Fresh Ideas to Make Money in China PE

By Peter Fuhrman
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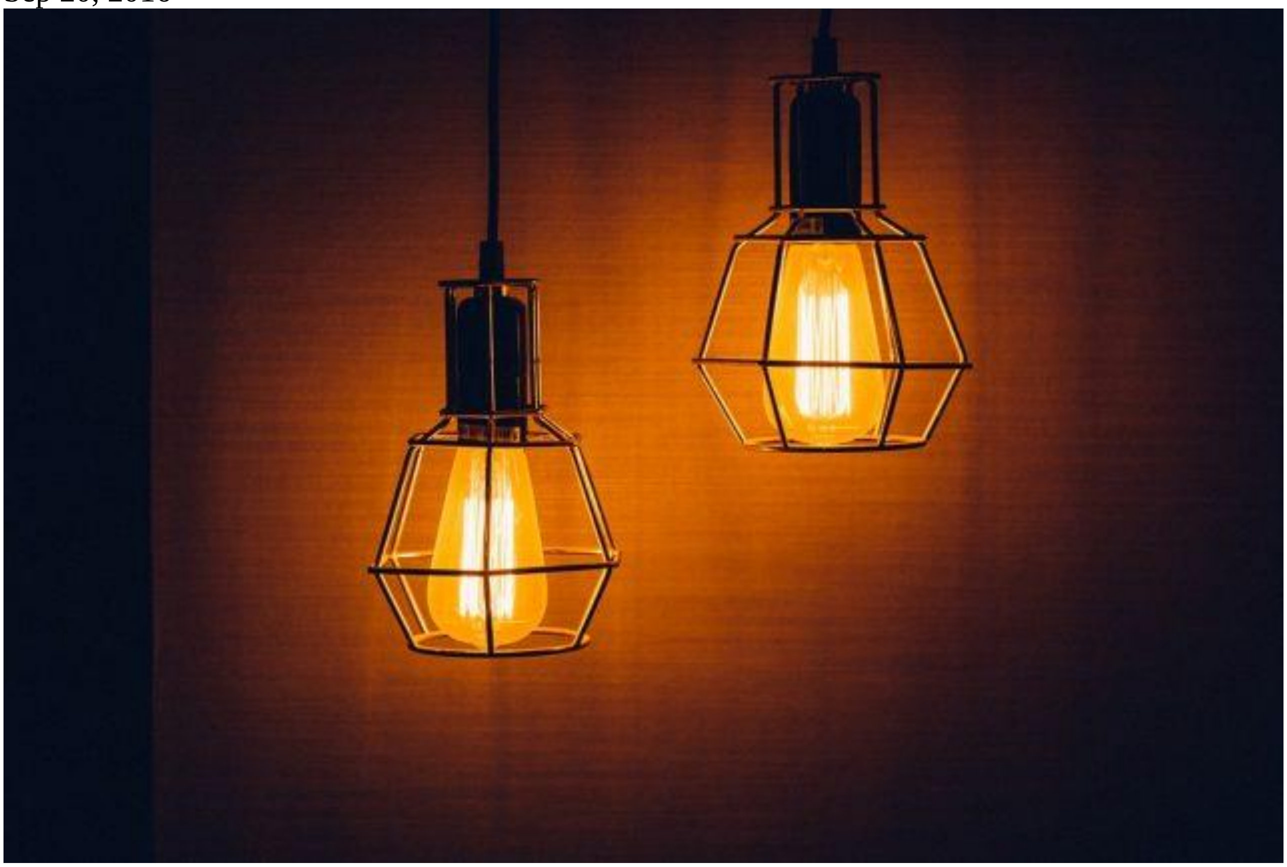

2016 is shaping up like another less-than-banner year for PE and VC in China. The problem, as always, is with exits. For years, IPOs in China for PE-backed deals have been too few and far between. There was initially a lot of hope for improvement this year. But, prospects unexpectedly turned bleak when the Chinese securities regulator, the CSRC, suddenly reversed course. Not only did they put on hold previously-announced plans to liberalize IPOs by opening a new “strategic board” in Shanghai and to shift to a registration-based IPO system, they also began clamping down hard on the two main exit alternatives, backdoor shell listings and trade sales to Chinese listed companies.

