

“Changes call for innovation, and innovation leads to progress.”

– Li Keqiang

Asia Venture Capital: Less Disruptive, More Additive

Over the past year and a half, US private valuations within venture capital (“VC”) have begun to retreat, the number of tech IPOs has fallen, and “tourist” VCs (i.e., hedge funds, public asset managers, and corporate groups that dabble only when market conditions are favorable) are focusing on their core markets. While American and European investors have carefully trimmed their stakes in start-ups, and announced the end of the Age of the Unicorn,¹ investors in China, India, and Southeast Asia (“SEA”) are just scratching the surface of this opportunity.

Over the past decade, Asia VC has become harder for sophisticated global investors to ignore. From next to nil at the turn of the millennium, Asia VC has grown swiftly alongside the region's major economies to become, by some measures, larger than its American counterpart.² An affluent consumer class and the rise of the internet and mobile technologies have converged to create a flourishing start-up community. The combination of these themes with abundant talent, capital, and liquidity has allowed Asia VC to blossom. This paper provides an overview of the sector's development, and suggests ways for investors to understand the role it plays in their broader portfolios.

¹ A unicorn (or, narwhal in Canadian tech) is a start-up company valued at over US\$1 billion.

² S&P Capital IQ, October 23, 2016.

Development of Asia VC

Any quest to understand VC in Asia must start in China. The country is now the world's largest destination for VC investment after the US, and the market capitalization of its technology companies rivals that of their American counterparts.³ Yet, while VC in China dwarfs—by both value and volume—the rest of Asia combined, it is also a guide for how VC in the rest of Asia will develop.⁴ As such, understanding the genesis of Chinese VC offers both a look into the past, as well as a peek into the future. Sophisticated investors have recognized the patterns around growth and penetration trajectory, and are quickly mapping China's path to other emerging markets whose growth potential is too big to ignore.

BUILDING BLOCKS

In StepStone's view VC markets require four things to flourish: funding, talented entrepreneurs, favorable public policies, and functioning capital markets.

In light of the vibrancy of VC in China today few may remember when funding was thin, experienced talent was scarce, regulatory barriers were high, and exit opportunities were rare. Such was the reality of VC in China in the 1980s: seed money for private enterprises typically came from government- or university-sponsored funds; talented youth avoided start-up risk in favor of middle class stability; the socialist government restricted private enterprises including prohibiting them from listing on the Shanghai Stock Exchange; and despite an underdeveloped domestic capital market, the Chinese government required that companies be preapproved before being listed in foreign markets.

Over the course of the 2000s the Chinese government slowly chipped away these barriers and the building blocks for VC in China were put into place. What followed in China was a classic story in which each of the elements required for a vibrant VC market started to develop, driving a virtuous, self-sustaining growth cycle. Gradually this model is being replicated elsewhere in Asia.

Foreign VC firms were first permitted to register as commercial enterprises in China in the 1980s. This did not herald a flood of capital. One of the first foreign entrants, International Data Group ("IDG"), tested the waters by incorporating as a joint venture with the Ministry of Science and Technology. The state council did not announce the policies that would eventually draw SoftBank and Granite Global Ventures until it was sure the new information economy could drive economic growth.⁵

The dotcom bubble that then ravaged American tech companies also reverberated across China's nascent VC landscape. The exit hopes of many companies were dashed, numerous VC firms were shuttered, and plans for a NASDAQ-esque board in Shenzhen were postponed. Nevertheless, the seeds of what would become "BAT"—China's trio of internet behemoths, Baidu, Alibaba, and Tencent—were sowed during this first wave of VC activity. The traditional banking system's unwillingness to lend to small- and medium-sized enterprises ("SMEs") generated demand for financial capital that VCs, motivated by China's increasingly affable policy climate, were keen to meet. This was enough to keep the green shoots of Asia VC alive. Were it not for the US\$ 1 million he secured from IDG in 1999, Pony Ma, Tencent's founder would have sold his business for less than US\$150,000.⁶

But the dotcom bubble that razed so many tech companies, delivered the fortunate few to the Promised Land. Five foreign-backed Chinese internet/telecom start-ups made their IPOs on NASDAQ in 2000.⁷ These landmark exits proved that American capital markets had finally accepted "China Inc."

