PRIVATE MARKETS INSIGHTS:

CHINA'S MODERATING GROWTH A BOOST FOR NASCENT BUYOUT MARKET

- **Moderating economic growth is combining with local trends to improve the prospects for private equity buyout strategies in China, though it will take time for these to become mainstream.**
- **Venture and growth equity strategies should continue to be the main source of outperformance in the near term, given favorable demographic trends, supportive infrastructure and sector-level tailwinds.**
- **As the market becomes more sophisticated and competitive, investors should look for local experience and established relationships, and build a well-diversified portfolio.**

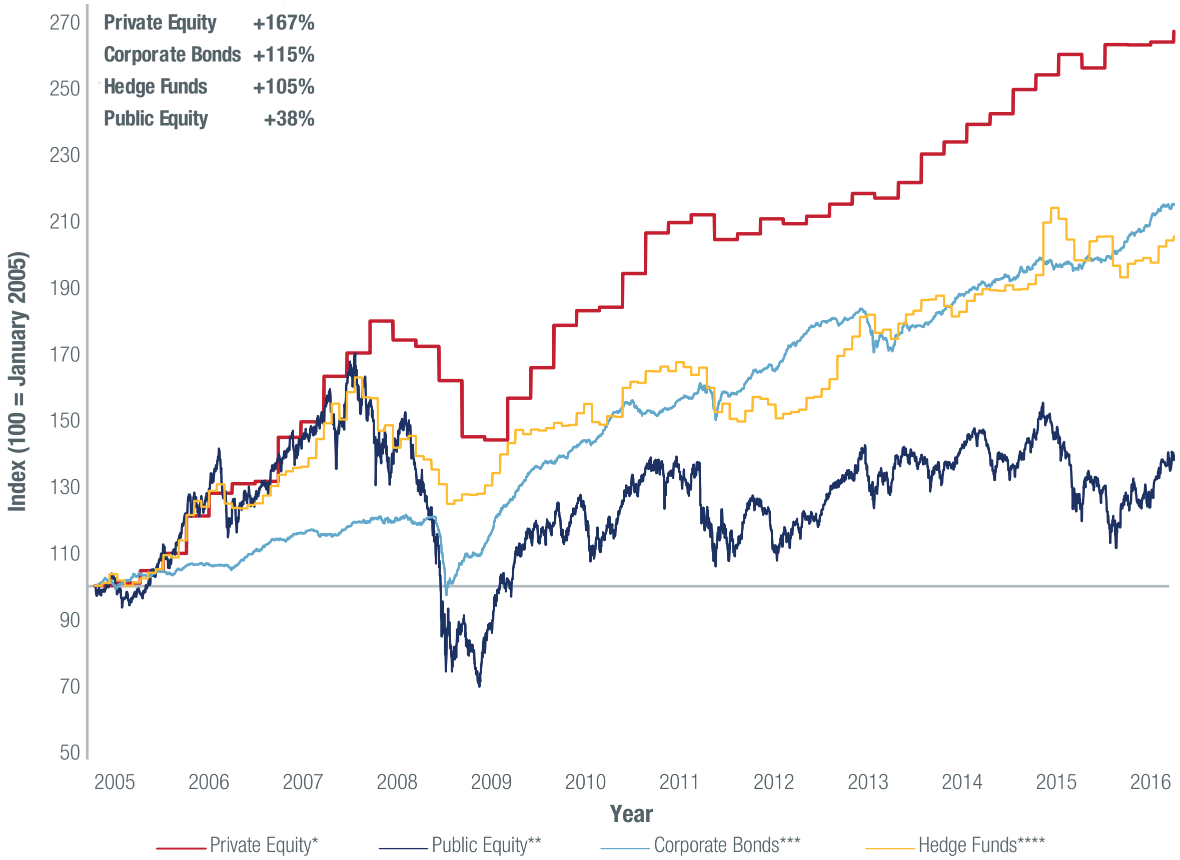
While investing in China could never be called easy, historically the sheer speed of its growth considerably broadened the investment opportunity set for private equity funds. These funds, particularly those following growth strategies, have exploited positive spillovers from rising household incomes, rapid urbanization, technology leapfrogging trends, and innovation to deliver broad outperformance over the past two decades. China has been a major contributor to the compelling returns private equity investors have received from the Asia Pacific region (see Chart 1).

China's economic growth is, however, now moderating, which is effecting shifts in the private investment landscape. How might investors interpret these changes?

We suggest, in short, with a degree of caution.

Early-stage venture strategies do face challenges from rising competition and high valuations, but we continue to view them as the main source of potential outperformance in China. Growth equity investment strategies similarly face a more difficult environment given continued rebalancing away from an investment-driven economy to one driven by consumption and innovation. However, sector-level tailwinds from rising incomes and supply-demand imbalances, as well as continued technological innovation, mean we believe there is plenty of life left in growth investing.

> CHART 1: Private equity has outperformed competing asset classes in Asia Pacific
Index performance of asset classes in Asia Pacific, Q105-Q316



* Cambridge Associates Asia PE & VC **MSCI AC Asia Pacific Index ***CS Asian Corporate Bond TR Index
****HFRX Asia Composite HF Index
Note: Most recent Private Equity returns data (Cambridge Associates Asia PE & VC) as of Q3 2016

For both venture and growth approaches, rising competition and slowing economic growth simply elevate the importance of judicious manager selection. Fund managers with established relationships who understand how to operate in China's complex business environment should continue to outperform.

Buyouts, meanwhile, are indeed becoming increasingly viable as the opportunity set broadens and implementation becomes easier, but it will likely take quite some time before they become mainstream private equity strategies in China. For now, buyouts may be best suited to a limited, complementary role.

