Essentials of Venture Capital
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CHAPTER 8

Going Global

After reading this chapter, you will be able to:

- Work in countries other than the United States and appreciate how their venture capital industries evolved.
- Avoid pitfalls common to investors doing business abroad for the first time.
- Implement strategies for establishing a venture capital investing office outside the United States.
- Deal with cross-border taxation and currency issues.
- Establish realistic expectations for travel requirements.

One of the most profound changes in the venture capital business during the past two decades has been its globalization. Conventional thinking dictated that U.S. venture capital was a local business and that investors would either want or need to be in constant contact with their start-ups to help them grow.

Wrapped into that practical concern was a political philosophy—namely that venture capital was essential to the creation and support

of technology start-ups that in turn assured American economic competitiveness. Exporting venture capital to other countries was tantamount to FedExing the gold bars right out of Fort Knox.

However, capital knows no ideology. It tends to flow to where it can multiply. And in the aftermath of the dot-com boom, Silicon Valley's soil seemed less fertile. Opportunity abounded abroad and venture capitalists soon sought it. The first part of this chapter covers their foreign investment strategies.

Each country has followed its own path in establishing an entrepreneurial industry and technology investing community. Some, such as Israel, managed to build a start-up culture during the 1990s. Other countries, such as Russia, have yet to make it work. We'll consider the development of several major venture capital economies in the second part of this chapter.

Despite the recent rise of venture capital in other countries, the United States remains the most active investor in start-ups. Over the past decade, start-ups in the United States have raised $488 billion from venture capitalists, according to data from Thomson Reuters. That's about 65 percent of all the money raised in the entire world from venture capitalists. Start-ups in Canada raised the next-highest amount of money, collecting $39 billion, less than a tenth as much, and still more than both China and India combined.

Strategies for Foreign Investing

The venture capitalist toolkit for going global is surprisingly limited given the diversity of locations, cultures, and industries of the world. Most firms have opted for one or more of several strategies:

1. Fly in, write a check, and fly out.
2. Open a foreign office.
3. Support an independent firm.
4. Affiliate with knowledgeable locals.
5. Subsume a foreign firm.
6. Let the government support you.

It is tempting to view one strategy as an evolution of another, especially when you see investor approaches to a country changing over time. But it may be better to think of these strategies as suiting different risk tolerances and different levels of involvement. The "fly in, write a check, and fly out" strategy is like dipping your toe into the pool to check the temperature. Subsuming a foreign firm is like diving in headfirst.

Fly In, Write a Check, and Fly Out

Investing takes a lot of trust. There's only so much any financier can do to make a company successful, and this is especially true for venture capitalists who make investments from half a world away.

For a venture capitalist to fly to a foreign country and make an investment takes almost complete faith in the local management team. This kind of trust is usually only allotted to executives who have already been successful in Silicon Valley.

This is one of the major reasons China and India gained such attention from U.S. venture capitalists during the past 10 years. Each country had a large community of entrepreneurs with Silicon Valley experience.

U.S. venture capitalists investing abroad must also have a good understanding of the technology or market a foreign start-up is pursuing. Usually that restricts "fly and buy" venture capitalists to industries that are well established in the United States.

For example, it's easier to invest in a start-up making semiconductors in China than one that hopes to open up a chain of Chinese fast food restaurants. It's easy to evaluate a semiconductor technology against what exists in the United States than to know what type of fast food will appeal to Chinese consumers.

Syndication is a classic way for venture firms to share risk and gain exposure to investments that they might not otherwise see. Yet syndicating in foreign countries is not always easy.

U.S. venture firms need strong partners whom they can trust in countries they hope to syndicate investments in. Yet there are few good firms established abroad and even fewer that have cultivated strong relationships with investors in the United States.

Investing in other countries from a home base in the United States also requires a lot of time on airplanes.

IN THE REAL WORLD

Travel

Arvind Sodhani runs Intel Capital, which is regularly one of the most-active investors in the world. The investment arm of the Santa Clara, California–based semiconductor giant has made investments in 35 countries. It has dedicated investment funds for China, India, the Middle East, and Brazil.

Sodhani spends a lot of his time on airplanes managing these investments. He says he books 250,000 miles on international and domestic flights each year.[a]

Don Wood runs Draper Fisher Jurvetson's global network of affiliate funds. Sitting in his office on Sand Hill Road, Wood keeps a map of the world on one wall, with pushpins indicating the locations of the 17 DFJ affiliates. The other wall has two framed Roger Broders original art deco travel posters.[b]

He has no idea how many miles he travels each year, but he does know that United Airlines has given him the distinction of being a ''United Global Services'' member. Details on the program are guarded, but this frequent-flyer status is reserved for the top 1 percent of the airline's flyers. It's one step above the customers who book more than 100,000 miles of travel each year.

Ajit Nazre discovered and supported India's Info Edge (operator of Naukri.com) as a partner at Menlo Park, California–based Kleiner Perkins Caufield & Byers. He was just past 40 when he worked with the Indian Internet start-up and helped to take it public. He visited India six times in 2006 to get the deal done.[c]

''Quite a few of the venture folks in the Valley have lifestyle problems when it comes to travel,'' he says. ''I'm not one of those people. What are you going to do? Say no? That's the reality. All of our businesses have business everywhere. You can't avoid it. There's no substitute for face time.''

[a] ''Remaking Intel Capital,'' *Venture Capital Journal*, December 1, 2006, http://bit.ly/dpojQ6.
[b] ''Balancing Act,'' *Venture Capital Journal*, July 1, 2007, http://bit.ly/db9P2q.
[c] ''Ajit Nazre: The Man behind Kleiner Perkins' First Big Hit in India,'' *Venture Capital Journal*, March 2007, http://bit.ly/9nqntu.

Open a Foreign Office

Flying into foreign countries all the time is not easy. That's one of the major reasons that U.S. venture firms open foreign offices staffed with full-time investors.

It takes a serious commitment to send a venture capitalist to a foreign country. Beyond the cost associated with opening a permanent office, just getting someone to leave a cushy life in Silicon Valley isn't easy.

It may, however, be an amenable arrangement for a venture capitalist with substantial family or cultural ties to the foreign country. He or she may already speak the language. The fact that many successful venture capitalists have connections to China and India may be one of the major reasons investment into those countries has taken off.

One seldom sees a firm hire for a foreign position, at least not until it is certain it wants to stay in a given country. This may be because venture capitalists are reticent to share compensation with another partner or just because the firm wants to train a new investor in the United States first, in order to keep its operations consistent across countries.

Support an Independent Firm

This strategy first appeared around 2005 as well-known U.S. venture firms sought access to investments in China but were unwilling or unable to open offices abroad. Other firms were concerned that they had little or no experience with this emerging economy and would have a tough time gaining it by themselves.

Venture capitalists wanted trusted partners in foreign countries to syndicate deals with, so they helped create them.

U.S.-based New Enterprise Associates (NEA) had tested the waters in China with a pair of late stage semiconductor investments. But making late stage investments in prepublic companies is different from time-intensive early stage investments. Without people on the ground in Shanghai and Beijing, it seemed impossible to penetrate the early stage market.

So NEA joined forces with U.S.-based Greylock Partners, another well-known and respected firm, to help launch a $125 million fund targeted at China called Northern Light Ventures. The two U.S.-based firms acted as limited partner investors in the newly formed fund and handpicked the venture capitalists they wanted to run it, putting the pieces together in late 2005. The Silicon Valley venture firms turned to Chinese nationals whom they had worked with in the past, especially successful entrepreneurs with significant experience working in California, to staff the new firms.

