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In focus

Miss it, miss out
The opportunity in Asian Private Equity

May 2019

The 21st century belongs to Asia, and China and India in particular. The region's economies are undergoing a dramatic transformation, powered by technological prowess and the 4-Ms which characterise Asian consumers: millennial, middle-class, metropolitan and mobile-enabled. Nowhere else can match the region's combination of scale and growth. Private equity has the keys to unlock this opportunity.

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Private equity in Asia, driven by China and India, presents investors with an unparalleled investment opportunity. This is hinged on three tenets:

1. 21st century Asian domination
2. The 4-Ms of Asian consumers: millennial, middle-class, metropolitan, and mobile-enabled
3. The advantage of tech-enabled disruption

In an environment of subdued global growth and lacklustre return expectations across most asset classes, private equity in Asia offers a rare glimmer of opportunity. The phrase "miss it, miss out" has never been more apt.

1. 21st century Asian domination

Statistics on the size and growth rates of emerging Asia, and China and India in particular, can be unfathomable compared with elsewhere.

With populations of around 1.4 billion each, China and India are both over four times more populous than the US. Their combination represents 36% of all the people on earth.

They are also economic heavyweights. Both are forecast to be among the top five economies by nominal GDP in 2019, and in the top three by GDP in purchasing power parity terms (Figure 1).

Not only is Asia large, it is also a significant engine of global growth. In 2018, the region was responsible for 41% of global growth, and it is forecast to contribute 44% of growth in 2019. China and India alone are expected to drive more than 30%.

It is also worth noting that, contrary to public perception, China's economy has a much lower level of dependency on exports. As a percentage of GDP, this dependency has decreased from 36% in 2006 to about 20% of GDP currently. In addition, although the IMF has recently lowered China's forecast growth rate for 2019 from 6.4% to 6.2%, in part due to recent trade war disputes, its economy is forecast to grow by as much in dollar terms this year as it did back in 2007, when GDP growth was 14% a year.

So despite trade war concerns, this combination of size and expected economic growth is unrivalled and stands in stark contrast to the sluggish growth expected in most of the developed markets.

Figure 1: China and India are now at the economic top table

	Nominal GDP in USD		GDP in purchasing power parity terms	
Rank	**1980**	**2019**	**1980**	**2019**
1	US	US	US	**China**
2	Japan	**China**	Japan	US
3	Germany	Japan	Germany	**India**
4	France	Germany	Italy	Japan
5	UK	**India**	Brazil	Germany

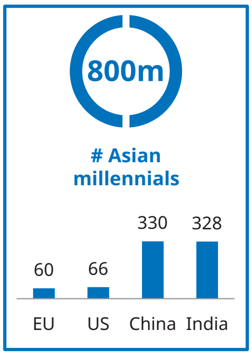
Source: IMF World Economic Outlook, October 2018

Schroders

2. The 4-Ms of Asian consumers: millennial, middle-class, metropolitan, and mobile-enabled

For investors, it is not just about the growth rate of the economy, but the composition of that growth that matters. Asia is set to be powered by the 4-Ms, being home to a large, millennial, increasingly middle-class, increasingly metropolitan, mobile-enabled population. They are set to transform their economies. Whereas Asia was once the manufacturing workshop of the west, 21st century Asia is set to be powered by domestic consumption.

Millennial



Source: IMF, WEO, Schroder Adveq

There are more than 800 million millennials in Asia, with around 330 million in each of China and India. In contrast, there are only 66 million in the US and 60 million in the EU. Although China's demographics are deteriorating, the size of its young population is enormous. India's demographics are even more favourable. Almost half of its population is less than 25 years old.

These millennials are also a very different cohort to their western counterparts. Young people are widely considered to have been the losers of the past decade in the developed world. A post-financial crisis jobs market that was difficult to get a foothold in, stagnating wages, rising living costs and the burden of student debts have all contributed to a feeling that older generations have profited at their expense. In contrast, the young is where real economic power resides in Asia[1] and emerging markets more generally. 65% of millennials in emerging markets expect to be better off than their parents whereas an almost identical percentage in developed markets expect to be worse off.[2] Millennials across Asia already earn higher incomes than their parents, whereas those in the west trail behind. Emerging millennials are also overwhelmingly more positive about the economic outlook.

