Matthews Asia

Matthews Asia Perspective

China's Growing Stable of Unicorns

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China is raising its profile as a world leader in innovation. Most telling is its growing herd of "unicorns," which are privately held startup companies valued at US$1 billion or more. In fact, 86% of China's unicorns appeared between 2014 and 2017, according to the Nikkei Asian Review.

Unicorns are being funded in China faster than anywhere in the world and China's largest technology companies control nearly half of these highly valued startups. As of February 2018, China ranked second behind the U.S. in terms of its number of unicorns and their total market capitalization. The U.K. came in third with only 13 companies. China and U.S. unicorns combined accounted for 83% of the total US$810 billion market cap of unicorns globally.

How Chinese Unicorns Are Born

It wasn't until the 1980s, after Deng Xiaoping initiated his reform and open-door strategy, that China encouraged its youth to study abroad. This government nudge led to skyrocketing demand for education in the West. From 2006 to 2016, the number of Chinese students at American universities increased fivefold to more than 320,000. Last year, more than 600,000 Chinese studied abroad, up 11% from 2016.

Previously, many students would remain in the West to pursue jobs and quality of life that were harder to find back home. Eager to end the brain drain, China has in recent years begun to lure back foreign-educated talent. It has enticed them with generous funding and attractive positions, particularly for scientists and researchers.

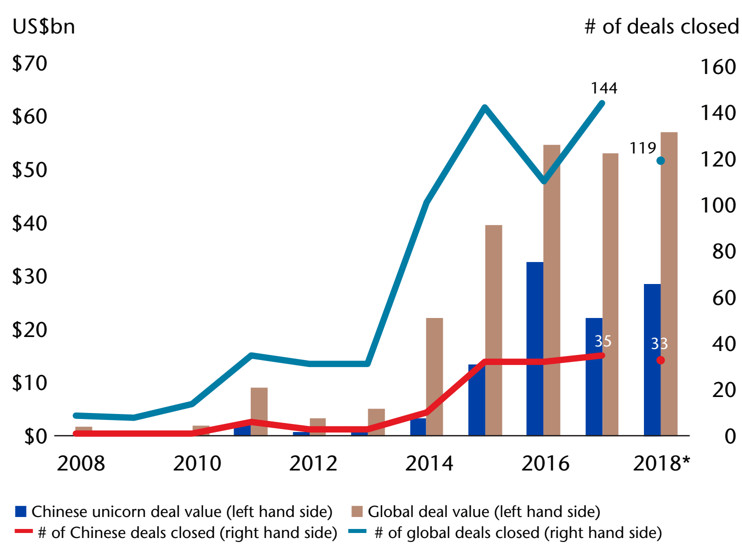
The government has also been nurturing its research and development capabilities. China's overall spending on R&D development reached an estimated US$279 billion in 2017—a 14% year-on-year increase and more than 70% higher than its spending in 2012. Cleaner, greener methods of promoting economic growth have emerged as the country eases its dependence on heavy industries. China has invested in high-tech industrial parks and incubators that are moving the needle in areas such as artificial intelligence, robotics and big data.

All of this has created new breeding grounds for tech unicorns. We can find them not only in China's largest "tier one" cities, but also in second-tier cities such as Wuhan and Chengdu. Overall, this shift toward innovation is aiding the transition of China's economy toward one that is driven more by services and consumption.

Attesting to the growth of China's venture capital (VC) industry, a record US$154 billion of VC money was invested in 2017, of which 44% came from the U.S. and 40% came from within Asia. China is now the world's second-largest VC market, and fundraising has almost doubled from just three years ago. Fueling China's venture capitalists are government supports and a push toward

Figure 1. Vast sums of VC have flowed into the coffers of fledgling Chinese tech companies in the past four years

Chinese unicorn activity versus global



Source: Pitchbook 2018 Unicorn Report
*As of August 1, 2018

more value-added industries as well as the rise of cash-rich internet giants.

China's VC industry has been focused on areas such as robotics, led by the need to improve manufacturing efficiency; driverless cars, led partly by its large passenger-car market, which faces the challenges of difficult traffic conditions; and biotech, led by the need for affordable health care in light an aging population. These are strategic sectors as they represent new industries and technologies.

Hurdles for China's VC Circuit

It's important to recognize the differing goals among VCs in China compared to those in the U.S. In China, VCs often demand short-term, aggressive returns. Startup founders may be asked to pledge personal assets during capital-raising rounds if results fall short of expectations. These hurdles often stifle the longer-term development of aspiring unicorns. In the U.S., VCs may be more willing to invest in a particular individual and may believe that startup failures serve as valuable experiences for future endeavors.

Compared to their Western peers, startups in China often aggressively cut prices to gain market share, betting heavily on winning through economies of scale. Western VC firms may pay more attention to market conditions for initial public offerings (IPOs) and require startups to focus more on profitability as they wait for the right time to launch an IPO.

Recent challenges for China's VC industry include somewhat diminishing access to funding. According to Zero2IPO, China raised just about US$30 billion (206 billion renminbi /RMB) in the first quarter of 2018, or a 30% decrease compared to prior years. Historically, wealth management products issued by banks have been a meaningful source of funding and liquidity for the market, which has benefited VCs. Given stricter enforcements that aim to reduce risky investments, however, access to capital has recently declined.

Incentives for A-share Market Listings

In an effort to lure some of China's largest, foreign-listed, technology companies back to list on its domestic markets, China's state council plans to allow firms to issue Chinese Depositary Receipts (CDRs), which are instruments that will allow Chinese investors to directly own shares of such companies. Currently, only foreign-listed companies with valuations of at least US$29 billion (RMB 200 billion) and unlisted companies with valuations of at least US$2.9 billion (RMB 20 billion) will be allowed to issue CDRs. We believe more foreign-listed firms or start-ups are likely to obtain easier access to domestic listings.

While China's unicorns have focused mostly on consumer services, the U.S. has more unicorns that cater to enterprises. This development of consumer-facing businesses may be a result of China's large mobile audience that has embraced new smartphone and internet services, and a much larger addressable market from a scale and user-base perspective.

At Matthews Asia, we focus carefully on the industry dynamics, business model sustainability and financial strength of our portfolio holdings. The overarching concern with investing in many of China's unicorns that go public is that profitability tends not to have kept up with their rapid pace of growth. In the past, access to capital had been far easier and many startups grew rapidly without clear paths to profitability. The current flurry of IPOs could signal that funding is more difficult and the business models of firms that go public may now be put to the profitability test.

We've also seen examples of failed start-ups, mainly due to irrational private funding into questionable business models. Earlier this year, Bluegogo, often called as "Xiaolan" by Chinese consumers, China's third-largest dockless bike-sharing startup, ceased operations, becoming the first major casualty in a fast-evolving technology sector. In China's bike-sharing space, even well-managed companies backed by strong strategic partners face an uphill climb. It could be the case of a questionable business model in a sector that has been experiencing a bubble, alongside many competitors that are backed by far too much venture funding and chasing too little profit. These are among the risks for China unicorns.

But as the caliber of unicorns improves and more go public with an IPO, we should find a deeper set of investment opportunities in new and innovative industries that may not have existed just a few years ago. We look forward to picking out the future leaders among this segment that may propel China to new heights of innovation.