Emerging Centers of Innovation

How investors can capitalize on the next decade of digital transformation

Where are the world's new innovators? Disruption and innovation have long been associated with networked US centers such as Silicon Valley and Cambridge, Massachusetts, which are familiar territory for most investors. In recent years, however, emerging centers of innovation have rapidly developed in places such as Beijing, Bangalore, and São Paulo. With younger populations, an expanding middle class that is a multiple in size relative to the developed world, and robust technology infrastructure, these centers are positioning many emerging market economies to be the leaders of the global technological innovation revolution. Knowledgeable investors who are able to access the investment opportunities created by these leading innovators are likely to reap significant outperformance.

The Innovation Revolution

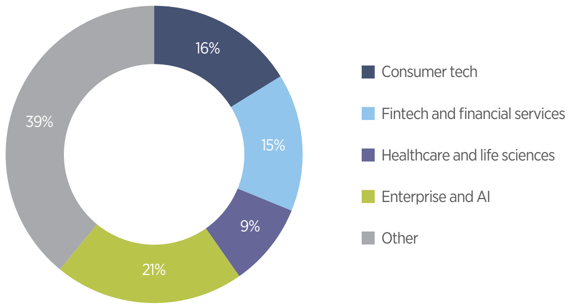
Over the last decade, technology adoption has profoundly changed the way companies and markets operate. New business models that use tech-enabled solutions to tailor their offerings to local environments have disrupted established industry players, providing consumers with a greater range of services at lower costs than ever before. While this transformation has taken place globally, it has been accelerated in emerging markets in particular, due in part to:

- The global connectivity of emerging markets, which allows innovators to share and adapt to new ideas quickly;
- Technology adaptation often moving faster in emerging markets ("EM") than developed markets ("DM"), where legacy behaviors and technologies may resist change;
- The near ubiquity of inexpensive smartphones and wireless data plans; and
- Greater capital availability, more vital to innovation than ever before, particularly as private investors seek to capitalize on the opportunity for outsize returns.

The shift in tech-enabled innovation density toward EM has happened fairly quickly over the last few years. Many investors are unaware that today more than half of global private startups with an enterprise value of USD 1 billion or more—so-called 'unicorns'—hail from these emerging economies. According to a 2019 study by the Hurun Research Institute, nearly half of the approximately 500 global unicorns originated in China or India. Moreover, China and India together represent about the same number of such companies as the US and Europe combined.

While the world's unicorns span more than 20 industries, about 60% of them belong to four broad sectors. Enterprise software and artificial intelligence together account for more than 20% of unicorns, followed closely by consumer technology, financial technology, and life sciences/health technology. These sectors have seen immense transformation over the last decade as technology adoption has enabled rapid customer aquisition at reduced costs by cutting out middlemen and allowing for increasingly insightful data analysis.

Leading Unicorn Industries



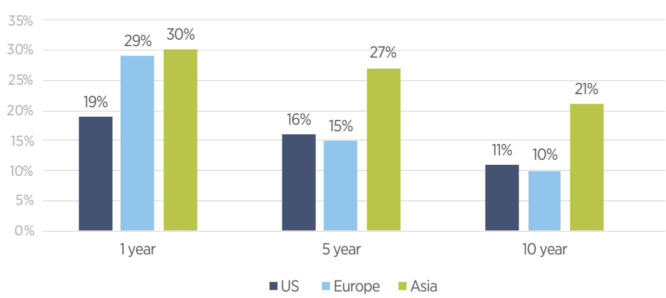
Source: The Hurun Research Institute, 57 Stars.

Rapid advances in global technology development and adoption over the last few decades have created a new industrial revolution, fundamentally altering the way products and services are manufactured and sold. The global scale of these changes demands the kind of broad capital support that, in emerging markets, is unlikely to come from traditional sources. This shortfall creates compelling opportunities for investors to benefit from the next set of global businesses emerging as part of this revolution. Many of these new companies will grow far more rapidly than established players, as they are nimbler and better able to navigate a rapidly evolving marketplace.

Generating Returns for Investors

Investors wishing to capture outsized returns created by technological innovation must learn to think globally. For those investors with foresight and skill, the rewards can be significant. Contrary to the misperception of many US-focused investors, the highest-returning asset class globally in recent years has been Asian venture capital. This asset class has offered opportunities on a scale similar to its counterpart in the US, but with faster value creation and better returns on capital invested.

