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Rebecca Fannin, author*, Silicon Dragon* and Columnist, *Forbes*

Testimony before the U.S.-China Economic and Security Review Commission
China's Information Control Practices and the Implications for the United States

Baidu is not a U.S. company, but it owes its origins to Silicon Valley's culture of entrepreneurship and venture investment. It was founded by two Chinese citizens—Robin Li and Eric Xu--who came to the U.S. for graduate degrees and career experience at some of America's finest organizations and then returned home as China was opening up to start a new business.

Robin and Eric were no different from dozens of other young entrepreneurial Chinese who were attracted by the new opportunities in their homeland and sought to capitalize on it. The Internet boom had started in China, and the mobile communications era was about to unfold. Today, China has the world's largest Internet and mobile communications markets, at 384 million online users and nearly 800 million cell phone users. Baidu's founders did what many of their peers did – they copied some of the most successful Internet business models such as paid search that had worked in the U.S. and tweaked them for China. Baidu was developed as a Chinese version of Google customized for local users.

The venture investment in China trend has steadily accelerated since 2002, with a peak in 2007 at $10.1 billion followed by nearly $10 billion in 2008, according to the Hong Kong-based Asian Venture Capital Journal. Most of this capital has come from U.S.-based venture investors, many of them from well-known firms in Silicon Valley.
Baidu follows the structure of most investments that have been made by venture capital firms from Asia, Europe and North America in Chinese startups over the past decade.

Like many others in China, Baidu got its start with venture capital funding from abroad and with board directors representing its investors. Two of Baidu's five current directors are American: Greg Penner, general partner of Madrone Capital Partners and William Decker, a retired partner of PriceWaterhouseCoopers.

Baidu was molded the typical way of most Chinese startups during these early days of China's entrepreneurial awakening with the rise of the Internet era. It was set up as a wholly owned foreign offshore holding company. Most of these so-called WOFIs were based in the Cayman Islands or the Virgin Islands. This structure is a way for venture investors to put capital (usually US dollars) into a Chinese company. It also provides an avenue for getting investment returns from the Chinese company as shares as sold, typically through an initial public offering in New York, London or Hong Kong.

Today, Baidu is one of dozens of Chinese Internet companies that now publicly trades in the U.S. Baidu went public on NASDAQ in August 2005, and its shares are held by Fidelity Management & Research Co.

The history of Baidu's investment is also fairly typical – except at one point Google was an investor in the Chinese search engine. The initial investors were Peninsula Capital and Integrity Partners, which put $1.2 million in the startup in 1999. Then, a year later in 2000, Baidu raised $10 million from DFJ ePlanet Ventures, a former affiliate of Draper Fisher Jurvetson, and from IDG Ventures China, an investment group that is part of the large Boston-based publishing and research group IDG. By 2004, Baidu began turning a profit and it soon raised another $15 million from DFJ ePlanet, which then owned a 28 percent investment stake. At the same time, Google invested $5 million for a 2.6 percent stake. In June 2006, Google sold its shares in Baidu for more than $60 million and began competing directly with the Chinese search engine.

Like all companies—Chinese or not—operating in the People's Republic of China, Baidu is subject to censorship. Indeed, companies in China *self-censor* their web sites. Baidu's search results filter out sensitive terms or topics such as the 1989 student uprising in Tiananmen Square. When searches are made for such subjects, users typically see a blank screen show up on their personal computer or mobile phone, with the message that the connection did not through.

The same is true for any Internet company operating in China—from search sites to video sharing sites to social networking sites. If companies do not censor politically sensitive subjects, they risk being shut down by the Chinese government. For instance, some video sharing sites in China have suffered from periodic blocks after airing what was considered offensive material – in some cases, pornography.

As an American company operating in China for several years dating from 2000 until early this year, Google has long faced censorship of its search results. Now that Google has withdrawn from the Chinese market and is directing searches through Hong Kong-based servers, it is managing to skirt the issue of censorship in China while still providing a service to Chinese users.

Interestingly, Google—by agreeing to open shop in the country—had agreed to censorship when it first entered the market in 2000. When Google later revamped its Chinese-language search engine in 2006 for speedier service and more precise search results from servers in China, it built in some additional safeguards to protect the privacy of its users. For example, Google opted not to provide blogging or email services – to avoid having to turn over the identities of individual users in China and face the political issue that Yahoo did after releasing the names in 2003 of two bloggers who had

criticized the Chinese government. But it still censored its search results in China. The company leadership argued that even a censored Google site in China was better than no Google in China.
With the departure of Google.cn from China, the search market is left open to Baidu. In early 2010, the Chinese search engine had a wide lead in the market with a 64 percent share – a lead built largely from a greater understanding of Chinese users. For instance, Baidu built in community-oriented searches to its site where peers could exchange answers. The large gap between the two rivals has remained in spite of Google going head to head with Baidu in China beginning in 2006 with the hire of former Microsoft executive Kai-Fu Lee as the head of Google China. Lee, however, was able to increase Google's portion of Chinese search revenues from 15% in mid-2006 to more than one-third by the end of 2009.

