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GROWTH SECTORS

All consuming opportunity

Actis's Beijing-based partner Max Lin describes where to pinpoint the growth investment opportunities in China's vast business landscape

Lin: fierce competition for quality assets

The economic and political tremors that have disrupted markets in some of the world's largest economies over the past year – the election of US President Donald Trump and the UK's decision to quit the European Union among them – have not left China untouched.

Among headline challenges facing the world's second largest economy are slowing GDP growth, a weakening currency, concerns over rising debt levels and stock market volatility.

However, China remains one of the fastest growing of the world's major economies, with the World Bank forecasting its $11 trillion GDP will expand by 6.5 percent in 2017.

Its swathe of investable companies, demographic heft and rising middle class with new spending habits and priorities, continue to beckon investors seeking exposure to emerging market growth dynamics. Dominating the Asia-Pacific region, in 2016 the Chinese market accounted for more than half of the region's total dealflow of $92 billion, according to Bain & Co.

Consumption-driven growth, particularly in specific segments, is still very strong, says Max Lin, Beijing-based partner at growth investor Actis. Lin describes where to look.

Q The Chinese government announced its 13th Five-Year Plan last year. What impact has that had on the business environment?

The government is staying its course on its reform programme, including supply chain restructuring and SOE reform. This means removing surplus capacity in specific industries to improve profitability and allowing companies to invest in R&D and upgrade manufacturing capabilities.

The second theme – which is very important to our strategy – is the ongoing government drive to rebalance the economy from investment driven to consumption led. And raising the level of urbanisation is an important ongoing initiative.

Q What do reforms mean for private equity investors?

Investors in China need to be keenly aware of the overall thrust of the government policy. If you look at Actis's sector focus in China, which is on consumer, healthcare and industrials, as well as financial services, other than industrials, all of them are directly or indirectly driven by the rising consumption of Chinese consumers. The increase in consumer spending and consumption upgrade are major themes for us.

Q Is it easy to find deals in the consumer sector?

It's not difficult to find deals; it's more difficult to find the assets that we want at the right valuation. Competition for quality assets in the consumer space are fierce. Our strategy is always to bring additional value to our investee companies rather than just capital. Frankly, China does not have a lack of private equity capital.

We need to be careful that we are in the right segments of the consumer sector from a growth standpoint. There are faster growing segments where there is more demand for particular products and services, and there are some where consumers are moving away. Rising demand for education and healthcare services as the Chinese consumers, particularly the middle class, climb up the wealth ladder, are two big trends. The third trend that we are watching closely – also in the consumer space – is the convergence of online with offline businesses.

Q Does the consumer upgrade theme apply to healthcare?

Yes, certainly. Both healthcare and education sectors have traditionally lagged behind other sectors in terms of regulatory reform and there is a massive demand for quality services. Consumption upgrade and import substitution are themes driving our healthcare strategy, where we have invested in both med-tech and diagnostic services companies.

With increased investment on research and development, many Chinese med-tech companies are starting to compete with global multinationals, starting from the Chinese domestic market.

Q How does the shift from heavy industrial to consumer-driven growth impact your portfolio companies?

We stay away from a heavy capex model of growth where you provide capital to a

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company to build a new factory. That sort of growth is over.

We are looking at manufacturing companies that present significant barriers to entry to their competitors. Last year we invested in fabric design and manufacturing company RGB Textile Printing & Dyeing Company. Typically you wouldn't say this segment presented strong barriers to entry, but in this case the company's design capability, its library of tens of thousands of designs that cater to their particular markets, and its reputation in the supply chain allow the company to compete effectively.

Q Actis has a watching brief on Chinese financial services – have you invested yet?

We are actively looking at the sector, particularly where historically Actis has been strong and where we believe Actis can bring value add to our portfolio companies, such as in the payments segment.

Q Some emerging markets have a reputation for slow deal execution. How easy is it to complete a deal in China?

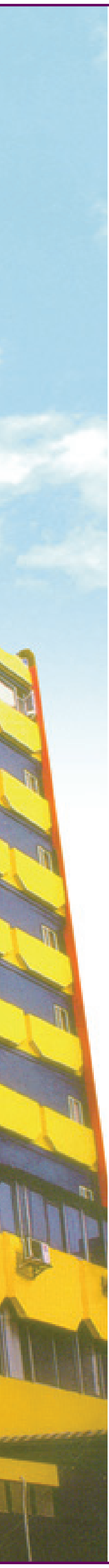
It depends on the situation and the structure you're looking for. Typically, in our deals, once we make a decision, it's not that difficult to complete the deal. We interact with entrepreneurs, founders and management teams and the difficult and the time-consuming part usually takes place at the beginning of the deal, particularly if it's a proprietary deal, where we identify our value addition to the company, and design and negotiate a deal structure that works for both parties. The time-consuming part is not the documentation.

