June 28, 2021

RPM Ep 8 Transcript

MV: You're listening to RPM., the podcast that explores the world of private markets. I'm your host Michael Venne. For several years, we've seen promise in China healthcare. In 2017, we wrote a white paper making the case that healthcare would be the next sector to attract Private Equity capital in China. And more recently, we have published an updated report that reaffirms our conviction in the sector and explains some of the reforms that have helped it to grow so rapidly. Like any evolving market, there are things investors ought to be aware of. Here to discuss some of these factors with me today are Vincent Hsu and Zhiyao Ma, both of whom are on our Private Equity Team and based in Beijing. Vincent and Zhiyao, welcome to RPM.

VH: Great to be here.

ZM: Thank you for having us.

MV: My pleasure. Before diving in, it would be great to hear more about how StepStone is set up in Asia and China specifically.

VH: Sure, more than happy to. StepStone has been in Asia since late 2009 when our Co-CEO, Monte Brem set up the first Asia office in Beijing. Even back then, I think Monte and the other Partners were big believers in the potential of China's PE market. And fortunately for the team here and the firm, it's turned out to be the right call setting up the Asia headquarters in Beijing. Right now, we have close to twenty-five people across five offices in Asia, with the bulk of the team based in Beijing.

An important thing to point out is that StepStone has been good about putting resources to where the firm believes the investment opportunities are for our clients. And in the case of Asia, it's been China. Having a large on-the-ground team in China has really helped us keep up with what is a very dynamic and fast-changing PE market. And as our research paper talks about, it's only since 2015 that the China healthcare PE market has taken off. And if you think of China's PE market as a whole, it's really only less than 20 years old.

In terms of activity in China we use the same playbook as we do in other markets that we help our clients invest in. We do quite a bit on the primary side and are quite active on the co-investment side, which is an area where we've seen an increasing amount of deal flow over the past several years as the PE market here continues to develop and there are more control deals happening. We also see a fair amount on the secondary side, but it's important to note that a lot of these deals are VC and early growth type deals or portfolios.

In Asia overall, StepStone has been putting to work about a billion dollars a year into the market on average over the past several years, and about half of that goes to the China market. And in terms of GP relationships in China, I think we have a pretty extensive coverage of the market from sector focused VC and Growth funds all the way to large over multi-billion-dollar generalist funds.

MV: So, it's really interesting to hear how active we are in China and what our approach has been to the market. How does healthcare compare with some of the other sectors that the Team, that you guys, are looking at?

VH: Yeah, it's quite interesting how the healthcare PE market has developed here. In the early part of my career, starting in 2003, I focused on the China TMT (technology, media, and telecom) sectors, and I think a good analogy for the healthcare sector in China is how the consumer Internet industry developed here in the early 2000s.

Similar to that industry you have regulatory reforms that have really paved the way for the creation of domestic champions, although it's not to the extent of the consumer Internet industry where regulations restricted foreign players. And as we've laid out in the paper, there are a lot of tailwinds that have propelled the industry and the creation of new companies. And, similar to the consumer Internet companies, healthcare companies (particularly those focused on biotech) are getting funded almost exclusively through Private Equity capital versus any bank financing.

If I think about what we wrote in our 2017 paper to what we are seeing today, it's pretty amazing how fast the market has developed. We used our SPI database to do some analysis of the market, and in 2011, healthcare deals based on value represented only 5% of the deals we tracked. Fast forward to 2020, and that number has increased to 20%. From a return perspective, I think it's safe to say that the sector has done very well and, in many cases, outperformed other sectors in China in a short period of time, given the funding and exit environments.

MV: And as the number and size of the investment opportunities has grown, have you seen any changes in terms of the types of investors pursuing China healthcare?

VH: Are you referring to GPs or LPs?

MV: Why don't we go with the GPs first?

