

China: The Great Wall of Worry & Opportunity

In this Thinking Man, we summarize the key takeaways from a recent trip to China where we met with multiple local private investment managers that our clients have invested with.

We discussed China's politics and economic growth, the impacts of the trade war with the United States, and how each of these factors have come together in shaping the current private equity environment.

Chinese public market indices are in correction territory, facing declines of 25% year-to-date, and the yuan has depreciated more than 10% within the same period.¹ This volatility presents short-term market risks, but also creates attractive buying opportunities for the longer-term. Private equity provides solution capital to the problems being faced in the region.

We reiterate our investment philosophy of approaching our core China exposure through private markets, which offer deeper intrinsic value, lower volatility and better access to the growing "new economy" sectors.

A quote from John F. Kennedy eloquently summarizes our market view: "The Chinese use two brush strokes to write the word 'crisis.' One brush stroke stands for danger; the other for opportunity. In a crisis, be aware of the danger, but recognize the opportunity."

China's Private Equity Environment

The trade war with the United States has increased uncertainty for private equity investors in China, creating a challenging investment and exit environment. Although paper returns look good, distributions remain low. Record fundraising is taking place as investors seek to take advantage of the market turbulence, but the most prudent investment managers are warning about rushing to deploy capital in this "correction" environment, recommending to remain cautious and control the pace of deployment.

The Chinese government has been taking steps in the right direction to attract capital to the region, which is positive news for PE markets. Some examples of these initiatives include loosening restrictions on foreign direct investment (by allowing foreign companies to take control positions) and forced deleveraging. The opening of China's market to foreign investment is expected to create exit opportunities from new strategic buyers, and as companies face more restrictive credit facilities, they are expected to begin divesting non-core assets (which could open up access to high quality businesses at attractive multiples given their need to sell).

1. Bloomberg

The Thinking Man's Approach



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- The trade war with the United States has increased uncertainty for private equity investors in China.
- Although growth equity and venture capital remain the dominant strategies in China, buyout dry powder has increased significantly.
- China's GDP growth continues to be above target, and it is moving towards a more consumption-driven and service-dominated economy.
- Many managers believe the trade war is a result of geopolitical tensions caused by the rise of China as a major power on the world stage.
- Supply chain disruptions will likely create an "inflationary tax" on U.S. consumers if escalations continue.

For more on how we are positioning our portfolios, please contact your investment advisor or: ideas@bigsurpartners.com



The private equity market has matured significantly in China. Although growth equity and venture capital remain the dominant strategies across Asian private equity fundraising, the buyout space has notably increased with recent dry powder exceeding over \$50 billion.²

The Chinese buyout market presents a significant opportunity to acquire companies directly from their founders, not from other private equity sponsors that have already squeezed the juice out of the operation. The first wave of buyouts are typically the most lucrative given the operational efficiencies driven by an institutional owner. In more established buyout markets, these companies are harder to improve given that returns are driven by financial engineering versus deep operational improvements. An interesting trend arising in Chinese buyouts is the presence of consortiums. Consortiums are primarily driven by the desire to control entry multiples and avoid bidding wars amongst competing PE firms.

Aging founders are one of the main reasons for the rise of the buyout strategy. Some interesting facts: 90% of privately held businesses in China are family businesses, 3 million private entrepreneurs will face succession challenges in the next 5-10 years, and only 35% of second generation children have indicated a willingness to take over the business.³ In most cases, these founders have already grabbed a meaningful market share of their industry and are facing slower growth, fear potential disruptions to their companies by technological innovations, or see that weak public markets do not present a proper exit channel.

Across the different strategies, growth equity is facing the most difficult challenge given a stagnant exit environment driven by weak public markets. In this strategy, funds typically invest into companies 12 to 18 months prior to an IPO, making their success highly dependent on market timing and cyclicalities.

Additionally, as mentioned before, not only are companies selling non-core assets or delisting from public exchanges, but many multinationals are carving out their Chinese assets and selling to more local and specialized players – as one of our managers stated, “local operators are taking the baton from global players.” Examples of this can be seen over the last year, with major global companies such as McDonalds and Uber both selling their China business to local players. Localization and specialization are key to value creation in the region, and an important theme in our manager selection process.

China's Economic Growth Drivers

Xi Jinping, President of the People's Republic of China, has been able to strongly consolidate power and is now focusing on market reforms. GDP growth continues to be above the 6.5% target (6.7% in Q2), and it is important to keep in mind the quality of this growth as China continues to move towards a more consumption-driven and service-dominated economy. In this transition, we are seeing a divergence between old and new economy sectors. Sectors that are growing faster than GDP present the most attractive opportunities for private equity managers, such as IT Software & Services (growing 26% YoY) and Leasing & Business Services (growing at 10.9% YoY).⁴

China is the largest consumer market globally, and consumer and service-related businesses are expected to grow as the middle class continues to expand. From 2013 to 2017, there was a 42% growth in annual disposable income per capita.⁵ The fundamental drivers for this growth are new age consumption, technology advancements and global integration. To put things into perspective, China has 5x the number of Millennials as the United States (330 million), and Asia as a whole has 12.5x more (828 million).⁶ By 2021,

2. Asia Private Equity Review

3. L.E.K Analysis, Chinese Academy of Social Sciences, Bain & Company

4. National Bureau of Statistics of China

5. National Bureau of Statistics of China

6. United Nations World Population Prospects



Millennials in China are expected to surpass older generations in terms of consumption power, and Millennials spend far more money on leisure and entertainment versus older generations. Not only are Millennials the drivers of new age consumption, but they are also at the forefront of the technological revolution.