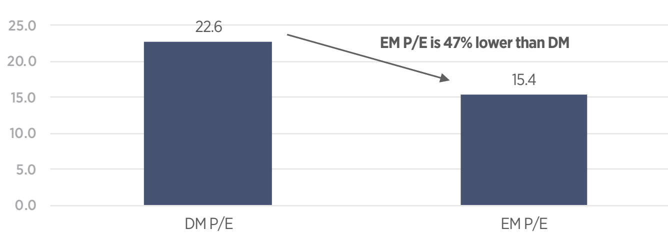
VC Horizon Pooled Returns



Source: Cambridge Associates, Q3 2018 Benchmark Study.

In public markets, EM industry price-to-earnings (P/E) ratios—an indicator of company valuation—at the end of January 2020 were 47% lower, on average, than DM equivalents, suggesting opportunities in emerging markets may also offer a much better value for investors. Similarly, entry prices for private, tech-focused investments in EM are typically lower than US equivalents, pointing to even more enticing opportunities in private markets for savvy investors.

Public Company P/E Ratios for DM and EM



Source: Bloomberg, 57 Stars. Accessed January 2020.

How Does an Investor Access Tomorrow's Unicorns?

To capture the enormous potential upside of this innovation revolution, private capital investors must gain access and exposure to the venture capitalists supporting the new business leaders in emerging markets. With a long and successful history of experience in EM, 57 Stars is well-positioned to take advantage of the opportunities available in these markets and to focus on the economic sectors undergoing disruption. Today, our focus revolves around four key sectors: tech-enabled consumer, fintech and financial services, healthcare and related technologies, and enterprise software-as-a-service (SaaS) / artificial intelligence (AI)—each sector growing at multiples of corresponding GDP growth while being less impacted by economic cycles. Given these dynamics, it is no surprise that the four leading unicorn sectors are the same as our focus sectors.

Key Sectors in Emerging Markets

Tech-Enabled Consumer	E-commerce & Retail	Logistics & Consumption Enablers	Marketplaces & Sharing Economy
Fintech & Financial Services	Payments: Digital, P2P, POS	Insurance & Insur-tech	Consumer & MSME Credit
Health & Care-related Technologies	Innovative & Generic Pharma	Hospitals & Diagnostics	Biotech & Medical Devices
Enterprise SaaS/AI	Artificial Intelligence & Data Analytics	Cloud Services	Enterprise SaaS

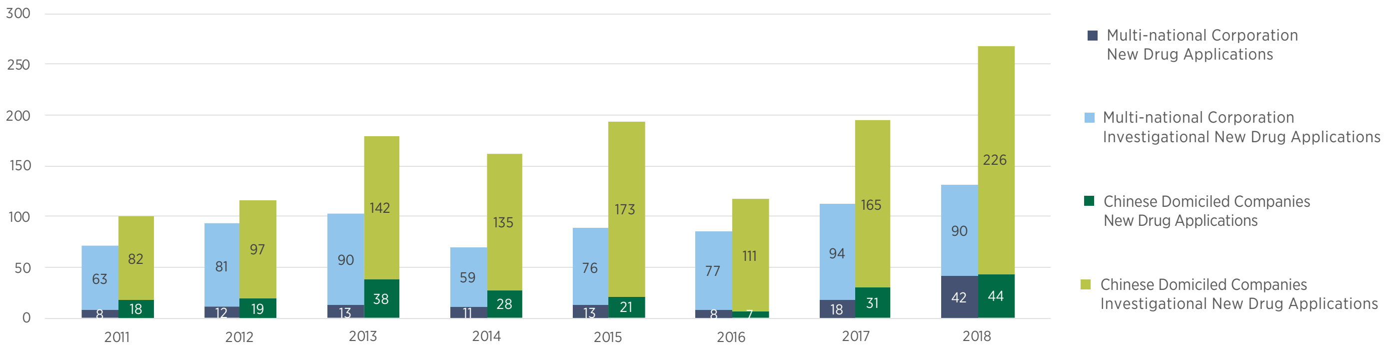
Networks as Catalysts for Growth

There are a handful of places around the world where a critical confluence of factors have blended to create the enabling environment for explosive innovation and growth. Successful innovation centers have developed ecosystems that attract more talent and capital, building on the spirit of innovation and disruption critical for new enterprises to flourish.

