The China Paradigm Factor

Why China presents a new investment model for private equity and venture capital — High growth, strong cash flows and more

By James Boettcher

Boardrooms are filled with entrepreneurs who pitch their ideas as a new paradigm or a paradigm shifter. After three decades in private equity, it's not hard to feel skeptical. But this hot button word may actually fit the current environment for private equity and venture investing in China. Why?

A paradigm is more than just a general descriptive model or prototype; it's a quintessential pattern – deeply rooted, self-contained, and entirely unique to whatever system it describes. That's precisely what exists in China today: a private equity and venture market that is evolving entirely unto itself, incorporating attributes that are highly specific to Chinese culture, politics, history, and business traditions. These defining characteristics are the critical, and often unexpected, variables that govern how Chinese companies are formed, run, and ultimately valued.

And for private equity investors, that is very good news, indeed, because these attributes – which taken together, I call the China Paradigm Factor – can markedly enhance the value of a Chinese company relative to a similar company in North America or Europe [See sidebar on page 5: A "Valuation-Added" Approach].

Any investor doing business in China or thinking about it should understand these intrinsic qualities and recognize how they are at work in their portfolio companies to maximize their effects on their investment outcomes.

So, what are the elements that comprise the China Paradigm Factor?

1 - Smart, Dedicated Managers

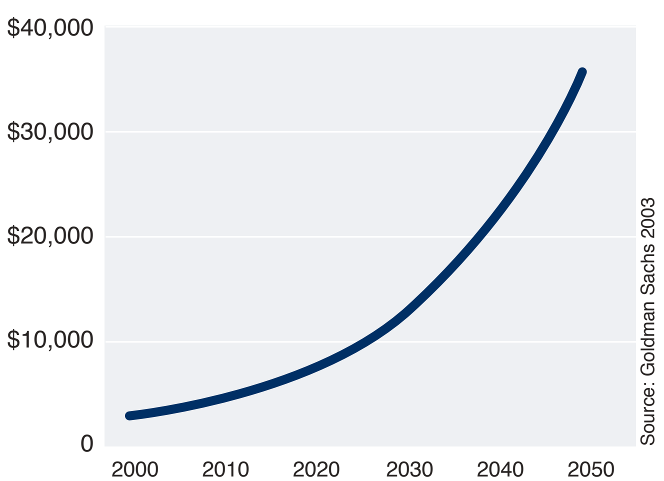
The first element often surprises newcomers to Chinese investing: the country has a wealth of excellent and well-educated managers at all levels. And unlike other economies that are trying to transition from a command-and-control system, China's leaders have assimilated many Western management concepts into the country's own unique approach to a liberalized market economy. As several government ministers have described it to me, "growth of GDP with social harmony". So far it's working incredibly well.

2 - High Rate of Economic Growth

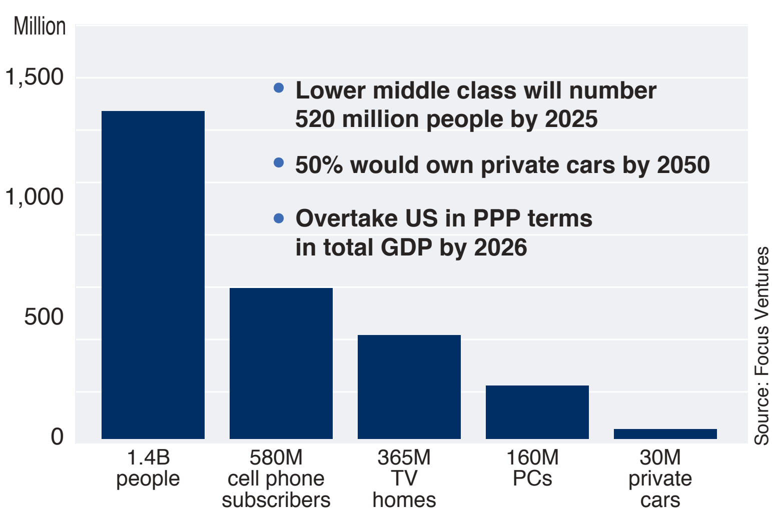
It isn't widely understood just how quickly China is evolving from an investment- driven economy to a consumer-driven economy. The country will have a middle class of more than

High Rate of Economic Growth

Consumer-driven Demand: China GDP Growth (per capita)



Energy/Materials Supply Imbalance (in 2010)



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500 million by 2025 – larger than the entire population of the United States. Goldman Sachs economists expect per capita GDP to grow from less than $5,000 today to more than $30,000 in 2050. That represents a huge emerging demand for everything from integrated circuits to cars to single-family homes.

3 - Capital Markets in Transition

In the United States and Europe, private and public markets compete as sources of capital. In China, however, there is no fully functional public equity market (though the stock exchanges are improving), a nascent corporate bond market, and SMBs have limited access to bank loans. Without these structures, private equity becomes an important source of growth capital. Note that it is only a matter of time before viable markets for public debt and ownership emerge. So this particular element will diminish over time.

4 - Abundant, Low-Cost Talent

China's secondary education system is world-class and the quality of its engineers, medical researchers, and other professional disciplines is equally excellent. The cost of that talent, however, is still much lower than in the US and Europe, meaning the core investment in intellectual property is very attractive. For example, one US telecom chip start-up I tracked needed about $85 million over five years to get to break even. A similar company in China requires only three years and less than $15 million.

