

China in Transition: “ Reform, Open Up & Innovate” creates Opportunity

We just returned from a fascinating trip in China. We visited the country with a few of our clients, invited by a private equity fund of funds manager our clients invest with. The manager is quite “active” as they also do direct deals and offer co-investment opportunities to their Limited Partners. After our visit to China, we had even more conviction that we have the right partner and vehicle to get access to the Asian Private Equity Market. The manager combines a local and Western presence – they were the first foreign General Partner to invest in Renminbi (Yuan) as a Qualified Limited Foreign Partnership and have investors from the Chinese local government and state entities. They combine a western approach (they are Harvard educated and headquartered in San Francisco) and an American governance style that fits BigSur.

In this Thinking Man’s Approach, we synthesize our key takeaways from all of the different meetings with General Partners of Private Equity Funds in different sectors and countries, key government officials, private sector entrepreneurs and other Limited Partners (both international and Chinese).

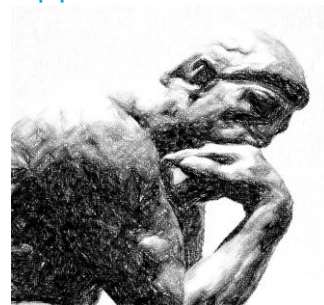
#1: We re-emphasize our thesis that there’s a huge opportunity to gain exposure to China via Private Equity, as opposed to Public Equity

As we wrote in our Thinking Man’s Approach #27 (Feb- 2015), we believe that private equity is the key to access Chinese private sector growth, talent, entrepreneurship and innovation. The private sector is responsible for about two-thirds of economic output in China today, and about 90% of the country’s exports. Almost all of the 250 million jobs created in Chinese cities since 1978 are from the private sector.

We don’t like the public equity markets in China from both a supply and demand perspective. The Chinese public equity markets are dominated by State Owned Enterprises and companies trading at high multiples in the “old world” economies, such as steel or manufacturing. The investor base of public equities is dominated by inexperienced retail investors (in China they make up 80% of the investor base vs. only 15% in the US).¹

A Special Report in the Economist in September 2015 argues that “private firms have been responsible for the vast bulk of modern China’s economic advance. They are agents of change, risk-takers, and these days, true innovators that take full advantage of potential new technology.

The Thinking Man’s Approach



October 2015 | Series #34
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In China, the number 8 indicates prosperity, wealth, success or social status. It is so special to the Chinese, that they scheduled the Opening Ceremony of the 2008 Beijing Olympics Opening Ceremony held on August 8, 2008 (08/08/08), at 8:08 pm. It seemed only fitting that we come up with 8 Key Takeaways after our trip to China. Spending time on the ground was invaluable: meeting with top minds in the private and public sector, visiting companies across different sectors, and experiencing the country first hand allowed us to develop our own conclusions about the opportunities in China.

For more on how we are positioning our portfolios, please contact your investment advisor or email:

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They are delivering not only ever better manufactured goods but also increasingly sophisticated high-tech based services...There is every reason to think that they can help deliver the required growth and turn the Middle Kingdom into the world's largest and most dynamic economy.”

#2: We strongly believe growth in China will be above 5% (and the base is growing quickly)

This week, the World Bank released its East Asia and Pacific Economic Update, and said China's growth will cool to 6.9% in 2015. Expansion will ease to 6.7% next year and 6.5 % percent in 2017. The market is concerned, however, that growth in the future could be lower than 5%.

Slower-than-expected growth in China has put pressure on commodity exporters, as well as trade, foreign direct investment and tourism in the region. This is comes at a time when the scope to ease monetary policy is constrained by the need to safeguard financial stability, while room for fiscal expansion is limited.

We consistently heard from managers that long-term growth is not going to be in the 7-8%, it's going to be in the 5.5-7% growth. It's important to remember that the base of the economy is much higher than it has been historically, so it's logical that there's some kind of slowdown. Even if growth is only at 5% next year, that represents more economic output than 14% seen in 2007 (as the economy today is so much bigger)!¹

Despite the current natural slowdown, we believe there are exciting long-term opportunities for our managers to take advantage of sectors poised to benefit from reforms (examples are included in Takeaways #6 and #7).

#3: China's commitment to reform is serious and for real

President Xi Jinping said: ““Like an arrow shot that cannot be brought back, we will forge ahead against all odds to meet our goals of reform.” And we trust this is the case, re: Social Reform, State Reform and Market Reform.

