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Emerging Markets Private Capital — A Focus on China

A Commonfund Webcast

Commonfund recently hosted a talk on evolving private capital opportunities in emerging markets. Mark Hoeing, Head of Private Equity, moderated the discussion, while Aaron Miller, Head of Venture Capital, interviewed BlueRun Ventures China founder and Managing Partner, Jui Tan.

Mark Hoeing: At Commonfund we believe portfolios are incomplete without meaningful emerging market exposure, in both private and public emerging markets. In private markets, that exposure focuses on new-economy companies—small, growing businesses that take advantage of domestic growth and consumption. We see the rising consumer as a key story in these markets.

Mark Hoeing

In many cases, private capital investment has significantly outperformed the public markets. Investing in private emerging markets requires access to managers with both a local presence and a global point of view. The strong entrepreneurial culture redefining many emerging markets lends itself naturally to private capital.

Emerging markets can't be painted with one brush, though. We see each market as unique and have adopted strategic overweights to the big three—China, India, and parts of Latin America—while taking a more limited, opportunistic approach elsewhere.

Median private equity benchmark data from Burgiss covering the 2011–2013 and 2014–2016 investment cycles show that emerging markets have performed strongly, and in some vintages are among the highest private capital performers globally. When you look at upper quartile data, the argument for having a large strategic position in emerging markets becomes even more compelling.

OPPORTUNITIES IN AN EVOLVING MARKET: CHINA VENTURE CAPITAL

Aaron Miller: Jui Tan joined BlueRun Ventures in Menlo Park, CA in 2001, later moving to Beijing to establish the firm's presence in China. BlueRun Ventures China invests in early-stage Chinese companies, notably in the internet services, communications, media, and mobile ventures sectors.

BlueRun Ventures's targeted subsectors represent the firm's view on how the Chinese market is evolving. The firm has shown the ability to identify and capture opportunities in some of China's earliest technology trends over the last 10 years. It invested in Ganji, a leading mobile Chinese classified ads business; Changba, a personalized mobile video karaoke application; and Qufenqi, a micro-lending installment payments platform that went public.

Let me add more context for today's conversation. China's GDP has grown more than nine-fold since 2000, to over $11 trillion today, with GDP per capita approaching levels of many European countries. Over the past 30 years, more than 800 million people have risen from poverty, many joining the middle class, which is expected to reach 550 million people by 2022.

Since the 1990s over 400 million people have migrated from rural China to its cities. And most staggering, China now has more than 100 cities with populations surpassing one million people.

Mobile payments have become the predominant payment method, with more than 700 million transactions daily, reflecting the rising Chinese consumer. The country also has over 850 million internet users. On a recent Black Friday-type event for online platforms, gross merchandise sales volume reached $1.4 billion in one minute.

China continues to deepen its capital markets and is now the second-largest equity market and the third-largest bond market in the world. Its top four internet companies—Alibaba, Tencent, Baidu and JD.com—all have valuations higher than $40 billion and place among the top 10 internet companies in the world by market capitalization.

Based on research from the Chinese Academy of Social Sciences, the new economy—including e-commerce software, semiconductors, and healthcare—accounts for over 15 percent of China's economy and has expanded at twice the rate as overall GDP over the last 10 years.

Commonfund made its first commitment in Asia in 1994. As of today, we've made over 65 primary commitments in China totaling nearly $1 billion.

AN EVOLVING ENTREPRENEURIAL ECOSYSTEM

Miller: I'd like to talk about changes in the Chinese entrepreneurial ecosystem. Five or 10 years ago many Chinese entrepreneurs looked to Silicon Valley for ideas, but that's evolved. What have you seen?

Jui Tan: I spent about nine years in Silicon Valley making investments, then moved back to China more than a decade ago.

China has experienced significant technology innovation over the past five to seven years. Initially, that innovation focused on consumer needs, driving the emergence of the big internet companies.

> *"The increasing need for consumer products and services in lower-tier Chinese cities presents a significant opportunity for companies.*
>
> *– Aaron Miller*

Recently, we've seen emerging innovation on the enterprise side as well. Certainly, companies do innovate on the customer side, but there's a better mix, which is relatively new. Earlier, most startups focused more on the consumer internet.