China: The New Powerhouse in Health and Biopharma

Over the last 15 years, China has gone from the ninth to the second largest healthcare market in the world. With its aging population and modest capital spend, China can be expected to need rapid growth in healthcare investment and expenditures on healthcare-related technologies. Faced with this reality, the Chinese government has promoted expansion and growth of the country's biotechnology sector, as seen in the dramatic increase in investigational and new drug applications over the past several years.

Biotech Investigational and New Drug Applications



Source: Insight Database (CDE data).

One of the clearest examples of this trend is in oncology. Paralleling the US a decade ago, China still relies primarily on chemotherapy to combat cancer and lags behind many developed markets in using targeted therapies and antibody immuno-oncology. With private capital investors willing to back them, however, Chinese oncology therapy developers are quickly catching up to the US in this focus area due to China's far lower development costs, favorable accounting treatment, and large pools of local patients available for clinical trials. Over the next few years, China is positioned to accelerate further the development of biologics and biosimilar drugs, including innovative oncology drugs, and to fast-track them to the global markets.

China's launch of a NASDAQ-style Science and Technology Innovation Board ("STIB") now allows, for the first time, qualified pre-profit companies to go public. Such an exchange may provide investors with an exit path far earlier in a company's life cycle, thereby increasing the velocity of capital investing in new startups. Together with the Hong Kong Stock Exchange, the STIB could well become a new hub for innovative healthcare companies.

India: A Growing Hub of Innovation

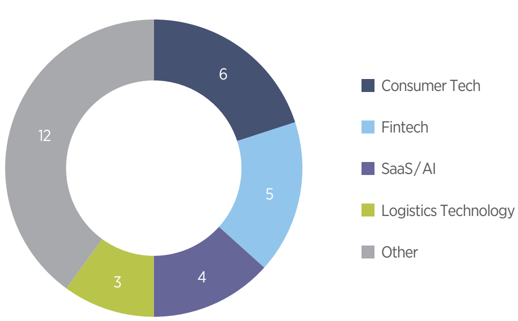
Technology expertise has long been associated with India, but only in recent years has the country leapt to the forefront of new technology development. Today, India has surpassed all developed countries except the US to become the third largest home of unicorns. During each of 2018 and 2019, more Indian unicorns were created than the sum of all Indian unicorns created from 2011 to 2017. Three business segments have led the way in this boom: consumer tech, fintech, and SaaS/AI. We expect these segments to continue to grow as innovation hubs provide a multiplier effect that, in turn, will spawn further innovation.

Given India's unique demographics and the increased flow of investment capital, the country is at an inflection point where ventures started by the new generation of innovators achieve billion-dollar valuations at an increasing rate. Young entrepreneurs are utilizing capital more efficiently, building ever-larger enterprises, and, for those who achieve it, getting to unicorn status within five years from their first institutional capital raise, on average. This success and growth has emboldened a generation of spinout companies founded by former employees with new ideas, drive, and a willingness to take on risk.

Further propelling these startups is a much deeper pool of later-round investors giving tech entrepreneurs the confidence that, with the right idea, they can obtain capital backing. Traditionally, India had only a handful of late-stage investors, effectively limiting the amount of capital available to startups and leaving pricing power in the hands of these few managers. Today, that situation has changed, with more private investors willing to look at and deploy capital to opportunities across the financing spectrum.

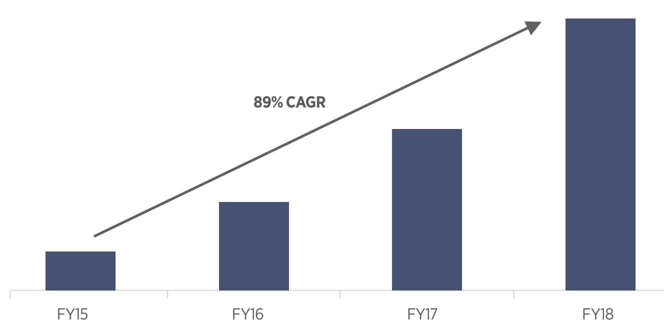
One example is Lenskart, an omnichannel eyewear retailer that has successfully passed the USD 1 billion valuation threshold. Lenskart owns its own production and assembly system of frames and lenses, and has integrated offline retail with its e-commerce platform to improve customer acquisition and reduce distribution costs. This successful adoption of consumer technology has allowed the company to grow its revenue at a compound annual rate of 89% rate over the past several years. With many other local startups following a similar model of consumer-tech innovation and adoption, the Indian entrepreneurial ecosystem is poised to continue producing such successes.

Indian Unicorns by Sector



Source: Iron Pillar Tech Unicorns, Hurun Research, 57 Stars.