Now with Google's decision to withdraw its Chinese search engine from the country, leading Internet analysts such as Richard Ji of Morgan Stanley are predicting that Baidu will capture 20% to 30% of Google's market share in China. That leaves China with no viable competitor. Minus competing search engines, the quality of service may decline, leaving individuals in China with fewer options to seek out information. Certainly, Google's retreat puts Baidu on a more powerful footing.

As Google has retreated from the market and began routing searches through Hong Kong, Baidu's financial results have soared. For the first quarter of 2001, net profits more than doubled to $70 million while revenue jumped 60% to $187 million. Second quarter results are expected to climb at least 67%. Likewise, Baidu's stock price has been trading steadily upward since the beginning of the year, to a high of $82 as of May 13, 2010, more than double the price at the beginning of the year. See http://www.nasdaq.com/aspx/dynamic_charting.aspx?selected=BIDU&symbol=BIDU

No matter how the censorship issue unfolds in China, it's a reality that Internet users in China can still find ways to access content behind the "Great Firewall." For most expatriates in China, virtual private networks (or VPNs) are the most common way. Such VPNs are typically the ways that users access Twitter and Facebook too, which are blocked in China. Proxy servers are another way.

The bottom line is that Internet users are an industrious bunch, and regardless of what controls are placed on content, have found ways to access content in China and readily shared these ways with their peers.

Commentary

Why Google Is Quitting China

Rebecca Fannin, 01.15.10, 4:40 PM ET

It's easy to give up if you've already lost the battle. And Google is doing just that in China. Eric Schmidt's move to quit offering a censored Google.cn search engine to the Chinese market has been read by idealists as the right thing to do. But it is first a business decision.

Even though Google's market share climbed from 15% in mid-2006 to 31% today, the company had hoped for a bigger share by now. Kai-Fu Lee, Google China's former president, told me in 2006 that Google not only wanted to have a competitive product to Baidu's, the local search leader, but a superior product. This didn't happen: Baidu has only increased its market share, going from 47% in mid-2006 to 64% today. That's a big lead.

Baidu, started by China-born entrepreneur Robin Li in late 1999 just as Larry Page and Sergey Brin were cranking up Google in Silicon Valley, understands the local Chinese market better than Google's Mountain View team.

Google fumbled with an initially inferior Chinese search engine launched in 2000, while Baidu grabbed the lead in China--and kept it--with several innovative search features customized for local tastes. Baidu introduced community-oriented services that appealed to Chinese Internet users, including bulletin boards where leads on information could be exchanged--a service that Google China's former president Kai-Fu Lee dismissed as having nothing to do with search. Baidu also offered instant messaging, a hit with China's Netizens.

Plus, Baidu was first to the market with mobile search and information offered up in multimedia, including video clips. Baidu also set up a national network of advertising resellers in 200 Chinese cities to educate businesses about the power of online advertising--a step that Google did not take.

Baidu's search feature for music also proved highly popular. Google, realizing the potentially illegal nature of the free music downloads, opted to provide links to music stores instead. Baidu later began collaborating with music labels on authorized downloads.

One other key factor put Baidu in the lead: Its search technology was considered superior to Google's in the Mandarin language. Scrambling to catch up, in 2005 Google hired the experienced Lee as its president from Microsoft. Then in 2006 Google launched its first Chinese-language search engine run from China, Google.cn. With Lee at the helm, Google recruited dozens of top engineers and linguists to its Beijing headquarters to perfect search results on Google.cn. Working at the towering headquarters of Google China at Zhongguancun Software Park in northwestern Beijing, some 100 engineers wrote codes to deal with inputting Pinyin or Roman letters to signify Mandarin sounds and such intricate tasks as delineating words in Chinese characteristics that don't clearly define white spaces.

The efforts paid off with speedier and more precise search results as well as more reliable service. But no matter the global brand name, the maximized effort and the financial resources, Google's Chinese search engine couldn't trump Baidu.

Perhaps Google should have turned over its business to local rival Baidu and let Baidu run with it. There is a precedent. Back in 2005 Jerry Yang turned over the management reins for Yahoo! in China to Jack Ma, the charismatic leader of China's e-commerce powerhouse Alibaba. Yang knew that Ma, thinking local, acting local, would have a better shot at getting the right formula for China.

Granted this is still a work in progress as Yahoo! refines its features for the Chinese market. But as Zeng Ming, former president of Yahoo! China, told me, "The net is about culture. You can't have expats running it."

Indeed, why give up now--unless you realize there's no way you're ever going to win the race. After all, Page and Brin had already crossed the line back in 2006 by agreeing to have their new Google.cn, run from China, subject to censorship. They didn't have much choice. All companies doing business in China follow the same Chinese government rules. Yes, Baidu's search results are also censored.