VH: Sure. I think what we've been seeing on the ground is that there are a few ways GPs are approaching the market. There are sector-focused GPs, which are usually more biotech focused. These GPs usually will have a team made up of professionals with science backgrounds given they need to be able to understand the science and data on the molecules and pathways they're potentially investing in. The same goes for GPs that also invest in medical devices, as they need to have professionals that understand the efficacy of the device and clinical trial data. And then there are more generalist funds, which tend to be on the larger end and now have healthcare as one of their sectors focuses. These GPs will come in at a later stage and will do control deals when available and appropriate. They'll also look at healthcare services investments, which tend to be more capital intensive.

MV: Interesting. And how are LPs investing? Is that traditional primary funds or are there secondary and co-investment opportunities as well?

VH: For the most part, it's still through primary funds. Most LPs that have exposure to the larger general funds in China should be getting some exposure to the healthcare sector, as this sector has grown in terms of capital allocation for GPs. The GP landscape is developed where there are a number of GPs that some LPs may consider more VC like, but there are also a growing number of funds that are $500 million to $1 billion or above that can be considered growth equity and even control in some case. Similar to the growing number of primary fund GP focus on the sector, we're also seeing a growing number of co-investment and secondary opportunities in the sector.

MV: Quite fascinating, Vincent. Zhiyao, my next question is for you. The Chinese government has made a concerted effort to modernize its healthcare system. Could you summarize some of the more important developments?

ZM: Sure, happy to. There are important developments on both the supply and demand side. On the supply side, the government is revising regulations to create an environment that's more conducive to innovation. The NMPA (National Medical Products Administration) is required to significantly expedite its review process for clinical trials and drug approvals. It's now required to approve or deny clinical trial applications within 60 working days.

In 2017 China joined the International Council for Harmonisation. This made it possible for the NMPA to accept data from clinical trials outside of China. This came in handy for the Covid vaccines. Because of the effective containment of the virus, China did not have the required number of patients to enroll in clinical trials. ICH membership allowed Chinese vaccine developers to leverage data from overseas. The introduction of the MAH system allows biotech companies to outsource manufacturing to CMOs and CDMOs. Biotech firms no longer need to invest in costly manufacturing facilities and just focus on what they do best. So, this trend towards specialization is also propelling drug development.

On the demand side, China has sought to reform the insurance and payment systems as more innovative drugs come to market. For example, the CBIRC revised health insurance regulations and licensing rules to diversify private health insurance supply.

MV: And that's the China Banking and Insurance Regulatory Commission?

ZM: Exactly, you're right. And then the National Reimbursement Drug List, the NRDL, which is a catalogue of treatments that qualify for reimbursement under government supported health insurance schemes, has included more innovative drugs in a timelier manner. I'd also highlight the recent public market reforms because they've really enhanced capital market access for innovative companies, especially biotech. In 2018 the Hong Kong Stock Exchange published new listing rules which permit listing of biotech issuances that do not meet the main board's financial eligibility tests. In 2019 the Shanghai Stock Exchange launched the new Science and Technology Innovation Board, and this board adopts a registration-based system, which is similar to Nasdaq's. It allows pre-profit biotech companies to go public. We think this in turn has really catalyzed Private Equity investment in China healthcare.

MV: So, I'm really glad you brought up stock markets, as you've probably seen, private market performance has been a hot topic as of late, given how well healthcare stocks have performed. The S&P 500, for example, their healthcare stock sector index has risen almost 50% over the last three years and almost 60% over the past 12 months. Why should investors invest in China healthcare through a private market vehicle?

ZM: Well, the simple answer is investing earlier can get you better returns as long as you choose the right targets. Historically in China, Private Equity has outperformed the public markets over the past 20 years. Some of the reasons for this outperformance has to do with the ability to identify and partner with solid management teams and influence the companies that GPs are investing in. I think incubation is a good example. We've observed that GPs are starting to incubate companies by investing very early and acquire influential stakes at attractive valuations. We've summarized three common incubation strategies in the paper, and these types of deals are unique to Private Equity. I would note that this is not to dismiss the public market. Like we just discussed, we are very much encouraged by the development of China's public markets. They've really enhanced our conviction level on Private Equity in China, and there is not a competition between public and private investments. Private Equity helps companies move through earlier development stages until they're ready to access capital markets. And in turn, healthy and dynamic public markets can help enhance Private Equity returns, both in terms of absolute returns and time to liquidity.

