Outsourcing offers prolific investment opportunities for PE: Jie Gong, Pantheon

The Chinese market, a happy hunting ground for local and global private equity firms despite the giddy valuations, continues to throw up sectors that are underinvested, and offer huge opportunities, Jie Gong, Partner, Pantheon Ventures, and a member of the Asia Regional Investment Committee and Global Coinvestment Committee, said in an interaction.

"You can think about general outsourcing as a theme for a prolific set of opportunities…This has been an area that has historically been underrepresented in the economy…This is not an area that has been as visible for PE investment as some of the more popular sectors. It has a lot of growth potential, and it is also often defensive and acyclical in its nature," she said.

Pantheon, which invests in primary funds and is active in secondary fund investments and co-investments. is among the largest private equity and infrastructure fund of funds globally, with assets under management exceeding $36 billion.

Gong, who is responsible for all aspects of Asian investment activities with a focus on China, said that PE firms could work around unrealistic valuation expectations, and buy into large companies in traditional sectors, by bringing in technology as an enabling layer to enhance operations of these cos.

"Using that approach, you can harvest the fruit of productivity gain brought home by digitalization, without the hefty valuations that are being paid to invest in some of the pure-play tech unicorns," she added.

Edited excerpts:

What are the sectors you are bullish on? Which ones do you think are underinvested, and can absorb significant amounts of capital?

I would highlight business services as a very interesting sector and see increasing opportunities to invest here. The service component of the Chinese economy has been expanding. With that, it brings a lot of opportunities for B2B services. This has been an area that has historically been underrepresented in the economy. With businesses focusing on efficiency and cost control, the business service industry has certainly expanded its breadth and took advantage of outsourcing trends as businesses want to reduce in-house costs.

You can think about general outsourcing as a theme for a prolific set of opportunities. Think about what a business does in-house - not everything is within its core competency. Businesses need to prioritise their resources in areas where they are most productive or have a competitive advantage. There are other functions that are necessary but are better done outside of the business. This gives rise to opportunities for third-party players to focus on execution of specific functions.

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The new age digital companies have received a lot of attention from investors, but traditional PE players still seem to be cautious about it. In China, it is BAT (Baidu, Alibaba and Tencent) that are doing many of the big M&A deals. While these companies are attractive, why are the traditionally large PE players not participating and only watching from the sidelines?

I think PE firms are focused on a large range of opportunities that are not pure-play technology investments. It does not mean they are not using digitalisation tools to empower traditional businesses to improve their efficiency, or to enhance their reach. I think the difference is that these companies are in manufacturing or services. They are not intrinsically technology businesses. Technology is just an enabling layer in their operations. Using that approach, you can harvest the fruit of productivity gain brought home by digitalization, without the hefty valuations that are being paid to invest in some of the pure-play tech unicorns.

What's your take on valuations? For about 2-3 years, there has been a talk of corrections happening, but we've not seen a major round of corrections in China for a bit. Why has that been so?

On valuations, the reality is a lot more complex than what you see by glancing at headlines of some of the highly visible companies that make news or are having IPOs. The market is anything but uniform. It requires an approach to dig deeper into the opportunity universe rather than focusing on the hottest sub-sectors and looking at the most prominent names within these sub-sectors.

We have seen players with industry expertise or with a combined credit and equity approach look for opportunities that create a solution for an issue faced by companies and thereby getting themselves in as shareholders at an attractive valuation.

Does that mean GPs now have to do far more than just bring capital? You mentioned how they are bringing solutions and entering companies at attractive valuations. Are companies increasingly evaluating what are the pre and post deal value-adds that a GP can bring in when raising capital?

That conclusion is right. The GPs need to evaluate what they can bring to the table. The GP should march to his own drum and accentuate its unique strength to create advantaged entries into deals.

I think the markets have always been competitive, and GPs need to understand their sweet spot and why that is a sweet-spot for them. That creates differentiation – be it specialization or particular skill sets that they bring, and this has been true for the last 10 years. About 10 years ago, we saw generalist companies dividing their teams into specific verticals. For the last 10 years, we've seen GPs building their operating team and hiring the right experts to enhance their capability in not only due diligence but also in adding value to particular types of companies.

What are Limited Partners looking for in Asia? Today, LPs have a wider range of GPs to choose from – so, do they want to go with GPs that have an established track record, or do they have a risk aptitude to support first time funds? Do they prefer GPs who do only certain sectors, or do they want to partner with GPs that allow co-investments?

For LPs, there are many considerations – if you boil it down, it is about risk-adjusted returns, and if you boil it down further, it is about risk-adjusted realized returns. If you look through these three dimensions, first it is about how if the investment is intrinsically risky, what types of risks the GP takes, how it mitigates or contains these risks.

Returns – what have been the historical returns, how they have achieved these returns, if the returns are sustainable, what is the depth of opportunity set for the next 3-4 years.

Realised – what has been the liquidity track record, if this is an area or strategy that is conducive for realizing liquidity, how mindful is the GP in exploring all avenues of liquidity to generate returns.

Sticking with returns, how have exits been in China?

The last year has been a strong year. Overall, the equity market has been very supportive across the board. Hong Kong has had a great year. The US IPOs for Chinese companies have been strong. All in all, the exit environment has been kind to the GPs in 2017 and year-to-date 2018.

By Joji Thomas Philip

IMPORTANT DISCLOSURE

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