Middle-class

Taking an even broader look, expansion of the middle-class in Asia is powering rapid growth in consumption. Hundreds of millions of people across Asia have been lifted out of poverty into the realms of the middle-classes. There is also a trend towards upward mobility within the middle-classes as Indian and Chinese individuals move towards upper-middle income and affluent classes.[3] The external perception that the Indian caste system stands in the way of such progress is outdated and false. These trends are the bedrock of the rapid acceleration in consumer spending that is occurring in Asia (Figure 2).

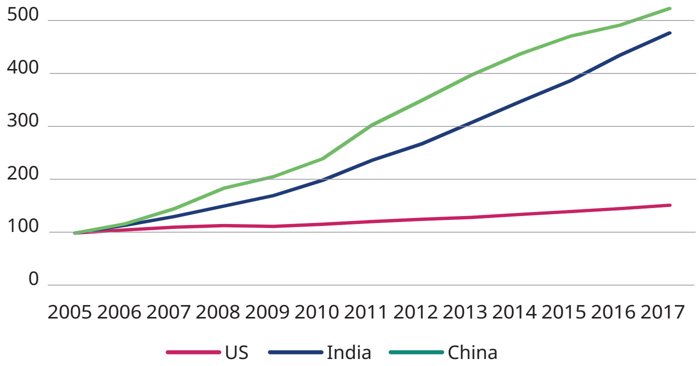
1 https://www.schroders.com/en/insights/economics/the-rise-of-young-asia-how-millennials-are-transforming-a-region/

2 2018 Deloitte Millennial Survey

3 Krishman and Hatekar, 2017, and McKinsey, 2013

Figure 2: Accelerating private consumption growth in China and India

Private consumption expenditure, rebased to 100

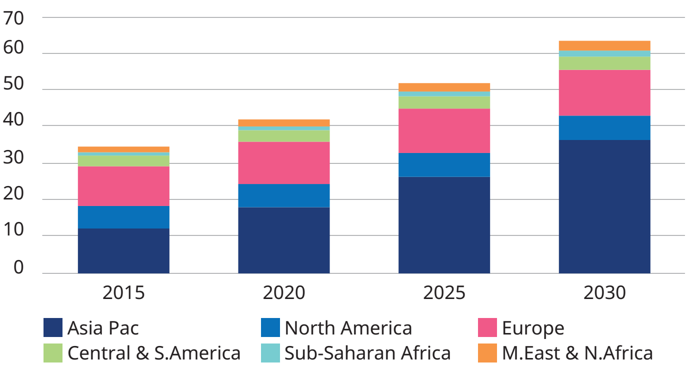


Source: Fred Economic Data, CEIC, Schroder Adveq, 2018

These trends are showing no signs of letting up. Almost nine in 10 of the next billion middle-class consumers will be Asian, according to the Brookings Institute.[4] These will be spread between China, India and South and East Asia. Their analysis also forecasts that, by 2025, consumer spending by the middle-class in the Asia-Pacific region will overtake the rest of the world combined (Figure 3). It is forecast to continue growing thereafter.

Figure 3: The dominance of the Asian middle-class

Spending, $trillion



Source: Brookings Institute, 2018

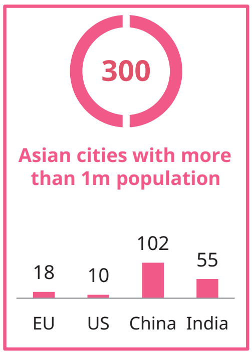
The rise of the Asian consumer has been ongoing for years, but its dominance is growing and its effects will be long lasting. For example, while China has been and still is the world's manufacturing capital, it is also now the world's largest market for passenger cars and for consumer retail. Asia's growth prospects are already impressive but industries and sectors which are geared to consumption have even more room to grow.

Many western companies have already capitalised on this shift. Asia represents a significant proportion of sales for many established names. For example, around 40% of revenues from both BMW and Daimler come from Asia and, outside of Europe, Asia is Volkswagen's largest market. Increased demand for luxury goods is a well-established path, with companies such as Hermes (48%), Burberry (40%) and LMVH (31%) generating significant proportions of their revenues from Asia. However, more sustainably, the Chinese are trading up in areas such as home appliances, fitted furniture, kitchen equipment and tourism. The growing middle-class is also increasingly health conscious.