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VENTURE AND GROWTH OUTLOOK STILL POSITIVE

If we first look at venture and growth strategies, while it seems to be true that much of the low-hanging fruit in certain sectors has already been harvested, fresh sources of returns continue to emerge.

China's technology firms continue to prove the "copycat China" depiction outdated. Its venture market is maintaining its rapid expansion, driven by innovation, the scale of the local market, and the high levels of connectivity among its population.

Meanwhile, China's ongoing "consumption upgrade" – as rising incomes translate into more sophisticated, diversified, and personalized consumption patterns – should continue to open up new avenues for profitable investment (see "Sectors Ripe for Investment").

However, accessing outperformance is increasingly dependent on finding pockets of growth, identifying niches benefiting from innovation, as well as pinpointing ways to exploit demographic changes and consumption pattern shifts. Furthermore, competition for prime assets is rising on the back of growing interest from global investors and cash-rich local market-leading companies, as well as a resurgence in commitments to renminbi-denominated private equity funds.

SECTORS RIPE FOR INVESTMENT

Healthcare: Products and services are undersupplied, especially at the higher end of the market – a legacy of the state-owned healthcare system. This supply-demand imbalance is exacerbated by a population that is rapidly aging and increasingly attuned to the importance of health.

Financial Services/Fintech: The ubiquity of mobile payment, rising income levels, and an increasingly sophisticated consumer base create a significant unmet need for services such as wealth management, private insurance, and online security.

Education: Chinese parents are willing to spend heavily on education, from kindergarten right through college, including on tuition and preparation for studying abroad.

GREATER ACCESS, FALLING RESISTANCE TO BUYOUTS

For buyout funds, the moderation in economic growth may actually prove a blessing.

First, it is helping improve access. China's huge state-owned enterprises (SOEs) have dominated most strategic sectors for several decades. Investing in these behemoths beyond a minority stake position, either via public or private markets, is almost impossible. Yet many of these companies, which often have interests across multiple – frequently unrelated – industries, are now being forced to restructure as part of an efficiency drive, creating opportunities as they divest of non-core assets.

Chinese private business owners are also becoming more receptive to the private equity value proposition. In a high-growth environment, there has been little incentive for entrepreneurs to cede control of their hard-built businesses in exchange for additional cash. However, as growth slows, this mindset is softening, supported by a number of local trends, including:

- Succession issues, with many founders approaching retirement minus a willing heir to the business, often due to the recently abandoned one-child policy
- Increasing competition and market saturation, prompting the recognition that private equity capital and expertise can help smaller enterprises scale up and market leaders expand internationally
- Founders' increasing exposure to private equity – via the media, word of mouth, or frequently from a child that studied abroad and returned home with a greater understanding of the asset class.

Second, the fundamentals for implementing buyout and control strategies appear to be improving. Finding skilled and experienced local management to support execution is becoming less challenging. Chinese business and management standards are improving rapidly via better education – either locally or overseas – and greater exposure to international business practices.

Furthermore, in terms of exits, the mergers and acquisitions market continues to mature, and has become the main exit channel for private equity and venture capital in China in recent years. While IPOs are still complicated by an approval-based system – reform of which has been rolled back several times – a permanent move towards a more registration-based system is probable. This would provide a clearer exit path for fund managers, though the timing remains unclear.

LONG–TERM OPPORTUNITY, SHORT–TERM CAUTION

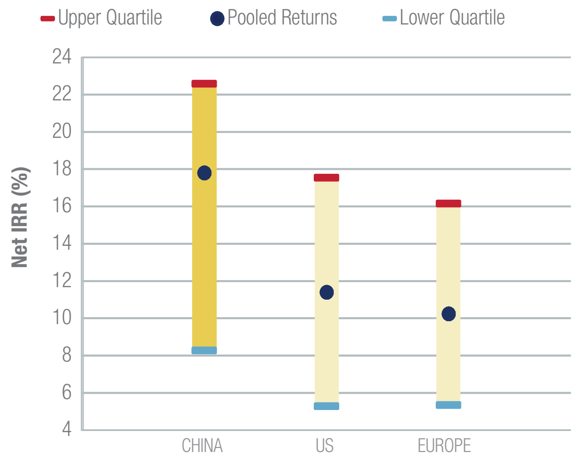
The opportunity set for buyout approaches does, however, remain constrained. Many of the sources of risk that have limited buyout volume over the last two decades remain and intensifying competition for assets is impacting deal access and inflating valuations. While many SOEs are being exposed to market forces and forced to slim down, they remain heavily protected. Even in the private sector, it is still necessary to conduct deeper due diligence than in developed markets and navigate complex webs of regulation.

This does not argue against any investment in buyout strategies, in fact some exposure provides diversification benefits and could offer significant potential upside. But it does suggest that investors perhaps limit that exposure, in the short term at least.

China is a complicated, nuanced market, with more risk than developed markets. The greater inefficiencies in China offer the potential for higher returns, but also widen the dispersion of those returns (see Chart 2). This amplifies the value of diversification, as well as selecting managers with established relationships and a local track record.

> CHART 2: Dispersion of returns from private equity funds wider in China

IRR dispersion by region, 2005-2013 vintages



Source: Cambridge Associates. Data as of 9/30/2017

In short, buyout and consolidation strategies seem to have great long-term potential, but are not as yet mainstream and come with additional risk. Early-stage venture and growth equity strategies, leveraging rising consumption and innovation, remain the most likely source of outperformance in the near term.

To find out more about HarbourVest's expertise in China and the wider Asia Pacific region, and how we can help you meet your investment goals, please get in touch with your HarbourVest contact or email **clientrelations@harbourvest.com**.