Each U.S. firm introduced the Chinese investors to their limited partners to assist them in fundraising. They also offered the expertise of their general partners as a resource. In return, the expectation was that the newly formed Chinese venture capital firm would find good investments and syndicate them with the U.S. venture capitalists. That way, the U.S. firms avoided the risk of beginning their own office, but were able to take part in investments as though they were sitting in China themselves.

Other U.S. firms began their own affiliate partnerships in China around the same time. Silicon Valley–based Mayfield Fund announced in October 2005 that it was both a limited partner in and a

coinvestor with Chinese venture firm GSR Ventures, which had a $72 million fund.

Both Northern Light and GSR have gone on to raise subsequent funds.

NEA did the same thing in India, putting former Intel Chief Engineer Vinod Dham in charge of its NEA IndoUS fund. Dham is considered to be the father of Intel's Pentium processor line and had been investing in India prior to partnering with NEA in 2006.

Affiliate with Knowledgeable Locals

This strategy is often compared to launching a chain of fast food restaurants. It's the McDonald's business model: A central organization dictates structure and brand and provides supplies in return for a big cut of whatever profits the local restaurant makes.

In the venture capital affiliation model, the central "parent" firm dictates branding and strategy to its affiliate partners. It helps them raise funds in exchange for a cut of their fees and carried interest. The affiliates also share attractive deals with the parent firm.

Affiliates are expected to maintain consistent branding with the parent venture firm and to share income into perpetuity. A particularly successful affiliate may later spin off into an independent venture firm, but doing so may be frowned upon by the parent firm.

Employing an affiliate strategy is halfway between creating an independent firm and opening a foreign office. An independent firm might do a portion of its investments with a U.S. firm as a syndicate partner, but an affiliate will do the majority of its investments in tandem with its parent firm.

U.S. venture firm Draper Fisher Jurvetson helped to pioneer this investing model during the 1990s. It began with affiliate funds in other parts of the United States and has since expanded into half a dozen foreign countries.

Its success with this strategy has been mixed. During the dot-com boom, it helped launch DFJ ePlanet Ventures, a $650 million affiliated fund with a global investing mandate. Over the subsequent half-decade the fund invested in Chinese companies Baidu, Focus Media, KongZhong, and Luxemburg-based Skype. Each led to a massively successful liquidity event that lined not just the pockets of the affiliate fund but also yielded ample returns to the parent firm.

The firm has had less success chartering affiliates focused on specific countries. Some have never made it off the drawing board, such as the Ukraine-focused DFJ Nexus or the Greece-focused DFJ Faros, while others, such as Brazil-based DFJ FIR Capital Partners, are still too early in their development to judge.

Subsume a Foreign Firm

Sometimes it is easier to buy a venture firm than to build one. That's the thinking some U.S. venture capital firms have employed as they expanded into unfamiliar territories.

Merging operations with a foreign venture capital firm already in operation can take away a lot of headaches. The investors at the foreign firm get along with each other and may have a track record of success. Perhaps most important, the partners of a foreign firm already have substantial connections to entrepreneurs and don't need time to come up to speed.

These reasons weighed heavily in the minds of the partners of Menlo Park, California–based Sequoia Capital and Kleiner Perkins Caufield & Byers (KPCB) when they decided to buy out venture firms. Sequoia subsumed India-based WestBridge Capital in 2006 and KPCB took on TDF Capital in China during 2007. Both WestBridge and TDF had successful investing track records in their respective countries and years of experience doing U.S.-style venture capital.

How such transactions work is not easy to learn—both firms have declined numerous inquiries to discuss specifics. However, it is clear that the strategy immediately exposed Sequoia and KPCB to top-notch investment opportunities in countries that have been difficult for other investors to crack.

Let the Government Support You

Foreign governments periodically attempt to recreate Silicon Valley's innovation ecosystem within the borders of their own country. Their efforts usually include some kind of incentive designed to import knowledge and investing talent from elsewhere in the world.

Both Israel and Russia have attempted to entice experienced venture investors during the past two decades. Each created a fund-of-funds structure with hundreds of millions of dollars designed to support the formation of venture funds in cooperation with foreign partners (more on this later).

Obtaining support from such a program has its plusses and minuses, but can be a good way for a venture capital firm to enter a foreign country for the first time.

Venture Capital Outside the United States

Knowing how to invest in a foreign country is one thing, but knowing which foreign country to go to is another matter completely.

Despite the recent rise of venture capital in other countries, the United States remains the most active investor in start-ups. Over the past decade, start-ups in the United States have raised $488 billion from venture capitalists, according to data from Thomson Reuters. That's about 65 percent of all the money raised from venture capitalists in the entire world.

The United States has developed a very attractive environment for small companies that no other country has yet replicated. People seem to be constantly asking: What makes Silicon Valley so successful at commercializing innovation? Some attribute the area's dominance to its proximity to Stanford University's major research and engineering centers. Others say it has to do with geographically centralized venture capital industry, or even the concentration of large tech corporations nearby.

But where else might such an innovation ecosystem emerge?

The number of start-ups financed in a given country might be indicative of its ability to sustain further investment. Exhibit 8.1 shows which countries have had the most active venture capital industries during the past decade.

Of course each country or region has its quirks, some of which have opened opportunities while others have made development more difficult. We'll consider several of the areas of greatest interest.

EXHIBIT 8.1

Venture Capital Investment around the World 2000–2010

Country	Number of Start-ups	Investment ($ Billion)	Country	Number of Start-ups	Investment ($ Billion)
United States	19,398	$488.1	Australia	809	$6.2
Canada	5,920	$39.0	Spain	716	$6.2
United Kingdom	3,234	$36.8	Sweden	892	$5.9
France	2,605	$23.5	Israel	522	$5.5
China	1,174	$18.5	Italy	433	$5.3
India	1,052	$15.9	Brazil	303	$4.7
Germany	1,692	$13.3	Hong Kong	179	$4.3
Netherlands	727	$10.0	Denmark	394	$4.2
South Korea	2,433	$9.5	Singapore	213	$3.4
Japan	451	$7.1	Rest of the world	4,599	$36.1

Source: Thomson Reuters

Israel

It's impossible to ignore the potential of Israeli entrepreneurs and technologists. The country has invested heavily on defense and technical training for its soldiers. And many of those who go through the compulsory military service end up applying their leadership lessons and technical know-how in the service of start-ups.

The military unit that mints the most entrepreneurs is also one of the most secretive. Unit 8200 of the Israeli Defense Forces is akin to the U.S. National Security Administration, only with more guns. It

recruits its members starting in high school and attracts many bright people for work in intelligence.

Once Unit 8200 members finish their term with the military, they seem to find their way into management positions at start-ups. Their experience working with high-performance teams and cutting-edge technologies can uniquely equip them to take on the challenge of running a start-up. "I salivate over these guys," venture capitalist Jon Medved recently told *Foreign Policy*.[1]

A large number of successful technology start-ups can trace their roots back to the Unit, but the most well known may be digital security company Check Point Software. Company founder Gil Shwed spent four years in the Unit, according to reports.

Unit 8200 members have become acutely aware of the success of their peers in the technology business and have tasked the section's alumni association with the role of facilitating networking and job placement.[2] It may be one of the best-networked groups in the entire country.

To be sure, not all of the country's entrepreneurs are Unit 8200 members. Israel has done a remarkable job of stimulating technology start-up development and its entrepreneurs come from every walk of life.

Yozma Program

Israel may have been ripe for an innovation economy to flourish, but it took a government program to attract venture capital investment.

In 1993 the government began the Yozma program, which used $100 million in public funds to match venture capital investment in

start-ups. *Yozma* means "initiative" in Hebrew, and the program was designed to jumpstart the nascent venture capital business. Its aim was to replicate the success of Silicon Valley by funding entrepreneurs with serious initiative.

