China or India: Which Is the Better Long-term Investment for Private Equity Firms?

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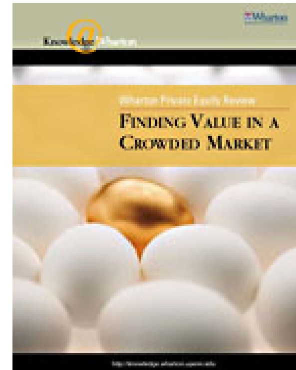

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India and China are both vast countries just opening to development, filled with opportunity and risk for private equity investors. Inevitably, the two countries' rising economic fortunes invite debate over which offers the better climate for investment.

At first glance, India might not seem the safer bet, with its pitted roadways, tainted water and visible, widespread poverty. Yet those outward signs obscure solid underpinnings for economic growth, including a democratic government, a strong education system, widespread knowledge of English and a deep pool of expatriates experienced in Western businesses, according to Wharton faculty and experts in emerging market private equity.

Cheap labor and foreign direct investment have made China the world's manufacturing powerhouse under a government that has embraced Western-style capitalism. China has provided spectacular private-equity returns in recent years, but, the experts note, weaknesses in China's legal system and the possibility of political instability remain concerns for investors.

"Clearly there's enormous private-equity opportunities in both countries," says Wharton finance professor Jeremy Siegel.

Valuations Matter

As for the better investment climate long-term, Siegel sides with India. He says the country's "soft" attributes, such as a democratic government and a free press that is rooting out corruption, outweigh China's more impressive investments in "hard" infrastructure such ports, plants, and transportation systems.

Siegel notes that he is also concerned about China's system of "guanxi" in which business is conducted more through elaborate networks of relationships than on merit. The willingness of Americans to let an entrepreneur succeed, regardless of his or her social or political connections, has been the cornerstone of U.S. economic success, he points out. "People with Chinese connections can do a lot, but I'm cautious about the whole question of whether the contracts written would be upheld with the wider amount of certainty that they would in India."

That said, Siegel adds a final twist that might steer investors toward China, at least in the near-term -- relative valuations. India's Sensex 30 -- that country's version of the U.S. Dow-Jones Industrial Index -- broke through 10,000 in February, up from 3,300 in December 2002. The price-to-earning ratio for India stocks is 21, while Chinese stocks on the Hong Kong Exchange are selling for 15 times earnings. In private equity, firms invested $2.3 billion in India in 147 deals last year, up from $1.6 billion in 68 deals the prior year, according to Venture Intelligence India.

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"India's edge is no secret and future returns will not match the stellar gains of the last three years," Siegel states.

Vivek Paul, a partner at Texas Pacific Group and former vice chairman of Wipro, the Indian technology and services firm, is also focused on valuations. He notes that while Chinese private equity investors are now enjoying an uptick, they have weathered earlier declines. Indian investors have yet to taste a downturn. "You have a more realistic hands-on valuation in China. In India it's only been up for the last three years."

A False Debate?

Paul believes that the major difference in investing in India and China lies in the industry sectors. In China, he says, deals flow across multiple industries, from auto dealer consolidation, to cell phone gaming companies, to medical leasing, while in India the focus is almost entirely on technology and services. India is developing some retail financial service businesses, he said, but China's consumer economy is more advanced.

His concerns for the markets are not tied to either country. He says that emerging market premiums are low relative to historic levels, creating systemic risk if economic collapse in another part of the world creates a contagion effect.

Rahul Bhasin, managing partner of Baring Private Equity Partners, believes that despite differences in the two countries, both will continue to benefit from globalization. "There has been a lot of hullabaloo about off-shoring and outsourcing, but the bottom line is, it is a globalized world," he says. "People will work harder for less in markets like India and China, and you are going to find most production work moving to these countries. There will be a shift in consumption globally from what is the developed world into the underdeveloped world. And it will happen faster than it has ever happened before."

The debate over which country is the better venue for investment is less important than knowing how the strengths and weakness of each nation would impact a specific investment, according to Stephen Sammut, Senior Fellow and Lecturer in Wharton Entrepreneurial Programs and Health Care Systems. Sammut made his comments while moderating a panel discussion titled "China vs. India: The Smarter 5-Year Investment" at the Wharton Private Equity Conference.

"The view of the two countries as being rivals in a war to procure more investment capital for either buyouts or venture capital is an entirely incorrect way of framing or charting what's going on," Sammut pointed out. "In fact they represent extraordinarily different markets on many levels."

First, he said the nature of entrepreneurship in India is different than in China because large numbers of Indian entrepreneurs have been able to work abroad as expatriates in many roles. "This will be manifest in the kinds of businesses they develop, particularly in information technology, and the pace with which they're going to be able to have technologies migrate from India." He also said India has an advantage in healthcare including biotech, pharmaceuticals and telemedicine, but he expects China to catch up rapidly.

The true promise of both nations, he added, lies in developing their internal markets. "There are rapidly emerging middle classes in both countries, hundreds of millions of people who are going to seek the same kind of standard of living as everyone else in the world," he said.

