China’s economy is undergoing a transformation – it is slowing as certain sectors such as manufacturing contract, but at the same time, other more consumer-driven sectors including healthcare and IT are booming. This, along with dampening venture valuations, suggests a potential upside for well-positioned private equity investors.

On October 23, 2015, four days after announcing that its third quarter growth came in at 6.9%,¹ the slowest pace since the beginning of 2009, China’s central bank cut both interest rates and the reserve-requirement ratio for banks. This marked the sixth time the central bank has moved to lower rates since November 2014 and the fourth cut to the reserve requirement this year. It also follows the August stock market turmoil when uncertainty around the Chinese economy’s growth prospects helped shake up markets around the world.

China’s Communist Party’s Central Committee met the week of October 26 to develop its five-year economic blueprint. Although details of the plan won’t be released until March, a few of the key policy guidelines that came out of that meeting include:

- A focus on moderate and balanced economic growth and continued transition from an investment-driven model to a consumption-driven economy
- Emphasis on promoting innovation as a driver of economic growth, particularly with respect to improving the market environment and IP protection
- Increased market liberalization, particularly in areas such as finance and technology, as well as increased effort to introduce market-based pricing of utility services (e.g., electricity, gas, water)
- A continued push to protect the environment, alleviate poverty, and reduce corruption

Finally, in a surprise move, China Securities Regulatory Commission announced on November 6 that it plans to reopen the A-share IPO market soon – once it completes the adoption of a series of improvements on IPO approval procedures. The approval of listings of the 28 companies in the pipeline whose IPOs had been delayed due to the temporary market shut-down in July is expected to be the first order of business.

The HarbourVest team believes that as the world’s second-largest economy and accounting for a third of global growth – China should not be a black box to investors.

As an active investor in the mainland for almost 30 years, and with an established local presence in Beijing since 2012, the firm strives to ensure that investors gain better visibility into the challenges and opportunities presented by the Chinese market. Here, Sally Shan, HarbourVest’s managing director in Beijing, offers an assessment of the recent dynamics across China’s economic, financial, and private equity investment landscape.
1 Macroeconomic landscape: The big news in October 2015 is that China’s third quarter year-over-year GDP was up 6.9%, which marked the first time growth fell below 7% since 2009, the trough of the global financial crisis (GFC). What is your view on some of the key drivers of the structural slowdown?

We see three key issues that are dampening growth in China. Number one is overcapacity. After years of high single-digit to double-digit growth driven by fixed asset investments, traditional sectors now face severe overcapacity as both overseas and domestic demand falls with a softening global macroeconomic outlook. Making this problem particularly intractable is that overcapacity (and deteriorating profitability) are issues faced primarily by inefficient state-owned enterprises (SOEs) in industries such as steel and cement. Moreover, the government still owns all the major creditors. Thus, the natural market forces that are generally expected to address this problem are absent.

Number two is weakening trade numbers. Both import (down by 15.1% year-over-year (YoY)) and export (down by 1.8% YoY) numbers dropped in September 2015 compared to the same period in 2014 as a result of weakening domestic and international demand and a strong renminbi (RMB) against most major foreign currencies, except for the U.S. dollar. That said, despite the fact that the Chinese labor force is no longer “cheap” compared to other emerging market countries in absolute terms, we think that if productivity is factored in, it remains relatively inexpensive, especially in manufacturing. Exports, in our view, will continue to be a major pillar to the Chinese economy and trade surplus.

Number three is an increasing debt-to-GDP ratio. The total debt-to-GDP ratio has risen significantly since the GFC to over 280%. This has led people to worry about the country’s economic health. Most countries’ heavy debt burdens lie in government debt that is owed to foreign creditors. However, China’s total debt is comprised of mostly corporate debt, and to a lesser extent, household debt.

We think corporate debt should raise more concern as it puts further pressure on corporate earnings, especially for those SOEs facing overcapacity.

2 Are there big macroeconomic bright spots in your outlook that investors tend to miss?

We think it is critical for investors not to lose sight of China’s inherent economic advantages – it is a big, dynamic economy with a good deal of wind at its back. For example, a 6% GDP growth rate still outperforms most other major economies. Given its size, it will continue to be a major driving force of global economic growth. In fact, it is expected to account for one-third of all global growth in 2015-2020.
There are important signs that the economy is moving towards a more sustainable consumption-driven model. Official data indicates that the service sector now accounts for more than 50% of the economy. Consumer spending in areas such as sports/wellness, beauty, healthcare, and leisure are growing at double-digit rates. For example, movie box office receipts are up more than 50% YoY in the second quarter of 2015. So while traditional low-value sectors such as manufacturing are slowing, higher value-added sectors are taking off.

