Thinking Globally, Investing Locally

At TIFF, sourcing new ideas and investing with the best managers knows no geographical boundaries. It is an intense exercise of opening doors, developing rapport and trust, and applying careful analysis. Selecting institutional investments for us is a matter of weighing potential merits and risks associated with a particular manager against the opportunity costs that one might incur elsewhere in the manager's market, or even elsewhere in the world. To best understand that global opportunity set requires more than networking and number-crunching. That is why we spent two weeks in China recently, returning with a clearer sense of the investing landscape and, we hope, a sharper capacity for smart manager selection.

The trip got us thinking more broadly about how we view the geography of our investing process. So before we dig deeper into what we learned in Hong Kong and Shanghai, it may be instructive to review the broad strokes of TIFF's approach to private investing outside the US.

As our members know, TIFF has enjoyed steady private investing relationships outside the US for many years. The vast majority reside in the United Kingdom, the Nordic region, and Continental Europe. Our limited exposure to China has come via a couple of managers over the years, one of which received a $5 million commitment from us earlier this year.

You might also recall that we try to maintain a steady toe in the water with new managers, both inside and outside of the US. We have long believed that US and non-US teams complement one another and have contributed in a balanced way to what we view as TIFF's strong aggregated performance since inception.

We are clearly seeing global growth in the number of private investment opportunities from which we can select and construct our portfolios. According to Preqin, there were 2,555 private equity firms worldwide actively raising capital in January 2016, compared with 918 in January 2007 – nearly 3x growth over the last nine years. To say it is a crowded fundraising market globally is a vast understatement. Now more than ever, LPs need to direct their attention, remain focused, and filter out the noise.

Concurrent with this reality is our sense that private investment firms in the developed markets, generally North America and Western Europe, are now in the midst of their third generational transition. The behemoth asset managers that began life in the 1980s, or in some cases earlier, are well known; several are now recognized not only by their global brand names but by their stock tickers as well. Many of the small to mid-market PE firms that came into being in the 1990s or early 2000s and endured the global financial crisis are beginning to create new products and expand their fund sizes into multiples of a billion dollars/euros (while trying to retain the look and feel of mid-market firms). Today, the market is solidly supporting numerous small-cap first- and second-time fund managers who have built niche businesses occupying a fund size category of roughly $500 million or less. The US and Western European markets are quite mature at this point. Is this a reason to look away? Hardly. We continue to see excellent returns being generated as well as the persistent conditions for deal-making. Those conditions include efficient capital markets, a plentiful universe of investment targets, well-defined legal frameworks and precedents, capable management teams, and regulatory ecosystems that, while occasionally presenting unexpected bumps in the road, can still be navigated.

We feel it's important to regularly confirm an answer to a critical question: are we missing something in our global search for the best investments? In formulating an answer, we decided it was time to return to China.

This note is not meant to lay the groundwork for any TIFF plan for large-scale capital deployment in the country. Our views are still evolving. Spending time observing private equity opportunities in any market, and emerging markets in particular, requires more than what one can extract from articles, research reports, and blogs. It entails a substantial commitment to learning and orientation in the field. We believe that we should get to know the market and its managers in person, just as much as they should get to know us and the characteristics of the managers we seek. Approaching a less familiar region for prospective investment requires that investors learn both why they should and why they should not invest there, and to develop an understanding of the different risks and potential return profiles that await them.

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Two members of our investment team, Stephen Williams and Chris Anderson (your author), visited Shanghai and Hong Kong in the first half of November. This was not the first trip to China for TIFF. Members of our private equity team have evaluated managers and invested there previously, in a limited way, and TIFF's public equities team has also spent considerable time on the ground in China of late. During our recent two-week trip, we met with 15 investment managers that spanned early stage venture capital, growth equity, and control buyout strategies. We also visited the Hong Kong-based investment team of an endowment peer and attended a luncheon with the Hong Kong Venture Capital Association, participating in a discussion of the structural dynamics of local venture capital investments and the current VC environment. Importantly, upon our return and after further analysis and discussion, we added six of the managers that we met to our private investments "prospect list." This internal tracking mechanism helps us focus our time on those managers that we believe are worth further consideration. Much work remains to be done, but our time on the ground already has yielded a far clearer picture of the opportunities and risks. Here are the key observations that emerged from our trip.

