

## A CONVERSATION WITH JOHN “JACK” WADSWORTH, JR., HONORARY CHAIRMAN OF MORGAN STANLEY ASIA

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#### **JABS: Morgan Stanley is very active in the venture capital investment business. How did Morgan Stanley get involved in this business in the first place?**

A: Morgan Stanley, in the United States, started the venture capital business in 1982. It was driven by our entry into the high tech investment business. Our first deal was the IPO for Apple Computer. We learned a lot. We recognized that venture capital investment, if successful, can make a lot more money than underwriting an IPO. We also learned that financial organizations and investment banks are not equipped to do start-ups. The companies that can do start-ups are the specialized tech venture firms. These companies are comprised of engineers and people who have run start-up companies and people who are experienced in the venture capital business. The best way for Morgan Stanley to participate in that opportunity would be to link up with a handful of leading specialized startup firms. So, we entered the venture capital business in the United States, and raised a \$15 million fund for Kleiner Perkins in 1982. This earned us a small stake in their general partnership and a friendship that still exists today. We probably have done 45% of their IPOs. That strategy paid off.

#### **JABS: Morgan Stanley's first entry into Asia was Japan. Could you elaborate on differences in entrepreneurial culture and environment among the U.S., Japan, and other Asian countries?**

A: When we went to Japan in 1987, we had a dream that, since we were newcomers to the Japanese market, a way to dive into the equity business would be to use the same formula we used in the United States. We started up a venture capital business to get in early into the IPO business in Japan. After 6 months, we realized that this approach would not work because there were many critical differences between Japan and the U.S.A.

Japan has the technologies and market size. It also has plenty of big companies that you would normally expect to spin off teams of entrepreneurs. But, risk taking is not a big part of Japanese culture, and failure is not well accepted in Japanese society either. In Silicon Valley, if your resume shows that you

have run a company that went into bankruptcy, it could be seen as a good thing, as it gives investors some confidence that you have been through the cycles of a company. Additionally, the Japanese education system could place more emphasis on liberal arts and MBA education, to encourage risk taking and entrepreneurial behavior. Nonetheless, there are a handful of entrepreneurs who are well known in the Japanese history.

Across the rest of the region, you would find that Hong Kong and Singapore have plenty of risk taking entrepreneurs. But their small economies limit the potential of creating large companies that have upside opportunities. Australia is similar. It is a very interesting place and has many of the cultural attributes you would expect to encourage venture capital and risk taking. But again, its small economy limits the potential of the venture capital business there.

#### **JABS: Could you elaborate a bit about India and China?**

A: China and India are very different. China, to me, is somewhere between San Francisco and San Jose, full of entrepreneurs. Its government is increasingly inclined to encourage new company formation, to grow the capital market, to accept the fact that successful companies and their shareholders will make a lot of money. In China, they have all the attributes for successful entrepreneurs that I saw when I first came to California.

However, one important element that has been missing until recently in China is management skills. To grow a start up company, you have to be able to manage. What is now developing in China is a class of experienced business people who have worked for Microsoft, McKinsey, Morgan Stanley, etc. They have management skills to combine with entrepreneurial behavior. This will lead to huge opportunities.

India has many of the same attributes. But what I observed about India is the culture. The best and brightest are more likely to be doctors, academics and software engineers, rather than entrepreneurs. Of course, this is a vast generalization, as there are many more entrepreneurs in India than there are in some Asian countries, like say, Japan. The other challenge that India faces is that its capital market is small and its regulatory infrastructure often makes it difficult to get things done.

**JABS: These days you see a lot more reverse brain drain. Many Indians and Chinese who are trained or worked in the U.S. are now going back to China or India. Will this change the mix and atmosphere of the entrepreneurial environment in India and China? Have you observed such changes?**

A: I am sure that it will happen. There is a wave of Indian students coming here to study science and business. You will find Indians in every hedge fund, Wall Street firm, and every business school. There is a generation of immigrants who did not go back, wouldn't go back, and will never go back. Younger generations of immigrants would probably be more inclined to go back. The prime reason is that opportunities are more significant and better at home these days.

I feel the profile of overseas Indians and Chinese will also affect the propensity to reverse brain drains. There are about 10 million or more overseas Indians. Many of them are doctors, academics and professionals. They are less likely to go back to start new venture business. On the other hand, there are about 50 million or more overseas Chinese. Many of them tend to run a variety of small businesses and tech firms. One of the reasons that China has seen \$50 billion in foreign direct investment, which no other country in the world or in history has achieved, is because 80% of these investments come from overseas Chinese business people. The typical profiles of overseas Chinese are entrepreneurs and risk takers. These people are more likely to return to China when there are business opportunities. We have a venture capital portfolio in China. Out of 21 early stage companies that we invested in, about 18 CEOs and founders are from China.

In addition, there is a brain drain to China. Now we see that some best and brightest students at good business schools, such as University of Chicago or USF, are learning Mandarin and going to China. This is a new wave of brain drain.

**JABS: What kind of venture capital investment models will work in Asia?**

A: There are really four types of investment models. The first is Silicon Valley VCs who fly in to Asia or China, spend a week there, make a couple of investments, then come home. This approach will surely fail.

The second is a global investment company model. These companies have global funds for worldwide investments. They allocate some portions of the global funds to Asia and have staff members in places like Hong Kong, Beijing or other Asian countries. Their mindsets and overall approaches are clearly globally oriented, with less attention paid to a particular Asian market.