In 2003 the Chinese government lifted the preapproval requirement that had previously limited private Chinese companies from being listed on foreign exchanges. By the following year the number of foreign-backed companies that went public had grown fivefold.⁸ Tencent listed on the HKEX in 2004, and Baidu listed on the NYSE the following year. The sudden explosion in lucrative exits drew more foreign VC firms into China. These foreign investors represented about 80% of fundraising for Chinese start-ups, who benefitted from their investors' superior professionalism, brand recognition, and familiarity with American capital markets.⁹

³ Ibid.

⁴ *Asia Venture Capital Journal*, April 2016.

⁵ Ahlstrom, Bruton, and Yeh, "Venture Capital in China: Past, Present & Future", *Asia-Pacific Journal of Management*, p. 250.

⁶ Zhou, Lazonick, and Sun (eds.), *China as an Innovation Nation*, Oxford: Oxford University Press, p. 78.

⁷ AsiaInfo, UTStarcom, Sina, Sohu, and NetEase.

⁸ See supra note 6, p. 76.

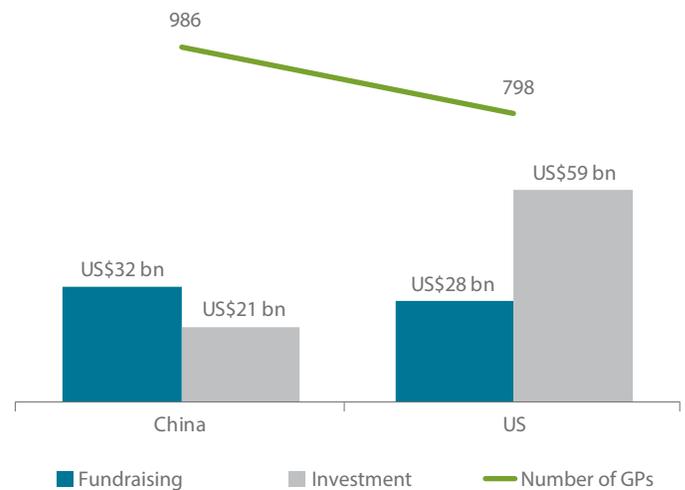
Higher capital flows also attracted more entrepreneurial talent to China's burgeoning start-up ecosystem. Early on, limited indigenous know-how meant that the first entrepreneurs were those who had paid their dues in Silicon Valley before returning home to create successful start-ups. Those who returned have since laid the foundation for a start-up culture that has allowed homegrown entrepreneurs to flourish, and spurred the formalization of entrepreneurial education. Between 2005 and 2015, the number of incubators in China quadrupled.¹⁰ In Shanghai alone there are more than 150 incubators; the number surges to 400 if you include co-working and innovation spaces. Nationwide the number of incubators is expected to approach 5,000 by 2020.¹¹

Several government policies, including a 2015 commitment to invest \$US336 billion in start-ups, have fostered China's entrepreneurial climate. Tax breaks and cut-price rentals have also helped to attract talent. In an echo of VC's earliest days in China, some of the capital the state has injected into VC has been done in partnership with private VCs. For example, Shanghai-based Gobi Partners, a consumer-oriented VC, has three RMB-denominated funds in co-operation with three state agencies.¹² The government's recognition of the importance of the technology sector to driving economic growth has resulted in continued support and funding for entrepreneurs and the ecosystem.

China's VC market underpins Asia's most vibrant and well-developed ecosystem for start-ups and entrepreneurs. While China's volume of VC investments still trails that of the US (US\$21 billion versus US\$59 billion), the Chinese VC market has surpassed the US's: there are more VC firms in China—986 versus 798 in the US. Chinese firms also have more dry powder.