More than a decade ago, Chinese startups acted more as copycats, trying to mirror ventures in the U.S. and sometimes in Israel and Europe. In the past few years, we've seen unique innovations that don't mimic the West. These innovations are moving beyond a purely Chinese customer base to a more global reach.

Miller: So the consumer internet story remains strong in China, but enterprise—a huge market and by far the largest in the U.S. from a venture-backed standpoint—is emerging.

Tan: That's right. And companies are moving from business-model to technology innovation.

Miller: What gets you excited today from a venture investment standpoint?

Tan: I think venture capital investment is all about discovering changes that drive growth and returns for investors. As I mentioned, China's economic growth drivers have changed in the past few years, shifting from a quantity-growth to a quality-improvement model.

By that I mean that for a long time, China focused on manufacturing and low-end disruption that relied on inexpensive labor. And that's been changing. Now, the country is leveraging a huge supply of engineering talent as it moves up the ladder. That's the first big growth driver.

The second driver stems from urbanization. Given China's 100-plus cities with more than one million total population, we've focused a lot on infrastructure in the past 10 years. Now we need added services for all the people living in those cities.

We're also seeing more R&D spending. With a good supply of engineers, companies are focusing on R&D innovation as they move up the value chain. These are the key drivers.

Our investment teams focus on understanding consumer needs. Even though we don't invest in healthcare or medicine, for example, we do invest in healthcare-related information services.

Why is that so important? China's population is aging, that aging population is big, and that means major spending on healthcare services. At the same time, life expectancy in China has increased significantly. It was only 50 years in 1949 and now it's approaching 78 years. People are living a long time after they retire and are spending a lot on healthcare.

Meanwhile, medical insurance penetration is low—under five percent. Given the tremendous pressure on its social security system and low medical insurance coverage, China needs innovative health insurance services. We've made several very good investments this area.

Another theme involves the rise of so many large cities. When I first came back to China, we spent a lot of time looking at consumer needs in the first- and second-tier cities.

Miller: The first-tier cities being the Beijings and Shanghais of the world, which are quite large. What does a tier-two city look like?

Tan: Tier-two cities include Nanjing, Hangzhou, and Chengdu. Classification depends on factors like population and per capita income. Among the first-tier cities, Beijing's population is approximately 20 million and Shanghai is even larger.

Because of China's focus on developing infrastructure, some of the lower-tier cities enjoy good highways, railways, and schools. Many workers who've gained experience in upper-tier cities often move back to lower-tier areas, which should help drive growth over the next five or 10 years. And that should open up opportunities for our invested companies that target those markets.

Aaron Miller

INNOVATION, URBANIZATION, AND A BOOMING MIDDLE CLASS

Miller: So, the technology sector is growing, the rising consumer is driving growth, and the increasing need for consumer products and services in lower-tier cities presents a significant opportunity for companies—correct?

Tan: Yes. Consider travel patterns in the fourth- to sixth-tier cities, which differ substantially from patterns in first- or second-tier cities. Because these cities are smaller, people can easily rent a motorbike to move from point A to point B. It's more convenient for them to get out and run errands or leave the office and enjoy their free time.

So, companies can ramp up revenue and make good profits by offering services in fifth- or sixth-tier cities that wouldn't do well in first-tier cities. The growth potential in lower-tier cities is ideal for venture investing.

Miller: The number of engineers and rising middle class coming from the education system is amazing. Where does the educated class want to work? How has that evolved and affected the talent pool in the entrepreneurial environment?

Tan: As I mentioned, there's been a gradual move from business innovation to technology innovation, with a focus on fundamental technologies. That requires engineers and Ph.D.s, and China has a good supply of both.

As Chinese companies become more innovative, entrepreneurs will be different from those a decade ago. Typically these are well-educated entrepreneurs—engineers or Ph.D.s—and some have lived overseas. They can identify new opportunities and build teams that consist of smart people who understand the market and can sell their solution.

One company we invested in has developed autonomous technology, which it applied to a new application: fully autonomous cleaning robots. To develop a solution like this, you need to understand customer needs and assemble a team of Ph.D.s to develop safe and reliable technology that you can deploy in shopping malls and airports.

This product also requires good manufacturing and a supply chain that make it cost-effective for the robot to replace a human worker.

