Sequoias Split Sends Warning to US Companies Doing Business in China

Lizette Chapman, Daniel Flatley & Sarah McBride - Bloomberg

(Bloomberg) -- Sequoia Capital's plan to split itself into three separate regional firms represents a major shift at one the world's foremost venture capital firms. The dramatic move may insulate Sequoia from pending regulation, but it's also a signal that ties to China are a growing liability in Silicon Valley.

The firm has long defended its Chinese investments both in public and — increasingly — in private. In recent years the firm has built up a quiet but powerful presence in DC, and just a few weeks ago argued to Capitol Hill staffers behind closed doors that its US and China operations are separate, according to people familiar with the efforts.

On Tuesday, Sequoia announced that its India, China and US units — which share investors and some returns — would officially become separate entities. "It has become increasingly complex to run a decentralized global investment business," Sequoia leaders said in a statement, citing the pitfalls of a centralized back office.

The move is seen by many in DC as a win for Biden administration. Yet it won't unwind a history of lucrative investments at the firm, and many of the institutions that back Sequoia — including investors like the University of Michigan and the University of California — still have money invested in Sequoia China, as do some US partners.

Sequoia's China investments have been the subject of criticism inside the normally clubby world of technology investing, and the firm is facing a looming executive order from the Biden White House that could curtail US investments into foreign entities. The measure targets the practices that helped Sequoia generate billions in profits overseas for more than 15 years, despite recent market tumult.

The split "clearly demonstrates extraordinary sensitivity to the risks to being so closely connected with China," said Jeffrey Fiedler, a former commissioner at the US-China Economic and Security Review Commission. Fiedler predicts that more investors who back VC and private equity firms will be asking: "Sequoia is nervous — are you guys nervous?"

A Simpler Time

Sequoia began its Chinese investing project in 2005, a simpler geopolitical time. That year, during one of his first visits to China, Sequoia's then-chief, Doug Leone, opened the door of his black SUV to find a literal red carpet stretched out before him, according to a person who was there. Leaving the car, as he walked toward the building for a meeting with Chinese tech leaders, along his path uniformed Chinese soldiers stood at attention, saluting, according the person, who asked not to be identified because the event was private.

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It was an era of warmer US-China relations, and money and professional expertise flowed freely between the two countries. Dozens of US-based venture firms sought investments in China, allocating money and time to build Chinese startups into behemoths and making billions in the process.

China's growing middle class fueled the rise of venture-backed giants like ride-hailing startup Didi and e-commerce platform JD.com. Sequoia China in particular earned a reputation as a standout investor, backing rocket ships like Alibaba Group Holding Ltd. and ByteDance Ltd., the parent company of social media phenom TikTok.

The TikTok investment, held by both Sequoia Capital and Sequoia China, became a flashpoint. After Sequoia first invested in ByteDance in 2014, TikTok's video app got wildly popular in the US — eventually raising concerns about the influence of the Chinese-owned app on the American psyche, and its presence on so many phones. By 2019, the Trump administration had placed the app under a national security review, and came close to banning it in 2020. While a blanket ban never came to pass (except in Montana this year), the drama was an early warning that China tech investments had become political.

Veteran Lobbyist

In its 51-year history, Sequoia hasn't overly concerned itself with the machinations of Washington. Like many venture firms, it has mostly kept its distance from politics. Venture investing in private companies is lightly regulated and, until recently, has been largely ignored by lawmakers.

Around the time tensions were rising over TikTok, Sequoia leaders realized it needed more help on the Hill, according to people familiar with the firm's efforts in DC. It also needed to be discreet. If it looked like Sequoia was trying too hard to influence US policy, it could find itself in Washington's crosshairs. If it did nothing, lawmakers could wreck investment returns that the firm was expecting to reap for decades.

In mid-2019, Sequoia sought a solution in Washington veteran Don Vieira, a low-profile former official at the Department of Justice who previously worked on reviews for an increasingly powerful government entity, the Committee on Foreign Investment in the United States, or CFIUS. As an attorney at the law firm Skadden Arps, Vieira became familiar with transactions that might come under CFIUS scrutiny. He also served briefly in the legislative branch.

Vieira delivered the message on Capitol Hill that Sequoia Capital and Sequoia China were separate, according to people familiar with closed-door discussions. Last month, at an introductory meeting with the House Select Committee on Competition with China, Vieira told policymakers that Sequoia's US partners weren't involved in decision making in China. However, the Hill staffers were largely skeptical. Vieira declined to comment for this story through Sequoia spokesperson.

One congressional aide who participated in the meeting said that policymakers felt there were too many connections between the US and Chinese sides of Sequoia to ignore. Those included joint compliance operations and revenue sharing agreements across the two entities, the person said. At the same time, many of the limited partners in Sequoia Capital are also involved across its international investments.

A point of push back in the meeting: While Sequoia may not control every decision Sequoia China makes, the US firm still makes money from its Chinese affiliate, the person said.