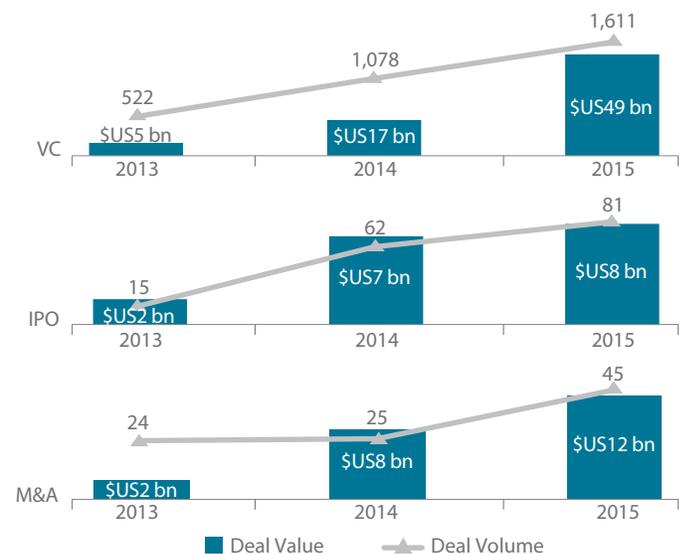
As **Figure 1** illustrates, Chinese VC funds raised US\$32 billion and invested US\$21 billion in 2015. In that same year, American VC firms raised US\$28 billion and invested US\$59 billion. With more capital chasing fewer deals, it will be hard for Chinese firms to maintain these fundraising levels. However, two features of the market have changed since 2013—the last peak in VC fundraising—that should serve as

FIGURE 1 | COMPARISON OF VC IN CHINA & THE US



Source: Ernst & Young, 2015.

FIGURE 2 | GROWTH IN CHINA VC FUNDING & EXIT ACTIVITY



Source: Asia Venture Capital Journal, Q1 2016.

⁹ Wong, "The Evolution of the Venture Capital Market in China: Current Trends in Venture Capital Financing Strategies and Investment Preferences", *The Journal of Investing*, p. 18.

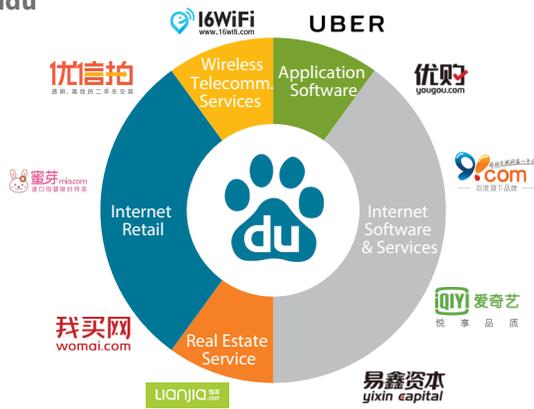
¹⁰ Xu, Eleanor, "Venture-backed IPOs and the Exiting of Venture Capital in China", *The Journal of Entrepreneurial Finance*, Vol. 11. No. 3 Fall 2006, Article 3.

¹¹ Chinese National Incubator Development Status Report, iiMedia Research Group, 2016.

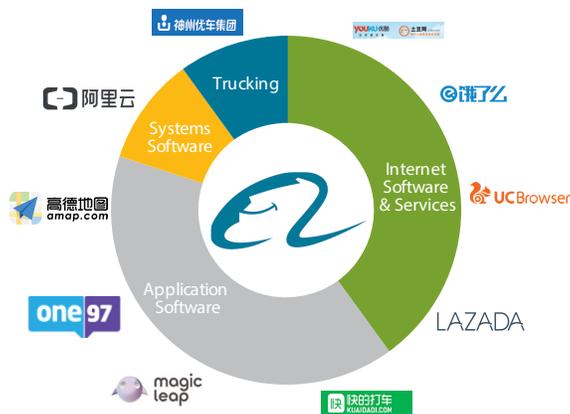
¹² Burroughs, "Gobi raises RMB fund for China start-ups", *Asia Venture Capital Journal*, September 11, 2015.

FIGURE 3 | BAT's Buying Spree (2011-2016)[†]

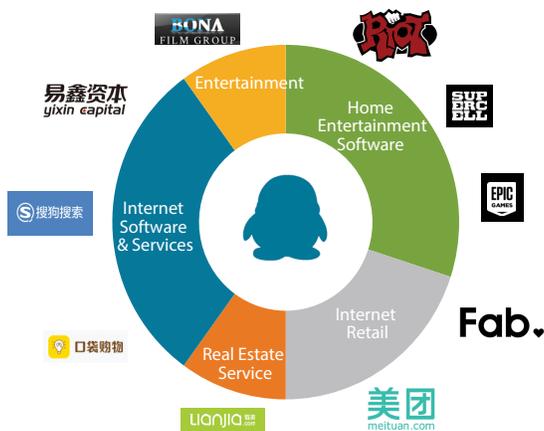
Baidu



Alibaba



Tencent



[†] Includes acquisitions and equity investments.