> *"The U.S.-China trade war actually may present opportunities, as Chinese companies figure out ways to fill gaps in a decoupled global value chain.*
>
> *– Jui Tan*

When I first returned to China years ago and we invested in consumer internet, the entrepreneur may not have had a Ph.D. or a strong engineering background. That person could build an interesting business. But entrepreneurs now need team members who can develop fundamental technology. That's the biggest change we see.

MORE WAYS TO EXIT

Miller: What exit paths are available now for Chinese startups?

Tan: There are more avenues for startups now than there were 10 years ago. Companies can go public in the U.S., whether it's on the NYSE or NASDAQ. Hong Kong is another avenue. For IPOs on a domestic exchange, there's the STAR Market, Shanghai Stock Exchange's new Science and Technology Innovation Board, intended to compete with NASDAQ. We've seen 33 companies go public through the STAR market and hope to see more.

China's private equity market has become very big. Besides exiting through IPOs, early-stage investors can sell shares to later-stage funds. And some of China's largest technology companies are constantly looking for good, quiet startups, so M&A is an active area. Because we focus on early-stage businesses, we can invest at a very attractive valuation.

Hoeing: One of our investors asks about U.S. investors getting cash out of China. An article in today's Wall Street Journal discusses the pullback in venture capital being raised there. Any comment on investors' concerns?

Miller: We have been active investors in the region for more than 15 years. Of those vintages, we have seen strong performance as well as strong realizations. With respect to 2018, as an example, of the largest 10 exits in our global venture program, five were from China, which were multibillion-dollar companies at exit. So we've seen money come back, but in venture it's always been a question of windows.

Jui Tan

Tan: I agree. In talking about exit windows, we always tell our limited partners that venture is all about long-term investment. If we make good investments, these companies will be able to exit after three to six years. If a company is ready to exit but it happens to be a bad year, valuation could prove problematic. To maximize your return, it's important to find the right moment to exit.

One challenge that some investors face happens when they exit by selling to a local company that pays in renminbi rather than U.S. dollars. Converting that can take time and delay receipt of U.S. cash proceeds.

But we've done well with exits. One such investment was a fintech firm, which went public on the NYSE. We invested in the company when it was insurance-based.

Hoeing: We're also seeing that the big tech companies in the United States and China—Facebook, Alibaba, Netflix, Google, Baidu, Tencent, JD.com, and others that are now public—want to acquire growing, innovative ventures. There's much more private demand to own those businesses in their younger stages. That exit path has been attractive, beyond the IPO route.

Shifting gears, we're often asked what impact if any the U.S.-China trade war has had on China's venture capital and private equity ecosystem. Your thoughts?

Tan: I think the trade war has more impact on manufacturing, and we don't invest in that area. The trade war has created a decoupling effect on the global value chain, which actually may present opportunities.

China and the U.S. collaborate to contribute to a value chain with, for example, the U.S. providing the semiconductor component for a system and a Chinese manufacturer using that part. But with the trade tension, the Chinese company will have to figure out ways to make its own semiconductor chips because they may not be able to get them from the U.S.

This may pose problems for the U.S. and China, but it opens up opportunities for venture investors like us, as Chinese customers may have to turn to domestic startups.

Hoeing: The transition to a more complex, high-value-add economy is a very investable, long-term trend that gets us excited when we look across the world. It's also a very low-levered investment opportunity when you're talking about small companies filling the gaps.

Clients also ask about healthcare opportunities. We've talked about the variety of cities, the different per capita income in each of them, and the need to provide a more balanced set of medical services, including dental.

One of the businesses we invest in offers two different dental brands, one very high-end and cosmetic, the other more basic. These brands can deliver a value proposition differently for each of these cities. And with 100 cities home to more than a million people each, you're talking about massive opportunities for dental services.

Medical insurance also presents very attractive opportunities. We see a trend toward more private company participation, and several firms are quite efficient. As global insurance investors look to this domestic Chinese economy, many small companies are filling that gap.

We also see attractive opportunity in the gaps in the Chinese's access to pharmaceuticals. A manager experienced in Chinese healthcare told us there's a 10- to 15-year gap between the high-quality, innovative pharmaceutical drugs available to U.S. consumers and what's available even to China's middle class.

That gap stems from the Chinese government's desire to support domestic pharmaceutical companies and essentially exclude other options. But the Chinese consumer economy wants better access to higher-quality pharmaceuticals, and local companies' ability to take advantage of that situation offers another long-term attractive investment opportunity.

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