Lenskart Revenue Growth



Source: Lenskart, 57 Stars.

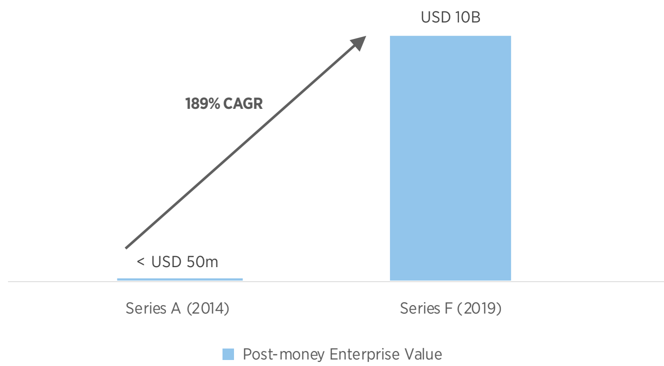
Brazil: Leading Latin America's Digital Transformation

As the largest, most connected, and most engaged economy in Latin America, Brazil is leading the region's rapid digital migration of consumer and corporate services. This transformation is taking place in all sectors of the economy, including in education, logistics, healthcare, and financial services. Today, there are nearly 20 unicorns across Latin America, with the vast majority concentrated in Brazil. Moreover, this number is expected to grow significantly, as several companies have raised capital at valuations above USD 500 million—a testament to the attractive opportunities that these startups represent.

Fintech companies are at the heart of the growth of Brazil's technology ecosystem. According to consultancy Ernst & Young (EY), Brazil has the fourth highest fintech adoption rate in the world.[1] Digitally native enterprises have taken on entrenched interests in the country's concentrated banking and payments sectors, where 72% of all assets are held by four large players.[2] Equipped with robust technology platforms, leading fintech companies have been able to outcompete legacy incumbents and build significant equity value over a relatively short period of time.

One such fast-growing fintech company is Nubank, a Brazilian "challenger" bank. The company was founded in 2013 as a no-fee credit card service delivered through a fully digital format. Today, just over six years since its launch, the company serves more than 12 million customers and has become the largest digital bank outside of China. Notably, the company's growth has come primarily as a result of both word-of-mouth and social media marketing, with limited customer acquisition costs. Its success has led to significant investor interest, with TCV (Technology Crossover Ventures) leading a USD 400 million funding round in July 2019 at a valuation in excess of USD 10 billion. Nubank's story demonstrates the attractive prospects for investors who grasp the depth of the digital transformation taking place in Latin America and the enormous market opportunity available to the new generation of fintech companies in the region.

Nubank Valuation Evolution



Source: Private valuation, July 2019.

The New Global Paradigm for Sophisticated Investors

Global capital allocator UBS highlights the opportunity in EM today.[3] "It is time for investors to start reallocating to EMs. First, we expect the growth differential between emerging and developed markets to widen in EMs' favor. Second, valuations in EMs are lower than in DMs. Finally, many of the greatest identifiable secular trends in the coming decade of transformation are going to play out in EMs. We expect the combination of 5G, artificial intelligence, big data, and cloud computing to define a new era of digital transformation and innovation around the world in the decade ahead. And EMs are at the forefront of this trend."

57 Stars believes that gaining access to leading venture capitalists in emerging centers of innovation and the explosive growth they can harness should be an important objective of any sophisticated institutional portfolio. To gain such access, however, requires a resource-intensive analysis of relatively small venture and growth funds managed by proven General Partners ("GPs") who invest across the spectrum of financing rounds for budding enterprises. A multi-manager solution can give investors such exposure, while also providing diversification and risk mitigation. Access to leading GPs can also create a healthy co-investment pipeline to tomorrow's unicorns, allowing for further outperformance and significant fee mitigation.

57 Stars' on-the-ground presence in five offices on three continents and long history of global relationships provides access to the leading GPs across emerging markets. As a result, 57 Stars is uniquely positioned to capitalize on the opportunity for outsize returns presented by our high-quality deal flow across geographies, sectors, and stages. Structured co-investment rights allow for access to various financing rounds and enables us to back potential emerging winners, reduce both fee loads and duration, and improve our liquidity cycle—all to our investors' benefit.

1 EY Fintech Adoption Index 2017.
2 Brazil business: "Brazil's banking system concentrated in the Hands of Four Large Banks."
3 UBS House View January 23, 2020.