¹³ Zero2IPO Annual Review, 2016.

¹⁴ Yu, "China's new third board booming, but IPO queue for the main market still backed up", *South China Morning Post*, August 17, 2016.

catalysts for fundraising in China. First, the market has begun to consolidate with top tier funds attracting more capital. From 2013 to 2015 the average fund size grew 66%.¹³ Second, funding has also diversified beyond traditional VC firms such as Sequoia and IDG. Today in China first-time funds and breakaway funds abound. Founders and early employees of big tech companies have returned as seed investors. This rich ecosystem is improving the quality of deal flow—a far cry from the early days.

Exit prospects have continued to improve since the first wave of overseas listings. In 2015 Chinese VC funds made more exits through trade sales than the preceding four years combined. While overseas listings remain popular, domestic listings are on the rise—fueled by the opening of the SME board in 2005, the NASDAQ-esque ChiNext in 2009, and the New Third board in 2013. All three offer new liquidity options for onshore-domiciled funds.¹⁴ VCs' paths to liquidity have also been driven by heavy spending by strategic acquirers. In 2005, there were only a handful of US-listed Chinese companies. By 2016, more than eighty companies with a combined market value over US\$600 billion were listed on American exchanges.¹⁵ In a trend of "outsourced R&D" consistent with what has been observed in the US, Asian corporates accounted for over 30% of start-up funding in the region in 2015. Internet giants such as the BAT triumvirate spent a combined US\$75 billion on strategic acquisitions between 2013 and 2015.¹⁶ Increasingly they are buying tertiary businesses rather than building them in-house. The result is an alternative exit option for entrepreneurs. These purchases have tended to reward these entrepreneurs well, many of whom return as serial entrepreneurs or angel investors.

OUTLOOK AHEAD

The BAT strategy of acquiring R&D underscores another, newer aspect of VC in China: true innovation. Previously, China's severe underdevelopment led entrepreneurs to emulate American companies, as seen in **Figure 4**—Baidu was a replica of Google, Tencent a copy of ICQ, and Alibaba a version of eBay. Global investors dismissed China as a

¹⁵ See supra note 2.

¹⁶ Perez, "BAT – Baidu, Alibaba and Tencent – lead charge in China mergers and show no sign of slowing down", *South China Morning Post*, April 7, 2016.

FIGURE 4 | THE “ASIA-EQUIVALENTS” IN VENTURE

Sector	Existing Company	Asia Equivalent
SNS		
Micro-blogging		
Photo-sharing		
Mobile video sharing		
Mobile/LBS chat		
Mobile/LBS friend finder		
Message boards		
Video sharing		
Q&A		
Wikis		
Deal-of-the-day		
Review		
Social travel		
Pinboards		
Professional SNS		

land of copycats propped up by a robust internet firewall and tepid IP enforcement. More recently these internet companies have evolved from copying their foreign counterparts to now surpassing them in both scale and functionality. Alibaba, for example, had nearly twice the gross merchandise volume of Amazon in 2015.¹⁷ While American apps tend to focus on a single functionality—Facebook, for example, has different apps for social media and messaging—BAT aims to roll services into an ecosystem.

Tencent’s WeChat, for example, is now an integrated platform offering gaming, social media, instant messaging, payments, e-commerce and more. In a reversal of roles, it is now Facebook that is late to the game, reportedly poaching product and design engineers from its Chinese counterpart as it seeks to imitate WeChat's deep integration with users’ daily lives.¹⁸

China’s technology companies have evolved to dominate through incremental innovation; however, that has yet to translate into globally appealing, truly disruptive technologies. With the world’s largest consumer market at their doorsteps, most Chinese technology companies remain focused on localizing and growing domestically. For a hardware manufacturer with global ambitions such as Xiaomi, on the other hand, the challenge of IP means it can only sell its smartphones in other growth markets, like India.

