

China: Marching towards global co-leadership

In late September 2019 and for the fourth time since 2015, we participated in the annual meeting of private equity manager Asia Alternatives, which took place in Hong-Kong and South Korea. Per our clients' feedback, we decided to focus this Thinking Man on China, with the idea of bringing the Eastern perspective to the table, as opposed to the U.S. centric viewpoint that dominates the Western media, arguably guided by Western investors' "herd" mentality.

China is, of course, one of the richest and most ancient cultures of the world. The name "China" comes from the mandarin word Zhōngguó, which means "Central Kingdom" in English, suggesting the country sees itself as having a central role in the world stage. Prior to the economic reforms and trade liberalization of 1979, however, China's economy was very poor, stagnant, and isolated from the rest of the world. But since the introduction of free-market reforms in 1979, its economy has been one of the world's fastest growing. China has now risen to become an economic super power and, in our view, it is steadily marching towards global co-leadership along the mighty United States of America.

Economic Standing

At the moment, China is the second largest economy in the world and growing at more than double the U.S. growth rate, according to official figures. However, when measured on a per capita basis, it remains poorer than many developed countries. For example, the U.S. has a GDP per capita of US\$60,000, several times higher than the Chinese number of approximately US\$10,000.¹ Nevertheless, we believe China feels it can challenge the U.S. dominance, and envision a world with one power in the West and one in the East. This may not come as surprise, as China is a nation with a 4,000-year long history of achievements that is unlikely to play second fiddle for more than a couple of centuries.

In 2013, President Xi Jinping coined the phrase "the Chinese Dream", in a clear reference to the American Dream, looking to capture the country's domestic, regional, and global ambitions. The next century could very well be defined in part by the tensions between the American and Chinese

¹ National Bureau of Statistics of China, World Bank

The Thinking Man's Approach



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- The next century may well be defined in part by the tension between the American dream and the Chinese dream.
- A holistic solution to the trade war will take long to resolve.
- The Chinese government is having more of a problem with optics than with content.
- The Chinese government rather focus the tension on trade (which is the low hanging fruit) versus changes in industrial policy. Chinese companies will end-up benefiting in the medium term from the strengthening in enforcement of intellectual property (IP) rights.
- We do not think this "trade war" will end-up being a military war.
- The Chinese economy is resilient and the 3 main structural engines for growth are: new consumption power, I&T advancement and global integration.
- Private Equity money is well-suited as "solution capital" (long-term and flexible capital) to capture best opportunities in the Chinese economy.

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dream, and everything that revolves around it, in our view. The trade war appears to be just the first stage in this process. However, we do not expect these tensions to escalate into a full-blown military war. For starters, China spent \$250 billion on its military in 2018, an increase of 83% during the period from 2009 through 2018, while the U.S. spent \$649 billion, representing a reduction of 17% during the same period, and the trend is likely to continue eliminating the gap.²

Trade War

Reshaping the global supply chain, but may not be a permanent shift. The prolonged US-China trade war, now 17 months long, is starting to produce its first negative effects, mainly in the form of a slowdown of industrial production worldwide. However, albeit slow, the trade war is forcing a reshaping of the global supply chain, out of China and into neighboring countries such as Taiwan, Vietnam, Laos and others in the region. Although this process has the potential to challenge China's growth, it is unlikely to become a permanent shift, in our view, as the other countries lack the infrastructure and IT ecosystem that are present in China.

Optics of trade war more of a problem than content for China. As a matter of fact, the main feedback we got from the leaders we met is that while the trade war will take long to resolve, the Chinese government is having more of a problem with optics than with content. This suggests that the Chinese government is more concerned with not looking weak (and not looking like they are being bullied by the Trump administration), than with actually producing a robust trade agreement. This seems to be a direct result of the 150-year history of humiliation the Chinese suffered since the beginning of the Opium Wars in 1820, a time when the Chinese economy had already been the largest in the world. Today, the trade negotiation is within China itself, the government and its constituents, and Chinese leaders are aware that they need to dig in for the long-term, which will prolong the tensions with the U.S. From the Chinese side, they would rather focus the tension on trade, which is the low hanging fruit that could be met immediately.

