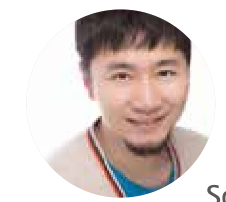
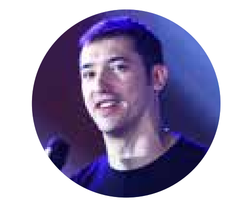


A Foreign Startups Guide to China


Martin Gothe
Co-Founder of DC-Hub


Bob Zheng
Founder of People Squared (P2)


Oscar Ramos
Full-stack innovator

Startups should look towards China, not primarily as a market but as a space to learn, inspire and invest. Three guys from Shanghai's startup scene describe China's entrepreneurial landscape and why not only startups but also corporations and SMEs should take a closer look.

Startup Land China

If you are a startup, you have to come to China. If you have an already-successful business, you have to come and see the startups in China—here is why.

When I was first asked to write this article, I decided to bring on board two fellow insiders: Bob Zheng, the CEO of China's first co-working space, People Squared (P2), and Oscar Ramos, the Managing Director of the popular Shanghai-based Chinaccelerator (SOSV). Having worked closely with Bob and Oscar through DC-Hub, an accelerator program I co-founded, and together helped countless entrepreneurs find their footing in China's elusive market, it was a no-brainer—not to mention, our offices are literally next-door to each other.

China's Startup Clusters: Beijing, Shanghai and Shenzhen

China is a cluster…so too is its startup ecosystem.

It can be divided into three main parts: Beijing, with its fintech and entertainment community, Shanghai, with its focus on e-commerce, service and software, and tech-savvy Shenzhen, China's primary hub for emerging technologies.

Beijing is No. 1 for obvious reasons when it comes to fintech and financial services startups: you have to be near the regulators. The same holds true for the entertainment industry, especially when it comes to streaming services or music.

Between Beijing in the North and Shenzhen in the South, there's Shanghai, which attracts mostly e-commerce, service and software startups. For a startup, it's the most expensive place to be but thanks to its vibrant, flourishing ecosystem, it's also the best place in terms of community, investors and opportunities.

Shenzhen is often described as the 'next Silicon Valley,' a label which, in my view, is not entirely accurate. If you're talking in the context of tech startups that need fast prototyping, then I agree. But overall, Shanghai still wins out thanks to its healthy investment scene and the sheer amount of startup companies produced every year.

Foreign Startups Must Engage with China

For the past 30 years, China has largely remained a developing country that has taken a back seat to foreign enterprise and innovation. More recently, however, China has started to come into its own and create its own innovation hubs and ecosystem. In the process, it's provided the startup community with an entire arsenal of new ways of dealing with the many challenges a startup may face.

One of the main reasons startups are useful is their ability to solve a prevailing problem better, faster and cheaper! Though most startups will have to adjust slightly to the market and their clients at some point, the problem-solving process remains one of the major challenges that causes most startups fail. China—Shanghai and Shenzhen, in particular—can provide entrepreneurs valuable solutions and insight in overcoming these challenges, which is something German entrepreneurs sometimes lack. Flexibility and speed, as well as the 71% rule, also come to mind. The 71% rule, which I often discuss in my four-week accelerator program, states that 71% of a startup's focus should be on progression in the beginning, rather than being a 'model' startup. So, if it works, attracts and gives traction to your startup business, it's good enough, even at 71%—a concept 99% of Chinese startups intuitively apply.

A startup experience in China is also valuable for the following reasons:

- Gaining a new perspective on multiple issues and problem-solving methods
- Learning from Chinese startups and their unique economy
- Engaging with China and understanding the country's importance on a global scale in relation to your own future
- Gaining access to a huge market, as well as possibly a new partner, supplier or off-shore investor

It's noteworthy that German startups are hardly ever consumer-focused. Instead, they mostly cater to industries important to the German economy as a whole, such as automotive, manufacturing and machinery. A lot of startups also flock to China because of their existing European corporate clientele, who see the bigger market. Even for startups seeking the US as their first market expansion (language accessibility, business practices, law, etc.), they eventually move first or early to China, because their first big client will prioritize the Chinese market over the US one. China is then often used as a stepping-stone for expansion into the Southeast Asian market!