IPO multiples remain sky-high in China. The IPO queue sits at 830 companies, with at least another 700 now lined up to get provincial approval to join the main waiting list. The CSRC did finally announce one liberalization of the IPO regime in China, but it will likely be of little help to the hundreds of PE and VC firms with thousands of unexited deals. Companies based in China's poorest, most backward areas, the CSRC announced earlier this month, will now get to jump to the head of the queue.

Not for the first time, it looks like PE and VC portfolios may be mismatched with IPO regulatory policy in China. PE and VC firms have of late invested overwhelmingly in two areas. First is healthcare. The industry in China is growing and reforming. But, entry valuations have been bid up to astronomical levels.

In terms of number of deals closed, Chinese tech startups are getting the lion's share of the attention. China's online and smartphone population as well as e-commerce industry, after all, are the world's largest. What's missing at most of the funded startups are profits or a high-probability path to making money one day soon. Most are using PE money as part of a "last man standing" strategy to win customers by subsidizing purchases. Loss-making companies are still barred from having an IPO in China.

The main building blocks of China's corporate sector, manufacturing companies and bricks-and-mortar businesses, are both highly out of favor with PE firms.

Amid so much misfortune, where should the PE and VC industry look next to invest profitably in China? What seems most clear is that any strategy linked to short-term IPO exit-chasing, or seeking to intuit the next flux in CSRC policy, has proved fundamentally risky. Some fresh approaches may be in order.

One priority should be on backing companies that can deliver sustainably high margins and positive cash flow over time to support regular dividend payments. Invest more for yield and less for capital gains.

There are such investment opportunities in China. I want to share six here. There are certainly many others. Looking outside the current China PE investment mainstream has other plusses. A troubling term has entered the Chinese financial vocabulary in the last two years, called "2VC". It means a Chinese company started and run primarily for the purpose of attracting PE and VC money and less about making money from customers. 2VC deserves a detailed analysis of its own, how much it may be warping the investment landscape in China.

GPs looking for durable margins, scaleability, and a dearth of competition in China could start their search here:

1. **Robotics gearbox**. China's robot industry is hot. By now, about everyone has read the stories suggesting China's robotics market, already the largest in the world, will boom for decades to come. For now, the investment money in China has gone overwhelmingly into companies that are making simple robots, rather than the robot industry supply chain. This overlooks perhaps the best opportunity of all. Robots rely on sophisticated

gearboxes to make parts move. Making and selling gearboxes, rather than the final robot, is where the big margins and demand are. The technology has been around for a while, but the industry is dominated by two big foreign manufacturers, ABB of Switzerland and Rexnord of the US. They make a ton doing it. A Chinese robotics gearbox maker, assuming they get the product right, could immediately roll up sales in the hundreds of millions of dollars, both to Chinese robot makers as well as US, European and Japanese ones. From conversations I've had with C Level execs at both ABB and Rexnord, this is the Chinese competition they fear most, but which to their surprise has yet to materialize.

2. **Hospice and specialized late stage care**. Healthcare investment, especially into biosimilar drug companies, hospitals and clinics for plastic surgery and dental care, has been abundant, averaging well over a billion dollars a year in China. Competition is rampant in all these areas. Late stage critical care, however, has largely gone unfunded. The unmet need in China is almost unfathomably large. There are basically no hospices in China, though some 10 million Chinese die every year, including a surging number from cancers and long-term chronic diseases. There are also 30 million Chinese with Alzheimers and virtually no places offering specialized care.

   Make no mistake, it's harder to provide this kind of medical care than to do Botox injections. But, anywhere money is easily made in China, it's getting harder to make any money at all. The biggest provider of specialized high-end late stage care in China is the French company, Orpea. They are doing a great job. I've had a close look at their business in China. They too are awed by the scale of the untapped market in China. A big plus: pricing freedom. The business doesn't rely, as most conventional hospitals and drug companies in China do, on state reimbursement.

