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ALTERNATIVE THINKING ABOUT INVESTMENTS

New China Perspectives

Welcome to the weekly issue of Morgan Creek's ***New China Perspectives****. It is comprised of research from Morgan Creek's China-based investment team together with curated articles of interest. In addition to timely political and economic news covering greater China, Morgan Creek's China team seeks to provide in-depth perspectives on investing in the technology, consumer and healthcare sectors in the region. Our research leverages the "on the ground" insights of our team together with Morgan Creek's decades-long experience in covering the region. Our team are focused, thematic investors primarily covering the technology, consumer, and healthcare sectors and investing in private companies and early-stage managers with deep local expertise. To learn more about our team and investment offerings, please email* chinateam@morgancreekcap.com.

Best Regards,

Mark W. Yusko

Mark W. Yusko
CEO & CIO

NOTES FROM THE BUND[1]

This is the second installment of a three-week discussion on the China SaaS industry, focusing on the challenges we have observed in the sector. In the prior newsletter, we discussed investor optimism towards the rapid development of SaaS businesses in China, which so far has yet to materialize. In this issue, we aim to analyze the reasons behind the disparity, and discuss:

- The higher valuations of private SaaS businesses in China compared to their public counterparts
- The difficulties of scaling many Chinese SaaS businesses
- The structure of the customers in the industry which influences the ability and willingness to pay for these services

As illustrated in the chart below, China's public SaaS companies have seen significant revaluations once listings have occurred, leading to price inversion between private and public markets.

Table 1: Comparison of China SaaS valuations in the public market [2]

Market Listed Market	IPO Avg. P/S	Current Avg. P/S (as of 3/31/2022)	% Change
US	802.8x	5.1x	-99%
Hong Kong	18.9x	2.0x	-89%
China	15.5x	8.1x	-47%

The price to sales ratio is currently a key valuation metric as many companies have yet to achieve profitability. A large proportion of the SaaS developers came into the China/HK market with a P/S generally over 25x. On the other hand, on average, these SaaS companies are only showing a 2% 3-year CAGR in revenues while their US comps are showing 16%. The average Chinese SaaS company has been publicly trading for 7 years.

The difficulty in scaling revenue for Chinese SaaS companies as compared to their US counterparts is due to the different customer profiles. In China, there are generally three categories of customers: **State-owned enterprises** ("SOEs"), **large private enterprises** ("POEs") and **Small and medium-sized enterprises** ("SMEs").

At the end of 2020, there are over 42 million SMEs in China, representing 98.5% of the total number of companies, roughly 460 thousand SOEs account for 1.1% of companies and POEs are 0.4% of the balance.[3]

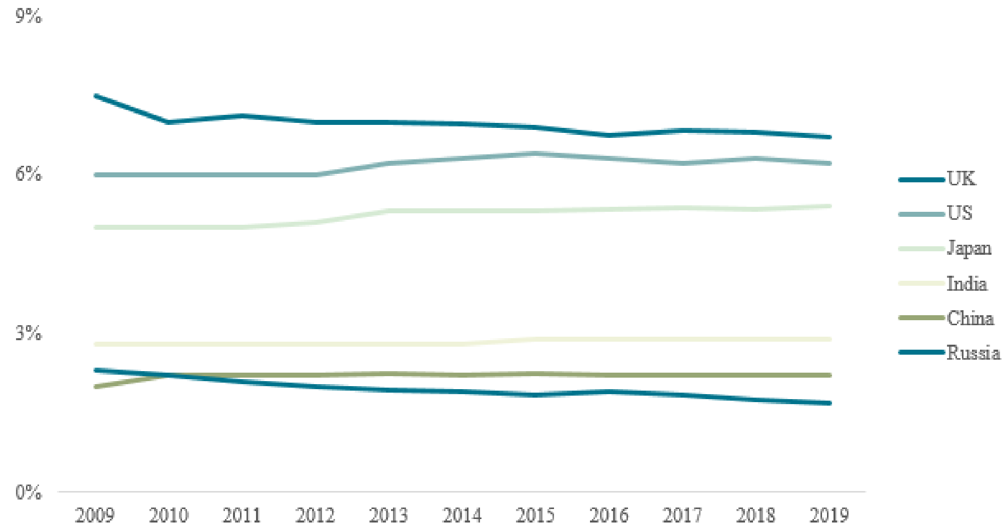
SOEs are not structured to optimize for efficiency. They have an average return on assets ("ROA") ratio of only half of their private peers[4], as they do not have to compete in the open market. As such, the motivation for them to upgrade their existing IT systems and leverage SaaS for their business operation is low. To the extent they do purchase add-on SaaS, they expect customization and due to data sensitivity, storage is usually on premise in a private cloud, which negates the cost advantages of a SaaS business model. Thus, the willingness to buy is quite low for this type of customer and the projects are typically time-consuming and not scalable.

POEs usually have a mature IT system and clear demand for a specific product function. Many of these are the Internet B2C companies we mentioned in the prior newsletter that do possess the ability to self-develop their own tools. SaaS companies, in an effort to gain a flagship client, often offer free services and customized features. As a result, revenues contributed by this category can (and usually are) relatively small.

The average life of SMEs in China is only 2.9 years, and only less than 7% survive for over 5 years[5]; this compares to about 8.5 years lifespan in the US. [6] SMEs are engaged in intense competition as many markets they operate in are fragmented and as such, the focus is on increasing market share, as opposed to maximizing operating efficiencies. The hyper competition in China makes the bar to sell to SMEs extremely high as the ability to pay is a challenge.