Usefulness of a Startup China-Experience

In 2018, China's share of the world economy stood at roughly 18%. In 2049, against the backdrop of the 100th anniversary of the founding of the People's Republic, China anticipates a share of 32%, a number closer to what it has shared historically. To reach this goal, China plans to become a leader in emerging technologies such as machine learning and big data, making innovation-driven companies, in particular startups, a crucial part of its future success. This technology-centric strategy creates a unique ecosystem for not only startups but also companies not yet in China, as well as policy and lawmakers.

China's Tech-Investment Slowdown Explained

According to CNBC in the US, the value of venture capital investments in China's startup scene in the tech sector slowed by a rate of 77% year-on-year in the second quarter of 2019. The article blamed lack of innovation, the ongoing trade conflict and other uncertainties for the sharp drop. I think the real reason, however, is the startup market's steep learning curve. After years of Chinese VCs and other investors pouring billions into startups and not receiving an adequate return on their investment, there's been a pullback. Even highly successful companies, such as ride-hailing giant DiDi and bike-sharing company ofo, have failed to live up to investor's initial expectations. With help from experienced backers from overseas, Chinese investors are now more cautious and, encouragingly, more deliberate. Not to worry, though, we'll continue to see long-term growth in investment thanks largely to China's leading position in emerging tech, such as 5G, which will usher in new opportunities for investors and startups alike.

The Thing with Chinese VC Money

From experience, 40% of startups come to China intending to raise funds. Taking on a Chinese investor, however, poses more than just a few challenges.

1. Most Chinese companies or private VCs can't easily invest overseas, so a startup has to open a legal entity in mainland China, leading to even more issues (see points 2-5).

2. Shareholder structures in foreign invested Chinese companies are rather rigid. Therefore shareholder changes are difficult to implement.

3. Chinese investors have no issue putting up large sums of cash, but they also demand a quick exit along with it—usually within three years or even one, putting nearly impossible expectations on foreign startups.

4. Chinese VCs are typically not as experienced as their counterparts in the US or Europe.

5. Startup founders need mentors and must have experienced investors guiding them towards success. Chinese investors, private or public, usually fall short of the necessary knowledge and decades-long experience that startups require. China developed very fast in a very short time.

6. Finally, despite market maturation in recent years, the Chinese startup ecosystem still needs more serious VCs and angel investors.

Why Co-Working Space is Essential for Startups

A lot of people ask me why certain startups fail. I often tell them it's because of a startup's failure to validate and get second opinions. Whether that's failing to update their business model or properly analyzing their team's ability, their company's approach or the market, founders should constantly seek to validate every aspect of their business. Co-working spaces allow for this validation to take place with little to no effort. Having a network of like-minded people with similar questions and concerns conveniently in one place, is an endless resource for early-stage founders. In my many years of experience, I can give you countless examples of startups finding an answer to a dilemma just by talking with their neighbors.

For a startup that's entering a new market, finding a local co-working space and being able to connect with the community is probably the easiest way to get started. Some co-working spaces even offer mentorship networks, accelerator classes, partnership programs and government support, which can largely reduce the learning curve.

Less Regulation, More Startups

In the age of big data, machine learning and neural networks, China has the advantage, simply by virtue of having a much bigger data pool from which it can source. Big data is indeed big in China. With less barriers to collect and utilize data in China, compared to places like Europe (e.g. EU's GDPR law), progress and innovation experiences far less legal, economic or social resistance.

Even German startups can benefit from China's deregulated big data ecosystem. I recently learned of a German tech startup that was cooperating with the Shanghai government to monitor elderly people living alone in their homes with relatives too far away to take care of them. The local government uses the startup to track users in real-time in a control station. If the movement pattern deviates from that which the neural network has learned over the course of six months, it will notify the control center or send relatives a message to check on their elderly loved one. Of course, this was also tested in Germany, but the lack of a suitably large amount of data to train the neural network in acceptable time made a move to Shanghai an obvious choice in the startup's early stage.

