

MORGAN CREEK

CAPITAL MANAGEMENT

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@morgancreekap.com.

Best Regards,

Handwritten signature of Mark W. Yusko

Mark W. Yusko
CEO & CIO

NOTES FROM THE BUND¹

This is the final installment of our newsletter exploring the reasons behind the difficulty of growing SaaS businesses in China. In the prior newsletter, we had discussed the structure of customers as an important reason behind this, highlighting that it is due to the different customer profiles from the US with the SaaS industry in China facing customers with a:

- High degree of demand for customization from large customers (state-owned enterprises ("SOEs" and large private-owned enterprises ("POEs"))
- Low willingness to pay for tools from small-medium enterprises ("SMEs"), resulting in
- Low pricing power by SaaS companies

In this newsletter, we will delve deeper into the current Chinese enterprise services ecosystem to analyze other components that might explain why SaaS businesses have had a difficult time scaling to date compared to their US counterparts. We do so by functionality below.

It is important to remember that the sole purpose of any B2B business, including SaaS, is to create value for customers. There are generally three ways they may do so, by helping customers:

- Increase revenue
- Decrease costs and/or
- Increase user experience

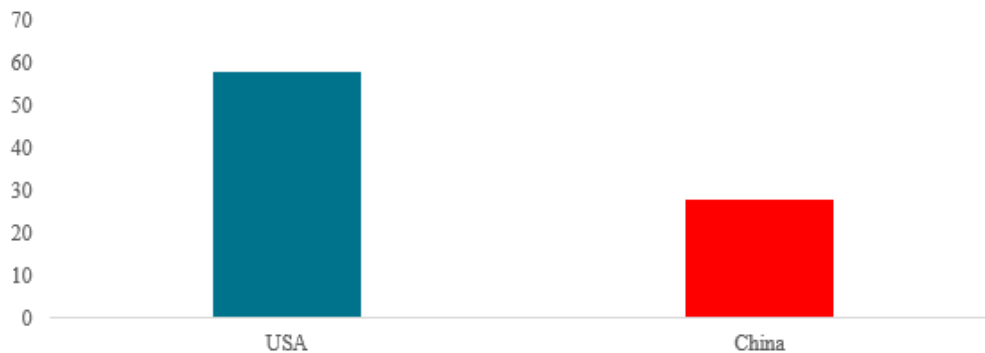
Table 1: Categorization of SaaS by function

SaaS Function	Characteristics	Willingness to Pay	Target Customer
Revenue increase	The metric is straightforward and can be easily quantified	High	SMEs
Cost reduction	The metric is straightforward and can be easily quantified	Medium	POEs.
Increase user experience	User experience is a qualitative measure and can be difficult to quantify	Low	SOEs/POEs.

Increasing revenues

The most valuable SaaS companies are closest to transactions, helping business acquire more customers and revenues. One of the challenges that Chinese companies face across many traditional industries is the low levels of digitization as compared to their US peers. As illustrated below, China’s digital economy is currently only half that of the US.

Figure 1: Digital Economy/GDP - USA vs. China²



Much of the data in these Chinese industries is haphazardly collated offline and may be costly to obtain. For Chinese SaaS companies to prove they can add value to their customers, they need access to readily accessible data. This is a catch-22. As a result, many Chinese SaaS companies have to first find an appropriate “entry point” to convince customers (many of whom may not have used enterprise service products before) to adopt their solution. Even if they are successful in onboarding customers, this only allows them to begin migrating data online and there remains a significant time lag for them to amass sufficient data to demonstrate their value to customers.

This is in contrast to US SaaS businesses, whose customers have already largely adopted prior generation enterprise services and where any required data is already available digitally and easily retrievable. Their US counterparts can immediately hone in on an existing problem and begin to prove that they have a better and/or cheaper solution.

Reducing costs

One of the reasons many SaaS companies can prosper in the US is America’s relatively high wages, which allows companies the ability to create value by significantly reducing labor costs and thereby charging higher prices for their services. Compared to the US, China’s labor costs are low. For example, the minimum wage in Shanghai is \$3.5/hour vs. \$15/hour in California, or a difference of 4.3x. Therefore, the hurdle to creating value via cost reduction in China is much higher than in the US, and the resulting demonstration of cost reduction can take a much longer time.

Increasing user experience

Of the three ways for SaaS businesses to add value, this may be the most challenging, as “user

experience” is not easily quantifiable and unless the purchasing officer is a “user” it could be difficult for them to understand the value of the product to justify a purchase.