The government started by inviting foreign investors to establish venture funds based in Israel that would invest solely in Israeli start-ups. It selected 10 firms it would support with public money, offering to contribute up to 40 percent of each firm's first Israel-focused fund.

When one of the supported venture capital firms picked a start-up to invest in, the government matched the venture firm's investment at its promised 40 percent contribution. The government bought an equity stake in the start-up, just like the venture firm did.

As a Yozma-supported firm's portfolio of start-ups grew and became more stable, the government's share became more valuable. But instead of reaping the upside of a successful investment, the government offered each venture firm the opportunity to buy back the government's initial investment in the fund.

When the government offered its investment back to the firm for sale, it was at a bargain basement price. It did not ask for a price that reflected the growth of the portfolio of start-ups, say double or triple what the venture investors initially invested; the government offered its stake in the venture fund at cost plus a modest annual interest.

That was a pretty good deal, effectively allowing a venture firm to almost double down if it was successful. If a venture fund turned out to be unsuccessful, the government shared in the downside. The government also made direct investments into start-ups, backing 15 companies, of which 9 enjoyed positive returns.

The Yozma program offered money to just 10 venture firms. Those firms demonstrated it was possible to make good investments with attractive rewards and their success attracted many other firms to the country. Moreover, many of the firms that got their start through the program have persisted and continue to invest today.

"Israeli Model"

Israel's entrepreneurs and technologists are top notch, and its government has supported the development of a vibrant venture capital community. The one thing Israel always seems to be missing is customers. As one entrepreneur explained to me, "You have to cross 1,000 miles of sand and desert just to sell something."

Customers are a key part of an innovation ecosystem. Beyond the obvious importance of exchanging money for goods and services, customers also play a critical role in the development and improvement of a start-up's product. Customers are the best testing ground for any innovation and regularly provide feedback to start-ups on how to improve their offerings.

Although many multinationals have offices in Israel, the country still lacks the large customers that its start-ups need to survive. But entrepreneurs have adapted to this challenge by developing what is often called the "Israeli Model."

Under this model, a start-up maintains its research, development, and production in Israel, but stations its CEO and sales team in a country with lots of potential customers.

Visiting an Israeli Model start-up is a strange experience. You meet with the CEO in a big office building in Redwood City,

California, and find out that he and the vice president of sales are the only two people working for the company in the entire building. You start to wonder where those millions of venture capital dollars are going. The developers, testers, support staff, and other employees all work from Israel, several thousand miles away.

IN THE REAL WORLD

An Area in Conflict

During the summer of 2006, the Israel-Hezbollah conflict revved up, sparking fears of a major military mobilization.

There was little immediate danger for many in the tech business though. The fighting focused on Israel's northern border, while most of Israel's technology companies are based in the southern city of Haifa.

But some start-ups still felt the effects. UCLT, a semiconductor start-up based in Karmiel, Israel, had to relocate most of its operations to be closer to bomb shelters, says investor Yoni Cheifetz of Lightspeed Venture Partners. Lightspeed invested $8.7 million in the company's first institutional round in January 2006. The start-up has had to postpone visits from foreigners concerned for their safety, Cheifetz says.

Meanwhile, the biggest strain on Israeli venture investors has been personal. Cheifetz says he has taken in friends from the embattled northern region just so they can get a decent night's sleep.[a]

Still, investors seemed undaunted in their pursuit of profits. U.S. venture firm Greylock Partners, for example, launched its first Israel-focused fund north of Tel Aviv during July 2006.

[a] ''Greylock launches fund in midst of conflict,'' *Venture Capital Journal*, September 1, 2006, http://bit.ly/cdG6VE.

Pullback

Interest in Israel peaked during the late 1990s as the country helped lead the development of telecommunications networks. U.S. venture capital firms opened offices in Israel, added an Israeli partner, or established funds specifically dedicated to investing in the country.

But the results of the dramatic push into the country have been mixed. Only a few major companies have emerged from Israel in recent years. U.S. venture capitalists feel increasingly pressed to find returns even within their own country and are reconsidering foreign operations.

The result has been a slow pullback from Israel. It is not always easy to distinguish which firms have withdrawn their support and which are simply slowing their investment.

Most notable in the retreat has been Benchmark Capital, the U.S. firm known best for its investment in eBay. The firm had established an Israeli affiliate fund in 2001, but announced it would no longer be working with the affiliate to do deals in Israel. It isn't ignoring the country completely though; it still considers investments there through its primary fund.

A Future in Cleantech?

Israel's technology business has historically focused on information technology. Yet there is a great deal of interest from both entrepreneurs and financiers to work on alternative energy and resource efficiency start-ups.

Water has always been an issue for Israel, and many start-ups are looking to exploit the country's long history of working on desalinization.

Others are more interested in developing energy sources to replace oil. For example, Project Better Place is run by Israeli Shai Agassi and has received $550 million from investors, including large Israel-based firms. Its goal is to build a national infrastructure of battery swapping stations for electric cars.

China

When investors and entrepreneurs talk about China, they invariably mention the fact that the country has more than a billion inhabitants, many of whom are coming into a consumption economy for the first time. From this fundamental principle extends any number of suppositions and investment theses:

- China will be a tech giant thanks to the massive number of engineers that it trains each year.
- China will have more people connected to the Internet than any other country in the world—it will make the U.S. Internet boom look little by comparison.
- China's middle class is going to be bigger than the entire U.S. population and all you have to do is sell to just 1 percent of those consumers to make billions of dollars.

"The Rise of China" was recently rated the most written-about news story of the decade and the rapid expansion of the country's

economy, which seemed only to accelerate in advance of the 2008 Olympics, has managed to sustain itself through the ongoing financial crisis.

A few adventurous U.S. investors began flying to China in 2000 to invest in deals that looked extremely similar to what one might have seen in Silicon Valley. Yet most venture capital investors did little or nothing to either leverage the country's base of engineers or tap its markets until after 2005. It was the point when skepticism finally gave way to greed, and soon many U.S. firms established either offices in Shanghai or started China-dedicated funds.

But just as soon as making money seemed easy, it proved to be hard. Competition for good investments heated up and talented entrepreneurs became harder to find. U.S. firms were faced with a choice. They could go all the way, hire local professionals, set up offices outside of Beijing and Shanghai, and invest in nontech start-ups. Or they could quietly pack up and pull out.

First Movers

The first iteration of venture capital investment in China filled a long-underserved need for capital there. Entrepreneurs versed in telecommunications migrated into dot-com start-ups, or worked on networking devices.

There was little to no domestic growth financing to support these start-ups and many U.S. venture capitalists were not ready to invest.

Most firms that were already successful U.S. investors were shy about visiting China. Many echoed the sentiment of Don Valentine,

the founding partner of Sequoia Capital. In September 2004, he addressed an audience in Palo Alto, California about the opportunities he saw in China during a recent trip he'd made there with 19 other venture capitalists that had been sponsored by Silicon Valley Bank.

He made it clear that he thought it was a bad idea to invest there. "China has no laws, no accounting system, bankruptcy banks, and according to *Fortune*, a stock market that is made up of a den of thieves," he said. "You're about to see a bubble burst in the next five years, or sooner, that will make our bubble look meaningless."[3]

Many in the audience that evening nodded their agreement. But a handful of small, newly formed firms emerged to grasp the opportunity. Foremost among them was Granite Global Ventures (now called GGV Capital).

The firm raised its first fund in 2000 based on a new strategy. It pitched the idea of investing both in the United States and in China and focusing on mature start-ups.

