

TO THE VENTURESOME GO THE SPOILS: VENTURE CAPITAL OPPORTUNITIES IN CHINA

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MARKET CHATTER: UPDATES AND INDUSTRY BUZZ

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America may be embroiled in a bitter [trade dispute](#) with China, but US investors have nothing but love to show for its private technology companies.

Their enthusiasm is hardly surprising: China is not only the world's second-largest economy, but also its most populous nation. With state entities unable to keep up with the demands of its vast population, private technology has stepped up to fill the gaps in healthcare, education and consumer goods, creating hugely successful and wildly popular startups flush with an abundance of venture capital pouring in from the United States. While many of these investment opportunities have reached saturation point in China's tier I cities—the country's largest and most affluent cities, for instance, Shanghai and Beijing—we believe there is tremendous potential in tier II cities and below where the majority of the country's urbanites reside. As China continues its push to transform itself into an innovation and technology powerhouse from a manufacturing behemoth that it was (and still is), a new generation of entrepreneurs is expanding to tier II and tier III cities to meet the growing demands of a tech-savvy population with rising purchasing power that is hungry for new services and applications.

This year, we put our money where our mouth is, and planned not one, but two trips to see the latest surge in China's venture capital opportunities for ourselves. In our first trip in 2019, we spent seven days over the summer in Shanghai and Beijing, meeting with 14 venture capitalists;

and we just wrapped up our second trip in September (more on that later this year). Our on-the-ground observations tell us that the heady days of meteoric rises and immense profits are over for tech startups in China. At NEPC, we view this as a positive because growth, when it slows, becomes more predictable and less volatile. And as the dust settles over the exuberance around venture capital, opportunities will become clearer. Careful manager selection and exhaustive due diligence will carry the day, hopefully lowering the potential for epic crashes and burns that are the flip side of giddy growth and quick riches.

THE STORY SO FAR

The immense potential of China's venture capital market was first revealed in 2014 when Alibaba, an e-commerce juggernaut, went public in the largest ever initial public offering. Since, it has birthed some of the world's largest private technology companies like Baidu, an online-search engine, and Tencent, a social media and gaming company. In fact, in 2018, nearly 30% of all global venture capital poured into Chinese startups, placing the country second to only the United States in terms of venture deal value, according to PitchBook.

Chinese tech firms initially started out as copy cats, duplicating the applications and business models of successes in Silicon Valley. The best and brightest tech minds would invariably go to foreign universities with the intention of staying on abroad. This phase was followed by an inventive breed

of entrepreneurs, many who came back after studying overseas to start a company. They were lured in equal measure by the vast potential user base (China has high penetration rates for smartphones, mobile payments and the internet) and looser restrictions on foreign investments.

THE CURRENT OPPORTUNITY

Now, investors and entrepreneurs are perceiving a need to do things differently. Instead of focusing on the usual big cities, they are going deeper into the under-served cities where large swaths of the urban population reside. At NEPC, we expect tier II and lower cities will play a large role in the overall success of the China venture ecosystem over the next five-to-seven years.

China has 65 cities with more than a million people, 360 cities with between 100,000 and one million people, and 388 cities with between 10,000 and 100,000 people. The largest city in China is Shanghai with a population of 22,315,474 people.¹ China's city classification is based on a tiered system that considers GDP contribution, political administration and population. Tier I and II cities include the directly-controlled municipalities and the largest cities by population. Tier III cities are not as developed as tier II cities but are typically economically significant. Tier IV and tier V cities are home to most of the country's urban population.

As state-dominated enterprises struggle to keep up with the surging demand for necessities such as education, healthcare and consumer staples, these venture firms are stepping in with technological solutions to meet an array of needs. Many of the managers we met with have started to focus their efforts on the lower-tier cities where the costs of doing business are not only cheaper, but also there is growing demand for services from a tech savvy population with rising purchasing power. An example that came up during our trip was from the portfolio of Xiang He Capital, a new entry to NEPC's Focused Placement List. Based in Hangzhou, Linlinyi is an e-commerce platform providing household products, including fresh foods and consumer goods, to residential communities in tier II and III cities in China through a group-buying agent model. While e-commerce is well established in China, there is a paucity of applications and services offering fresh food deliveries in the tier II and III cities.

In another instance, Long Hill Capital, a venture capital firm based in China, has invested in My Dental, which focuses on innovative surgical centers for dental implants in lower-tiered cities because of the cheaper rents there; it uses the car-sharing service DiDi to ferry its patients in and out from its centers. Since Long Hill's investment in 2017, the company's surgical procedures have risen four-fold with revenue growing by nearly as much.

Tier Classification:²

City Tier	Tier I	Tier II	Tier III	Tier IV
GDP	\$300 (+) billion	\$68 billion–\$299 billion	\$18 billion–\$67 billion	Below \$17 billion
Political administration of the city	Directly-controlled municipalities and leading provincial capital cities	Directly-controlled municipalities, provincial capital cities and economically important cities	Provincial capital cities and prefecture-level cities	Prefecture-level cities and county-level cities
Population:	> 15 million	3 million– 5 million	150,000–3 million	< 150,000
Examples:	Beijing Shanghai Shenzhen	Chongqing Nanjing Qingdao	Changde Nangton Wenzhou	Chanshu Hulin Linhai

We would be remiss to not talk about the ongoing trade dispute between the United States and China, and its potential impact on China's private tech sector. We believe this (computing!) cloud could have a silver lining as higher prices on American imports, especially components and technology used by tech firms, could compel China to look inwards, creating new opportunities in venture. There is also the matter of the Chinese government, which holds substantial sway over all businesses and investments in the country. As in many countries, investors fear regulations can change on a whim, endangering their capital. That said, we believe China has worked hard to attract foreign investors and will likely steer clear of any sudden moves that will drive away investment.

For those investors willing to explore new markets, we see attractive investment opportunities in Chinese venture capital, particularly those firms investing in lower tier Chinese cities. To learn more about this opportunity, please contact your NEPC consultant.

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- Past performance is no guarantee of future results.
- All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.
- The information in this report has been obtained from sources NEPC believes to be reliable. While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.
- The opinions presented herein represent the good faith views of NEPC as of the date of this report and are subject to change at any time.

¹ <http://worldpopulationreview.com/countries/china-population/cities/>

² <https://www.china-briefing.com/news/chinas-city-tier-classification-defined/>