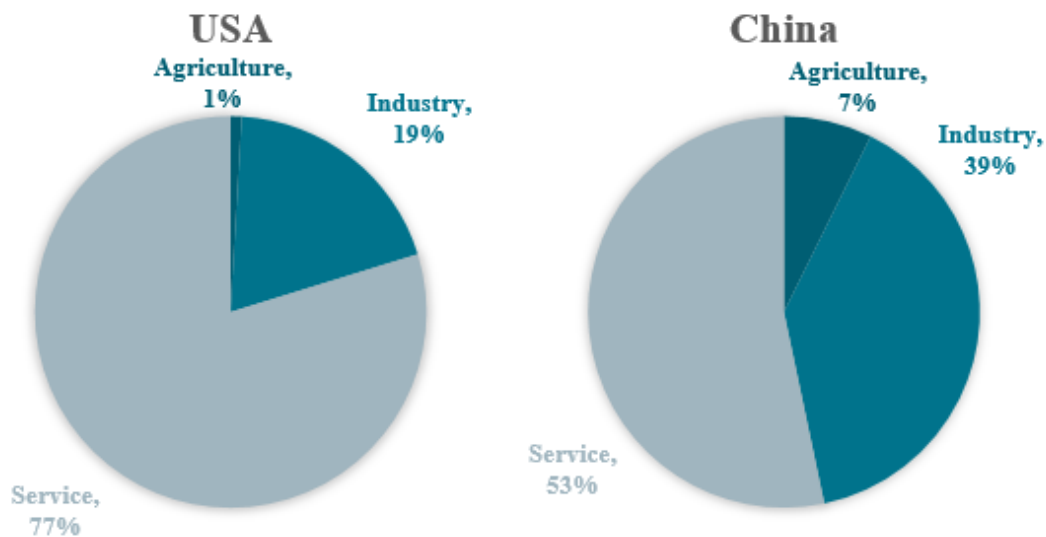
Examples of successful US SaaS companies include the likes of Zoom and Twilio. Zoom [NASDAQ: ZM], founded by an ex-Webex engineer, was built to be a “better Webex”: a simple (join via a link with no app download necessary) and seamless (good quality streaming with no dropped calls) product. Zoom scaled by targeting individual users with a freemium product, who after becoming converts, pushed to have their employers switch to its product.

Twilio [NYSE: TWLO], whose advertising tagline is “Ask your developer” [about them], had a similar initial model. Its user (and initial targeted customer) is the individual software developer, whose work is expedited by its functionality. After becoming converts, the developer would then push to have their employers onboard Twilio.

These “grassroots” sales tactics from the employees up the value chain have proven effective in the US, but face a more difficult challenge with top-down, founder (or state) driven enterprise customers in China.

While part of this disparity could be attributed to differences in management culture, important to note also is the difference in the economic structure of both countries. The US is largely a services-dominated economy as compared to China, whose economy is manufacturing-led. The value proposition and purpose for developing tools for service providers are quite different from that of a factory worker.

**Figure 2: Distribution of GDP across economic sectors
USA vs. China³**



Given the current disparities between the US and China in economic structure, customer profile and levels of digitization across industries, it is likely that China’s path toward enterprise services development would differ from that of the US. That said, the key to evaluating successful businesses remains similar.

Ultimately, the customer’s decision to purchase a tool is rational: if the value provided by the SaaS company exceeds the cost charged, then the purchase occurs. As such, the two most important determinants are its value creation and the overall cost of providing that service:

- **Value creation.** Having an experienced team who truly understands the industry they are serving and can identify pain points is critical. Selecting the right problem to solve (one in which customers are willing to pay the problem to go away) is half the battle won. Also

important is the team's breadth and depth of resources to systematically acquire customers to monetize that value.

- **Cost of providing the service.** This is highly dependent on each individual subsector and the inherent readiness of that ecosystem. This includes, for example, the cost of obtaining inputs like data – how drastically do you have to change user behavior and how difficult is it to educate the user to use your solution, etc. Also important is the structure of customers in the industry – are they mostly comprised of SOEs and POEs which likely have high customization needs (and thus may be low margin customers) or SMEs where there is potential to provide a standardized product? For instance, Youzan [HKG: 8083] and Weimob [HKG: 2013] are e-commerce SaaS developers in China whose customers are the latter and they enjoy relatively robust 3-year revenue CAGR of 38% and 73% respectively.