GGV Capital planned to nose its way into deals on both sides of the Pacific based on the idea that it could help U.S. companies navigate the offshoring of certain manufacturing or software development to China and that it could help Chinese companies access U.S. consumer and capital markets. The firm was one of the first to open a permanent office in Shanghai.

The firm's aggressive move to capitalize on the opportunity in China paid off. Entrepreneurs there were yearning for capital to get their businesses off the ground. Larger U.S.-based companies wanted better access to Chinese manufacturing facilities and invited GGV Capital to invest, join their corporate boards, and help them meet partners in China.

The firm's first fund returned 2.3 times what it raised from limited partners, which is a good return. One or two investments might yield 10X or more in any given venture fund, but to get back more than twice the value of the entire fund is impressive. In fact, records show it was one of the top-performing funds investing anywhere in the world at the time, according to data from CalPERS.

But GGV Capital was an exception. Most U.S. venture capital firms didn't touch China at all during the dot-com boom or immediately after its bust. The few that did involve themselves did so only by sending junior investors on airplanes to report on what was going on there.

Baidu, Alibaba, Focus Media, and the Olympics

Investors are motivated by fear and greed. And fear was still very much in the air when it came to investing in China at the beginning of 2005. But the dam was weakening. Soon, a torrent of suppressed greed would be let loose on the country.

Thomas Friedman came out with the globalization manifesto "The World is Flat" in April 2005. It lauded the internationalization of business empowered by the Internet and the free flow of people and capital. You could not attend a Silicon Valley investor conference without someone reminding the audience that "the world is flat now," as though some fundamental physical principle had recently been reset.

Then the summer came and brought with it IPOs. Early China investor DFJ ePlanet Ventures took digital billboard advertising company Focus Media public in July. It jumped 20 percent over its offering

price on its first day of trading on NASDAQ. After the IPO, the company was worth $1 billion and was still less than three years old.

China exploded into the psyche of U.S. venture capitalists on August 5, 2005. That was the day that Chinese search engine start-up Baidu offered its shares on NASDAQ via an IPO. The shares offered at $27 and closed that Friday at $123.90, up more than 350 percent during the day.

The next week Yahoo spent $1 billion to buy 40 percent of Chinese Internet auction company Alibaba. U.S.-based Granite Global Ventures had invested early in the company's development and received a substantial payout.

The boom was in full swing and everyone in Silicon Valley was talking about how to get in on the easy money. Entrepreneurs pitched China-focused start-ups that would take advantage of the country's rapid growth. The chief executives of every major tech company in Silicon Valley had to field questions about how they would approach China as either a resource for inexpensive labor or as a market to sell into. Venture capitalists who had said a year or two before that they'd never invest in China saw their firms launch dedicated Chinese funds, or establish satellite offices in the country's biggest cities.

But the sudden rush on Chinese start-ups exhausted the supply of competent managers. Venture capitalists started complaining about a shortage of executive talent. Even skilled Chinese leaders knew little about international financial accounting standards or how to effectively use stock option grants as an incentive for employees. Some people believed that Chinese start-ups would need to offer dormitory housing to attract employees. The learning curve on both sides of the Pacific was steep.

And everybody was concerned about the role the government would play.

To date, the Chinese government has provided little impediment to the free flow of capital both in and out of the country. Local governments maintain varying degrees of interest in the technology businesses within their borders, but there are few reports of problems.

The big problem for venture capitalists investing in China has been keeping up with the rapid pace of change.

Going Native

The first big change took place after the money started to seriously flow in to China. Venture capital firms soon found themselves competing as aggressively in Shanghai as they were in Menlo Park, California.

The first wave of investment in China, from 2000 to 2005, had helped release the pent-up demand for capital and had borne a wide array of successful start-ups. The venture capital firms that came first picked the ripest fruit.

The second wave, which lasted from 2005 to 2006, ensured that any reasonably attractive start-up got the funding it needed for growth. The venture capitalists picked any fruit that looked like it was edible. Native Chinese entrepreneurs living in the United States traveled home to take advantage of the opportunity.[4] The "invisible hand" of the marketplace had moved to stuff money into the pockets of any entrepreneur who needed it.

The third wave of venture capital in China began when all the edible fruit had already been picked from the entrepreneurial tree. Venture capitalists found few tech start-ups that needed as much

money as they were able to invest. Even the start-ups that had been financed during the second wave still had more cash than they knew what to do with.

Once the venture capital spigot had been turned on, it was hard to stem its flow. The money sloshing around Shanghai and Beijing had to be redirected. The best firms found two solutions. They either piped their money deeper into China or sent it into companies outside the technology industry.

China's second tier cities are hardly household names in the United States. Still, Tianjin, Wuhan, Guangzhou, and Shenzhen have populations greater than that of Manhattan. Despite their size, they seldom see the level of foreign visitation that Shanghai or Beijing does. Just getting around takes a firm grasp of at least one Chinese dialect. And it was to these cities that venture capitalists went next.

Notably, native Chinese had an advantage over Westerners when it came to finding and financing opportunities in these regions. Firms that committed to China early and recruited Chinese investors found themselves increasingly successful.

Just as venture capitalists began to look beyond Shanghai and Beijing, they also started looking beyond the traditional technology industries. Larger, more mature businesses in manufacturing, agriculture, and retail needed expansion capital, and venture firms were anxious to put their funds to work. Kleiner Perkins Caufield & Byers, a firm well known for its technology investments such as Amazon, Netscape, and Sun Microsystems in the United States, invested in a Chinese T-shirt manufacturer. Sequoia Capital, backers of U.S. tech companies such as Apple, Cisco, and Google, bought into a publicly traded Chinese dairy company.

China may be gearing up for the next wave of venture capital evolution. It's difficult to say what form this may take, but there is reason to believe that the country may be developing its own base of institutional limited partners. Many are government-affiliated entities that have been encouraged to include venture capital funds as a part of their investment portfolios.

An increase in the available funds for Chinese venture firms could put additional competitive pressure on the market for good start-ups and eventually drive down investment returns. It might facilitate the growth of economies outside the major cities. One thing is certain: Adding money will send China's venture business in a new direction.

India

U.S. venture capitalists often talk about India in the same breath as China. Both countries have a base of well-educated engineers and a burgeoning consumer class. But the similarities end there.

India benefitted from a telecommunications infrastructure constructed to make outsourcing services reliable. Major technology companies established offices in cities such as Bangalore, first to take customer service calls and later to develop large swaths of complicated software. It brought millions of people in contact with computers and the Internet, many for the first time. That cleared the way for e-commerce and other online start-ups that venture capitalists have experience financing.

More important, it has contributed to education and employment in India. There were some 2.3 million software and service sector employees by the end of 2009, nearly three times the number

employed at the end of 2004, according to the National Association of Software and Services Companies.[5]

And that's not just people answering customer support calls. According to reports, between 2004 and 2007, the number of workers engaged in software research and development grew by more than 75 percent to an estimated 144,000. This would explain why the number of patents granted to companies in the Software and Services sector grew 22X between 2005 and 2008.[6] Other technology sectors, such as semiconductors, networking gear, and mobile devices are seeing similar spikes in employment. That kind of innovation gives venture capitalists a good reason to lick their lips.

Demand for technical talent has fueled a surge in engineering students in Indian universities. Those students numbered just over 1 million in the 2003–2004 school year, up from the 590,000 enrolled during 2000–2001, according to a study by the National Council of Applied Economic Research. Engineering is the country's fastest growing course of study, the report shows.

