The Rise of the Red Unicorn

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China is on track to absorb more venture capital than the U.S. this year.

In January, Sequoia's Michael Moritz, **wrote** in the *Financial Times* that the venture community in Silicon Valley needed to wake up to the competition from Chinese technology companies. His warning may have come too late. But it should not have come as a surprise – for those paying close attention, as far back as 2013, President Xi Jinping was on **record** saying "Our technology still generally lags that of developed countries, and we must adopt an asymmetrical strategy of catching up and overtaking." It appears as though he is now delivering on that promise.

The Central Committee's most recent five-year plan encourages private Chinese technology firms to spread their wings globally and to seek validation and additional capital through IPOs. As a consequence, the results of that asymmetrical competition approach were revealed: Both a far deeper bench of privately held Chinese companies valued in excess of US$10 billion than had previously been known and a surprising lack of visibility of the scale and maturity of the Chinese venture ecosystem. What Moritz saw on his recent China trip may just be the tip of the iceberg.

The who's who of red unicorns

A global ranking by the venture industry reference **CB Insights** of the largest privately held technology companies in April 2018 listed 232 companies with valuations in excess of US$1 billion ('unicorns'), 63 of which were Chinese. A report from a unit of China's Ministry of Science and Technology **published** concurrently counted 164 Chinese unicorns. Moreover, within that group of unicorns were an astonishing ten privately held Chinese technology companies with a valuation above US$10 Billion (which we'll call 'Red Unicorns'). This difference between Eastern and Western venture worlds needs to be better understood.

The first step is to compare and combine the two reference datasets as seen in Exhibit 1. A simple combination of the two lists yields a surprising result: Ranking the top five companies by value, four are Chinese.

Exhibit 1: Combined MST/CBI unicorn list

#	Company Name	Val. ($B)	Country
1	Ant Financial	75.0	China
2	Uber	68.0	United States
3	Didi Chuxing	56.0	China
4	Xiaomi	46.0	China
5	Alibaba Cloud	39.0	China
6	Meituan Dianpin	30.0	China
7	Airbnb	29.3	United States
8	SpaceX	21.5	United States
9	Palantir Technologies	20.0	United States
9	Wework	20.0	United States
9	CATL Battery	20.0	China
9	Jinri Toutiao	20.0	China
9	Cainiao Logistics	20.0	China
10	Lufax	18.5	China
11	Pinterest	12.3	United States

Is this credible? A quick comparison of the reference criteria for the two reports does reveal some differences. We approached the authors of the CBI report to try to understand why they had apparently missed these Red Unicorns. According to their methodology, only companies that are not consolidated subsidiaries of a larger corporation; have raised third-party equity; and have a valuation in excess of US$1 billion qualify for inclusion. Applying this definition, one Chinese company would fall out of the top five

(Alibaba Cloud), only to be replaced by another (Meituan Dianping). There is a deep bench here.

How has this happened? One reason is speed. Another is capital. Three years ago this list would have looked very different. As has been seen in many areas, the ability of China to scale at speed is impressive. We will look more deeply into the ecosystem that has stimulated such impressive growth separately, but to make an illustrative comparison, the largest five Red Unicorns are on average seven years old with an average value of US$49 billion. The largest five non-Chinese unicorns are 11 years old and valued at an average of US$32 billion. While far from scientific and even accepting that valuations may be inflated, this does illustrate the speed and scale of the Chinese ascendency.