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CHINA NEWS SPOTLIGHT

China Inflation: Increased Demand as Coronavirus Restrictions Ease Could Push Up Prices:

Increased demand due to the easing of coronavirus restrictions could contribute to a rise in China's consumer inflation later this year, analysts said, even after prices remained stable last month. The consumer price index (CPI) rose by 2.1 per cent in May from a year earlier, unchanged from an identical rise in April, the National Bureau of Statistics (NBS) said on Friday, as China's consumer inflation remained within the government target of "around 3 per cent" for the year. [Read More.](#)

China's Economic Stimulus Explained – Understanding China's Monetary and Fiscal Policy:

The COVID-19 pandemic has presented unprecedented challenges to the world economy, many of which persist until today. The sky-high cost of commodities and enduring supply chain bottlenecks caused by the disruption of 2020 has now been exacerbated by geopolitical conflict. In China, new waves of COVID-19 have led authorities to lock down parts of the country, creating new hurdles for an economy already facing a slowdown from global economic pressure and a slump in the property sector. [Read More.](#)

Didi Ends Tumultuous Run as a New York-Listed Company: Didi Global Inc.'s bumpy ride in the U.S. public markets is over-after 11 months. The ride-hailing company marked its last day as a New York Stock Exchange traded company Friday, according to a person familiar with the matter, after an ill-fated debut turn it into a poster child for China's tech crackdown. [Read More.](#)

BYD says shift to electric vehicles moving "much faster" than expected: The electrification of the automotive industry is progressing faster than expected, according to Wang Chuanfu, the chairman of Chinese automaker BYD, who told investors this week that the automaker with the most resources, healthiest supply chain, and product advantages will win the larger market. [Read More.](#)

TuSimple Co-Founder Mo Chen Launches Hydron, Producing Hydrogen-Powered Autonomous-Ready, Freight Trucks: Mo Chen, Co-Founder of San Diego-based autonomous driving company TuSimple (Nasdaq: TSP), has started a new company, Hydron, committed to developing, manufacturing, and selling hydrogen-powered trucks equipped with L4 autonomous driving technology. Chen is set on transforming long-haul freight transportation through hydrogen-powered autonomous trucks making trucking safer, cleaner, and more efficient, minimizing the carbon footprint of class 8 heavy-duty trucks globally. [Read More.](#)

CStone and Pfizer announce NMPA approval of sugemalimab in patients with unresectable stage III non-small cell lung cancer: CStone Pharmaceuticals ("CStone", HKEX: 2616), a leading

biopharmaceutical company focused on research, development, and commercialization of innovative immuno-oncology therapies and precision medicines, and Pfizer Inc. (NYSE: PFE) today announced that the National Medical Products Administration (NMPA) of China has approved sugemalimab (Cejemly[®]) for the treatment of patients with unresectable stage III non-small cell lung cancer (NSCLC) whose disease has not progressed following concurrent or sequential platinum-based chemoradiotherapy. Together with the previous approval of the treatment for first-line stage IV NSCLC patients, sugemalimab is now the only anti- PD-1/PD-L1 monoclonal antibody for both stage III and stage IV NSCLC patients. [Read More.](#)

Everest Medicines Announces Approval of Trodelvy[®] in China for Second-Line Metastatic Triple-Negative Breast Cancer: Everest Medicines (HKEX 1952.HK, "Everest", or the "Company"), a biopharmaceutical company focused on developing and commercializing transformative pharmaceutical products to address critical unmet needs in Asia Pacific markets, announced today that China's National Medical Products Administration (NMPA) has approved Trodelvy[®] (sacituzumab govitecan or SG) for the treatment of adult patients with unresectable locally advanced or metastatic triple-negative breast cancer (TNBC) who have received two or more prior systemic therapies, at least one of them for metastatic disease. This is the first drug that Everest has obtained New Drug Application (NDA) approval to launch in China. In May 2021, the NMPA accepted Everest's NDA for Trodelvy with Priority Review designation. [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: China Academy of Information and Communication Technology

³ Source: Statista

Important Disclosures

The above information reflects opinions of Morgan Creek Capital Management, LLC ("Morgan Creek") as of the date it is written and, as such, all such opinions are subject to change. No representation or warranty, express or implied, is given by Morgan Creek as to the accuracy of such opinions and no liability is accepted by such persons for the accuracy or completeness of any such opinions. Further, Morgan Creek does not warrant the accuracy, adequacy, completeness, timeliness or availability of any information provided by non-Morgan Creek sources.