Representative Mike Gallagher, a Wisconsin Republican and the chairman of the House committee, said Wednesday that Sequoia's decision to split its operation into three separate entities did not resolve his concerns over the firm's business practices and investments.

"You can rebrand and restructure all you want but this does little to solve the actual problem," Gallagher said in a statement. "American capital should not fund PLA military modernization or the CCP's techno-totalitarian surveillance state. Period," he said, referring to the Chinese military and Communist party. "We need strong outbound investment restrictions to ensure we aren't funding our own destruction."

Retroactive Rule

The latest version of the government's planned executive order, expected later this year, would require VCs to report investments in potentially sensitive Chinese technologies, and could restrict their ability to make some bets, according to people with knowledge of the plans.

The rule is aimed at curbing the transfer of knowledge between US investors and up-and-coming Chinese companies — a valuable service Sequoia has provided in the past. US partners have helped Chinese portfolio companies by sharing their elite network of contacts and providing timely introductions to potential customers, employees and investors, according to a person familiar with the matter.

The restrictions target "US dollars and investments that are sophisticated, that come with technological know-how, that come with expertise and contacts," Treasury *official Paul Rosen said at a security conference in May. The Treasury Department declined to comment on Sequoia's separation.*

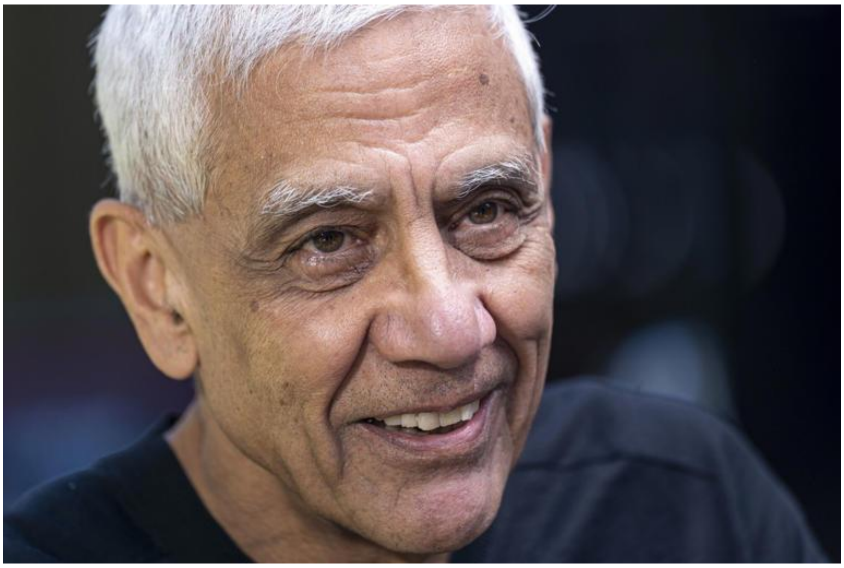
There is some good news for the firm in the latest version: The rule is expected not to be retroactive, which would protect future profits on existing investments for firms and their limited partners.

That means that longtime US Sequoia partners such as Mike Moritz and Doug Leone will retain their shares in hundreds of startups they've been bankrolling for years by investing in Sequoia China. The same goes for the more than three dozen other US institutions — including the University of Michigan endowment, the University of California regents and a Massachusetts Institute of Technology retirement plan — that have invested in the firm, according to PitchBook data.

Nationally Sensitive

The split comes at a time when startups in China have less allure than they used to. Since the boom years when Sequoia first started investing, Beijing has cracked down on high-flying tech companies, including taking action against Alibaba, whose chief executive officer had criticized the government.

At the same time, US tech leaders including billionaire Peter Thiel have ratcheted up their criticism of Sequoia and other firms for helping Chinese companies in sectors like artificial intelligence, thought to be a threat to US national security.



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Last month, VC Vinod Khosla told Bloomberg he thought Sequoia "should subscribe to Western values." Meanwhile, VC giant Andreessen Horowitz has said it will commit millions to startups supporting "American dynamism" and acting in the "national interest" — an effort implicitly at odds with Sequoia's overseas investments.

Lux Capital partner Josh Wolfe said that tech investing has long been a nationally sensitive undertaking. "Silicon Valley was born not in the myth of hackers in garages, but rather with radar, semiconductors and electronic warfare calculating trajectories of projectiles," he wrote in an email.

In a statement, a Sequoia spokesperson said, "There was no single catalyst or event that led to the decision." The unwinding will result in two new entities — HongShan, formerly Sequoia China, and Peak XV Partners in India, a reference to a name for Mount Everest.

The formal split will functionally complete by the end of the year, with names and branding updated by the end of next March. Over the next few months, DC policymakers aren't likely to stop pushing for more restrictions on US tech ties to China, even beyond the pending executive order.

"There's support to do more" in Congress, said Dmitri Alperovitch, chairman of Silverado Policy Accelerator, a Washington-based bipartisan think tank. "That's not the end of this issue."

**** With assistance from Bill Allison.*