The third approach is the Sequoia formula, which is to sponsor a local group of Chinese in fund raising and provide guidance to the local people in investment activities.

The fourth approach is to use local Chinese entrepreneurs and venture capitalists operating in China. These local Chinese partners may have never left China. This fourth approach is almost like the Chinese version of Kleiner Perkins or Sequoia. I believe that this last formula is the best one and

the one that will work because there are so many investment opportunities in Asia, especially in China. The local VC approach enables VC firms to capture the opportunities.

In terms of VC investment and management philosophies, I do not see fundamental differences between Asia and the U.S. My friends at Kleiner Perkins always say that VC investment should follow a "one mile rule", which means that you should be close to the start-ups you invest in. If there is ever a piece of advice that I would give about venture investment, it would be "don't be very far away from the locations of the venture investments in which you are investing". You should frequently meet and talk to the companies in which you have invested, discuss their business and check their progress. All the disciplines of venture investment we use in Asia are the same ones that are used in Silicon Valley. Venture capital investment is different from investing in a \$35 billion real estate company. If you are investing in new start-ups, you have to be in constant contact with these entrepreneurs.

**JABS: Do you see any difference in investment activities between China and the U.S.?**

A: The first difference is the nature of technologies we are investing in. In China, so far, many investments are applications of existing technologies that are designed to tackle market opportunities in China. The venture investments in China are not transformational technologies that will lead to the emergence of new industries or trends. The second difference, which is almost an extension to the first, is that in China, many early stage investment opportunities are service oriented. The manufacturing in China is mostly low cost and there is not much pressure on innovation in manufacturing in China. For example, the next big innovation in semiconductor manufacturing probably will not come from China. But this will change as there are a lot of innovations happening in China. The other striking difference is the burn rate of venture companies. If you put \$400 thousand into a start-up company in China with 20 employees, even if you hire top class scientists in China, the burn rate is \$35 thousand a month and the company will run for a year. If, however, you put that kind of money in a California company, the money will be gone in a month.

Although there are some cultural differences between entrepreneurs in China and in the U.S. in the ways of approaching issues, the ultimate objectives of entrepreneurs and the entrepreneurial spirit are very similar between the two countries.

**JABS: From the venture capitalist's perspective, what are the challenges of investing in China?**

A: There are many complexities associated with the fact that the RMB, the Chinese currency, is not convertible. Because of this, companies have to take unusual steps to set themselves up within a legal framework. This way, if you have a successful company, you can sell it to overseas entities or go public on NASDAQ or in Hong Kong the stock market

where you can get your investment back. That is going to change because the Chinese government is very pragmatic. For example, recently the Chinese government felt that the stock prices were too high. To cool down the market, the Chinese government encouraged more companies to go public in the Shanghai stock market, to increase supplies in the stock market and to put a damper on the stock prices. This is good for us and we told them that we are willing to go through the effort of IPOs in Shanghai but let us get the money out. The Chinese government agreed that this is a reasonable request and they are finding ways to do that.

**JABS: Can you talk about Vietnam?**

A: Vietnam is a smaller market. The communist overlay in Vietnam is stronger than that in China, both from a market economy point of view and from a regulatory point of view. That does not mean that it will not change. We have a small investment company in Vietnam. There are 240 companies listed in its stock exchange and the market capitalization is not much more than a couple of billion dollars, although people made a lot of money in real estate. Vietnam is a little bit like China was in every aspect in 1989 and may grow faster. Not long ago, we met with senior government officials of Vietnam. Although there was a lot of talk about privatization, you still have the feeling that government has tight controls on a lot of things.

**JABS: You have led a global company in Asia for a long time. What is your advice on developing competitive strategies in Asia?**

A: Based on my own experience, the essence of our strategy is to design business models that fit each country. You should not think of a standard strategy in Asia. If you are going to build business in an Asian country, you have to look at an array of local factors, such as how the local government treats derivatives, how they treat asset management, and if there will be a bond market in the country. You then design your business accordingly. For example, after 6 months in Japan, we concluded that we will never be able to compete with Nomura Securities for the domestic Japanese corporate finance and investment banking business. So, we decided to build the trading business, trading stocks and bonds in Japan, but the main obstacles there were the Ministry of Finance and the Tokyo Stock Exchange. They were reluctant to introduce new ideas, new innovations and new instruments. Back then, our allies were Goldman Sachs, Solomon Brothers, Credit Suisse First Boston, Merrill Lynch, among others. But when we went to China, our competitors were Goldman Sachs, Solomon Brothers, Merrill Lynch, and our allies were the Chinese government. The government asked us to come and help them build their capital market. That tells you how you should adjust your strategy according to each country's situation.

**JABS: You have worked closely with many governments in Asia, what is your advice on how to work with governments in various Asian countries?**

A: Over the years, I have developed some basic principles. One of them is transparency. For example, when government officials make certain inquiries or ask questions about our operations, I will be totally honest with everything I say. I will never pay off government officials no matter what. If you do that, you will be fined. When my colleagues in the security business got into trouble, regulators came in, said there is something wrong and wanted to look at the company books. My colleagues tend to ask regulators to explain the reasons and show the subpoena, etc. But whenever I was asked that question by government regulators, I said to them, "my books are your books. If we do anything wrong, the first person that I want to inform is you". The other advice on working with government is just "do your homework." Every single government has a set of complex regulations. You just need to understand the importance of details.