5 - Advantageous Business Models

These kind of operating cost advantages make Chinese company P&L's highly – and sustainably – profitable. Ongoing research and development and SG&A costs for a semiconductor design company like Solomon Systech can be less than 5% of revenue. And as the Chinese economy continues to modernize and supply chains and logistics improve, cost of sales should also decline for manufacturing companies, further enhancing profit margins.

6 - Creative Solutions/Early Adopting Consumers

One of the most unexpected attributes of the emerging Chinese market economy is how consumer-savvy its entrepreneurs are. Even after decades of centralized economic planning, the Chinese remain consummate creators and marketers of interesting products. Online gaming, wireless instant messaging, and wireless value-added services are just three markets that the

"Valuation-Added" Approach

Private company valuation has always been a combination of art and science, and at Focus Ventures we have a variety of ways to assess the current and future market value of our portfolio companies. In the simplest view, however, it can be boiled down to one of two equations. For a revenue-stage operating company, we see value as the product of revenue growth multiplied by profitability. For early-stage venture companies, value can be thought of as a function of the size of the problem or market need being addressed multiplied by the uniqueness of the solution and the quality of the management team. For each type of company in China – which has both proven State-Owned Enterprises being transformed to private ownership and exciting young entrepreneurial companies – the impact of the China Paradigm Factor can significantly enhance their core value and potential future valuations. And because these companies can be floated on global markets with global valuation metrics, the positive impact of the CPF is even further heightened. Indeed, roughly half of the last ten $1 billion+ initial public offerings on NASDQ were Chinese companies – proof that the world recognizes the intrinsic value being created by Chinese entrepreneurs and their investment teams.

Enhancing Private Equity Valuations

Revenue-Stage Companies

Value = [RG x PF] x CPF

RG = Revenue growth

PF = Profitability

Venture-Stage Companies

Value = [P x S x E] x CPF

P = Problem

S = Solution

E = Entrepreneurial team

CPF = China Paradigm Factor

Source: Focus Ventures

A culture that is naturally comfortable with risk and with developing innovative ways to solve problems and create wealth both for individuals and for society at large.

Chinese more or less created out of thin air. Each of these businesses has growing customer bases (and have spawned successful public companies like Shanda, Netease, Tencent, and Linktone); and none of them have significant participants yet in the United States.

7 - Risk-taking, Innovative Culture

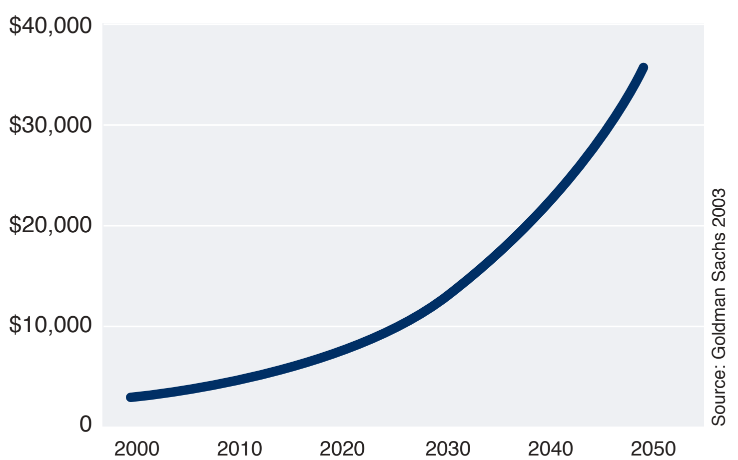
The seventh characteristic of the China Paradigm is a culture that is naturally comfortable with risk and with developing innovative ways to solve problems and create wealth both for individuals and for society at large. An excellent analysis of this cultural trait can be found in the book The Genius of China by my friend Robert Temple. Robert looks back over the past 2,000 years and concludes that for most of that period, China has been the undisputed world leader in technological innovation and application. War, revolution, and bureaucratic lockstep will temporarily subvert this historic national mindset, but Robert believes it will – indeed, has already begun – to reassert itself. I agree, and I think every private equity investor should bear this in mind when looking at China.

Capital Markets in Transition

Private Equity Opportunity

- Dysfunctionality in domestic shares market
- Corporate bond market only emerging
- SMB access to bank credit emerging
- Inefficiency and information asymmetry
- Higher pay off to experienced due diligence

China GDP Growth (per capita)



These seven synergistic and interactive elements, then, constitute the China Paradigm Factor. Yes, there are mitigating factors to consider, including the potential for government meddling, difficulties obtaining and protecting intellectual property, concerns about corporate governance and financial transparency, growing demand for higher and more comprehensive employee compensation, and more. But the China Paradigm Factor still remains a unique and powerful force that is enabling the creation of very valuable companies. By understanding it, investors can put it to use in building, expanding, and managing their portfolios.

And maybe even doing something equally important: making the world a better place. After all, barring any kind of cataclysm, China will definitely become an economic superpower. If Western leaders opt for cooperation and collaboration, the future will be bright for all involved.

As investment professionals, we can't do much to affect the behavior of our governments. But with each investment we make, each alliance we forge, and each board meeting we attend, we place one little brick at a time into what will hopefully become a bridge of common understanding between China and the West. If a deeper understanding of the China Paradigm helps facilitate that process, then all of us – investors and entrepreneurs, policy makers and private citizens, Asians and Westerners – will reap the rewards for many years to come.

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