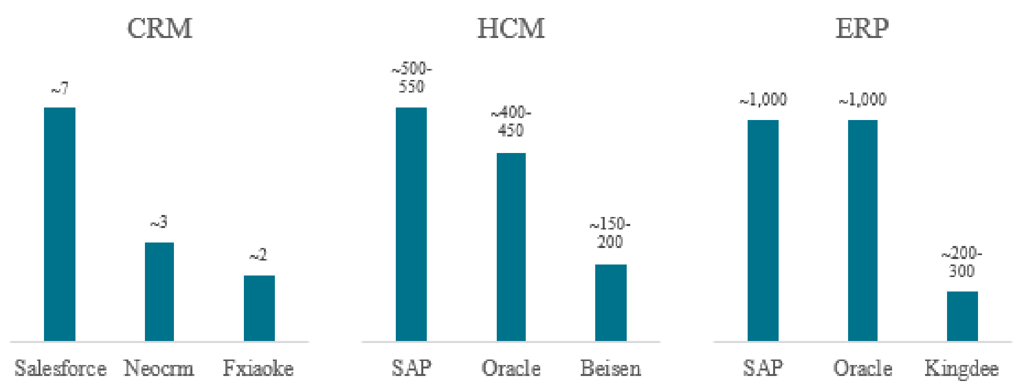
As a result, China lags the US in the level of its IT spending. For Chinese corporations, SaaS tools only account for 1.3% of the total IT spending while the number is over 6% for the US and UK.

Figure 1: Enterprise IT spending as % of GDP [7]



The condition further leads to SaaS developers' poor pricing power. The pricing of an international product is generally 3-4x higher than local players. This is true even for established global developers like Microsoft Office, which is offered 25% cheaper in China.

Figure 2: Examples of SaaS tools pricing disparity in China
(2019, China, RMB'000/SME/yr)



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CHINA NEWS SPOTLIGHT

China's shipping industry readies for surge in demand as Shanghai restarts its export machine: China's shipping industry is bracing for an uptick in demand and freight costs as manufacturing activity in Shanghai roars back to life following the end of a two-month lockdown. The Port of Shanghai is the world's busiest in terms of container throughput and a major gateway for goods produced in nearby manufacturing hubs. *Read More.*

3 Chinese astronauts arrive at Tiangong space station for 6-month stay: China's three-person Shenzhou 14 mission arrived at Tianhe, the core module of the under-construction Tiangong, early Sunday morning (June 5), about six hours after lifting off from Jiuquan Satellite Launch Center in the Gobi Desert. The capsule docked to the Earth-facing port of Tianhe at 5:42 a.m. EDT (0942 GMT), according to a Weibo post from the China Manned Space Agency. *Read More.*

China's EV 'New Force' Weltmeister Files for HK IPO: Chinese electric vehicle maker Weltmeister Motor submitted its prospectus to the Hong Kong Exchange for an IPO. Haitong International, China Merchants International and Bank of China International were the joint sponsors of the deal. *Read More.*

Amazon is closing down its Kindle store in China: Amazon stopped supplying retailers in China with Kindle e-readers and will close down the country's Kindle eBook shop, *Reuters* reported based on a post made to the company's WeChat account. Starting June 30th, 2023, users will no longer be able to buy digital Kindle books in China, while Amazon will pull its Kindle app from Chinese app stores one year later. *Read More.*

HUTCHMED Announces TAZVERIK® Approved to be Used in Hainan Pilot Zone in China: HUTCHMED (China) Limited (" HUTCHMED ") (Nasdaq/AIM:HCM; HKEX:13) today announces that TAZVERIK® (tazemetostat) has been approved by the Health Commission and Medical Products Administration of Hainan Province to be used in the Hainan Boao Lecheng International Medical Tourism Pilot Zone ("Hainan Pilot Zone"), under the *Clinically Urgently Needed Imported Drugs* scheme, for the treatment of certain patients with epithelioid sarcoma ("ES") and follicular lymphoma ("FL") consistent with the label as approved by the U.S. Food and Drug Administration ("FDA"). *Read More.*

Innovent and IASO Bio Jointly Announce the NMPA Acceptance of the New Drug Application for Equecabtagene Autoleucel for the Treatment of Relapsed and/or Refractory Multiple Myeloma: Innovent Biologics, Inc. ("Innovent") (HKEX: 01801), a world-class biopharmaceutical company that develops, manufactures and commercializes high-quality medicines for the treatment of oncology, autoimmune, metabolic, ophthalmology and other major diseases, and IASO Biotherapeutics ("IASO Bio"), a clinical-stage biopharmaceutical company engaged in discovering, developing, and manufacturing innovative cell therapies and antibody products, today jointly announced that the China National Medical Products Administration (NMPA) has formally accepted the New Drug Application (NDA) for Equecabtagene Autoleucel (Innovent R&D code: IBI326□IASO Bio R&D code: CT103A) , a fully human anti-B cell maturation antigen (BCMA) chimeric antigen receptor (CAR) T-cell therapy for the treatment of relapsed and/or refractory multiple myeloma (R/R MM). *Read More.*

[1] The Bund is a historic waterfront area in central Shanghai, where Morgan Creek's office is located. From the 1860s to the 1930s, it was the rich and powerful center of the foreign establishment in Shanghai, operating as a legally protected treaty port. The picture above is part of the historical waterfront.
[2] Source: Wind
[3] Source: China Briefing
4Source: Wind
[5] Source: SPDB International
[6] Source: The New York Times
[7] Source: https://www.weiiq.com/32199.html