

Role of Hong Kong in China's Internet Business

A REPORT FROM THE YORK GROUP CHINA / GCiS

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Currently in the emerging land-grab for Chinese language Internet acreage, there are five main sources of new start-ups and three main sources of funding. Chinese language Internet start-ups are being formed at the pace of 20 to 30 per week. At this time the main sources of these are (not in order): Hong Kong, Shanghai, Beijing, the United States and Taiwan. Funding for these start-ups is coming primarily from China domestically, Hong Kong (which also serves as an investment conduit for the overseas Chinese community, which includes Taiwan) and the United States.

In general, several of these participant's positions are untenable over the long term. In this respect, Hong Kong calls itself out for special examination.

Hong Kong has made news internationally with recent IPO's, government sponsored initiatives and several major deals by some of Hong Kong's dominant business groups/families. We believe it is quite possible that Hong Kong will not only be unsuccessful in its efforts, but that there is a good possibility that its crash will be so spectacular as to do significant damage to its own development and that of China's Internet over the medium term. The reasons for this are as follow:

Hong Kong does not have the technical expertise to support a large development community. Hong Kong's companies have traditionally been transaction oriented and speculative in nature. Collectively they spend a very small fraction of revenues on R & D. There is a severe shortage of competent network engineers, let alone programmers and IT-savvy business managers and entrepreneurs.

Likewise it does not have the direct cultural exposure to generate consistent content results within China. The very social fabric, form of government organization, educational system and most other aspects of Hong Kong life and society are fundamentally different from China's.

Hong Kong also has a speculative equity market that promises to do severe damage to investor confidence over the next couple of years. A case in point would be the so-called "Red Chip" market of several years ago. A "Red Chip" was a company that had significant relationships and exposure to China's market. The current wave of Internet stocks is being led by companies without content, without technical competence, without experienced (net) management and with highly "flexible" business plans. In essence, anyone buying into tom.com or China.com is not buying into an operating company. Rather it is buying into an investment fund - at outrageous prices. The investor's hope must be that these companies invest the funds raised wisely.

This must be combined with the knowledge that the first "land grab" stage of Internet IPOs appears to be coming to an end. It seems highly likely that in the near future, E.com's will be required to grab either profits, or dominant market share in good time - otherwise they are going to get severely punished by the markets. In other words, E.com investing is going to look a lot like more traditional high-tech investing in the very near future.

This does not bode well for Hong Kong in light of the current froth.

On the other hand it has several advantages, the most notable of which is its legal structure and capital markets. Unfortunately, Hong Kong's government and markets are reacting irrationally to the emerging Internet boom in China. Rather than expanding on Hong Kong's advantages, the Hong Kong government has rolled out a number of plans involving significant public funding and/or concessions with the objective of spurring Hong Kong's equivalent of a Silicon Valley. While several major players may be able to leverage their capital and connections into significant positions, in the long-run the majority of these plans are doomed to failure.

Some basic limitations in the current environment should be illustrated:

- China uses simplified characters - Taiwan and Hong Kong use Traditional Characters; all three have different cultural language usage patterns
- The entire social system, from government structure to education are completely different in China and Hong Kong;
- Both the Hong Kong people and the Mainland Chinese hold a significant level of mutual disdain for one another in the cultural and business fields;
- Smaller Hong Kong companies, without special connections and operating without a clear understanding of the Mainland market will encounter a wide range of time and capital sapping obstacles;
- Most small Hong Kong companies, paying top-dollar for inputs, will not have the staying power to operate and develop until the Mainland market develops;

Because of all the above, there is a basic cultural disconnect between Hong Kong and China. Hong Kong companies, with a few exceptions, will find it hard to compete in a market where their Mainland competitors are equally well financed, have better technical resources, and enjoy the advantages of closer cultural understanding and regulatory support.

Some salient features of the Mainland market:

- While growing rapidly, there are still only an estimated 8 million Internet users in China;
- There is no payments system in China at this time. Credit card penetration is very low, and inter-bank networks are very incomplete. It is usually the case that a client carrying one bank's debit card, cannot access his or her account from the same bank in another part of the country.
- Access rates are very slow, with common access rates in the low hundreds of bits range. China's backbone can handle significantly higher access rates, but ISP's in China are heavily under-invested, thus cannot handle the traffic that currently exists.
- Nearly all ISP's in China lose money currently due to the high monopoly access rate charged by China Telecom and the low fees that China's consumers can realistically bear;

In the medium term, it is highly likely that Hong Kong is going to suffer a significant speculative bubble burst that will hinder normal development for years to come. This combined with the fact that most of the Chinese language development and marketing skills reside in China and Taiwan, leaves Hong Kong with a dubious role to play in the actual provision of value added Internet and software service.

In the past, Hong Kong companies have prospered because of their open trading and financial regimens, which they have been able to exploit effectively in the Mainland. The Internet removes many of these advantages. Mainland companies are being financed and given technical and management support from Silicon Valley and Taiwan in far greater proportion than Hong Kong. Returning Chinese engineers and business people prefer to take their stake on the "home" market, which is potentially much, much bigger. The same holds true for the Taiwanese.

Hong Kong main advantage will continue to be its legal and financial structures. Eventually Hong Kong will discover that these advantages are only enhanced in the Internet age, and will stop wasting its taxpayers money on futile public projects.