Venture Capital & Growth Equity. The Chinese venture capital market is not incredibly different from that of Western venture markets. There is a growing universe of managers. Venture and growth equity investments in China are targeting returns that are compelling. Company disruption is rapid and is affecting many mature industries, but increasingly we are seeing many of the recent disruptors become quickly disrupted themselves. Companies in China focus intensely on innovation to stay ahead of the curve. The venture capital market in China is absolutely subject to valuation cycles, which some investors are now experiencing, in what appears to be a fully priced environment. Liquidity has fallen off in the last year, so we expect there will be a growing backlog of companies seeking an exit in the near to medium term. Institutional venture capital investments within China range from firms focused on Series A rounds on up to larger, multi-stage and growth equity managers. Seed-focused funds like those in the US are not common in China. The demand for those investments is typically filled by wealthy individuals (angel investors).

Leveraged Buyouts. The buyout market in China is far less mature than the venture capital market. Target portfolio companies have generally been large state-owned enterprises (SOEs) that the government chose to divest. As a result, a handful of large multi-asset fund managers with footprints across Asia, and even in developed markets like the US and Europe, have taken hold. TIFF's general buyout focus remains tilted toward small and mid-cap managers, of which there is a small universe in China. However, smaller and more diverse buyout investment targets are surfacing with the maturation of smaller private enterprises and the holdings of local wealthy individuals, along with generational succession issues facing family-owned businesses. This is a market to watch. There are few institutional options that we feel are worth pursuing at this time, but the benefits of low competition for deals can generate attractive deal dynamics that are often correlated with high returns.

Sector Themes. Attractive sector themes for investment in China do exist. For example, China has a severely under-served market in health care services and biotech/ pharmaceuticals. Hospitals, delivery of care, and the availability of a variety of medicines and treatments have significant growth prospects, in our view. The consumer itself remains a central area of growth for China as the middle class continues to expand and increase its spending. Consumers have vastly integrated their consumption with e-commerce and have moved past buying mere "things" toward increasingly purchasing experiences, such as entertainment and travel.

Conflicts of Interest. Potential conflicts of interest among private investment managers are clearly present. Growing and established public Chinese corporations have significantly embraced the private markets as an avenue for their own growth, innovation, and maintaining a competitive edge. Several private equity and venture capital firms in China may engage in partnership through investments made by such corporates. Baidu (think Google), Alibaba (think eBay/ Amazon), Tencent (think Facebook), and Ctrip (think Priceline) are examples of large corporates that actively invest in private transactions alongside institutional investors in deals or even in the funds themselves. This creates certain advantages and validating strengths for particular opportunities, but it also highlights that a manager may need to answer to another party with interests not wholly aligned with those of institutional investors.

Currency. The business of forming investment funds by Chinese managers sometimes comes with multiple funds of differing denominations managed by the same firm. Many managers will form funds denominated in US dollars as well as locally denominated renminbi funds. Policies and controls that govern how a manager will allocate investments among these funds are vague. This creates a need to research and understand a manager's portfolio construction choices.

Legal Frameworks. Incentive structures, fund formation, investment terms, and other legal frameworks are essentially Westernized. Operationally, little additional complexity and few new concepts are involved. However, regulatory and legal risks remain a concern. Because private investments incur increased market exposure risk from their extended hold periods, the Chinese variant may hold additional risk due to instability. Regulatory, legislative, legal, and policy changes can impact businesses, and thus their stakeholders, with little or no warning. Managers must be diligent and thoughtful about these potential risks and how they can mitigate them during their hold periods.

Product Lines. Many successful managers are expanding their product lines, which is to be expected given that many of these firms have taken cues from large Western counterparts. The allure of building a scaled brand is understandable. But it is also something that we feel can potentially take the manager's attention away from the best interests of its limited partners, regardless of geography. We don't feel that these firms are necessarily unfit for TIFF; they have likely demonstrated a repeatable ability to generate attractive returns, after all. But alignment of interest is, at a minimum, questionable when we observe these businesses develop this way.

As we've said, we are not rushing to deploy capital into China. Careful market observation, building relationships of trust with top-tier managers, and confirmation of a thesis – while understanding merits and risks -- are prerequisites we apply to investing in China, just as elsewhere. We believe our framework for manager selection is horizontally transferable from one market to the next. As in any new market, we prefer to take time to earn solid returns rather than rush and potentially suffer losses from unforeseen or unexamined risks. Patience is key.

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