

Government & Online Video in China: WeTube, not YouTube?

China has seen a proliferation of YouTube-style video sharing sites. Inspired by the USD 1.65 billion valuation ascribed to YouTube by Google in its October 2006 purchase of the company, hundreds of “me too” websites have popped up in China. From a niche-application for geeks a few years ago, online video has grown into a mass-medium consumed by tens of millions of Internet users every day. Some individual sites are serving up over 100 million videos per day, rivalling traditional broadcasters in their reach and impact.

Inspired by this mass-market and fueled by excess liquidity in China's venture capital markets, eight online video companies alone have taken in over USD 190 million in funding since 2005.

On December 27th 2007, the Chinese government sent a shiver through the industry with its announcement from the State Administration of Radio, Film and Television (SARFT) and Ministry of Information Industry (MII) regarding new regulations for Online Audio and Video Services, to take effect on January 31st 2008. The regulations represented an attempt by the Chinese government to assert its control – including the imposition of majority state-ownership as a condition for the continued operation of online video and audio websites.

The rules, posted on the MII's website on December 29th, appeared to represent a major land-grab by the government (with SARFT at the vanguard and MII as a monitoring body) over the online video/audio sector by requiring that operators of these services be majority state-owned. The regulations pertain to the production, editing, and aggregation of audio and video content and dissemination to consumers over both the Internet and mobile networks. From January 31, if implemented fully, all online video sites would be required to have an "Online Audio-Visual Broadcasting License" which would entail being majority state-owned/-controlled and satisfying a number of other conditions, including carrying out a comprehensive censorship system and being funded by approved (“legal”) sources. Video sites which transmit news content would be required to obtain an additional “Internet News Information Service License” and sites broadcasting entertainment content such as talk shows, interviews or independently-produced online dramas or films would need a “Radio/TV Broadcasting Production License”.

Applications for licenses would have to be made to local broadcasting authorities, but SARFT would have the final say over the issuance of licenses. An Internet access license would also be required from MII.

A debate raged in China on the impact of the new regulations, and a full range of voices was expressed. Some surprisingly strong opinions were voiced in editorials (some subsequently removed from websites) in domestic newspapers. The Oriental Morning Post in Shanghai said the regulations were “clearly an act of establishing administrative licensing” which constituted a violation of Article 15 of China's Administrative License

Law – supposedly restricted in scope to areas as national security, public safety and the public interest.

An editorial in Southern Metropolis Daily said that an “icy wind is cutting across the Internet as we enter the New Year”. Predictably executives in the online video companies interviewed were more sanguine. Attempting to put a brave face on the regulations, a theme of “the move will be good for the industry” was common, and that this would help “clean up” the sector and “separate the large players” from the rest.

Yet February 1st 2008 came and went without any attempt by government to block the sites in question or to impact their operations. Indeed, in what appears to have been a climb-down on February 3rd the two key government bodies that had promulgated the regulations – the State Administration of Radio, Film and Television (SARFT) and the Ministry of Information Industry (MII) - convened a joint press conference to address industry concerns including those expressed by the operators of the online video sites. SARFT and MII effectively grandfathered the hundreds of existing players already in operation and instead stated that the new rules would apply only to new market entrants.

Although none of the companies involved can claim profitability, China’s leading YouTube wannabes can claim huge popularity amongst users – apparently to the point that even the Chinese government’s hand was stayed in its attempt to reign them in. Instead of using regulatory muscle to take over these sites, the approach of traditional media outlets such as CCTV appears now to cooperate with them to enhance their own – lackluster to date despite a decade of opportunity – efforts to forge an effective online strategy.









The May 12th Sichuan earthquake and its tragic aftermath have further highlighted the power of the online video sites who have carried extensive retransmitted or original video clips of the disaster, pushing traditional media outlets further forward on the road to transparency.

So it seems that online video sharing sites are more than just a flash in the pan. As they are an increasingly central feature of China’s mass media, it is worth looking in closer detail at these sites, their financial backers, the business models they have adopted and the challenges they face in achieving profitability.