Bullish Long Term

Other panelists working in private equity in India and China laid out pluses and minuses in the two markets during the Wharton conference, which was titled "Driving Returns: Value Added Investing."

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Mukund Krishnaswami, managing director of Krilacon Group, an investment firm based in New York and Philadelphia, agrees with Siegel about the current investment climate in India. "Long term, I'm a very big bull on India. India is a country where they've done so much wrong in the last 45 years. Yet despite all that there's so much that is good going on that if they just get it right, the opportunities [will be] fabulous in 25 years," he said. "In the short-term, I'm quite a bear. I think the risk premium just isn't there in most assets to be spending a lot of money [in India] today."

Krishnaswami advised investors to follow the broader economy, not the trends that are hot today, including information technology or real estate. "Look for derivative areas of economic growth and take a 12- to 25-year horizon. Those who do will be fairly compensated for the risk they're taking."

Panelist James Hahn, CEO of Global Venture Network and managing partner of China Private Equity Partners with operations in Hong Kong, said an overflow of foreign capital could hurt private equity returns in China, but he does not see that happening until after the 2008 Olympics or the Shanghai World Expo in 2010.

Chinese companies with good management are growing at a rate of 30% internally and 30% globally, Hahn said. "A good company operating in a good macro is a formula for success." He said there are at least 3 million privately owned companies in China. Of those, his firm believes 300,000 would qualify to list on NASDAQ or NYSE today. One percent of them, or 3,000 companies -- "jewels" that have sound management -- comply with Sarbanes-Oxley, and could be scaled up.

Hahn noted that his firm invests only in companies with management that operates under U.S. rule of law and accounting standards. "We will spend time with any Chinese CEO who has made the first step by showing his or her commitment to the process by having the company audited under U.S. GAAP rules. We are betting on the current quarterback."

He said that while returns for the best performing 10-year private-equity funds from 1986 to 2003 were 12%, and 11.9% for hedge funds, the maturation of U.S. private equity is now generating mediocre performance mimicking money market returns. Many U.S. investors are happy to find a 5% return, he noted. In China, today, the average investment is $5 million for a 30% stake in a Chinese growth company grossing $10 million with net income of $3 million and a pre-money valuation of $15 million, or 5 times net income. Comparable U.S. public companies in the same high-growth sectors such as healthcare, media, and education are trading at price-to-earnings ratios of 25 times. Buying low and selling high has delivered a minimum return of 100% a year for a five-year, $100 million size fund in China, said Hahn.

"This 'PE arbitrage' has delivered extraordinary performance. We're achieving that and everybody we know in China is achieving that," he said. "It's just the way things are today until the markets become more efficient."

Xiaojun Li, principal at IDG Venture Investment, remarked that he is bullish about China over the long-term because of its growing middle class and potential as a consumer market. He pointed out there are more Internet users and engineers in China than any other country, and that China also has a strong entrepreneurial culture. "You need to be patient," he said.

Li added that although some analysts have predicted China will eventually rival India in the service sector, he does not see that happening. He said that while there is some outsourcing of services for Japanese companies in China, manufacturing will remain China's key sector.

Evolving Capital Markets

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Conference panelist Seth Freeman, co-founder and CEO of EM Capital Management, described how in India his firm uses quantitative tools to sift through the country's 7,000 listed companies in search of opportunities. Freeman noted that in India, many listed companies act more like privately held firms because they are under tight control, usually by founders.

"I think the global private equity investor really has to dig deep to understand the motivation of the founder-managers," said Freeman. "Our strategy is find and choose companies that are willing to embrace global corporate governance and other buzzwords that will create more liquidity in their stocks."

Freeman said Singapore has set out to become for India and surrounding countries what Hong Kong has been to China. "There are other Asian investors clamoring to get involved in India, as well as the Japanese who are becoming increasingly interested."

During the World Economic Forum in Davos, India made an all-out push to promote itself as a business-friendly environment for investment. In a move that seemed timed to coincide with the forum, the government lifted limits on foreign direct investment. The most notable change was in the retail sector where outside firms selling a single brand, such as Nike, will be allowed to own a majority stake in Indian stores. The cabinet also decided to lift the limit on foreign direct investment for the development of airports, mining for diamonds and other precious stones, and power trading.

Still, India trails far behind China in foreign direct investment, with just $5.3 billion in 2004 compared to $55 billion invested in China. "Foreign direct investment has been slow in India compared to China, and they are interested in getting that up," according to Siegel.

Local Partnerships Are Key

One stumbling block has been property rights. While the Indian legal system offers more protection of property rights than China, it does not do so with great speed, said Krishnaswami. "India has exceptional property laws," he said, "but if you have to enforce them you're dead." Krishnaswami said a court case takes seven to 10 years to complete. Bankruptcies can take three to four years.

Freeman said in this environment local partnerships are crucial. "You really have to know who you are getting into business with. If the locals don't have confidence in the local legal system, it's crazy to think that foreigners will," he said. "Local market expertise is critical. To be successful you can't overlay your U.S. or Western European private equity experience in these markets."

Li noted that despite China's reputation as a haven for intellectual property pirates, the country is now taking those complaints seriously. "My long-term prediction is that intellectual property protection is going to get better," he said.

