CHINA: THE NEW OPPORTUNITY

AS THE CHINESE ECONOMY PIVOTS FROM A MANUFACTURING POWERHOUSE TO A CONSUMER-DRIVEN INNOVATOR, INTERNATIONAL INVESTORS ARE RAMPING UP THEIR EXPOSURE TO THE WORLD'S BIGGEST MARKET

Words:
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THE CHINESE ECONOMY is at a turning point. As an engine room for global manufacturing, China's meteoric growth over the past four decades has been driven by cheap labour costs and an explosive export market. More recently, a rising cost base and rapidly expanding middle class has driven some of that manufacturing activity overseas. And that's created huge opportunities for businesses targeting the vast, and increasingly affluent, domestic population.

Indeed, China is transitioning from high-speed to high-quality growth and the world's private equity and venture capital firms are keen to get in on the act. Despite deepening trade tensions with the US and a slowdown in GDP expansion, foreign investment has continued to climb steadily, reaching $70.74bn in the first half of 2019, up 3% year on year.

"There are these two ships moving past each other in opposite directions," explains Paul Wilkes, Group Partner at Collas Crill. "China's position as an engine room for global manufacturing is slowly declining as a rising cost base pushes some of that economic activity to places like Vietnam and Cambodia. At the same time, private equity has always done well focusing on companies looking to serve the middle-income market. I think that the domestic Chinese market will be the interesting opportunity for international investors over the next 15 to 20 years."

Indeed, China's middle class is expected to represent more than two-thirds of its 1.44 billion citizens within the next decade. This makes it the largest internal market in the world. It is also the number one economy in terms of purchasing power parity. These profound demographic shifts are creating myriad opportunities across consumer sectors, from retail to real estate and from education to healthcare.

"The Chinese middle class has all the aspirations and desires of middle classes everywhere," says Mourant Hong Kong Managing Partner Paul Christopher. "Given the scale of the market, that's creating a lot of exciting investment opportunities."

"All Chinese businesses – start-ups, mid-market operators or state-owned enterprises – have large domestic audiences in an increasingly digitised economy," adds Singapore-based Carey Olsen Counsel Andrew Tually. "There are more than 800 million internet users – more than the US and Europe combined. Accordingly, a lot of new venture capital and private equity activity is focused on early and growth-state investments in technology, financial services, education and healthcare."

INTERNET BUBBLE?

Investment from international VCs in China's booming internet and tech markets has grown phenomenally, supported by the country's Greater Bay Area initiative, which sees the government positioning the Guangzhou, Shenzhen, Hong Kong region as a centre for innovation akin to what Wilkes calls "Silicon Valley Plus".

Therefore, despite declining GDP growth, global investment in the Chinese new economy reached $81bn in 2018, with its global share rising to 32% from just 4% five years ago, according to Bain, and rapidly closing in on the US at 47%.

Chinese consumers have an enduring love affair with tech for convenience, happily snapping up new products and services as soon as they come to market. Mobile payments in China reached $9trn in 2016, compared with $112bn in the US. Meanwhile, China is churning out six times more computer science graduates than the US, with workers in the industry habitually putting in 72-hour weeks, claims Bain.

However, valuations in the Chinese tech sector have reached stratospheric levels in recent months, with median M&A multiples of 31 times Ebitda.

International venture and private equity investment have fallen sharply as a result, while managers wait on the sidelines until the market has cooled.

TRADE TENSIONS

A potential internet bubble is not the only challenge that international investors face when navigating the Chinese market. There are significant geopolitical headwinds, says Ben Honeywood, Director in the private


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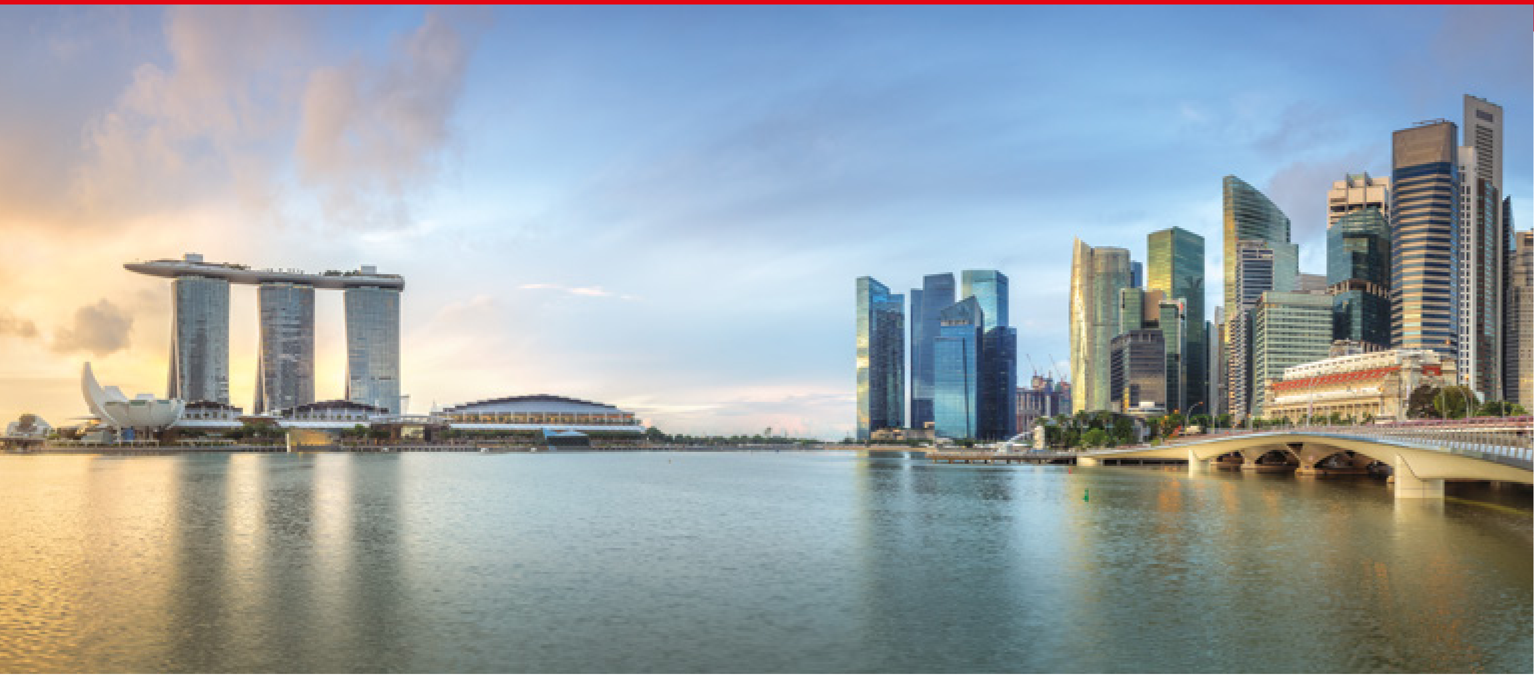