Chinese Startups are a Source of Global Innovation

When I moved to China 12 years ago, the hottest business model for startups was C2C—not consumer to consumer but 'copy to China'. Although venture capital has "venture" in the name, most investors were looking to de-risk their investment by investing in business models that had some validation. Back then, the best way to get support from a VC was to clone a working model and "adapt" it to China. The adaptation was key because lots of founders were using that strategy. Most of those cloned business models had limited barriers to entry and multiple competitors popping up—sometimes thousands of them. As a result, the competition to have the best product or best business model transformed into a race where only the fastest—the fastest to adapt not the fastest to execute—were successful.

That extreme competition made the "innovate or die" statement a reality startup founders had to face every day. To the outside world, Chinese startups were only copycats. But there is a reason why only Meituan, as one of the thousands of copycats of the Groupon model (daily deals sold online for restaurants and other offline services) today is among the top three Chinese internet companies in terms of market cap and the others failed.

These days the perception of Chinese startups in the global venture capital community is very different. In terms of venture capital invested, China surpassed the US in 2018. That venture capital hasn't just been deployed, it's also been shown to be properly utilized. In 2018, China also surpassed the US in terms of unicorn startups (a private company with a valuation, usually set in a funding round, north of USD 1 billion).

A deeper look into those numbers reveals some interesting facts regarding startup trends in China. I want to highlight one of these, relevant to not only VCs and entrepreneurs but also for multinationals in search of innovation in China. Most Chinese unicorns, though they're tagged as technology companies, are actually traditional companies born digital. These companies are not just technology enabled, technology is in their DNA—from operations to user experience and beyond. This might not be very interesting for some VCs looking for companies with global expansion, but I think it is essential for multinationals looking to better understand the Chinese startup market. It shows them what the future is going to look like. The Chinese market might be very big, but an even more impressive aspect is how open to the use of technology Chinese consumers are. As real early adopters in both the consumer and business arenas, they've become a big reason for companies now looking to China as the first market to launch—and optimize—a product. Additionally, the agility of businesses here helps startups react and reinvent themselves at a speed that we rarely see in other parts of the world, which is why they are known as "dancing dragons".

Despite most of China's unicorns having a non-tech background, there are still more real tech unicorns than in any other market—and the number is growing. In fact, Chinese startups are not only expanding first in emerging countries such as Southeast Asia, India and Latin America (where they dominate the mobile consumer space) but also in developed markets, thanks to China's ability to apply existing technology and innovation. Just look at the success of Bytedance's short video app Tiktok, which now outperforms both Facebook and Instagram among Millennials and Gen Zers.

This innovation is increasingly attracting multinationals that realize China is becoming a hub for innovation— an innovation lab with massive scale that allows companies to not only build products for that market but to stress test and improve products for any other part of the world. Multinationals are changing their "innovation learning journeys," and besides visiting Silicon Valley they are coming to China (especially Beijing, Shanghai and Shenzhen). In the last few months, this trend has skyrocketed, and both companies and governments are approaching us to understand what is happening in the innovation space across China, how this will impact them and how they can use it. The most interesting comment I heard came from the organizer of one of these delegations: "We have been organizing tours to Silicon Valley for years and things look pretty similar every year, but every six months when we visit China we see so many differences that make it obvious that change is happening in the Far East."

Martin Gothe graduated at ISM Business School, Frankfurt/Main Germany, and is an entrepreneur and mentor with ten years of experience in China. He is also the Co-Founder of the DC-Hub Accelerator Program in cooperation with the University of Leipzig.

Bob Zheng is the founder of People Squared (P2) - the first co-working space in China.

Oscar Ramos is a full-stack innovator with expertise ranging from product to strategy. He is a Telecom MEng and Biomedical PhD dropout, who has twelve-plus years of experience in the startup community in China as a founder, advisor and VC investor.