A Flood of Liquidity for Streaming

China has seen an explosion in online video sharing sites. Eight online video companies alone have taken in over USD 260 million since 2005 (See Exhibit 1 below), with USD 25 million completed in late 2007 in one round of investment in Youku.com led by Brookside Capital, an affiliate of Bain Capital, and in April 2008 a record USD 57 million investment in Tudou.com led by existing investors.

Exhibit 1: Financings of Selected Chinese Online Video Websites

Name	Year	Value (USD MM)	Investors
56.com	2006	10	Sequoia/Steamboat Ventures/SIG
 56.com	2007	20	HIKARI Private Equity/SIG/Adobe Systems Incorporated/CID/Sequoia/Steamboat Ventures
6rooms	2006	0.5	Ceyuan Venture
 6rooms	2006	6.5	Ceyuan Venture/Transcosmos
Ku6	2007	10	Draper Fisher Jurvetson (DFJ)/DT Capital
 Ku6.com			
PPLive	2005	0.8	Softbank China
 PPLive	2006	5	Softbank China/Bluerun
	2007	21	DFJ
PPStream	2005	1	Ceyuan Venture
 PPS	2007	10	Ceyuan Venture/Ignition
Tudou	2005	0.8	IDG
 土豆网	2006	8.5	IDG/Granite Global Ventures (GGV)/JAFCO
	2007	20	Capital Today/General Catalyst Partners (GCP)/KTB IDG/GGV/GCP
	2008	57	
Uusee	2005	10	Sequoia/SIG
 UUSEE.COM	2007	23.5	DFJ/Highland Capital/Steamboat Ventures/Sequoia/SIG
Youku	2006	3	Farallon Capital/Chengwei Ventures
 YOUKU.com	2006	12	Sutter Hill Ventures/Farallon Capital/Chengwei Ventures
	2007	25	Sutter Hill Ventures/Farallon Capital/Chengwei Ventures/ Brookside Capital (an affiliate of Bain Capital)

Source: BDA

The traffic generated by these sites is impressive. In interviews with BDA, executives from Tudou indicated the company had 17 million registered users and daily video views of 77 million by year-end 2007, and claimed they were the largest in the pack. Meanwhile Youku.com, which completed a USD 25 million financing-round as recently in November, on 9 Jan 2008 released data from Nielsen/NetRatings for the week ending December 16 that showed it recording more than 100 million daily video views – which Youku’s CEO Victor Koo points out was the level YouTube had obtained when acquired by Google - and attracted 12 million daily ‘unique visitors’ during that week (a number it is worth pointing out is significantly lower than YouTube at the time of its acquisition). Nielsen’s data indicates an increase of 30 million daily video views since October 2007. Rival monitoring firm comScore recorded Youku as having 72 million visits in the month of November 2007.

Business Models: Video Sharing and Online TV

Within China's burgeoning online video sites, two types of businesses are emerging: online video sharing and online television.

The first type of website allows users to upload and view video clips, which are predominantly (although not exclusively) 'home-made' or User Generated Content (UGC), through an online platform. These video sharing sites use streaming technology (users are not required to download an application before viewing videos) and with their short-format videos most closely mimic YouTube. Selected examples include 56.com, 6rooms, Tudou and Youku.

The second type of business allows users to watch full-length television programs online. These sites typically operate using Peer To Peer ("P2P") technology (users are required to download a small application to their computer before viewing or sharing files) and feature mainly TV programs from terrestrial broadcasters. These programs include both live TV broadcasts carried online or video on demand (previously broadcast TV programs). Examples include PPLive, PPStream and UUSee.

While Chinese content is the dominant category featured by online TV websites, these sites also carry a significant amount of overseas programs, including popular shows from South Korea or hit TV shows from the US and UK. TV programs or films often features Chinese subtitles, broadening the appeal to the mass market. Sports events are also featured. The NBA has cooperated with UUSee for example in offering live games.