4 A global tipping point: Half the world is now middle class or wealthier; Brookings Institute September 2018

In an important shift from an investment perspective, Chinese consumers are showing a growing preference for local brands, as opposed to those from overseas. A survey from McKinsey found that local brands were preferred for 15 of the 17 categories they asked about.[5] This covered a range of products including fresh food, beer, personal care products, small and large electric appliances, clothing and cosmetics (only for wine and infant milk powder were overseas brands preferred). In many cases, local brands were a stand-out preference. The problem of hoping to gain exposure to Asian consumers through international companies, when those consumers are exerting a preference for domestic brands, operated by mainly domestic companies, many of which are in private hands, could not be more obvious.

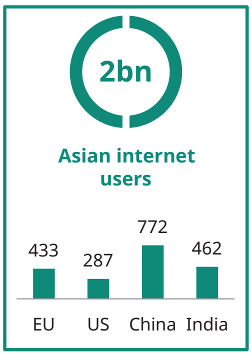
Metropolitan

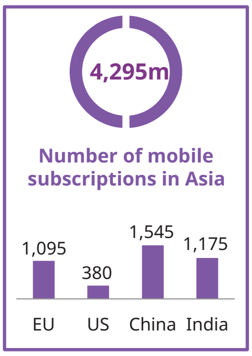


Source: IMF, WEO, Schroder Adveq, 2018

Consumption growth is further facilitated by the growing urbanisation of Asia, as workers flock to the cities in search of jobs and money. There are now 300 cities in Asia with a population of more than one million people, with more than 100 in China alone. In contrast there are only 10 in the US and 18 in the EU. For a consumer-focused company seeking to expand, it is much easier to do so when you have access to such large numbers of consumers within a relatively concentrated area. These high density populations therefore provide the perfect backdrop for companies to grow in scale. These scale effects lead to faster, newer, cheaper, and better products and services. There is then a multiplier effect of population, economic growth and purchasing power which can drive value creation. The rapid growth of the taxi company, Didi Chuxing, highlights how this advantage can play out in practice (see case studies on page 5 for more details).

Mobile-enabled





Source: IMF, WEO, Schroder Adveq, 2018

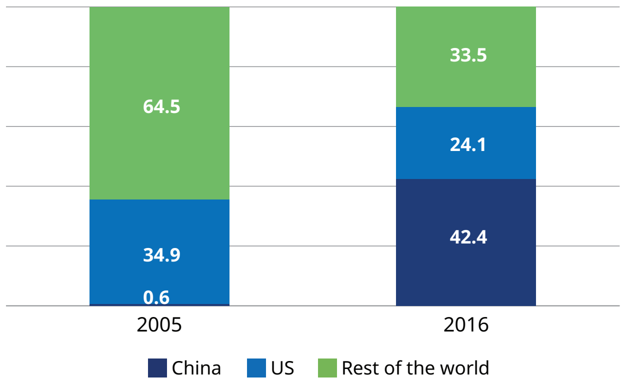
Asia is home to more internet and mobile users than anywhere else on earth. It has over 2 billion internet users and more than 4 billion mobile phone subscriptions. This enables consumer technology businesses to grow in scale rapidly.

5 Double-clicking on the Chinese consumer, McKinsey Global Institute, November 2017

One example is the growth of the eCommerce market in China. As recently as 2005, China represented less than 1% of global eCommerce sales. However, by 2016 it had become the largest market in the world, representing over 40% of transactions by value (Figure 4). Chinese consumers are also avid users of mobile payment technology, with applications such as Alipay and We-Chat dominating.