Social reform: Today the average Chinese family still saves 35% of their income because they don't have a social safety net. Record amount of money is being spent by the Chinese government to address this need. Today, for example, 60% of people are covered by state plans of health care, a significant jump from just a few years ago. The government targets to cover 80-90% of the population in the next 5 years. The hope is that when people feel that there is a real social safety net for them, they will feel more comfortable spending, and there will be a boost in domestic consumption.

State reform: Previously, bribery and corruption were huge problems with Chinese state officials. There has been a massive crackdown on corruption, and there has been evidence emerging that this has taken place. Chinese officials used to patronize casinos in Macau, China's gambling mecca. With

¹ Vijay Vaitheeswaran, “Special Report: Business in China, Back to Business,” The Economist, September 12, 2015



major crackdowns, these Chinese corrupt officials are no longer gambling: last December, casinos in Macau posted a 30.4% fall in revenues from the last year.¹

There are also key reforms happening with **State Owned Enterprises (SOEs)**. The state seeks to reform SOEs by diversifying these companies' shareholder base and improving corporate governance. There are some opportunities with Private Investments in Public Entities (PIPEs) and some private equity managers we met with are focusing on these types of investments. They have found some SOEs with strong management teams who act like real business entrepreneurs and provide full alignment of interest with shareholders. They've found attractive entry points (deals at 5-6x earnings) and focus on having a hands on approach on the board, improving processes and performance, and then having a strong exit strategy.

Market reform: Mr. Xi's clearly stated in his first speech when he took office: the market forces must play a decisive role. This was very telling because up until this point, the state played the decisive role. He recognizes that if China is going to become a global economy it needs to have a more supply and demand driven global economy

In an effort to become a major global economy, the government has been tackling interest rate, current account and exchange rate liberalization. All of this is has happened at incredibly fast speed, much faster than even some managers we spoke with had expected. In fact, the government's attempt to fast track this reform of letting market forces is so much change so quickly that the market cannot adjust, which is why there has been so much volatility.

There is a balancing act for Chinese policymakers between long-term reform and short-term measures. There is no doubt they have made some mistakes in this process, but the focus is in the long term reforms. An example of mistakes is the way the PBOC communicated the Yuan devaluation, which was a natural event.

The capital market structure is also being reformed. The Chinese state official and regulators are seeking to develop a more efficient market to meet various companies' financing and trading needs by building up "multi-level capital markets" as shown in the graphic on the right. This has allowed for an increasing number of listed companies with market makers – for example in the New Third Market,



Source: New Alliance Capital

¹ Scott Neuman, "Chinese Gamblers See Macau As Bad Bed Amid Corruption Crackdown," NPR, January 2, 2015



there were 1,232 companies listed in October 2014, and by September 2015 the number had almost tripled (3,442 listed companies).¹

The government is also encouraging reform in [business](#). Previously inventive entrepreneurs lacked protection for their intellectual property but also social status in a society that highly regarded bureaucrats. Now Chinese leaders have started to praise innovation, and successful entrepreneurs like Jack Ma (Alibaba) and Robin Li (Baidu) and Ma Huateng (Tencent) are idolized throughout the nation. The state has also made significant investments in technology to stimulate innovation and economic growth (more in this in Takeaway #6 “Internet +”).

This widespread reform will lead to a new economy for China, and we believe the key to finding good investments is to balance the risk and opportunity of this transition. The managers that impressed us are focusing on mitigating risks under complicated circumstances and capitalizing on opportunities emerging from the transition China is undergoing.

#4: The change in economic model from being the World's Factory to being the World's Market

The Chinese officials seem to be willing to take short-term pain for long-term gain, in the economy's transition from a model based on investment to one based on consumption and services. Between now and 2020 there will be an increase of 100 million urban residents in China and 250 million more members of the middle class, who will be earning twice the per capital income than they do today. The latest annual global wealth report by Allianz SE reported that China's strong growth over the last decade has already left the country accounting for more than half of the global middle class. Another factor which will fuel consumption is the age demographic of the Chinese population. The chart on the next page shows that household consumption tends to peak when the head of households reach 45-49 years old. In China, the percentage of households with 45-49 year old heads will peak in 2015 - 2025, further supporting predictions of a consumption boom ahead.