Inevitably a significant amount of the content featured on these sites is pirated. China's stringent restrictions on the number of foreign feature films and TV shows have long fuelled demand for pirated content, and now this content is increasingly available online as well as on the street corner.

In an effort to attract content uploads - itself a key metric in the broader competition for venture capital - some websites such as Ku6 have pursued innovative models that share advertising revenue with video developers.

Profitability Still a Major Issue Worsen by Self-Censorship Costs

Advertising is the primary source of revenue for both online video sharing and online TV websites.

Online video sharing sites are almost exclusively dependent on online advertising, which takes three main forms: banner advertising on the sites; video advertisement inserts at the beginning "pre-roll", middle or end "post-roll" of a video clip and; sales of video player "skins" (personalized designs of video player programs).

Given that one video program on an online TV site usually attracts a far greater aggregate download or concurrent audience than a single video on a video sharing site, the online TV model has been more rapidly embraced by advertisers. UUSee, a leading Chinese online TV website, stated to BDA that it expects its revenue in 2007 to reach USD 10 million, and the company had planned to break even in December 2007. Advertising made up the bulk of UUSee's total revenues.

Paid subscriptions also generate some revenues. UUSee for example offers a RMB 10 (USD 1.37) monthly subscription to a channel for viewing up to 10 movies a month. Some of the online TV sites have also tapped into Wireless Value Added Services (WVAS) revenues by cooperating with broadcasters. As a result of their more diversified revenue sources online TV websites have been more successful in financial terms so far than online video sharing sites. 56.com revealed that in 2H 2007 its online advertising revenue reached RMB 1 million (USD 137,000) per month. Ku6 claimed it generated USD 3.5 million ad revenues in 2007, taking over 50% share of China's video sharing market.

While viewers pay nothing for watching the content, online video sites have to incur high expenses on bandwidth to ensure a decent-enough (if not perfect) viewing experience.

Looking at 56.com again, while it generates only RMB 1 million per month in advertising revenue the company must spend RMB 4 million per month on hosting expenses. 56.com claims its compression technology keeps its bandwidth costs lower than other sites. If this is the case then even leaders in the sector have a massive effort ahead and may need yet more capital to emerge on top.

This raises a fundamental concern for the sector. If even YouTube has failed to break-even in the US market despite its huge consumer uptake and the relatively lower cost of bandwidth due to a deregulated telecommunications market, how can smaller Chinese sites hope to become profitable when hosting videos costs more than their US counterparts?

Another expense line which weighs heavily on Chinese video sites finances – and their management time - is content filtering. Video sites in China have to adhere to a very strict – yet ill-defined - standard of what content is permissible. In discussions with various online video sites contacted by BDA, company executives were at pains to stress how effective they were in filtering content, either through the dedication of superior numbers of personnel or through the deployment of more sophisticated technology – for example searching for offensive key words (to find a video amidst the torrent of content consumers need to start with a key word) or randomly sampling frames of content and detecting offensive uploads.

Whatever the efficacy of these systems, as the volume of content uploaded increases the burden of hosting and filtering will inevitably increase.

Whither .gov.cn?

In light of the recent regulatory intervention and retraction, investors are likely to expect a higher return for future rounds of investments to offset the increased regulatory risk. This at a time when it remains to be seen how soon these sites can generate profits, let alone avoid falling foul of government restrictions or, as with YouTube, being the subject of lawsuits from content owners over videos which are deemed to violate copyright. Venture capitalists are no strangers to risk of course, but those investing in

online video ventures in China might now perhaps be best described as Adventure Capitalists. Web 2.0 investments now involve a bit more risk than these investors had bargained for, yet the mass appeal and reach of winning sites makes the potential returns involved all the more alluring. The USD 57 million investment by existing investors in Tudou.com is a sign of how powerful the appeal of being number one in this sector really is. Whether investors in other sites will up their ante in this high stakes poker game has yet to be seen. Whether the government looking over their shoulders will take further steps to reign in the power and reach of these sites is also an open issue.