And Indians are becoming increasingly connected to each other and the rest of the world. The number of people subscribing to broadband in India was 20 million in 2007, while the number of Internet users was about 40 million, according to the India Department of Telecommunications. That's where the United States stood in 1995 and it represents less than 10 percent of India's growing middle class. Mobile phone penetration is much further along. India broke the 100-million-subscriber mark in April 2006 and has since been adding new subscribers at a rate of 4 million a month, according to the Internet & Mobile Association of India.

Each of these factors—computer experience, large markets, emerging innovation, engineering education, and communications infrastructure—mirrors some part of what has made Silicon Valley successful and attractive to venture capitalists. An optimist might look at India and see many of the necessary components for a lucrative venture capital investment market.

Infrastructure Issues

For all there is to be excited about in India, there are several major problems that impede growth and have made the country difficult for venture capitalists to invest in. Foremost among the problems is the infrastructure issue.

Uncertain electrical power and a lack of transportation infrastructure top the list. India's manufacturing sector suffered as many as 17 power outages each month during 2004, which resulted in an estimated loss of 9 percent of its output, according to a study by the World Bank. Running a start-up is hard enough without having to worry about basics like keeping the power on.

It isn't easy for venture capitalists to even get to potential investments. As recently as 2007, the entire country had only 2,000 miles of four-lane highways, or about 20 times less than United States. Even if you can take the highway it isn't likely to help you much. The average speed on those highways is 20 miles per hour, according to the World Bank.

As if these issues were not enough to deter foreign investors, the business infrastructure problems are elephant-sized, such as the deficit of suitable office space or the time it takes to set up a dedicated high-speed data connection. There's weak intellectual property protection,

making it difficult for would-be innovators to secure any defensible advantage from research and development. And Indian courts process legal claims at a pace that would put a snail to shame.

It is by no means Silicon Valley, where office space abounds, patent lawyers are a dime a dozen, and the San Mateo County Court works with deliberate speed. Yet that doesn't dampen the desire for investment capital. After all, it took decades before business infrastructure came south from San Francisco.

Investment Trends

Investor enthusiasm for India peaked in 2007. The country's stock market reached its apex during the first week of January 2008. At that point, the Sensex, India's version of the Dow Jones Industrial Average (DJIA), closed at over 20,800, more than 5.2 times higher than it had been during the same week five years before. To put that in perspective, if the DJIA had grown at an equivalent pace during the same time period, it would have topped out at over 45,680.

For India, it was a period of unprecedented growth.

Still, the venture capital opportunities remained somewhat limited thanks to a lack of management talent and too many entrepreneurs pursuing the same opportunities. For example, eight Indian online travel start-ups had raised venture capital by 2007. That's a lot of start-ups chasing a new market. What's worse, the market was still small because few Indians were online.

It seems clear that India will eventually develop a multibillion-dollar online booking business similar to the market Kayak, Expedia,

HotWire, and others serve in the United States. In fact, the market could eventually be much larger, not only because of India's population, but also because the process of buying travel tickets is more difficult to begin with. But having eight companies compete against each other makes it a lot harder for any one venture capitalist to make money.

Still, many U.S. investors were emboldened by the success of Info Edge, the company that runs online job site Naukri. The start-up raised money from Kleiner Perkins Caufield & Byers and Sherpalo Ventures. The two U.S.-based firms had invested together before in the United States, but the investment in Info Edge was their first foray together into India. The two firms collectively paid $6 million for 5 percent of Info Edge in April 2006.

It proved to be a lucrative investment. Info Edge went public on the Bombay Stock Exchange in October 2006 and closed its first day of trading at nearly double its offering price. The venture capitalists' stake was valued at $75 million. Not bad for just six months of investment.

Like Netscape in the United States or Baidu in China, many venture investors looked at this as proof that venture firms could come into India, invest, and get their money back via an IPO.

Every U.S. venture capitalist that had either been to India or was thinking about going there talked about Info Edge's Naukri job portal. It seemed a marvel to those accustomed to the high barrier for public companies hoping to get attention via a U.S. IPO. "A $20 million [revenue] company wouldn't get noticed on the NASDAQ, but in India it's huge because there's not that many Internet stocks there," says Deepak Kamra, a Menlo Park, California–based general partner at Canaan Partners.

Indian Stock Markets Garner Attention

The run up of the Sensex combined with the burgeoning supply of companies looking to list public offerings made the stock markets themselves attractive businesses.

The New York Stock Exchange (NYSE) took note. In January 2007, the NYSE Group said it would buy a 5 percent stake in the India National Stock Exchange (NSE) for $115 million. Two years later, U.S.-based venture capital firm Norwest Venture Partners invested $55 million into the NSE. "We are extremely bullish on the value proposition NSE offers shareholders at a time when India is on the cusp of global influence," Norwest Managing Partner Promod Haque said at the time.[7]

The strength of the NSE and Bombay Stock Exchange (BSE), both of which are based in Mumbai, prompted more companies to consider going public. It's relatively easy for an Indian company to go public. The minimum requirements to list are a market capitalization over $1.1 million with revenue of more than $600,000 in the past year and more than 1,000 investors after an IPO. The exchanges also don't have the Sarbanes-Oxley restrictions that have caused so much heartburn in the United States.

IN THE REAL WORLD

Mauritius Tax Pass-Through

If you're thinking about investing in India, then you need to get up to speed on the island Republic of Mauritius, 500 miles east of Madagascar and about two-thirds the size of Rhode Island.[a]

There you'll find Kleiner Perkins Caufield & Byers, Sequoia Capital India, and Norwest Venture Partners, to name a few. Well, you're not likely to find any of those firms' actual partners, but that's where they have incorporated their Indian investment vehicles.

Mauritius, which rhymes with ''delicious,'' has been an Indian tax haven since April 1, 1983, when it entered into an agreement with India to avoid double taxation of its residents. India agreed not to levy a capital gains tax on the sale of shares of Indian stock owned by a Mauritius entity, under the Indian–Mauritius treaty.

The treaty is important because India taxes its residents differently than the United States. The Indian government collects a tax whenever an Indian asset is sold, no matter who sells it. The United States government taxes citizens for the capital gains they realize as income. ''If you bought some stock in the Indian stock exchange, even when you don't live in India, you're subject to tax on the Indian shares,'' explains Fred Greguras, an attorney at Fenwick & West. ''A lot of people have located their funds in Mauritius to avoid this.''

Mauritius doesn't tax capital gains, so international investors that locate subsidiaries there completely miss out on any taxation on shares of Indian companies they sell.

[a] ''Meet Mauritius,'' *Venture Capital Journal*, March 1, 2007, http://bit.ly/d8Agj3.

Russia

Venture investors periodically get excited about the potential of Russia. They see the country's strong scientific history, its defense-industry technical prowess, and the tenacious ability of its people. It looks like an attractive investment opportunity. But Russia has yet to develop a robust small company innovation ecosystem.

The latest craze for the country came in 2006, when the government took steps to actively promote the establishment of a venture capital industry.

Government Stimulus

In 2006, the Russian economy was in the midst of resurgence, averaging 6.4 percent GDP growth each year since 1998. The Russian Trading System, that country's version of the NYSE, was up 330 percent from 2003.

And it wasn't just the oil oligarchs making money. Personal incomes increased more than 12 percent each year since 2000, according to the CIA World Factbook. The middle class seemed to finally be coming into its own as an economic power, and people with greater income have greater freedom to both consume and take entrepreneurial risks.

At the same time, Russia's communications ministry was predicting computer penetration would quadruple and the percentage of people using the Internet would triple by 2010. There was going to be lots of money made in information technology and communications, the government assured anyone who would listen.

It was during this time that Russia's Communications Minister Leon Reiman announced that the government had launched a $500 million fund-of-funds to stimulate growth among technology companies in the region. The fund could expand to $1 billion, depending on the interest of outside investors.