Strengthening intellectual property (IP) rights might benefit China. Another interesting viewpoint from our meetings is that China's companies and economy might end up benefiting in the medium term from the fact that the U.S. is pushing China to strengthen intellectual property (IP) rights. The U.S. is requiring China to end unfair subsidies of Chinese high-tech firms, let U.S. data firms operate without interference, and reduce pressure on technology transfer. China has responded by passing a new foreign Investment Law with a key mandate to protect IP of foreign companies and treat foreign investors equally in China. They have also unveiled a new reform plan to crack down subsidies to zombie state-owned-enterprises (SOEs). Thus, China is making positive changes and given their incredible IT eco-system, this push from the U.S. could likely end up benefitting China in the long run. This shows a parallelism with China's entrance into the WTO in 1999, when Western standards were adopted. This time around, there is another wave of pressure for China to continue the reform of its economy and the strengthening of its IT ecosystem. The existence of these external forces, especially from the Trump administration, has challenged the Chinese government, and will probably end-up favoring Chinese companies. However, there is consensus in Beijing that China needs to develop a self-sustaining IT eco-system, not to instantly

² Forbes: <https://www.forbes.com/sites/niallmccarthy/2019/10/01/how-military-spending-has-changed-since-2009-infographic/#15d555a05797>



switch it on, but initially as back-up. Today there are large IT companies in China demanding protection. China's IP issue has never been caused because of lack of regulation, but rather because of lack of enforcement. The tide seems to be changing in China and the government has started to shift its focus to enforcing the law.

Trade war threatens China's geopolitical stability. As President Xi has famously remarked, "long-term growth stays the course thanks to structural resilience". For the time being, fundamental drivers of economic growth are resilient and quite intact in China. However, political stability is key in what is known as the *decade of transition*, for the Chinese economy to achieve the New Normal from a manufacturing and export driven economy, to a consumer-driven, and service and IT based economy. Thus, the challenge faced by the Chinese government today is not only to achieve domestic political stability, but also an international geopolitical one, as the existing trade war with the U.S. will likely become a multi-year power struggle, that some analyst have started to refer to as the new "cold war".

Stable and Resilient Growth

China's GDP growth is steadily slowing to around 6.3% according to official figures, and remains within the government's target range of 6.0-6.5%, suggesting that GDP could almost double in the next decade.³ The lower growth rate is consistent with the process of transforming the economy from a manufacturing economy to a consumer-driven, services economy. As a reference, the U.S. GDP is roughly 2/3 driven by consumption and 1/3 by industrial production, which is what China is looking to achieve. During the first half of 2019, China's manufacturing activity has been contracting and industrial profit growth has turned negative due to the transition, as well as to lower industrial production worldwide. Chinese exports have also suffered due to the trade war, a shift in global supply chains and sluggish global growth. However, headline GDP numbers do not tell the full story, given that the Service sector growth has far exceeded GDP growth. For example, IT Software grew at over 30% in 2018 and looks to continue on this trend; Transportation & Logistics sector has been growing above 8% per annum.⁴

Domestic pressure to support economic growth and consumption is larger than ever. Government policies prioritize near-term stability in employment, trade, finance, and investment. Stability is the only environment that allows perpetrating the new economic model based in consumption. The reform agenda is taking a back seat, albeit it continues at a good pace. Even though China faces unprecedented challenges that are both internal and external, the three long-term engines of growth are intact:



³ National Bureau of Statistics of China

⁴ National Bureau of Statistics of China



Consumption is very strong and consumer confidence remains at 5-year high due to steady income growth and strong employment market. The new consumption power is mainly driven in two forms:

- a. Millennials consumption. There are 330 million Millennials in China (population between 18 and 35-year old), compared to 66 million in the USA.⁵ In addition, Chinese Millennials spend 30% of their incomes in Leisure & Entertainment versus 9% for all Chinese.⁶ Lastly, they move online a lot faster, so this enhances technological advancement. The pace of adoption across many technology platforms in China far exceeds the one in the US. For example, while it took 9 years for WhatsApp to reach 50% user penetration (the ratio of registered users to the total number of internet users in a given year), it only took 3 years for WeChat to do so in China.⁷
- b. Increasing consumption in tertiary and below cities: While there are 67 million people living in primary cities (Beijing, Shanghai, Guangzhou and Shenzhen) and 175 million living in secondary cities, there are almost 1.1 billion people living in over 3000 tertiary and below cities and towns (that are far behind in terms of GDP per capita), with at least 100,000 people each.⁸ The majority of Chinese internet users are in these lower tier cities and towns, and their youth spends more on lifestyle.⁹

The second and third wheels of fundamental drivers of economic growth are technology advancement and global integration. These engines will not stop and are a consequence of China's four decade long reforms, which started in 1978 with China's first "Special Economic Zone" built in Shenzhen. Clearly, reform will not stop, but is being deepened to ensure stabilization. Some of the key reforms include the State-owned enterprises (SOEs), with more mixed ownership for the top 100 SOEs, including Gree Electric (the world's largest air conditioner maker). Also, China will continue opening-up and relaxing controls over market access and allowing foreign companies to operate in more sectors. On the regulatory side, China is focused on global integration and has recently launched the Shanghai Technology and Innovation Board (STIB), which will pilot with a less bureaucratic registration-based system and allows unprofitable companies to get listed.