When comparing the pace of adoption across technology platforms in China with those of the U.S., we see that in terms of innovation, U.S. companies have almost always created the initial technology, and Chinese companies later create a local version that reaches massive scale at a faster rate in terms of user penetration. This adoption is driven by sheer population size and the embracement of new technologies.

Examples of this can be found in E-commerce (Amazon vs. Taobao), social networks (WhatsApp vs. WeChat) and ride-sharing companies (Uber vs. DiDi). The one notable technology in which China has been the creator and earlier adopter is in mobile payments, which have become a part of everyday use for the Chinese and is still in its early years in the United States. We see this in play when comparing online sales penetration versus total retail sales – 20% in China versus 13% for the U.S.⁷

Trade War: United States & China

The biggest challenge in the short-term for China is overcoming the escalations of the trade war with the United States, which can present an impediment to China's growth story. Many of the managers we met with mentioned that the trade deficit with China has been present for many decades, but that it has only recently been brought into the spotlight because of geopolitical tensions caused by the rise of China as a major power on the world stage.

China is now testing the U.S.'s global dominance, and a good example can be seen with the revival of the Silk Road, called One Belt One Road (OBOR), which is a trade and infrastructure network unveiled by President Xi that spans from East Asia to Western Europe and Africa consisting of roads, railways, ports and pipelines. The network covers 65% of the world population, 75% of global energy resources and 40% of global GDP, and greatly strengthens China's global influence.⁸

Another highly contested region between the U.S. and China is the South China Sea, where over \$5 trillion of global trade flows through. The South China Sea is under territory conflict between China and 6 other countries that have secured military support from the U.S., and as recently as last week, the U.S. Navy proposed a major show of force to warn China.

By 2029, assuming the current growth rates continue, China would overtake the United States as the world's largest economy.⁹ Compared to China though, the U.S. has 7x greater GDP per capita, 3x greater military spending, and 2x greater research and development capabilities.¹⁰ An interesting debate to consider is whether China's rise to power will be a peaceful one, or if it will present a global threat.

Impacts & Resolutions

Sitting in the United States, the \$110 billion of tariffs has yet to show a significant disruption on financial markets. The problem will arise if and when the rest of the proposed tariffs are enacted, given that successive rounds will increasingly be imposed on product categories with fewer sourcing alternatives. These supply chain disruptions will create an "inflationary tax" on consumer goods, given that companies cannot immediately shift their manufacturing and suppliers. The U.S. consumer will ultimately bear the

7. Digital Commerce 360 / Forrester

8. PricewaterhouseCoopers

9. World Bank

10. IMF



cost, which is when we can expect to see a real market-sell off driven by the trade war. Some companies have begun outsourcing and shifting part of their operations to other regions as a hedge, but it is very difficult to do so, especially within a short timeframe given the rapid trade war escalations.

Sitting in China, the threat on all Chinese exports presents an even bigger problem due to their direct impact. Chinese exports to the U.S. represents 1/3 of all Chinese exports, meaning that a full-blown tariff would directly negatively impact GDP growth by 1%.¹¹ GDP growth would fall to 5.7%, resulting in the lowest GDP growth for China in over two decades. And this is just accounting for the “direct” effect of tariffs, not including all the businesses leaving and shifting their operations and suppliers to other low cost regions.

In terms of a trade war resolution, there are three main contentions being negotiated between the U.S. and China: 1.) Buying More U.S. Goods, 2.) Opening Up Markets 3.) Changing Industrial Policy. Buying more U.S. goods is the low hanging fruit, and we are already beginning to see China buying more goods from U.S. companies. For the second point, as mentioned before, the Chinese government is already undergoing market reforms which will allow for increased foreign investment and more equitable ownership rights. The most difficult point is the third, where there seems to be low probability for resolution.

Foreign companies that partner with leading local players are “forced” to give up intellectual property rights and their respective user data on whatever business developed in China. The government says they do not enforce this, but rather that the local business founders do (therefore it is demanded by the market). They argue that foreign companies are willing to forego these rights given the enormous market potential of China and the amount of money they are able to generate.

The U.S. sees this as a form of government interference and is trying to make them stop these practices, although this is something the Chinese government claims to have no control over. The U.S. is also seeking to end local companies from receiving “unfair government subsidies” (such as free debt) in order for foreign companies to compete on an equal playing field. What is important to understand is that many of China’s companies are SOE’s (state owned enterprises), meaning that this poses a direct challenge to China’s state controlled economy. For this reason, we believe it will be difficult to find common ground on this contention.

Conclusion

Although we believe that China will continue to experience amplified volatility in the short-term, our view is that the long-term growth story remains intact. We reiterate our investment philosophy of approaching the region through private markets, which offer deeper intrinsic value, lower volatility and better access to the growing “new economy” sectors. Remaining invested with blue-chip investment managers will allow us to benefit from the value that these managers are able to create and unlock as the Chinese economy stabilizes and matures.

11. Capital Economics / Asia Alternatives



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