The move was met with great optimism from U.S. investors. "This is the clearest effort to date from the government saying that Russia's future isn't just petrochemicals," Palo Alto, California–based

investor Colin Breeze said at the time. "It's defining Russia's future in technology, communications, and services."[8]

Earlier Attempts

U.S.-based venture capitalists looked to embrace Russian entrepreneurs for decades with little success.

Perhaps the first venture capitalist to see opportunity in the country was Pitch Johnson. Johnson is famous in Silicon Valley for being one of the first west coast venture capitalists to open shop during the 1960s. He is considered a pioneer of the industry.

Johnson attempted a $10 million Russian-focused venture fund in 1995, which did well until the Russian financial crisis of 1998. After the correction, it made a handful of investments that are now getting serious revenue. These more recent successes may be enough to make the fund worthwhile, Johnson says.

Johnson's first trip to the country was in 1990, when he gave a talk about entrepreneurship to the Leningrad City Council. Johnson, an avid pilot, says he had wanted to fly his private plane into Russia for years and was excited to finally get the chance. It was a fortuitous meeting. Sitting in the audience that day was then–City Councilman Vladimir Putin.

When Putin became Russia's president, he was instrumental in turning around his country's economy and wanted to rev it up even more by fostering venture capital and entrepreneurship. The Russian government's fund-of-funds program was part of that effort.

Built on Yozma's Back

The government established the Russian Venture Corporation to invest the money associated with its fund-of-funds program, and its

officials met with venture capital luminaries, such as Pitch Johnson, for guidance on how the program should work. Together, they agreed to model it on Israel's Yozma program.

The Russian Venture Corporation (RVC) planned to invest in 10 funds, owning just half of each one. At the end of the investment period, the Russian government would collect its principal back along with 3 percent of any of the profits made from investing it. Investors familiar with the arrangement likened it to a form of venture debt, where a bank lends money and gets a variable payback if the loan does well.

As similar as the Russian program was to the successful Israeli one, there was one key difference. The Russian government stipulated that foreign investment firms that wished to raise money through the program would have to apply in conjunction with a Russia-based partner.

Venture capitalists formed three firms that received the first round of promised government funds. U.S.-based Draper Fisher Jurvetson launched an affiliate fund called DFJ-VTB Aurora in partnership with Russian Bank VTB. Pitch Johnson's U.S.-based Asset Management firm partnered with Russian bank Vneshekonombank (VEB) to form Bioprocess Capital. Israel-based Tamir Fishman worked with Russian partners to establish a firm called Finance Trust.

The Problem with Partners

Partnership is a sure impediment to progress. Any action requires two sets of approval. Any policy needs multiple meetings to hammer out. It takes time to build a rapport and years to build trust. Problems

among the international partners in the Russian venture market arose almost immediately.

It all started when Oleg Shvartsman opened his mouth. Shvartsman was a midlevel investor working on the Russian side of the Finance Trust firm established with Israeli firm Tamir Fishman. Shvartsman told a reporter that he used ties to government security officers to force private business owners to sell their companies below their market value.

It reinforced the worst fears of foreign investors, namely that Russia was a lawless place unfit to do business in.

The Israelis yanked their support from the fund.

Then Pitch Johnson ran into trouble with the firm he was working with in Russia. "They didn't want to do anything I'd call venture capital," he said.

Johnson's partners in Bioprocess Capital were not crooks. In fact, Johnson goes out of his way to stipulate that they were "square guys and on the 'up and up.'" The problem was that they were uninterested in financing start-ups or working with entrepreneurs.

"As the fund finally shaped up, with VEB in control, venture capital for start-ups and young companies was not high on the agenda, and investments in existing companies would be the primary activity," Johnson says. "While we Westerners were listed as 'experts' in the application [to receive funds from the RVC], our venture skills are not being utilized and I don't expect any further involvement."[9]

But such blows have not been fatal to the program. Bioprocess was still a going concern when Johnson left, even if it isn't making venture capital–style investments. Tamir Fishman returned to Russia with a new partner in June 2008. It launched Tamir Fishman Russia

as a $100 million fund with help from Central Invest Group, a Russian investment bank.

Questions Remain

It's not clear whether technology start-ups and venture capital will take hold in Russia, even with government support. Universities have yet to embrace the idea of start-ups and technology transfer as a way of improving their balance sheets or increasing their prestige. The mindset of Russian business people, at least these days, is that the most valuable natural resource is oil, gas, or some other thing that can be pulled from the ground. They have yet to embrace the idea that it is the ingenuity and efforts of entrepreneurs that are the greatest resource of a country. Wealth in Russia remains a thing you take, not create.

This can change. Change, if it comes, will be a product of the Russian people and their will to build a different future. This matters more than government intervention, better business education, or well-defined and fiercely protected property rights.

Europe

Homogeneous markets are great for business—you make one product and many people buy it. But years after the advent of the European Union, selling products and services in countries with vastly different needs and cultures remains a challenge for start-ups. However, they have managed to raise $133.3 billion from investors over the past decade, according to data from Thomson Reuters.

That money has funded start-ups that have gone on to sell for billions of dollars. Perhaps the most dramatic recent example of this

is Internet telephone company Skype, which began in Luxembourg in 2003. It was financed by an early angel investor in Denmark, quickly raised venture capital, and sold to eBay in 2005 for $2.6 billion with another $1.5 billion in earnouts.

There have been several other successes for both entrepreneurs and venture capitalists. U.K.-based online music start-up Last.fm raised $5 million from venture capitalists before selling to CBS for $280 million a year later in 2007. Swedish start-up MySQL raised tens of millions of dollars from venture capitalists in both Europe and the United States before selling to Sun Microsystems for $1 billion in 2008.

Rewind even further and you'll find a handful of dot-com-bubble-era successes, such as communications chipmaker Giga. The Danish start-up raised $2 million from European venture capitalists before selling to Intel for $1.25 billion in 2000.

Despite this appearance of success, European venture capital is underrepresented relative to the size of the combined European economies and has underperformed its U.S. counterpart. Even those successful venture investments owed much of their good fortune to the United States. The European start-ups raised money from U.S. venture capitalists, turned to U.S. customers for revenue, and later sold to U.S. corporations. This is not always the case, but there are several factors that hold European venture capital back.

Lack of Centralized Resources

Europe has its outposts of innovation, places where technology start-ups thrive and grow. Yet there is no central repository of investment

capital and experience, no preponderance of strategic acquirers, nor even a single public marketplace that rises above all others as a place for high-growth technology start-ups to go public.

That's a weighty anchor on the innovation industry of Europe. A central place where start-ups can go to find financing, such as Silicon Valley's Sand Hill Road, can drastically cut down the time it takes to raise money. An entrepreneur can meet with several venture firms in a single day, just by walking down the street.

That not only speeds the time it takes to raise money, but also forces a higher level of competition between venture firms. That's good news for entrepreneurs, who will get better financing terms as a product. Next-door neighbors are more likely to compete than venture firms based in different countries.

The same logic extends to the lack of large strategic acquirers. Europe has large technology companies in every industry. Yet there are few local competitors anxious to get the edge over each other. That means fewer bidding wars to acquire start-ups.

The lack of a central stock market presents a more serious problem. A single market for fast growing technology start-ups is good for three things.

First, it creates a critical mass of investment banking analysts who can specialize in evaluating technology companies. That helps large institutions better understand these companies and their growth potential.

Second, it creates a group of public market investors interested in technology companies. For example, it's easy to imagine an investor who has money in Cisco, Amazon, and Microsoft taking a chance on a newly public Google.