Both countries have recently signed onto the World Trade Organization's Agreement on Trade-Related Aspects of Intellectual Property Rights, or TRIPS accord, but Sammut said it is too soon to tell how soon the emerging countries will comply. "Both countries have had very rapid changes in the underlying policies and laws that make Western-style transactions possible. Both have only recently embraced TRIPS, so the judicial infrastructure is going to have to evolve quickly. If the Western experience is a prologue, it's going to take a decade or more for that to reach functional maturity."

Venkateshwaran Raja, India head of Deutsche Bank Real Estate Opportunities Group, said that until the Indian government began to liberalize financial rules, including limits on foreign investment in the early 1990s, the country's real estate industry languished. Since then, sustained economic growth, a decline in interest rates and a growing middle-class employed by the service sector have created a real estate boom.

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"In the last 10 years there has been a confluence that is making the real estate market exciting now," said Raja. "In the last few years, as government loosened the barriers of entry to real estate, combined with a supply of funds from domestic and foreign sources, the level of quality in the market has increased."

Real estate is cyclical, he stressed, and predicted a correction will take place, but he said India is not vulnerable to the kind of real estate crash experienced in the United States after the 1980s building glut. "Growth in the real estate market may appear disorganized from the outside," he said, "but there has been progress internally."

Meanwhile, in China, members of the Shanghai banking regulatory administration have suggested excluding real estate loans from government control measures initiated last year to cool the property investment sector. Last year, bank financing for real estate, which accounts for nearly 50% of the banks' credit business, dropped 80% from 2004 levels. At the same time, overseas banks increased their real estate credit business by 14.4%.

Banking and finance is a critical concern for private equity investors in both developing countries, according to the Wharton conference panelists. Freeman said he is optimistic about the future of banking in India and said it is likely to become like Mexico, where a large number of banks are owned by foreigners. "That puts pressure on the local banking system to take more proactive steps to keep their books clean. You'll see more Chinese and Indian banks wanting to attract foreign banks over time . . . and that will change competition in the local banking system."

Hahn said the financial structure in China suffers from a lack of mid-tier capital providers, and big Wall Street firms are not interested in smaller deals in China that don't generate massive fees. "The optimum size of a foreign private-equity fund in China today is $200 million," he said. "There are mega-billion-dollar hedge funds flocking to open an office in Hong Kong, but they are unable to deploy their capital efficiently."

Note the Exits

At the Wharton conference, Sammut stressed the importance of an exit for all private equity investments. He said Indian companies are more strongly linked to U.S. firms than their Chinese counterparts, noting a large number of Indian companies that are co-based in the United States. Investors in these firms can exit through a U.S. sale or initial public offering. Chinese firms, he said, may replicate this pattern in the future.

Krishnaswami noted that while it is easy to invest in public companies in India through transactions that are similar to a purely private deal, it can be difficult to exit. The Indian public markets, he said, lack liquidity and many Indian companies are thinly traded in markets controlled by powerful local brokerages. "It's tough to get out of even a public company," he remarked.

The Indian market did show its ability to absorb some exits, however, when the international private equity firm Warburg Pincus sold a $560 million stake in Bharti Tele-Ventures, India's largest publicly traded mobile telephony company, last year. The transaction, on the Bombay Stock Exchange, was the largest block trade ever on the Indian market. It was also consummated in a breathtaking 28 minutes, prompting stock market observers in India to remark on the unexpected depth and maturity of their equity markets.

Hahn pointed to a number of successful exits by Chinese firms. Chinese venture capitalist Golden Meditech invested $5 million in China Medical Technologies, which went public in August 2005 on the NASDAQ. That $5 million investment is now valued at $280 million, an estimated return of 70 times its investment in 30 months.

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But private equity is no different than any other investment in which returns are nothing without risk. Sammut asked the panelists what unexpected or unlikely events could rock the markets in India and China.

Li pointed to healthcare or the environment as possible trouble spots for China. Krishnaswami, too, pointed to environmental concerns in India. "The problem in India is not political," he said. "It's clean water."

Hahn said the greatest risk to China is a collapse on Wall Street that could come as a result of any number of potential problems, including a U.S. real estate bubble, healthcare crisis, a rapidly aging population or a sustained decline in innovation. "If the U.S. stock market loses value and this affects global valuations including those in China, then we all lose."

Demographics will also shape the future of India and China, as increasingly aging populations loom over the economies of North America, Europe and Japan, according to Siegel. China's one-child policy will cause it to age more rapidly than India, leaving China to face the problem of too many retirees supported by a shrinking pool of workers. By mid-century, India's most populous age group will be 40 to 50, while in China it will be 55 to 65, Siegel notes, citing United Nation figures.

Sammut said the key to successful private-equity investments in both countries depends less on what happens in New York, London, or other financial capitals than in dusty, developing villages in both India and China. "The wild card is how quickly their own internal markets will develop."

And in an increasingly complex world, evolving at an ever quickening pace, any gap between the two is not likely to last long. "In certain sectors [India] is probably a more inviting place for investment at the moment," said Sammut, "but the gap over China in the business context will not be meaningful for much longer."

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