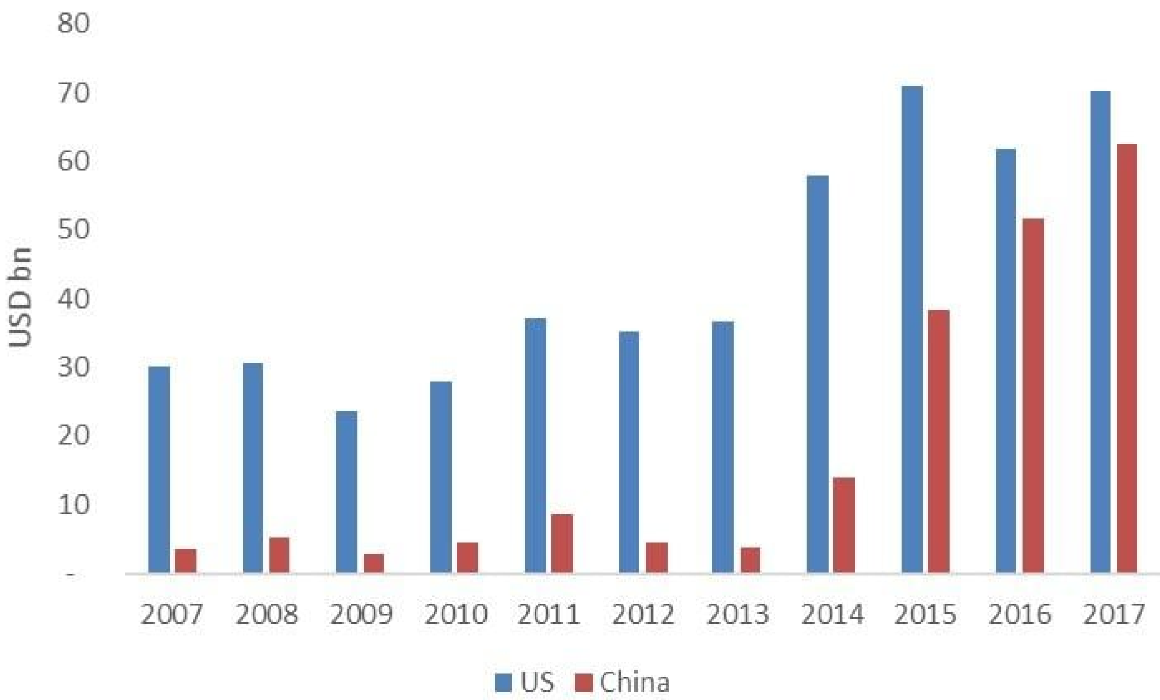
The drivers of growth

Now that these companies are emerging (at least to Western eyes) from their ‘submarine’ phase, we need to understand the environment that gave rise to them and enabled them to grow so big so rapidly. Should we paint this as a battle of ideologies – a case of a centrally directed effort eclipsing the famously libertarian approach of the Valley? It’s tempting and for many emerging economies, this is a central policy question, but the answer we feel, is ‘likely not’.

In simple terms, the necessary ingredients for venture success might be summarised as talent; capital and credible institutions directed at large market opportunities.The West has had all these elements for some time, but it is relatively recently that China also has them. The accumulation of Chinese investment capital is hardly news. Nor is the prodigious talent of its scientists and engineers – global graduate schools have enjoyed their labours for years. What has changed is the maturity and support of the institutions that govern the allocation of capital, property rights and, to some extent, enforcement. This has taken place in a large, controlled domestic ‘sandbox’ where foreign competitors have been constrained (which is possibly the ‘asymmetry’ that is referred to by Xi).

More specifically, recent changes in domestic investment policy (that both focus and constrain domestic capital allocation); simplified and speedier access to (especially domestic) capital markets has driven a rapid rise the in the amount of capital flowing to venture investments in China. In 2017, reported VC investments in China reached US$62 billion, or almost 90 percent of the U.S. equivalent. In 2018, if the current trend is extended, China will, for the first time, absorb more VC capital than the U.S.

Venture Capital flows



The main drivers of the rapid ramp of capital flows into VC are the rapid increases in domestic funds – partly as a result of capital controls, but partly as a result of an improved VC investment universe. The combination of constrained capital seeking high quality investment opportunities and a large population of high quality domestic talent addressing a rapidly changing and permeable market is powerful and the fund flows reflect that.

Sceptics will point to the immaturity of the Chinese exit processes, the possibility of artificially high valuations and the opacity of financial performance. All are real risk factors that could mean that the Red Unicorns' values are overstated. What is less likely to be the case is that they are coming, they are many and they are serious about challenging the West for ownership of the future. Is this a local peak or the eclipse of Silicon Valley's dominance? It's far too soon to say. But what is clear is that Mr Moritz was right to be alarmed.

*This article draws on work from INSEAD's Global Private Equity Initiative and a student project executed by MBAs entitled '**China's Venture Capital: Bigger than Silicon Valley's**?'*

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