The third thing that a central market is good for is increased trading liquidity. More liquidity means if an investor decides to either buy or sell shares, the stock price will not fluctuate greatly. A stable stock price can help companies plan for the future by ensuring they'll have a ready currency for making acquisitions or raising more money later on.

Cultural Impediments

It's difficult to say how an idea takes hold, especially when it is a broad idea about a diverse group of people. Yet investors in Silicon Valley have it in their minds that Europeans are unwilling to become entrepreneurs. They believe that Europeans are risk averse and that the business culture of Europe punishes those who try something new and fail.

I have sought out and interviewed some of the most successful entrepreneurs and investors in the region and found them as willing to try and fail as anyone I have ever encountered. Yet they were, at some level, importing the ideas of what it means to be an entrepreneur.

One well-known European investor deeply admired U.S. venture capitalist Tim Draper. He borrowed many of Draper's tropes and mimicked Draper's rhetoric about the importance of entrepreneurship.

A respected venture firm in Geneva saw the majority of its managing partners educated at Harvard Business School. They were decidedly European, but equipped with a U.S. education and appreciation for entrepreneurs.

Many of the venture firms themselves are U.S. exports. Europe-based Balderton Capital, DFJ Esprit, and Accel Europe all started as affiliates of U.S.-based venture firms.

Even a staunchly European venture firm, such as France's Sofinnova Ventures, keeps an office in San Francisco to be close to Silicon Valley.

The thing that many in the United States too readily forget is that the father of venture capital in our country was, in fact, French. General Georges Doriot was born in Paris, taught entrepreneurship at Harvard Business School, and began American Research and Development, which is considered by many to be the first venture capital firm.[10]

TIPS AND TECHNIQUES

Dealing with Currency Issues

At the end of 2007, Partech International was nearing the final close on its fifth venture fund but running into problems with its European limited partners.[a]

The San Francisco–based firm had relied heavily on its European heritage when raising past funds and anticipated that as much as half of the money for its new fund would come from Europe. But the U.S. dollar was rapidly depreciating. In fact, over the previous five years, the dollar had lost half of its value against the euro.

This was a big problem for the limited partners. The firm's last fund, which was raised in 2000, evenly split the commitments from U.S. and European investors. The firm called down money from its limited partners to write checks for start-ups over a period of several years. But as the value of the dollar fell, the

European limited partners effectively bought a greater equity stake in each start-up that Partech backed.

This became a point of contention when the start-ups were acquired and Partech had money to pass out. The European limited partners might have reasonably argued that they deserved more of the payout. After all, the value of their euro-denominated contribution to the start-up's financing was 50 percent more valuable than the dollar-denominated contribution from U.S.-based limited partners.

To avoid these problems in its next venture fund, Partech developed a structure to shield its limited partners from the effects of dramatic currency fluctuations. ''That's the tricky part where we had to get pretty creative,'' says Managing Partner Vincent Worms. ''It's very simple once you do it, but very complicated to set up.''

The trick, Worms says, is to have each group of investors treated almost as though it has its own sub-fund within the firm's overall fund. Each sub-fund is denominated in the currency that the limited partners prefer, and then converted at the time an investment is made.

''We had to make sure that the U.S. investors were not favored or disfavored in terms of gains,'' Worms says.

[a] ''Falling Dollar Hampers Partech Fund-raising,'' *PE Week*, November 26, 2007, http://bit.ly/bsK3nw.

Regional Policies Promote Cleantech

A highly fragmented marketplace for investors, acquirers, and stock exchanges is a problem for start-ups looking to grow. But it can also provide rich grounds for policy experimentation and a variety of government support programs.

Perhaps the most important facet of government policy for start-ups has been the feed-in-tariffs and other state-supported initiatives for stimulating demand for solar panels in Germany and Spain.

A feed-in-tariff is a way governments can skew incentives to stimulate a market for a new product. It gives tax breaks to anyone who makes a qualifying purchase. It works especially well when consumers are *price-elastic,* meaning that a little drop in price can greatly increase the quantity purchased.

These tax breaks have given the two countries vibrant solar panel industries, replete with both major energy corporations and start-ups. It has taken the industries in Germany and Spain beyond simple manufacturing and installation to real innovation.

A good example of this is Bitterfeld-Wolfen, Germany–based Q-Cells, which makes high performance solar panels. The company raised $15 million from London-based Apax Partners Worldwide, Good Energies, the venture capital subsidiary of Switzerland-based COFRA Holding AG, and others in 2004. Q-Cells went public the following year, raising $325 million on the Frankfurt Stock Exchange, and was worth over $10 billion within two years.

The start-up managed to get out in front of competition in the United States, thanks to the early sales it made in its home country.

The Future of Venture Capital in Europe

In January 2010, Boston-based Atlas Venture announced plans to shutter its operations in Europe. The venture firm had been investing there since 1992 and had financed over 120 European start-ups.

Atlas investor Fred Destin, who worked out of the firm's London office, initially said that the move was not a product of a bearish outlook on Europe. He pointed to the firm's recent success selling French pharmaceutical company Novexel to AstraZeneca at the end of 2009 as an example of a good reason to remain optimistic about European innovation. The start-up raised more than $125 million from European and U.S. venture capitalists before selling for $500 million.

But then, two months later, Destin blogged about the problems of making venture capital investments in Europe. He cited the lack of ambitious youth and political leadership, the weight of pension funds, continual talent loss, and other issues. "We're f—ed if we don't wake up soon," he wrote. "The rest of the world works harder, smarter, produces more engineers, is hungry, is globally mobile, has inherent competitive advantages we often don't have."[11]

Destin's frustration is something other venture capitalists have echoed over the past decade. Yet for each Atlas that leaves, there's an Atomico Ventures that launches.

Atomico formed in London in 2006 and began investing the money that Skype founders Niklas Zennström and Janus Friis earned from selling their start-up to eBay. In 2010, the firm raised its first institutional venture capital fund, weighing in at $165 million. "With the rise of companies like Skype, there's been a regeneration of people who had been working as product managers or in other positions who now are going out to start something new," Zennström said.[12] He plans to be the one that finances those entrepreneurs.

Atomico is one of the few examples of a European venture firm founded by successful entrepreneurs. Although this has long been the model for establishing firms in the United States, seeing entrepreneurs turn into investors in Europe remains anomalous.

But it does happen. Successful advertising entrepreneur Morten Lund put $50,000 into Skype shortly after it formed. He got more than $20 million when it sold to eBay. Lund went on to invest in over 80 start-ups during the next several years, including Danish data sharing company Zyb, which sold to Vodafone for $50 million not long after Lund invested.

The future of venture investment in Europe depends more on reinvestment from people such as Zennström and Lund than on imported capital from firms such as Atlas.

The Rest of the World

Israel, China, India, Russia, and Europe have garnered the most attention and interest from U.S. venture capitalists during the past decade.

Which countries will be attractive to venture investors in the future is anybody's guess. But there are a few countries that may be particularly well poised to rapidly ramp up their innovation industries and accept additional foreign investment.

Japan

Venture capitalists have traditionally had a difficult time penetrating the Japanese market. "It's historically been quite closed to outside investors," says Draper Fisher Jurvetson's Don Wood. "There's a

tradition there where the smartest university graduates are tempted to join larger, stable companies. It's harder to attract talent to smaller companies there."

Still, Japan is the world's second largest economy, and entrepreneurship is starting to take root there, says Wood. He attributes the change to a critical mass of successful entrepreneurs whom new founders can emulate and a greater understanding of how start-ups work in the United States, gleaned from the Internet.