It wasn't all that long ago--2004--that it looked like Google might use Baidu as its entry route. Google invested $5 million in Baidu for a 2.6% stake but shifted strategy in mid-2006 by selling those shares for more than $60 million and rolling out Google.cn the same year. In hindsight, and given its bumpy history in China and this latest jockeying with the Chinese government, maybe Google should have pursued the go-with-Baidu strategy.

If Google exits the $300 million Chinese search market now, it's giving Baidu runway to be a monopoly. And if that happens, Baidu has a shot at becoming the world's dominant search company (it's already entered Japan) by sheer arithmetic alone.

By serving China's nearly 300 million Internet users and 670 million mobile phone users--both the world's largest markets--Baidu may someday be bigger than Google globally, something Robin Li once told me he has no doubts will happen.

Rebecca A. Fannin is an internationally recognized author and journalist who has been writing about entrepreneurship and innovation for nearly 20 years. Her book, Silicon Dragon*, was published by McGraw-Hill in 2008 and translated into several languages. During the height of the dot-com boom from 1999-2001, she was international news editor at* Red Herring*, later joining the* Asian Venture Capital Journal *as international editor and writing for several leading business publications, including Inc.,* The Deal*,* Worth*,* CEO *and* Fast Company*. She also authored "A New Dawn" for KPMG in 2009. Fannin has lectured at several universities in Asia and the U.S., and has made numerous public speaking appearances worldwide. For more info, see www.rebeccafannin.com.*

See Also:

Google's China Blues

Google Takes on China

Baidu Rises on Google News

Forbes.com

Commentary

Google's China Blues

Rebecca Fannin, 12.21.09, 6:00 PM ET

Rumors have been flying about Google's future in China ever since the company's China head, Kai-Fu Lee, resigned in early September to start an incubator lab in Beijing. His departure seemed awfully abrupt.

Lee scurried to set up an office for his incubator, raise a fund and assemble a team from thousands of job seekers. Lee's PR reps in China and the Valley hyped his new project as his fulfillment of a dream to coach young Chinese entrepreneurs and support their best start-up ideas.

My venture investing sources in Beijing and Shanghai suspected then that there was more to Lee's departure than was being told. Maybe Larry Page and Sergey Brin want to exit China and Lee knew this, my sources speculated. Certainly, the rush to the exit door by Google staff in Beijing since September suggests that.

Indeed, Google has been trying to become the top search engine in China for nearly a decade, without success. Google hasn't said it is shuttering its local operations in China, but the company plans to power its Chinese search business from its Mountain View, Calif., headquarters.

Why did the mighty Google fail in China? For years, the company fumbled with inferior search results and unreliable service, not to mention censorship issues and that annoying upstart Baidu, which raced ahead with innovative technology that had a search algorithm for generating results that were more relevant in Mandarin.

To compete with Baidu head on, Google set up business on Chinese soil, recruited former Microsoft exec Lee, and began to gain traction. Lee hired more than 100 Beijing-based engineers and linguists. The effort moved the needle on Google's market share to 31% in 2009 from 21% in 2007.

But Baidu couldn't be crippled. The Chinese search company widened its market dominance of Chinese search to 64% from 58%. Not only was Baidu considered superior to Google for Chinese search, the team led by founder and CEO Robin Li proved nimble and innovative at introducing new popular features.

For example, Baidu began offering mobile search in China in 2006. It took Google nearly a year to catch up. Baidu also was first to use social media for conducing searches. It beat Google to the market with video clips too.

It shouldn't be all that surprising to see a big American brand being one-upped by a local competitor. Indeed, the story of a home-grown Chinese start-up triumphing over an iconic Internet rival is by now a familiar theme.

Just like Chinese search engine Baidu trumped Google, online bookseller Dangdang outsmarted Amazon in China with better merchandising skills while Alibaba-owned Chinese auction site

Taobao took the lead from eBay by giving sellers a free listing of their goods and charging only for premium accounts.

In all three cases, astute local managers who were attuned to the culture and able to gauge consumers' buying and surfing habits on the Web were able to grab first place.

What helped was being on site to respond to China's fast-moving marketplace rather than in a faraway office on the other side of the Pacific.

But Google had the formidable Lee in China building a strong team. Still, the company's efforts proved too little too late to grab market share from Baidu.

Who could really blame Google for shifting gears? The censorship of the Internet in China has been a big enough headache for Google, let alone competing with Baidu. It was tough for top management to agree to Chinese government censorship in order to do business in China. Moreover, Google's standard, English-language Google.com site has continually faced blockages and search directs to other sites.

Google faces major challenges in China that are not going to disappear anytime soon. Stay tuned for the next chapter on Google's saga in China. I wouldn't be shocked to see Google retreat from China.

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