Figure 4: China has grown from nothing to be the biggest retail eCommerce market

Share of retail eCommerce transactions by value, %

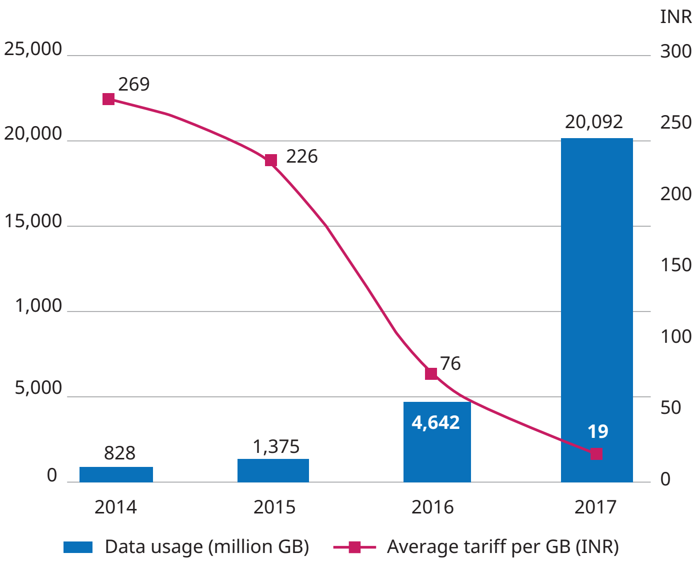


Source: McKinsey, 2017

India's adoption of mobile technologies is also expanding at a rapid pace. Mobile data usage was 20 times higher in 2017 than in 2014, while data tariffs came down by more than 80% over the same period (Figure 5). The democratising of access to mobile data is transforming the way society interacts, in both personal and business settings. For example, farmers can now access information via mobile apps on weather, market prices of commodities/crops in the nearest towns, fertilisers, crop development, insurance premiums, and more. Local "mom and pop" retail stores are also taking advantage of mobile technologies to sell their goods online. This infrastructure will underpin the potential for companies to scale up rapidly, as has happened in China.

Figure 5: Soaring mobile usage and plunging costs

India - wireless data usage & tariff (million GB)



Note: includes GSM + CDMA

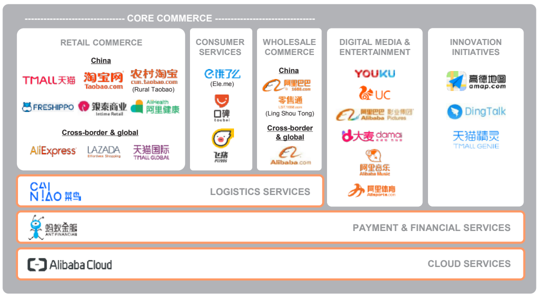
Source: TRAI, May 2018-Yearly performance indicators of the Indian telecom sector 2017

3. The advantage of tech enabled disruption

Asia has been able to leapfrog stages of development with the help of technology enabled business models that span multiple sectors.

The rise of the platform enterprise in Asia has been a game changer. This can be best exemplified through the Alibaba ecosystem, comprised of multiple interconnected businesses from logistics, to financial services, to cloud computing, to retail (Figure 6). Serving as the core of this ecosystem is the technology platform that connects consumers, merchants, brands, other enterprises, third-party service providers and strategic alliance partners.

Figure 6: The Alibaba ecosystem



Source: Alibaba, February 2019. For illustration only. Logos are the property of their respective entities and do not reflect any endorsement, affiliation, or recommendation to buy/sell on behalf of Schroders or Schroder Adveq.

Home-grown companies across sectors have been able to maintain their market leadership by mastering local contexts. Flipkart in India was able to address needs around convenient payment, product choice and fast delivery. For example, in a cash transaction oriented market, cash-on-delivery required the need to build out a separate cash handling logistics division. Data/mobile driven platforms have allowed India to speed up financial inclusion that included the opening up of 330 million new bank accounts in the last four years and achieving a pan-Indian unique identification (analogous to a SSN in the US) for more than 1 billion people.