There are signs that China’s government is recognizing that technology companies need a more robust IP regime at home before the right incentives are present to encourage disruptive innovation. In 2014, three special courts for IP rights cases were established in Beijing, Shanghai, and Guangzhou. Within its first year, the Beijing IP court accepted over 9,000 cases out of nearly 14,000 cases received.¹⁹ While challenges remain, an improved IP regime could increase VC investors’ willingness to underwrite investments in China with globally disruptive potential.

CONSUMER INTERNET

Asia's rapidly growing middle class has led to rising affluence that is altering consumer behavior. In this regard China is farther along than India and SEA, consistent with the stage in which

¹⁷ "Amazon Vs. Alibaba: GMV, Revenue & EBITDA", Trefis, April 12, 2016.

¹⁸ Young, Doug, "Facebook Inches Closer To China With Tencent Poach", *Forbes*, July 18, 2016.

¹⁹ Li, Iris, "China Establishes New Specialised IP Courts", *Deacons*, January 8, 2015.

its VC market has developed. As **Figure 5** illustrates, by 2020, China's middle class is expected to make up a whopping 71% of its population, compared to 39% in India, and 55% in SEA.

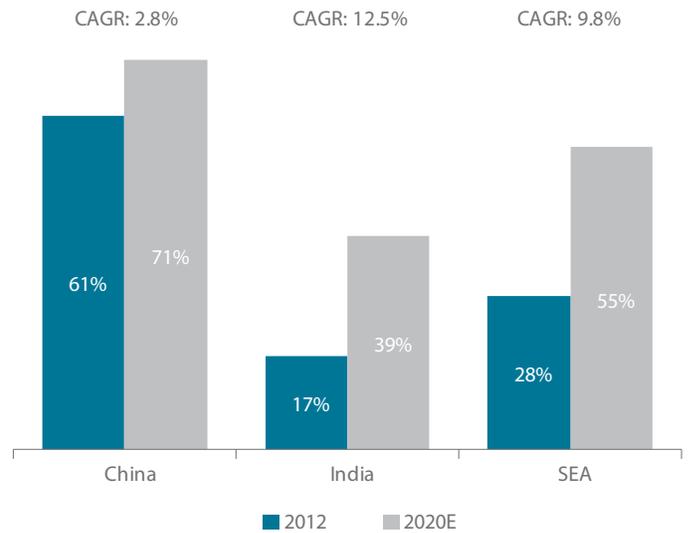
China's consumer class has grown tremendously in the past two decades. From a base of less than US\$1,000 in 2000, by 2010, per capita GDP had grown by 350%, and is projected to grow another 140% by 2020.²⁰ China's growing middle class has brought changes to lifestyle and a propensity to consume, reflecting the higher disposable incomes that are swiftly becoming an economic force.

Asian consumers are increasingly online, nowhere more so than in China. Although less than half of China's population is online, the country has the most internet users in the world. China is also the largest smartphone market in the world with a user base greater than the entire population of the US. These fundamentals for growth have underpinned robust valuations versus developed markets.

The convergence of a rising consumer class with increasing resources and internet penetration has led to the consumer internet phenomenon. Coming of age in the internet and mobile era, Asian consumers have proven more willing than their Americans and Europeans to adopt innovative methods of product and service delivery. Asia's consumer internet is part of a broader trend towards online-to-offline ("O2O") models, where start-ups use apps and other digital tools to connect users with real-world products and services ranging from door-to-door meal delivery to private car hailing. Six of the ten most valuable Chinese start-ups in 2015 were O2O-related including Didi, the car-hailing app that recently bought Uber's China business.²¹