THE CHANNEL ISLANDS AND CHINA

While Chinese investors looking to target European opportunities have long turned to the Channel Islands, international money targeting Chinese opportunities has historically favoured Caribbean structures, and in particular the Cayman Islands, according to Collas Crill's Paul Wilkes. However, the global introduction of substance requirements has brought costs in those jurisdictions more closely in line with the Channel Islands and this has created a real opportunity for both Jersey and Guernsey.

Danielle McIver, Vice Chairman of the Guernsey branch of ICSA: The Governance Institute, adds that not only do the Channel Islands have a greater depth of governance expertise than some other jurisdictions, but the time zone is also more convenient than that of Caribbean jurisdictions.

"And when you compare Jersey and Guernsey to jurisdictions such as Singapore and Hong Kong, distance can be an advantage," she says. "A lot of investors don't want to use a local structure. They prefer to be further afield. The Channel Islands also have a good reputation and a mature legal framework, which gives investors more comfort."

In particular, McIver believes that Guernsey's protected cell company (PCC) structures have been an attractive and cost-effective option for managers and investors deploying capital into China. "While there are other jurisdictions that offer PCCs, including some in Asia itself, the legislation is not as well developed. We believe Guernsey and Jersey are ideally placed to work with international investors looking to China."

equity group at KPMG in the Channel Islands. "Not only do you have the trade war with the US, which I suspect will get frostier before it thaws, but you also have China's position on Hong Kong, which is not particularly internationally friendly. These practical blockers are likely to remain for some time."

An ever-changing legal environment; bureaucratic and administrative complexities; and lack of transparency, coupled with corruption and weak intellectual property rights protection also present big hurdles for private equity and venture capital firms operating in the region. "There are certainly challenges around the ability to enforce legal rights," says Wilkes. International players are taking a transactional rather than legal approach, he adds, structuring agreements so that there is interdependence between all parties in order to mitigate any mistrust.

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Furthermore, while the country's skill base has expanded significantly, middle management remains under-developed. The Chinese State demands forced technology transfer and the environmental degradation in some areas is profound.

GREATER COMPETITION

An abundance of cheap debt is also making private equity a less attractive – or necessary – option for some investors and investee companies, according to Tually. "Another negative is that private equity targets are becoming more expensive as entire sectors are becoming more leveraged," Tually adds. "Similarly, an abundance of foreign and local managers and domestic conglomerates with active M&A appetites means greater competition for assets."

Finally, China remains more restrictive than other major economies around protection of 'strategic' assets, as well as sectors that have historically benefited from state monopolies and investments intended to profit from speculation.

However, China has been committed to a programme of liberalisation since 2013 and, despite its tussles with the US, the government's apparent willingness to embrace international investment has only accelerated over the past 12 months.

FOREIGN INVESTMENT LAW

A new Foreign Investment Law came into force at the start of 2020, with the aim of putting foreign investors on an equal footing with domestic investors. In addition, the country's Negative List – which outlines sectors of strategic interest where foreign investment is limited – was slimmed down last year.

"Areas that were once restricted or prohibited have been relaxed," explains Carey Olsen Senior Associate Susan McKinstray. "China particularly encourages foreign investment in modern agriculture, advanced manufacturing, high technology, energy conservation and environmental protection, as well as modern services.

"I think we can anticipate further developments and regulatory reforms in this area. I expect the impact will be an increased competitive environment, further private equity investment, both into and out of China, and a structural update of China's industries."

Indeed, Linklaters predicts that the Foreign Investment Law, coupled with the more limited Negative List, will herald a new era for international investment in China, potentially reaching $1.5trn in the next 10 years – triple the level seen in the past decade.

"China continues to be a relatively untapped market," says Honeywood. "That means there is a huge number of assets ripe for private equity investment at every stage of growth, every size and in almost every sector." ■