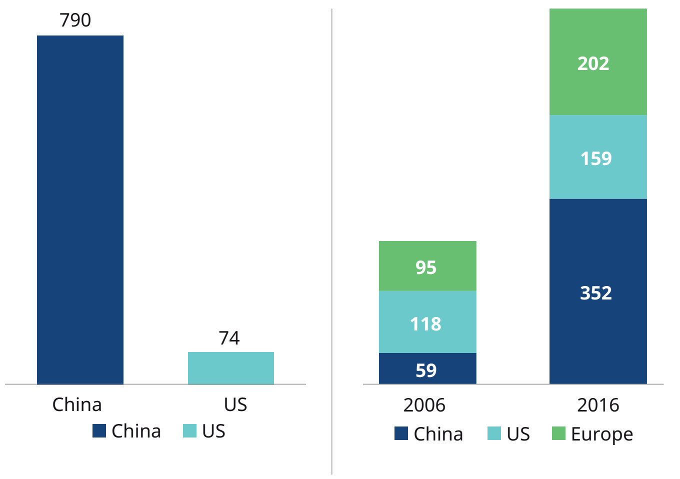
The perception of 'Copy-to-China' is also transforming. China is more and more becoming the innovator across a number of technology areas. Patent applications provide an indication as to the scale of Asia's ambitions, when it comes to developing new technologies and products. According to the World Intellectual Property Organisation (WIPO), more patents are filed in China than anywhere else, ahead of the US, Japan, Korea and Germany, in aggregate. Part of this is due to China's high domestic patent filing activity, which can be prone to distortions due to the effects of government subsidies for filings. Another way to compare China's patent activity is by looking at WIPO's Patent Cooperation Treaty (PCT) global data. This covers patents that have been registered for international protection, which can be a more reliable guide. Here, we see that while China is 5th on the list, the year on year pace at which their filings have been processed has far outpaced the largest developed economies. (Figure 7).

The financial ecosystem is in place in Asia to harness those early ideas and build world leaders in their fields. Two of the three largest unicorn private companies (worth more than $1 billion) in the world are Asian (Bytedance, also known as Toutiao, and Didi Chuxing). In total, 94 unicorns have been created in Asia, second only to the US (which has 121)[6].

The ideas and the financing have enabled China to disrupt traditional industries like the solar sector. It was initially dominated by the west but then witnessed a trend of China moving up the value chain, a phenomena which has occurred across many other sectors too. Biotechnology has been a core area of focus, with an increasing level of joint collaboration with the west.

However, the 4-Ms have driven the pace of disruption in newer, consumer-focused, sectors to even higher levels. China's eCommerce market has grown from nothing to be the world's largest within a decade, the value of mobile payments in China is 11-times higher than in the US, and China buys more electric cars every year than Europe and US combined (Figure 8). The 20-times increase in Indian mobile data usage within only three years shows how fast things are changing there too.

Figure 8: China leads disruption in newer sectors



Source: McKinsey, IEA, Schroder Aveq, 2018. Based on most currently available data.

6 Source: Research form CB Insights, Schroder Adveq, September 2018

Figure 7: China's international patent filings have grown nearly eight-fold since 2008, a far faster rate than developed economies

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
USA	150,995	135,891	148,440	149,814	152,175	164,767	176,262	200,873	180,336	191,111
Japan	76,015	79,782	92,360	97,373	113,933	121,822	124,555	121,928	121,960	130,017
Germany	67,535	63,780	70,570	72,459	75,134	78,568	74,428	72,056	71,503	70,520
France	27,698	27,952	33,212	34,868	35,870	36,534	37,012	37,787	37,944	37,246
China	**4,617**	**5,273**	**7,996**	**13,241**	**17,272**	**18,814**	**22,893**	**28,387**	**35,001**	**36,307**

Source: WIPO, 2018. Based on most currently available data.

Case studies

The latest in consumer trends: Kans

Kans is a leading domestic cosmetic brand established in 2002. It is positioned as a truly home grown brand offering Chinese consumers a valuable alternative to highly priced international brands. This has allowed it to capitalise on the rising trend of local brands gaining market share over foreign competitors. Today, Kans has a strong network of distribution channels with more than 70,000 retailing terminals in over 30 provinces and 300+ cities in China. Revenues have been growing at a rate of over 50% a year since inception.

Disruption effects through scale: Didi

Despite launching three years later than Uber and focusing mainly on the Chinese market, the scale achieved by Didi Chuxing (Didi), the Chinese taxi company, far outnumbers what Uber has been able to achieve globally.

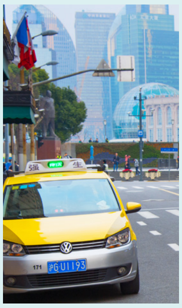


Figure 9: Rapid scaling in practice

	Uber	Didi
Launch date	2009	2012
Active drivers	3 million	30 million
Daily rides (2017)	11 million	20 million
Annual rides (2017)	4 billion	7 billion
Cities present	600 globally	400 within China

Source: Didi, Bloomberg News, Schroder Adveq, 2018

Capturing discretionary spending shifts: Lenskart

Lenskart is India's leading eyewear company and the world's fastest growing such company. Its potential customers are the 532 million Indians, representing 40% of the population, who need their vision corrected. Capitalising on increasing wealth and consumption growth, it has managed to grow its sales by a factor of 10 times in the past five years.