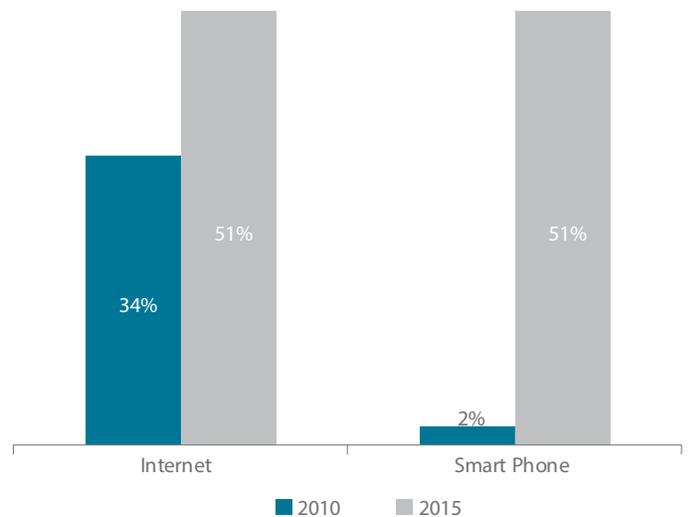
In many cases, the advent of O2O and e-commerce has proven less disruptive than it has in the US where mature and slow-growing markets have forced start-ups to seize market share from legacy players to fuel their expansion. In China and the rest of Asia, by contrast, underdeveloped traditional product and service delivery models have meant fewer incumbents to beat. The pie, though smaller, is growing much faster, with enough to go around for both incumbents and newcomers. For example, the record-setting Singles' Day in China started as an online shopping event in 2009, and has by

FIGURE 5 | MIDDLE CLASS AS % OF TOTAL POPULATION



Source: Media Business Asia, June, 2015.

FIGURE 6 | CHINA INTERNET & SMART PHONE PENETRATION AS % OF TOTAL POPULATION



Source: ITU, World Bank & United Nation population division.

²⁰ World Bank.

²¹ Carson, "The unicorns of China: 11 Chinese startups you need to know", *Business Insider*, November 3, 2015.

2015 become a shopping extravaganza involving both online and offline retailing platforms. While online sales volumes in China grew at a CAGR of 51% from 2009 to 2015, offline sales volume continued to increase at a CAGR of 14%. It would seem that the online effect added more value than cannibalizing traditional sales channels.²²

On the other hand, certain severely underdeveloped markets have also led to a leapfrog effect, whereby older technologies are almost completely bypassed. For example, credit cards did not have dominant market share in China by the time mobile payment technology came of age. As a result, China is now the world's largest mobile payment market, with transaction value more than doubling between 2014 and 2015.²³

REST OF ASIA

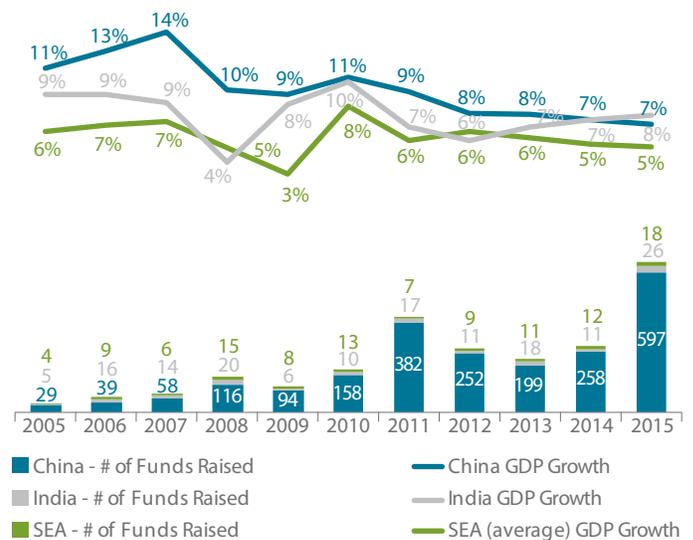
China saw US\$21 billion of VC investment last year, dwarfing the US\$1.7 billion in India and US\$0.4 billion in SEA.²⁴ Despite this disparity, investors ought to pay attention to these markets. VC investment in India last year was at the same level as China's ten years ago, suggesting a long runway for growth. Further, signs suggest that the acceleration in growth will be faster. In the same way VC in China developed faster than in the US, VC in India and SEA is developing faster than in China.

Part of the reason for supercharged growth in SEA and India is that the cycle for local talent to mature is becoming shorter. China's first wave of entrepreneurs encountered personal computers in secondary school; India's current crop of first-generation entrepreneurs likely encountered them in kindergarten. While China's first wave of entrepreneurs came to technology largely as a second career—Jack Ma, Alibaba's founder, was a schoolteacher—India's entrepreneurs are coming straight out of top, globally competitive institutions that offer courses in technology and entrepreneurship.