3. **Dog food and other pet items**. When I first came to China in 1981, it was basically illegal to keep a dog or cat as a pet. There was barely enough food to feed the human population and food was rationed. To say the growth in pet ownership since then has been explosive would risk understating things. China is now the third largest dog-owning market globally, with 27.4 million dogs (behind the US with 55.3 million dogs and Brazil with 35.7 million), and the second largest cat-owning country with 58.1 million cats, behind only the US with 80.6 million. China's pet market will soon blow past that of the US. Everywhere this is presenting great opportunities in pet care, pet food, pet hotels. The US pet food giant Mars has a large chunk of the dog food market here. But, there are still many opportunities to carve out a niche in pet food, both via sales at veterinary clinics and online. The other vast uncharted market: pet insurance.

4. **Server storage**. Chinese law mandates that the country now has and will continue to have the largest ongoing demand for high-end servers, as well as the software that powers them. The reason: all the major sources of online traffic — Alibaba, Tencent, JD.com, Baidu — must permanently store virtually everything that runs across their network. In the case of Tencent's Wechat business, that means keeping billions of text, audio, video and photo messages generated every day by its 600 million users. Tencent's ongoing investment in servers is almost certainly larger than any other company in the world, with

the other big Chinese internet companies following closely behind. The growth rate is dizzying.

This has created a wonderful profit-center for otherwise troubled chip giant Intel. Its Xeon chips power virtually all high-end servers. No single domestic company has yet emerged to build a sizeable business in storage software, maintenance and integration tailored to the regulatory needs in China. In parallel, there's also a large market for similar made-at-home software solutions to sell to the Chinese government. They are the reason all this server storage demand exists.

5.**<u>Mall-based attractions.</u>** Shopping malls in China are in a fight for survival. Clothing retailers, which just two to three years ago took at least half the floor space in Chinese malls, are disappearing. They can't compete with online merchants offering the same products for one-third to one-half less. The going has proved especially hard for Chinese domestic retail brands, quite a few got PE money back when this sector was hot.

Chinese malls need to change, and fast. Their main strategy so far is increasing the floor space allocated to restaurants and movie theaters. Another area with huge potential, but so far little on the ground, is "*edu-tainment*" attractions. A prime example is a mall-based aquarium. I was recently shown around one of the few such mall aquariums by its owners, a large Chinese real estate developer. They initially knew nothing about aquariums. Their design, operational ability and selection of fish are hardly stellar. The owner, though, is coining money, with over 45% pre-tax margins. Tickets sold days in advance, not just on weekends, for average of $15 for adults and about half that for kids. It's been open and thriving for three years. Every mall they are building now will have a similar attraction. They expect it will be the most profitable square footage they own. Based on calculations I've seen from a US company in this industry, a capable operator in China should be able to push pre-tax margins to +65%, roll out quickly nationwide, while enjoying concessional rents from hard-up mall owners desperate to increase foot traffic. On average, 55 million Chinese go to the mall each week.

6. **<u>Indoor LED vegetable growing</u>**. China has a big appetite for vegetables, about 100 kilos per person per year, or seventy billion tons. Many Chinese, especially the 55% living in cities, have concerns about where and how the vegetables are grown, what's sprayed on them and how they get to market. The worry rises in lock step with per capita income. One suitable idea that's not yet taken root in China: growing vegetables indoors, using LED lights.

   The cost of LED lighting has fallen by over 90% since 2010 and will continue to decline, thanks in large part to over-investment in this sector in China. LED efficiency has also nearly doubled over that time. It now costs about the same to grow vegetables indoors with LEDs as it does in well-irrigated farmland. Growing in locations close to the final market will lower shipping costs and improve freshness and flavor. Supplying vegetables to urban China this way has another crucial advantage, a secure chain of custody from the place where the food is picked all the way to the customer's hands. This will go a long way towards addressing consumers' food safety fears.

The LED-farm business is already doing well in the US, though conditions are less optimal than in China. Different business models should all do well, including large growing areas inside abandoned urban factories to supply better supermarket chains in China like Walmart, Carrefour and China Resources, or smaller-scale packages home-delivered or sold through vending machines placed inside high-end residential complexes in China. Organic or non-organic, catering to Chinese picky consumers could keep a company in profit for decades.

Since PE first took off in China in 2005, China's economy has grown by almost four-fold. Few GPs in China have done as well in DPI terms. It's likely not going to get any easier to make or raise money, nor to rack up IPO exits. More than ever, PE firms need to back or incubate ideas to grab and hold onto a piece of the new wealth that's getting created every day in China.

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