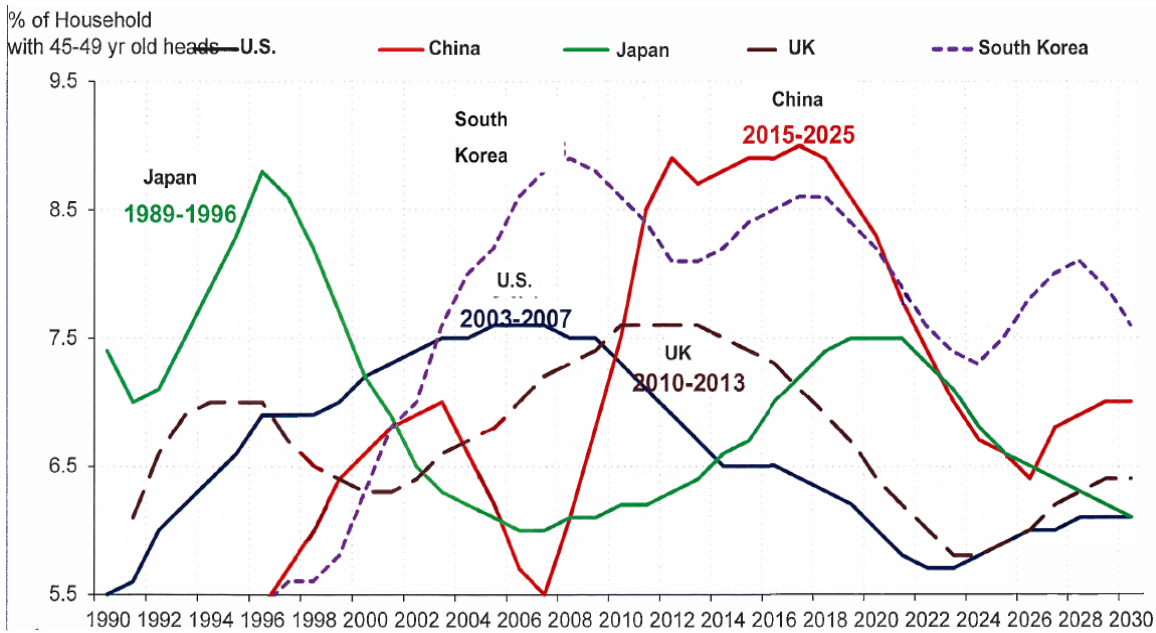
Additionally, the service sector is highly under-penetrated in China, contributing only 53% to GDP vs. the global average of 61% and 66% for high income countries.² This service undersupply will be forced to change especially as booming consumer demand will be unmet - healthcare, banking services, logistics, education, food safety, entertainment are just some of the sectors that are set to benefit. With the great internet infrastructure, Chinese consumers are fast becoming the world's most discriminating and knowledgeable. Thanks to the convergence of mobile commerce and social media, China is the epicenter of “social commerce”. Thus, we think the change will be quite fast and provide a cushion to a natural slowdown.

¹ NAC Capital, Wind

² Hony Capital



International Experience of Structural Adjustment: Consumption is about to Boom



Source: Honv Capital

#5: Internet+ is the KEY to the new Chinese Economic Model

Chinese Premier Li Keqiang defined “Internet +” as the catalyst to promote future growth in the Chinese economy. “Internet +” is the initiative to promote integration of mobile internet, cloud computing, big data, internet of things and modern industrialization of different industries. This model is technology centric and different than a “+ Internet” model, which is based on a traditional business model and then enhanced by technology. The below table highlights the different between the “Internet +” and “+ Internet” model.

Internet +	+ Internet
Technology centric	vs. Traditional business model centric
Online product experience	vs. IT implementation
Create new consumer entry points	vs. Online marketing
Keyword is Disruption	vs. Keyword is enhancement

Over the last two decades, the Chinese government has spent hundreds of millions of dollars on high tech infrastructure. We heard from company management and private equity managers alike that as far as they could tell, no other country has spent that kind of money – and they unilaterally agreed that it would be very difficult for another country to catch up in the foreseeable future. A great example of a company that has blossomed with the Internet + concept is Xiaomi, a privately owned Chinese electronics company which is now the world’s fourth largest smartphone maker, and has the largest share of the Chinese smartphone market. We met with Shou Zi Chew, the CFO of Xiaomi in Beijing.