²² "What Can U.S. Retailers Learn from Alibaba's Singles' Day Success?", Knowledge@Wharton, November 30, 2015.

²³ Osawa, Juro, "China Mobile-Payment Battle Becomes a Free-for-All", *The Wall Street Journal*, May 22, 2016.

FIGURE 7 | VC FUNDING ACTIVITY & GDP GROWTH



Source: *Asia Venture Capital Journal* & Worldbank.

Like the early of days of VC in China, India and SEA are benefiting from capital and returnees from America and Europe. At the same time, they also gain the benefit of funding and expertise from China. Alibaba's investment in Snapdeal, its Indian analogue, has valued that company at US\$6.5 billion, while its investment in Lazada, a Singaporean equivalent, valued that company at US\$1.5 billion.²⁵ Not to be outdone, Tencent added to a string of investments in mobile

²⁴ See supra note 4.

²⁵ Purnell, "Alibaba Thinks Outside the China Box", *The Wall Street Journal*, August 12, 2016.

FIGURE 8 | MARKET MOVEMENTS

Pre-Money Valuation (US\$)	SEA	US
Seed	\$1-3m	\$5-8m
Series A+	\$6-15m	\$15-25m
Growth	\$30-100m	\$50-200m
IPO Path/Exit	>\$150m	>\$300m

Source: StepStone analysis.

gaming companies by investing in Singapore's Garena, which is valued at US\$2.5 billion. India and SEA also benefit from highly developed Singapore, which is emerging as a regional hub for entrepreneurial talent, capital, and liquidity.

Driven by the massive adoption of cheap smartphones, technology is growing even faster in SEA than in China. While China's middle class came of age in the PC era, India and SEA's are jumping straight to mobile. The region's underdeveloped IT infrastructure forces internet users to connect via mobile because fixed-line internet doesn't exist.

Although India and SEA's middle class populations are less developed than China's the World Bank expects them to expand at a much faster rate—110% to 160% in the period from 2012 to 2020 versus just 25% in China.²⁶ Similar patterns prevail across other metrics: India had an internet penetration rate of just 8% in 2010 and in less than ten years, China went from the same 8% penetration rate in 2005 to 48% by 2013; India's penetration rate is expected to exceed 50% by 2021.²⁷

Despite potential for supercharged growth, pricing for start-ups in Southeast Asia remain modest compared to those for counterparts in Silicon Valley. This reflects in part the relative underdevelopment of the VC ecosystem in the region.

On the other hand, investors have the opportunity to enter at attractive valuations and, in return for some regional risk, accessed a high return profile potential. Valuations in China have quickly caught up with those in the US over the past decade. India and SEA portend a similar trend in the future.

India and SEA's place on the development curve suggests that VC investors may be able to ride the same explosion of growth that China experienced during the past decade—a golden era during which BAT came of age, and paved the way to China becoming the world's second largest VC destination. India and SEA do not yet have these same heavyweights to lever as strategic acquirers. Nor do they have the same level of talent; sourcing certain positions (e.g., marketing and HR) is still hard.

There are the early signs of regional strategics forming, especially in China. Everyone is seeking growth, and SEA holds the next leg of growth. However, VC investment is less engrained, and the incubation and mentorship ecosystem has yet to materialize fully. Arguably capital markets are yet to reach sufficient depth. In addition, there are many local nuances. For example, India has twenty-three official languages. Despite these challenges, the trends are evident and VC investors cannot afford to ignore them.

EMERGENCE OF "UNICORNS"

The developments outlined above in Asia have resulted in the emergence of both local and foreign investors and partners who have proven their ability to create value. One tangible proxy for value creation can be seen from the rise of unicorns in Asia.