Finally, despite the general slowdown, we see select sectors in China continuing to experience solid growth. According to Goldman Sachs, the size of e-commerce (both B2C and C2C) in China is $454 billion, almost twice as big as the U.S. ($260 billion). Thanks to accelerating demand from an increasingly health-aware, aging, under-served, but now more well-off population, the growth rate of China’s healthcare industry is expected to hit 13% from 2014 to 2020, and its healthcare market could top RMB8 trillion.

What are investors to make of the People’s Bank of China (PBOC) surprise move in early August to change its long-standing daily currency fixing mechanism, which led to a 3% plus devaluation of the RMB against the U.S. dollar?

In HarbourVest’s view, the move by the central bank is intended to facilitate the liberalization of the RMB in order to pave the way for RMB to join the SDR (Special Drawing Rights) currency basket by making the exchange rate more market determined rather than to rescue the economy by devaluing the currency. With as much as $4 trillion in foreign reserves, we anticipate that further RMB devaluation will be in a manageable range. The RMB is one of the most resilient currencies against the rising U.S. dollar – it has experienced almost zero change in the past four years, whereas other major currencies are down by 10 to 50%. From a currency risk and industry perspective, investing in China is an attractive emerging market strategy in the current cycle.

What’s behind the recent volatility being experienced by China’s A-share stock market, and what is the impact on private equity?

The volatility is largely driven by retail traders: approximately 80% of market participants are individuals, compared to the U.S., which is 80% institutional. Also unlike the U.S., the stock market isn’t deep. In response, the government has come up with a series of measures, which added to the uncertainty, including tightening controls on leverage, increasing margin requirements and transaction fees for index future trading, buying stocks using state assets, and temporarily shutting down the IPO market.

While the market has stabilized and started to rebound, we expect continued high volatility in the A-share market in the foreseeable future.

The recent market turmoil is upending the public-to-private plans of some U.S.-listed Chinese companies that were looking to relist on the domestic stock exchange with the objective of achieving higher valuations. We expect valuations to continue to soften and entrepreneurs’ expectations to become more rational, which could translate into 2016 being a strong vintage year for venture investment.

To some extent, this is already happening. Software application developer Xiaomi, which was valued at $45 billion in its last round of financing in 2014, is rumored to have recent secondary deals value it lower. The “unicorn” candidates are also encountering hardships in raising new financing rounds as investors become more prudent. In spite of this cool down, good deals continue to be highly sought after.
What can investors expect from China Securities Regulatory Commission’s recent announcement to shortly reopen the A-share IPO market?

We see this as an encouraging development, particularly given its positive impact on China’s exit environment. It also showcases the government’s commitment to capital market reform. Among the issues that are expected to be addressed include: the “lottery” system used for allocating heavily oversubscribed new issues (a source of turmoil that caused CSRC to shut down the market), a simplified procedure for companies issuing less than 20 million shares, and adoption of more small- and medium-sized investor-friendly policies to better protect individual investors.

Are market dynamics in China creating M&A opportunities?

The current environment is conducive to consolidation. In the Internet and mobile sectors, we continue to see mergers between industry-leading companies in order to achieve scale and end cash-burning marketing efforts. For example, on-demand transportation applications Didi and Kuaidi, the top companies by market size, merged to create a company valued at $16 billion. Also, rival online advertising providers 58.com (WUBA) and Ganji.com combined to achieve a market capitalization of $9 billion.

HarbourVest expects to see many more similar combinations urged by savvy investors.

Generally, how have HarbourVest’s investments in China performed relative to its investments in the rest of the region?

HarbourVest accesses China specifically and the region in general through its primary, secondary, and direct co-investment platform. Over the past five years, we have invested nearly $440 million in China and almost $2 billion in the region across these strategies. Most recently, China has been a clear outperformer, as we have been able to realize approximately 3.5 times (gross) the cost of our investments.

Despite the many bumps in the road, as long-term investors we remain optimistic that China’s growing middle class as well as dynamic and large scale economy can continue to act as an engine to global economic growth and offer an increasing number of attractive investment opportunities.

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1 China National Bureau of Statistics.
4 Chris Giles, “For Every Economic Growth Laggard, There is a Gazelle,” Financial Times, October 8, 2015.
6 Cited in Henry H.McVey, “A Shifting Landscape,” Thoughts on the Road, KKR Global Institute, p. 7.
7 Ministry of Health, Healthy China 2020, strategy research report.
8 SDR or Special Drawing Rights are supplementary foreign exchange reserve assets maintained by the International Monetary Fund with the basket including the U.S. dollar, euro, pounds sterling, and Japanese yen.
10 Shuli Ren, “Did 58.com Overshoot After Reported Merger with Ganji?” Barron’s Asia, April 15, 2015.
11 As of March 31, 2015. Represents performance (realized value / realized cost) of underlying Asian Pacific company investments made by the Asian Pacific partnerships (primary and secondary) in which HarbourVest funds invested. This does not reflect the fees or expenses of the HarbourVest funds or the partnerships. Past performance is not a guarantee of future results.