Q Do Chinese entrepreneurs understand the value GPs can bring?

Not always. China is a big place and there are a variety of entrepreneurs. It depends on whether a sector attracts private equity capital or whether they have personally dealt with GPs before. Sectors such as

Travel upgrade

Actis took budget hotel operator Plateno on a transformational journey that mirrored changes in consumer travel preferences in China



Formerly known as 7 Days Inn, Actis invested in the economy hotel operator Plateno Hotel Group in 2008. Over its eight-year hold the firm helped management grow the single-brand operator with 160 hotels in 28 cities to 20 brands and more than 2,500 hotels in 300 cities across China.

By the time Actis exited its stake in February 2016 at an enterprise value of $1.5 billion to Chinese conglomerate JinJiang Group, the business had been transformed and become the second largest hotel chain in China.

Q Why Plateno?

When we first invested, we backed a capable management team looking to rapidly expand to serve a market that almost didn't exist before – the economy leisure and business travel markets.

Originally, we provided capital to help management roll out across the country, sign new lease agreements as quickly as possible, and build up the brand, the back office, the IT networks and the booking system, as well as train staff, all to grab market share.

On the back of that strong growth, the company listed in the New York Stock Exchange [in 2009] joining two of its biggest Chinese competitors. For a period of time that growth was sustained, especially in the tier one and tier two cities.

Q Plateno was Actis's first take-private transaction. Why did it delist?

In 2012 we started to evaluate our strategic options – for Actis and the company and its founders. There was a lot of price competition between the three biggest players and tier one cities were almost saturated with economy hotels. We realised it was time to change the strategy to penetrate tier three and tier four cities with a different format. We reviewed the portfolio and assessed individual hotels and locations, as well as operational improvements like improving supply chain efficiency and monetising Plateno's membership programme.

"We do see a lot of opportunities in the mid-market segment, but we are yet to see an attractive investment"

With management and the founders, we also agreed to embark on a mid-tier strategy to create new brands serving those original economy hotel travellers who now wished to stay in a hotel that was slightly fancier.

That all required both investment and patience. The US capital markets were quite short-sighted and removed from the market reality in China. So we decided to increase our investment and brought in two other financial sponsors to take the company private in June 2013. That done, we were able to change our strategy to focus on operational improvements and building new mid-tier brands. That's what made the asset attractive to JinJiang Group.

Q Would you invest in the hotel segment again?

The economy hotel segment will continue to grow but it is dominated by the three or four largest players. There is no room for new players to emerge. That consolidation is done.

We do see a lot of opportunities in the mid-market segment, but we are yet to see an attractive investment. The leisure and travel space is pretty attractive and it's one of the higher growth segments within the consumer sector. ■

healthcare and financial services attract VC and PE investments. They are usually well-versed in negotiating and discussing strategy and understanding what private equity can bring to the table. And they know what they want.

In some of the other sectors, the more traditional offline consumer space is one, industrials is probably another, we talk with a lot of entrepreneurs that have never had to deal with private equity. They require some educating. That is why you need an on-the-ground team in China that can deliver the value-add message and the global network in a language they understand to gain their trust.

Q In light of volatile equity markets over the past year, where are investors opting to exit?

For us, trade sales are typical and that's a growing trend for our industry. A lot of our competitors used to rely on IPOs as the main route to exit, but the capital market is volatile. In domestic stock markets, valuations are high but timing is unpredictable.

We are also seeing more secondary interest from GPs and we are also looking at assets being sold by other private equity firms. There is a lot of demand for quality assets – particularly if you are selling a controlling stake – from private equity and Chinese and international strategics.

Q Is the new US administration's hostility toward China a cause for concern?

I see no risk of a trade war. The Chinese government sees an opportunity for China to step up and be the champion of free trade. It's a potential reversal of roles. It is an opportunity to push China's international trade strategy, the One Belt, One Road initiative. ■

*Shanghai-born **Max Lin** joined Actis in September 2012 after a career that included investment banking at Credit Suisse, HSBC and Citigroup, and being a founding member of HOPU Investment Management.*