The company was founded only 5 years ago has grown into one of the most important players in the smartphone industry. When asked why the company grew that fast, the CFO said it was



because the strong e-commerce infrastructure which has been set up over the last 5 or 6 years. Guys like Alibaba and JD.com really pushed the proliferation of e-commerce in China and allowed for their online only business to take off.

Why does Shou Zi say this? Xiaomi leveraged the “Internet+” concept to scale their business: they do not have any physical stores in China, all of their sales come from online – and today, 40% of all smartphones in China are sold online. Xiaomi’s has been able to build such enormous net revenues in a short period of time with the volume of the Chinese market and also by maintaining very low operating costs. The CFO mentioned single digit operating expenses are less than half of their competitors – their online sales only model in China has relieved the company of the expenses of operating a flagship store; they have virtually no marketing team (everything is done on social media) and do not have any distribution agreements.

Xiaomi further used the technology shift in China to scale their business, by creating a software that allows for open innovation and pure feedback from their customer base. Xiaomi’s operating system (OS) is highly interactive with users, is available in 17 different languages and is updated weekly (vs. other mobile phone OS updates, such as Apple, which updates their OS quarterly). This makes their platform more robust – they intelligently use their users for cheap feedback on improving their software and products. It also keeps their fans loyal. Their OS was launched 1 year before their phones, and ensured that from Day 1 the company was profitable.

Xiaomi MI 4 Phone



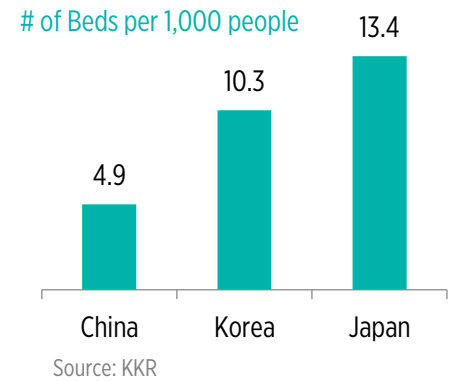
The ecosystem which Xiaomi created through their OS allows their users to connect to devices such as speakers, wearable fitness trackers, water filters and air purifiers via their smartphones. These devices are manufactured by partners in their ecosystem. Through these devices and through access of traditional smartphone applications like online gaming and entertainment, Xiaomi has been able to attract users to spend an average of 4.5 hours a day on the Xiaomi platform, more than six times the amount of time people spend on Facebook per day. The company has yet to build an advertising platform – and when it does, it has a huge potential of monetizing their software.

#6: We believe there are incredible SECTOR specific opportunities



The opportunities do not just lie in the technology sector. Some of the more traditional sectors are also experiencing transitions as they “open up, reform, and innovate,” which has created significant opportunities.

Health Care: China's spending on healthcare (5% of GDP) pales in comparison to other developed nations, which spend between 11-18% of their GDP on healthcare services. The accelerated aging trend (in 2014, 15.5% of Chinese population was over 60 years old, in 2020 it is estimated this will be 19.3%) will further tighten the supply-demand imbalance of healthcare services. ¹ Something as basic as hospital beds are majorly lacking in China, as demonstrated by the chart on the right.



Managers we met with consistently singled out the medical device industry as an area expected to experience growth rates higher than the average economic sector. Currently in China, medical devices only make up 15% of the total healthcare market, whereas in the US market, medical devices constitute about 50% of the healthcare market.² This enormous gap shows the potential of growth of the market.

Air and Water Contamination: We like to have these types of plays in the portfolios, which are not linked to interest rates, GDP growth, or broader macroeconomic issues. China's rapid economic growth has resulted in significant environmental degradation. The China Environmental Technology Industry Forum showed data that the Beijing air pollutant density is slightly higher than the average US airport smoking room! Their study also showed that one-third of China's population does not have access to clean drinking water. ³

Managers identify air and water contamination as one of the most significantly under-invested niche sector of the economy, and thus are focused on finding players that they can develop into early industry leaders. One portfolio company we studied is a water treatment provider, and over the last 4 years has expanded to operating 40 wastewater treatment plants across China, has grown its revenues by over 51% and provided the private equity company a gross 40% IRR.

Even Xiaomi is producing a cheap air purifier, which connects with their phones. They launched the product seven months ago, and it is now the number one selling air purifier in China by sales, with a 28% market share!

