

US-CHINA TENSIONS

China private investment firms face growing U.S. scrutiny, analysts say

In first, Pentagon lists IDG Capital among 'Chinese military companies'



U.S. scrutiny of Chinese private investment activities amid concern over alleged links to China's military is increasing. (Nikkei montage/Source photos by Reuters and screenshot from IDG Capital's website)

ECHO WONG, Nikkei staff writer

February 9, 2024 16:56 JST **Updated on February 14, 2024 19:42 JST**

HONG KONG -- The Pentagon's addition of a Beijing-headquartered private equity and venture capital firm to a list of companies with alleged close ties to China's military underscores growing sanctions risks for the industry and is likely to result in pressure for more investment self-scrutiny, analysts say

In an updated Department of Defense (DOD) list of entities identified as "Chinese military companies" operating in the U.S., IDG Capital Partners is among 17 newly added names. They are seen as helping to support the "modernization goals" of the Chinese military by "ensuring it can acquire advanced technologies and expertise" developed by Chinese companies, universities and research programs "that appear to be civilian entities," the Pentagon said on Jan. 31.

The list previously comprised only technology companies and manufacturers. IDG Capital Partners is the first private equity and venture capital specialist to appear on it, which by itself does not mean being directly sanctioned by the DOD.

"This is the first case that a major Chinese-headquartered investment firm is being added to a sanctions list by the U.S. government," said Wilson Zhao, a Hong Kong-based associate focusing on sanctions and export control at law firm Steptoe.

"With IDG's designation, investment firms, especially those headquartered in China, now need to worry not only about [their] portfolio companies being sanctioned, but also [whether] they could be sanctioned as a result of investing in or co-investing with certain companies," Zhao said.

Other high-profile companies listed include newly added Hesai Technology, a self-driving car lidar-maker that held the largest Chinese initial public offering in the U.S. last year, and 360 Security Technology, part of IDG's portfolio. Hesai said it plans to challenge Washington's decision in court.

"Our inclusion on this list follows a one-year media smear campaign based on unsubstantiated, baseless and false allegations about Hesai lidars' potential involvement with military use and surveillance," Yifan Li, Hesai's CEO, said in a news release on Wednesday.

A spokesperson for IDG Capital said his firm was "surprised" at being included.

"We were not approached, consulted, nor given any opportunity to provide any pertinent information" by the Pentagon, the spokesperson said in an email to Nikkei Asia. "We are not a Chinese military company, nor do we have any association with the Chinese military, and we do not belong on this watch list."

She said the inclusion has "no factual or legal basis," adding that IDG Capital plans "to engage with the relevant agencies to seek clarification and redress."

A source close to IDG Capital told Nikkei that it will contact the Pentagon to revisit the decision. "Internationally, they don't think the impact is substantial," said the source.

The U.S. has mostly sanctioned Chinese entities through several agencies, including the Department of Commerce, the Department of the Treasury and the Pentagon.

The Pentagon bars identified companies from providing direct services to the U.S. military or its suppliers. Treasury bars U.S. persons from trading publicly traded shares of the specified companies, while Commerce requires parties that want to do business with the sanctioned company to obtain a special license.

"Getting on such a list could increase the possibility of future escalation of sanctions against the designated entity," Zhao said, citing the potential for different government agencies to work together to draw up blacklists.

The sanctions threat raises reputational risks for IDG Capital, as U.S. investors may "reconsider co-investing" with an identified company, Zhao said. IDG Capital has invested in more than 1,600 portfolio companies. It has 12 offices worldwide, including two in the U.S. and six in China. The others are in Singapore, South Korea and Vietnam.

Claire Chu, Washington-based senior China analyst at consultancy Janes Group, said she sees the likelihood of "heightened scrutiny over IDG Capital's operations in the coming months that could lead to more severe restrictions on the firm." And like Zhao, Chu also cited reputational risks associated with being added to the Pentagon list, which "can also be materially damaging."

One of the first Chinese VC investors, IDG Capital began in 1993 as a China-focused investment arm under U.S. company International Data Corporation. The Boston-based group was founded in the 1960s and focused on market intelligence research, publications and communications. It moved into venture investments in 1992.

IDG Capital later became independent. Founder Xiong Xiaoge, called "the first Chinese venture capitalist," made his name as an early backer of China's top internet companies, including Baidu and Tencent, and later electric vehicle manufacturers Nio and Xpeng.

The split lasted until 2017, when IDG Capital and Chinese real estate developer China Oceanwide Holdings together acquired the entire IDG group. IDG Capital has since become the owner of IDG's U.S.-based venture business. China Oceanwide Holdings bought a majority stake in IDG Group's research and communications business, selling it to U.S. private equity firm Blackstone in 2021.

"We will forever keep the imprint of IDG in our name, while the [Boston] IDG group takes a smaller and smaller proportion as an investor of our funds as our assets under management grow bigger," Xiong told Chinese media in 2017.

Close connections between many of China's top government funds, rather than the companies in which IDG Capital invests, is what may have landed it in hot water with U.S. regulators, say some analysts. They point to examples such as the recent 5.1 billion yuan (\$7.18 billion) mandate to IDG Capital from China's National Social Security Fund in November to run a Shanghai-based fund to invest in tech and manufacturing.

IDG Capital was named as one "instructive example" to facilitate U.S. investments into "military and military-civil fusion contributors" in China in a hearing in Congress by the U.S.-China Economic and Security Review Commission in 2021. The commission cited IDG's U.S. limited partners and its portfolio which includes 360 Security Technology.

Han Shen Lin, China country director at U.S. business consultancy Asia Group, said the situation highlights how the focus of venture capital firms to find "scalable businesses and technology" is colliding with an increasingly murky landscape.

"The expansive application of frontier technologies like artificial intelligence renders any boundaries between military and civil research obsolete," Lin said. "Since there is no easy way to separate military and civil technology applications, IDG's inclusion on the DOD list is a signal that the innocent days of free flowing capital will be replaced by a more rigid investment capital ecosystem fragmented by geopolitical security boundaries."

Last year, under growing U.S. congressional scrutiny by the House Select Committee on the Chinese Communist Party, Silicon Valley venture firm GGV Capital announced it was spinning off its Asia business. And Sequoia Capital China became HongShan after a split from its U.S. parent company in 2023 following regulatory pressure.

On Thursday, the committee accused GGV Capital, Sequoia Capital China, Qualcomm Ventures, Walden International and GSR Ventures of having made investments worth at least \$3 billion into China technology companies "that facilitate human rights abuses including genocide, contract with the Chinese military, or strengthen the PRC's semiconductor supply chains and advance China's national security ambitions."

Additional reporting by Pak Yiu.