MV: And with all these reforms and the speed at which the sector has matured, grown, developed, having a local presence is critical, I should think, for investors as they try to select the fund's most adept at responding to these dynamics. Would you, Zhiyao, quickly describe some of the ways GPs have responded?

ZM: Sure. I think GPs are becoming more entrepreneurial. It's pretty common to see a GP investing across various stages and subsectors. It's challenging to define a GP as a VC, a growth stage investor, or late-stage investor. This is pretty evident in our market map in the paper. I think they're doing this for several reasons: they want to build diversified portfolios for more attractive risk return profile. For example, we know there's higher risk with biotech, but potentially fund returning results, but with MedTech and services deals, they are relatively de-risked from a scientific standpoint, but there are still complexities related to execution. Because of the different characteristics, GPs have preferred to adopt flexibility in going in and out of segments. Another rationale is to create synergies and ecosystems. For example, there are potentially a lot of synergies between biotech and CROs or CDMOs. This value is further amplified by the recent implementation of MAH system, which we just briefly covered.

MV: So, it sounds like that can make the due diligence process more complicated. What's our view on this response by GPs and kind of bridging multiple strategies to tap the healthcare market?

ZM: We generally prefer for GPs to remain focused on their specialties, but we understand that sometimes flexibility can produce attractive returns when executed with skill and discipline. As GPs expand on their strategic coverage, they need to develop and acquire talent required to navigate a more complex landscape. So, I think all of these necessitate local market knowledge and a more rigorous due diligence process.

MV: So that covers some of the ways in which GPs have adapted. Vincent, what are some of the things LPs ought to look for, when considering such a dynamic investment opportunity?

VH: Yeah, Zhiyao talked about that briefly, but I think when you're looking at the market, particularly for the LPs, how they want to view it is…the first consideration is how they are thinking about their approach to the sector in terms of stage. So, the healthcare GP landscape today is much more developed than it was in 2015, and we think it will continue to grow and develop. As Zhiyao mentioned, there are a number of flexible strategies, but there are still a number of GPs that, if an LP wants to get more VC exposure, they can focus on GPs that are focused on pre-profit and even pre-revenue biotech companies. For LPs looking to get more growth equity exposure there are a number of GPs coming in at later rounds in biotech companies, and also looking to build out more diversified portfolios and investing in medical devices and healthcare services. And for LPs that want to get a more broad exposure, they can invest with some of the larger generalist funds which have healthcare as one of their several sector focuses. The nice thing is that we feel the healthcare sector lends itself to being a fit for any LP that wants to get exposure, whether it's through VC growth and control opportunities.

And then once an LP has figured out how they want to approach the sector, then it's time for manager selection to find the right GP fit. Things to focus on are portfolio construction of the GP, whether their focus on more biotech, medical devices, healthcare services or some ancillary subsector. Another focus should be on the background of the team, how many are from science backgrounds, academia or industry, and their relevant work and investment experience. We also think LPs should spend a good amount of time looking at the prior investments done by a GP and trying to verify how the GP accessed those deals and what value they've added to those companies post investment. Given there are a number of the same investments which show up in multiple GP track records, we think it's very important for LPs to verify this info through industry reference calls.

I think the last consideration I'll bring up is what type of relationship an LP wants to and can build with a GP. For LPs looking for co-investment deal flow, it's important to make sure there is potential co-investment deal flow and in what type of companies. For LPs that are looking to get more knowledge about the market in general, it's important to gauge how much information a GP is willing to provide their LPs and how available they are for update discussions.

MV: Vincent, Zhiyao, thank you so much for joining us. Be well and I hope to speak with you again soon.

VH: Thank you.

ZM: Thank you.

MV: That does it for this episode of RPM. Stay tuned for new episodes every few weeks. And please be sure to follow us on Apple podcasts, Spotify, Stitcher, or wherever you get your podcasts. If you enjoyed this episode, please read our latest white paper, “China Healthcare and Life Sciences: Separating from the Pack,” which explores this topic in greater depth. That report, along with all our research on Asia Private Equity, can be found at www.stepstonegroup.com