Food Safety: Another transformation China is experiencing is from “enough food” to the new focus on providing “high quality” food. This growing demand for safe and quality food has created opportunities for managers to improve local players (many of which are family businesses) by modernizing upstream suppliers and vertically integrating players in the market. One portfolio

¹ KKR

² New Alliance Capital

³ China Environmental Technology Industry Forum, 2014



company we learned about is a dairy that a private equity manager overhauled by improving the process of feeding and sourcing, implementing new technology and machinery to boost productivity and bringing management skill to the family operating business.

Entertainment: China's deep investment and development of technology infrastructure has fueled the growth of mobile entertainment: online gaming, video streaming (of movies and TV), and digital music streaming have taken off over the last few years. The entertainment sector has also experienced continuous rapid growth based on strong demand; the sheer number of users (see chart below) creates significant opportunities and many of the subsectors provide healthy cash flows. A company like Xiaomi for example, has become the third largest video company in China with 77 million users with "not that much effort," according to CFO Shou Zi Chew. They have not fully monetized their video or music apps with advertisements yet.

#7: It is not an easy task to become a reserve currency for the world

The Yuan will eventually become part of the IMF's SDR global reserve currency basket – the IMF will decide only if they believe the Yuan meets their criteria. When this happens, it will be an important step for the Yuan to become a reserve currency for the world. But in order to become a "true" reserve currency, China needs to improve its currency transparency standards and it needs to liberalize the financial markets and the capital controls (capital account).

The timing and the way the PBOC communicated the Yuan devaluation was not ideal (to say the least), but after the trip it seems clear the regulators were trying to achieve more "flexibility" in the currency that it is required by the IMF, which is a good thing for the long term. Ironically, they achieved more uncertainty and shockwaves in the world FX markets and they were forced to intervene to limit the devaluation vs. the USD to only 3%-to-4% (they will probably keep it stable for the next few months before gradually devaluing during 2016).

Indeed, more transparency and better communication is needed. But the example of the devaluation also shows that it may be tricky to liberalize the financial markets and the capital account. In particular, we believe that lifting "capital controls" will be a big challenge. It is going to be key their capacity to balance the "capital outflows" (locals with full access to international markets) with the "confidence" needed from international investors to bring capital to China. It is particularly difficult due to the size of the flows; with huge national savings (estimated around \$4.5 trillion) the possibility of huge capital outflows is not minor. True, the reserves are also huge (they peaked at \$4.0tr by mid-2014 and they fell to \$3.5tr in Sep 2015) but they can also fall quickly given the size of potential outflows. We believe this delicate balancing act in the capital account (and not the trade balance) will drive the Yuan going forward and the success of becoming a "true" reserve currency for the world.

#8: China is not a typical EM anymore

As President Obama said, "we cannot treat China as an emerging market anymore." The sweeping and significant reforms combined with the change from the world's factory to the world's market and a massive technological infrastructure that enables companies to leverage the internet to capture opportunities quickly all show us that China is poised to become the #1 global economy. In our experience, from some points of view that China is more advanced than the US. The streets of Beijing and Shanghai were cleaner and had better roads than many US cities. Everybody we saw



had a smartphone – from taxi driver to hotel maintenance worker – and were constantly glued to their phones, which they use for everything, from banking to watching TV shows. The Beijing airport boats incredibly modern design and is the sixth largest building in the world by area. Many of the airports systems are automated – machines to read your boarding passes and passports make security a much swifter process. We arrived in Chicago (the third most important US airport) on a layover and the experience was a sharp contrast –the unorganized lines and completely manual security process were chaotic (and almost lead to us missing our connecting flight).

Conclusion:

As we re-emphasized our thesis of gaining exposure through Private (and not Public) Equity to China, we think that despite the natural economic slowdown there are very exciting opportunities for us in the long term. We believe that the market dislocations caused by equity markets also creates arbitrage opportunities for attractive long term investments. The key for us is endeavoring to get ahead of the competition in identifying right industry themes and to use deep sector knowledge – those are the managers we focus on. Managers that are focusing on long term fundamentals as opposed to the markets “flavor of the day” able to pick management teams with strong track records and alignment of interest.

Lastly, our networking with other LPs provided us with a great educational experience, both in terms of how to construct portfolios as well as sharing best practices. Other LPs included \$50B pension fund managers, several large university endowment funds and a few large multi-family offices with great international perspective and experience.



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