"People are no longer just looking in their own backyard," Wood says of Japanese entrepreneurs. "They have proof that you can raise venture capital, take your company public, make yourself a lot of money, and create a lot of jobs. That's really just occurred in the last three to four years."

Venture capitalists invested $7 billion into 450 Japanese companies during the first decade of the twenty-first century, according to data from Thomson Reuters. Yet nearly half of those investments were made in 2000.

One of the most attractive aspects of Japan is its Mothers market, a subset of the Tokyo Stock Exchange that promotes high-growth, small companies, says Wood. "It's a training-wheels public market. You could be public there with a $25 million market capitalization."

In fact, the average trading value on the Mothers market at the end of 2008 was just less than $14 million, according to the exchange. Mothers hosted 12 IPOs during 2008 and 23 during 2007.

The country has yet to host a runaway success that will prove its viability as an investment hub. One of the biggest recent new issues on the exchange was Internet services company Gree, which listed a

$143 million IPO in 2008. The company was founded by a 26-year-old, according to reports, and is one of the companies that are likely to act as an example for other entrepreneurs.[13]

Brazil

With the Summer Olympics heading to Rio de Janeiro in 2012, one can expect Brazil will see plenty of media attention in the coming years.

One of the things that may be most interesting to foreigners is the country's expertise in alternative fuels. Brazil has been on the forefront of ethanol development by distilling sugar since oil shocks in the mid-1970s.

U.S. investors flocked to invest in ethanol production facilities during the past decade, and much of the money that came into the country was from hedge funds.

Venture capitalists have focused on Brazilian Internet start-ups and wireless companies. Internet penetration has gone from less than 3 percent in 2000 to more than 34 percent in 2008, according to data from the International Telecommunication Union, and that has opened an opportunity to build companies and services similar to those that have been successful in the United States.[14] An example of this is Draper Fisher Jurvetson's $10 million investment in Power Ventures, which makes an online social network similar to MySpace or Facebook.

Other start-ups are carving out different parts of the information technology market. São Paulo–based Scua Seguranca develops digital security technologies and has raised more than $750,000 from local

venture capitalists. Internacional Syst S/A operates an information technology consulting company and has raised just under $1 million from Brazil-based FIR Capital Partners.

Yet Brazil's information technology sector has been somewhat slow to get going, investors say. Venture capitalists invested $4.7 billion into 300 Brazilian companies during the past 10 years, according to data from Thomson Reuters, though this data may be inflated by one or two large investments primarily run by hedge funds with some little participation by venture capitalists.

South Korea

Samsung, Daewoo, and LG are all household names in technology. The country has a history of semiconductor production and one of the highest percentages of broadband penetration of any country in the world.

Venture capitalists invested $9.4 billion into 2,400 Korean companies during the past decade, according to data from Thomson Reuters. A third of those investments were made in 2000, but Korea has maintained a steady stream of investment since.

Only about half of the money going to South Korean start-ups came from South Korean investors. Part of the reason for this is that the South Korean government has carefully regulated its domestic venture capital firms. For example, prior to 2005 the government prevented local venture capital firms from owning more than 50 percent of any start-up they invested in.[15]

U.S. investors have been happy to step into the breach. Yet the South Korean government has not always welcomed this

development. Large buyout firms were prosecuted for tax evasion in 2005 after the government discovered they had made large profits on deals done in the country.[16] Although it was not directly related to the start-up business, it may have driven down investment in this period.

One of the most promising sectors in South Korea is online gaming. The country's high broadband penetration positioned it to have a natural market of early adopters for online games. Nurian Software, for example, has raised $25 million from U.S. venture capitalists such as Globespan Capital and New Enterprise Associates among others. Seoul-based Wemade Entertainment, maker of "The Legend of Mir" video game, raised $28.9 million from South Korean venture firm Skylake Incuvest in 2008. It went public at the end of 2009 on the Korea Exchange.

Summary

Venture capital has a long history in the United States, stretching back as far as the late 1950s. Yet the past two decades have seen venture capitalists taking their expertise and money to other countries.

There is no simple way for a U.S. venture firm to "go global." There are several strategies that a firm might consider, depending on its preferences for risk, the makeup of its partnership or the nature of the country it aims to invest in.

Some firms prefer to keep their relations with foreign start-ups at arm's length. They fly to another country, pick a start-up in an industry they know with a management team they trust, write a check, and fly home.

Other firms prefer to open their own offices in a foreign country. This strategy may be particularly well suited to firms that already employ native language speakers.

U.S. venture firms have had some success partnering with each other to form new firms focused on foreign countries. Others have worked to affiliate themselves with local investors. Both strategies work well if the U.S. firm is a competent fundraiser and can help the local firm connect with U.S.-based limited partners. Other venture capitalists would rather get into the foreign market faster and may buy a successful foreign investment firm.

Venture firms hoping to syndicate across borders must be prepared to explain what useful things they will do, from making introductions to major customers to helping recruit experienced executives.

Governments periodically try to stimulate innovation and create incentives to attract experts, though these programs typically come with various strings attached.

Knowing how to invest abroad is one thing; knowing where to invest is another.

The United States remains the number one spot for start-ups and venture capital investing in the world. Many places have tried to replicate Silicon Valley's unique confluence of innovation resources, but few have succeeded. It may just take time.

Technology start-ups in Israel have benefited from the country's investment into military technology and training. The country's government launched a successful stimulus for technology investors during the first half of the 1990s called the *Yozma* program. It acted as a fund-of-funds investor to support foreign firms interested in opening

shop in Israel. The country suffers from a lack of major customers and its start-up executives will sometimes set up shop in Silicon Valley just to make sales. Israel has seen foreign interest in its technology start-ups fade somewhat since the dot-com boom, but it may have a promising future in cleantech.

China's massive markets have attracted venture capitalists during the past decade and the first firms to invest there were richly rewarded. Even the most skeptical venture capitalists eventually relented and pursued a China strategy after several major success stories started to emerge from the country during the summer of 2005. Competition to finance Chinese start-ups increased, and venture firms were forced to go deeper in the country to find deals, invest in start-ups outside of traditional technology sectors, or give up on the country altogether.

India also experienced rapid growth in venture capital investment during the past decade thanks to early outsourcing efforts, growth in the number of engineering students, and the country's increasing use of communications technologies. Still, it lacks critical physical and business infrastructure. This has hampered growth. Some U.S. venture firms have been successful investing there, but one or two technology sectors have been subjected to overinvestment. Understanding the listing requirements of its stock exchanges and the way it taxes capital gains may require the help of a lawyer.

Russia is well respected for its technological prowess and potential to become a lucrative market for new companies. The country's recent economic boom led the government to create a program to stimulate start-up creation. It formed a fund-of-funds

similar to Israel's Yozma program, but required foreign investors to partner with a Russian investment firm to qualify for the stimulus. This minor twist in policy caused problems when the partners didn't see eye to eye. U.S. investors involved with Russia say the opportunity there still needs time to develop.

Europe is made up of many smaller markets, none of which has the critical mass to create a consolidated pool of talent and investment money. Still, each country in Europe is free to pursue its own development strategies, and governments are able to establish policies that promote specific high-growth industries. The region still imports many of its entrepreneurial concepts from the United States but is slowly developing its own batch of home-grown expertise.

Other countries may become interesting to venture capitalists in the coming decade. Japan, Brazil, and South Korea each have experience in technology and may be primed to rapidly grow.

Notes

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4. Entrepreneurs working or studying in the United States who returned to their native China to start companies were so prevalent that they merited their own term. They were called "sea turtles."

5. "Indian IT—BPO Industry Exports Touches USD 50 Billion Landmark," National Association of Software and Services Companies, February 4, 2010, http://bit.ly/aTgsdh.
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