Hong Kong’s economic crisis spills over to venture capital activity

VC investors have yet to see the end of their woes, even as domestic volatility has already dragged investment down by 39.02% YoY to $1.28b, from the $2.09m recorded in 2018.

As Hong Kong has been beaten down by economic downturns, its venture capital (VC) and private equity (PE) sectors have followed suit. Data from the Hong Kong Venture Capital and Private Equity Association (HKVCA) revealed that between 2018 and 2019, aggregated investment crashed 39.02% YoY to $1.28b, from $2.09b, and the average deal size fell from $40.9m to $21.9m.

Volatility in the domestic economy for the second half of 2019 affected investment across a range of sectors, said Dorothea Koo, head of Baker McKenzie’s Private Equity Practice in Greater China. Things are unlikely to get easier from there, however. “Further regional uncertainty coupled with a consumption slump following the COVID-19 outbreak, has resulted in a general pause in investment as venture capital funds wait to assess the broader implications for certain markets,” she said.

Denis Tse, founder and managing partner at Asia-IO Capital Management, echoed this and added that they are expecting more hiccups in H1. “Right now, there are a lot of logistical constraints. Just because we cannot go [around] and travel, there will be a bit of hold up,” he told Hong Kong Business.

VC sponsors have postponed their investments until the conditions of the COVID-19 epidemic have stabilised, said Robert Wright from Baker McKenzie’s Private Equity and M&A practice. “We await the anticipated bounce back, particularly across Greater China. However, most industry players have indicated we are unlikely to see a return to 2018 levels any time soon,” he said.

Even with challenges ahead, Tse said that the PE and VC sectors should be able to hold up. “If you look beyond, and in terms of the underlying flow, it hasn’t really changed much in terms of at the end of the day. Startups still do have to get back to work and build products and expand on business. So, it’s still normal, but we haven’t gotten to the real critical mass that perhaps you know Singapore would have achieved.”

Carry reform

In an effort to pull its economy from the trough, Hong Kong is introducing tax concessions for carried interest to encourage the setting up of PE funds in the city. As announced in the Budget Speech for 2020, the tax concession will be subject to the fulfillment of certain conditions. Industry consultations are also expected to come in the year.

This reform should provide some relief to PE firms faced with uncertainty over previous policies. Carried interest...
has been treated by the government as a fee for services, or a type of disguised management fee. But in a note, KPMG held the opinion that carried interest can be considered an investment return, and can be treated as returns received by investors in the fund.

PwC Hong Kong noted that amongst other proposed economic stimuli, this one comes with great significance. “We are sure that a swift end to the uncertainty that has hung over this issue will be greatly welcomed by the industry.”

Edwin Wong of Baker McKenzie’s Fund Practice, echoed this, saying “The proposed measures will be beneficial to enhancing Hong Kong’s position as a hub for international asset and wealth management. In addition, our PE fund clients will be pleased to see greater certainty in how carried interest is taxed in Hong Kong.”

In order for the reform to significantly affect the sector, KPMG noted that the government must engage with the PE industry before finalising any legislation. “If the provisions fall short of what is necessary to arrest the increasing trend of funds establishing operations elsewhere such as in Singapore, Hong Kong’s position as a leading PE hub could be impacted.”

**Biotech exit boom?**

Even with a dreary economy in the background, Hong Kong’s VC firms continue to hunt for startups across sectors, with some paying off exceptionally. Notably, investment activity is high for startups in the life sciences and biotech segment, said Alfred Lam, research director at Hong Kong Venture Capital and Private Equity Association (HKVCA).

Previously, the sector has been lowkey due to technicality of product launches, but Lam noted that awareness of the sector has heightened as investment conditions sway to its favour. “A lot of these things are actually below the radar screen, because the entrepreneurs in the life science sector tend to be media-shy. They just focus more on the product, going on stage and talking about their company. All types of products are harder to understand until recently, when people are now paying more attention to help,” he added.

More companies are also taking advantage of the Hong Kong Stock Exchange’s new regulations to allow unprofitable biotech firms to go public. Thus, more biotech startups are able to lure capital, as seen in 2019 with Insilico Medicine, which bagged $286.9m in a series B funding round led by Qiming Venture Partners to speed up the process of drug development whilst leveraging artificial intelligence (AI).

The government’s push for activity in the biotech space should make way for an exit boom in the years ahead. Ivy Wong, Asia Pacific chair of Baker McKenzie’s Capital Market Practice, commented, “We do expect to see exit booms in the biotech sector as there are more listing venues in recent years (including the HKSE’s new pre-profits biotech listing regime and the Shanghai STAR Market) and we are also seeing more VC investments in the biotech space. There are more VC investments at a very early stage (as compared to previous years) and institutional investors are making proprietary investments in biotech startups, which show that there is a strong interest and belief in the growth prospect in this sector.”

In fact, the $1.02b (US$131m) Alibaba Hong Kong Entrepreneurs Fund said that it would bolster its capital injection in Hong Kong’s biotech startups, emphasising that the next unicorn may emerge from this scene. Its focus is on startups in the series A or B round. One of the startups it has invested in is Prenetics ($310.16m or US$40m), which provides genetics testing solutions for cancer screening and pharmacogenomics.

**More investment hotspots**

Other investment hotspots are on the rise. HKVCAs Lam noted that education technology is an attractive segment for the retail investor. “You will see that a number of the online tutorial surface platforms operating in China and in Hong Kong have raised a certain amount of money.”

One of the most recent and notable funding rounds raised $271.29m (US$35m) for Hong Kong-based edtech brand Snapask, which develops data analytics and video learning content. The firm started out as a mobile app that matches students with questions to quality tutors for instant one-on-one learning sessions.

Baker McKenzie’s Wright commented, “Whilst consumer demand for online education, grocery and entertainment businesses was already grabbing the attention of VC investors well before the COVID-19 outbreak, interestingly, it seems restrictions on the usual consumer habits, may pave the way for new opportunities and further innovation in these areas. For example, many Chinese consumers have already turned to new tech applications and the internet for shopping, work and other online activities. We may be on the verge of an even wider adoption of digital transformations as businesses are forced to adapt.”

The rise of VC interest in edtech is in line with increasing consumer demand for online education, grocery, and entertainment businesses. However, the rest of the year will still be challenging for start-ups. “During the 2003 SARS outbreak, the strongest players came out as triumphant leaders of their sectors. We expect VC investment to play it safe (following more dominant players in certain markets) whilst the dust settles in the current climate,” Wright added.