Technology advancement will be driven by China's vast highly educated population. For example, as per the OECD and World economic forum, in 2016 there were 4.7 million STEM (Science, Technology, Engineering and Mathematics) graduates in China compared to 600 thousand in the U.S. Also, while in 2017, the US spent US\$484 billion in Research & Development, China is quickly catching-up, and spent US\$445 billion.¹⁰ In 2018, as per OECD data, the percentage of firms adopting AI (artificial intelligence) was 22% in the US and 32% in China. Finally, China continues to build critical infrastructure to support I&T progress. The best example is 5G, where China seems poised to win the race. The threat that the US feels

⁵ United Nations World Population Prospects and Asia Alternatives Analysis

⁶ KKR, Goldman Sachs, IMF, Xinhua, Fudan University Daxue Consulting, and Asia Alternatives Analysis

⁷ KKR, BCG, and Asia Alternatives Analysis

⁸ Sixth National Population Census of the People's Republic of China in 2010

⁹ QuestMobile

¹⁰ OECD, China Aerospace Science and Technology, Federal Aviation Administration, and U.S. National Science Boards



with Huawei, one of the top telecom operators in China and the leader in 5G, speaks for itself and seems to be a “Sputnik moment” for the U.S.

Global integration is led by the 150 million outbound Chinese tourists¹¹ as well as by the leading “Chinese Champion” companies that are supported by the government. For example, the top four Chinese smartphone operators (Huawei, Oppo, Vivo and Xiaomi) have 83% of the domestic market and 43% of the global market, while Apple, Samsung and all others have only 17% of the Chinese market and 57% of the global market.¹²

Private Equity as “solution capital”

Investing in Private Equity in times of transitions makes a lot of sense, as Private Equity money is well-suited as “solution capital”. This is because it is long-term and flexible capital, looking to capture the earnings growth occurring through this huge transition. As select new economic sectors offer higher growth driven by “new age” consumption, technology advancement, and global integration, we see attractive opportunities to build innovative and market leading businesses. However, patience is needed as these transitions take time, as it takes time for transitions to turn into profits.

Our colleagues from an Asian private equity shop called CDH Investments, a growth and buy-out fund, shared the following chart, highlighting the main growth opportunities just in the consumer sector. These are sectors growing at more than 25% per annum and are thus expected to multiply by 10 in 10 years!



Private Equity is an alternative source of capital to support local entrepreneurs and professional management teams, to create value from Buyouts and Venture investments. Our friends from Asia Alternatives are partnering-up with top quartile managers, who can potentially make the most out of these transitions, as they are able to detect and get in early to maximize returns. The large percentage of opportunities seem to be in the intersection of Technology, and traditional industries like Healthcare.

¹¹ China Tourism Academy, Nikkei Asian Review

¹² IDC, and Counterpoint Research



China spends an average of US\$63 per person per annum, compared to almost US\$10,000 in the U.S.¹³ The category of Cosmetic & Beauty, such as skin care, constitutes a great opportunity, given that Chinese women spends 4 times less than in other countries and the trend is changing rapidly.¹⁴

Another example is in the intersection between Food and Tech. One example is the “cloud kitchen” concept, which is a shared kitchen with a variety of foods and brands for delivery-only restaurants. This offers extra capacity to restaurants and chefs whose existing kitchens are straining under the new demand for food delivery and helps them to broaden their reach in a given city. These cloud-kitchens offer lower upfront and operational costs than chefs independently leasing and fitting out their own food preparation facilities. The attention is shifting towards online marketing, fast delivery and keeping rents cheap.

Some of the main concerns we have heard from institutional investors (SWFs, University Endowment Funds and Pension Plans) in our trip are: exit strategies, fund sizes increasing relatively quickly, and fragile political stability. In the first half of 2019 total private equity exits dropped to 492 from 708 in the same period of 2018. However, PE-backed IPOs increased by 29% year-over-year and have been dominated by IPOs overseas, while domestic listings slumped.¹⁵

¹³ CDH Research

¹⁴ Euromonitor, CDH Research

¹⁵ Asia Venture Capital Journal (AVCJ), Asia Alternatives analysis



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