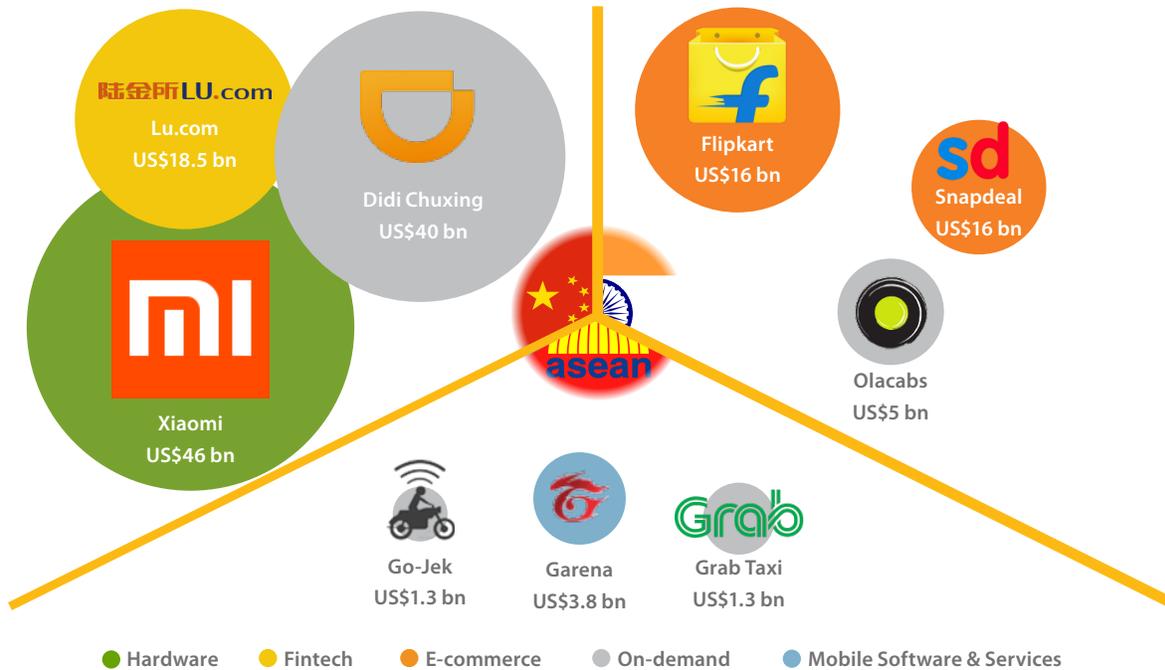
There are 168 unicorns globally, with a cumulative valuation of US\$599 billion: China accounts for thirty-two, at a cumulative valuation of US\$165 billion; India accounts for seven, at a cumulative valuation of US\$32 billion; and SEA accounts for three, at a cumulative valuation of US\$6 billion.²⁸

²⁶ Torre & Rigolini, "The Rise of the Middle Class", World Bank MIC Forum, April 19, 2013.

²⁷ "India Internet: Unlocking the Potential of a Billion Digital Users", Goldman Sachs, May 2015.

²⁸ CB Insights, June 2016.

FIGURE 9 | SELECT ASIAN UNICORNS



Source: CB Insights.

Conclusion

Over the past several years, investing smaller amounts and using capital efficiently have emerged as important strategies for VC investors. This dynamic has allowed small VC funds that focus on making operational improvements to flourish.

While seed and early stage investments tend to be the riskiest, early stage venture has also been the highest performing segment of the Private Equity market over the last two decades. Early stage rounds also make up the largest portion of the market by number of deals. In 2015, about 45% of VC deals in Asia were categorized as seed or early stage.²⁹

Relative to later stage players early stage investors tend to have more control over deal access and flow through their pro-rata rights and their ability to lead financings ahead of more competitive fundraises. To consolidate this opportunity, several Asia-focused VCs, including Morningside and Sequoia, have raised “opportunity” or “growth” funds to capture pro-rata rights of their breakout companies.

²⁹ See supra note 4.

VC investing in Asia provides the potential for portfolio diversification, as returns are increasingly driven by regional demographics and local market conditions. Earlier stage investing also allows investors to tap growth exposures not readily accessible via listed markets. While VC in Asia was previously dependent on large IPOs in America, the growth of local investment and capital markets has meant either more IPOs at home or in many cases none at all, as strategic acquisitions and additional rounds of funding increase the liquidity of the VC ecosystem in Asia.

Similar to venture investing in the US, VC in developing Asia requires a certain risk tolerance as loss ratios are higher than traditional Private Equity. The rewards, however, can compensate for this risk. Sophisticated VC investors are quickly wising up to the fast growth and enormous potential of markets in Asia, and are seeking the appropriate exposure for their portfolios.

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