Asia going global: Xiaomi

Having only been formed in 2010, Xiaomi has rapidly grown to be the world's largest consumer "Internet of Things" platform (as measured by number of connected devices). It achieved a valuation of $54 billion in its initial public offering in Hong Kong in 2018. In Q3 2018, revenue from international markets accounted for 43% of total revenues, growing at 113% year on year.[7] According to Canalys, a leading global technology market analyst firm, Xiaomi was ranked top five in the smart phone markets of 30 countries and regions in terms of shipments in the third quarter of 2018.

7 Xiaomi result announcement for the three and nine months ended September 30, 2018

Source: Schroder Adveq. For illustration only. Companies referenced are not intended to serve as any recommendation to buy/sell any security. Some data shown is from third-party sources we consider reliable. Any performance references is past performance, and there can be no guarantee that these or any results will occur in the future.

The keys to unlocking the opportunity

For those who have invested in Asia, the traditional route has been through public markets, via strategies benchmarked against indices such as the MSCI Emerging Markets or All Country World indices. However, this captures only a fraction of the opportunity set. In public markets, the largest sector of the market, the domestic A-share market, was historically excluded from major benchmarks. It was also absent from most investors' portfolios as a result. This is changing but, even now, A-shares are only 0.8% of the MSCI Emerging Market index, despite representing around 70% of the Chinese equity market by both market capitalisation and number of companies. Major benchmarks are also concentrated in the largest, most liquid companies. These are often dominated by financial and industrial companies, eschewing the sizeable diverse and more consumer-oriented small and mid-cap sectors. The traditional route provides limited exposure to the 4-M driven consumption story.

One option is to take a more active approach within public markets, by relaxing benchmark constraints and allowing a portfolio manager to focus on those sectors where growth looks more promising. However, this can only go so far. Public markets in general represent only a fraction of the Asian opportunity set.

1,500 new companies are funded by the private equity industry every year in China and India.[8] While some of these companies may eventually join the public market, many will not. Our research has found that companies are increasingly staying private for longer, meaning public market investors are accessing companies at a much later stage of their growth, if at all.[9] Based on this research, the best way to really access these companies is through Asian private equity. However, for the majority of investors, they need to rely on external expertise to do this successfully.

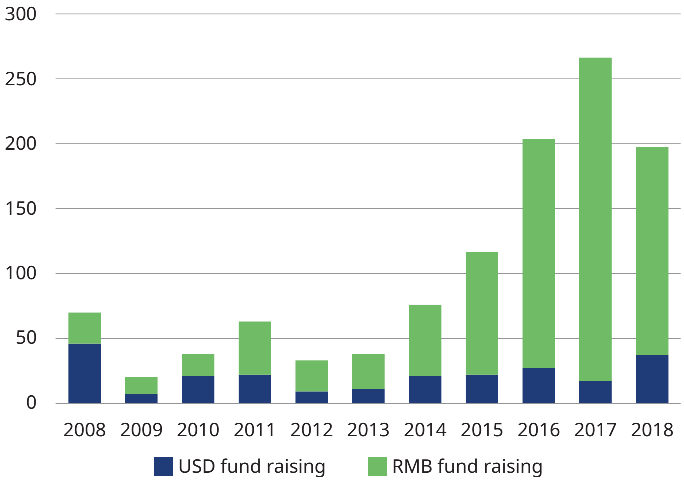
Asian private equity is a large and established market with Asia dedicated private equity funds raising the equivalent of around $60 billion per annum. This figure does not include the local Chinese renminbi market, which has historically been inaccessible to international investors. This market has expanded significantly over recent years (Figure 10). Following in China's public equity and fixed income markets' footsteps, there are signs that the domestic Chinese private market is starting to open up now too. Including it in the Asia total makes Asia the world's largest private equity market.

8 Venturesource
9 What is the point of the equity market?, Schroders, April 2018

Asia has historically been a highly profitable market for private equity investors. The median Asian private equity fund has generated an internal rate of return (IRR) of 10-20% a year over the 2009-15 vintages, net of all fees and expenses.[10] This is similar to the experiences in North America and Europe. Importantly, despite the perception of Asia as a higher risk destination for investment, this is not borne out by the data. IRRs generated by the median Asian private equity fund have been no more variable than those elsewhere. But the risk profile of Asian private equity investments is different from western buyout investments, which creates important diversification effects for an investor's portfolio.

Figure 10: Private equity capital-raise activity in China

(USD bn equivalent)



Source: zero2ipo, 2018

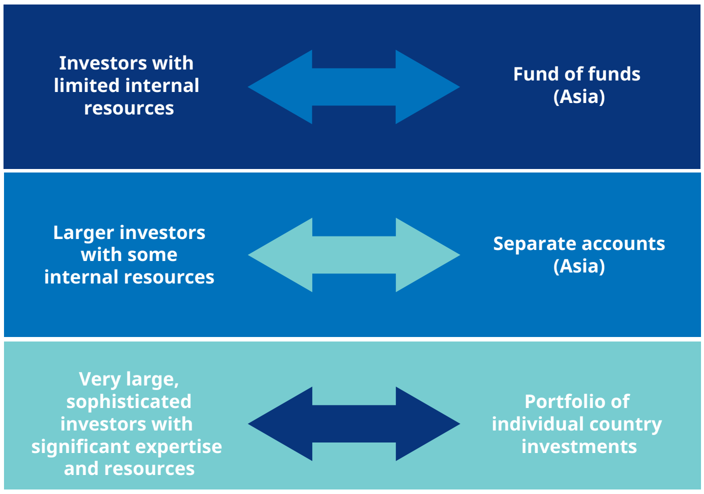
Most international investors who have allocated to Asian private equity have tended to focus their attention and capital on the well-known large mega funds (who fundraise over $1 billion at a time), partly because of greater accessibility. One consequence is that the market has become increasingly concentrated. Around 50% of the capital raised in a given year finds its way into less than 10% of the funds closed,[11] which means that this part of the market is becoming increasingly crowded. These mega funds only consider very large transactions, in order to put their capital to work in an efficient manner. The availability of debt for such large deals has also meant that these deals tend to be highly leveraged. Paying high prices upfront for future growth can increase the risk of such large transactions and can reduce performance expectations.

10 Source: Cambridge Associates, Schroder Adveq
11 Source: AVCJ, Preqin, Schroder Adveq, 2018

Capital supply/demand dynamics are more attractive for smaller private equity transactions in Asia. These deals tend to be less competitive and less reliant on financial engineering and leverage to generate performance. Smaller companies have also often never received institutional investment before. This leaves open far greater opportunity to add value through operational improvements than would be achievable at a large company, which may have already been through one or more rounds of institutional ownership. Furthermore, smaller Asian private equity transactions can also help to increase the level of diversity and diversification in a portfolio.

The appropriate route to accessing the Asian private opportunity will depend to a large extent on the size, sophistication and resources of an individual investor. While it may be practical for very large investors with high levels of internal expertise to construct and manage portfolios of private equity strategies at the individual country level, this would be impractical for most others. Having local teams that can assess investment opportunities in local language is essential, which for most investors means the best approach is to partner with providers who have the necessary resources, experience and track record in Asia. Figure 11 sets out some potential approaches that can be taken by different categories of investor. While the opportunities for return generation and diversification are significant in Asian private equity, these markets can be complex. Differences in business practices and culture can be significant. Emphasising investments that follow strong environmental, social and governance (ESG) standards is also an important element for many institutional investors. Furthermore, the Asian private equity markets are growing fast and changing quickly. They are not for the naïve.

Figure 11: Potential routes to market



Source: Schroder Adveq. For illustration only.

Conclusion

In a world where returns expectations are depressed across many asset classes, Asian private equity is a welcomed bright spot. In our view, the growth and increasing economic clout of the Asian consumer will be one of the dominant global trends of the coming years; and it is only just getting started. In addition, Asia's increasing standing as a technological centre of excellence, driving innovation and the development of both disruptive products and business models, cannot be ignored. From an investment perspective, private equity provides the keys to unlocking this unparalleled opportunity.

Important Information