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Behind the curve

Gaining an accurate impression of an industry is vital for investors, but this can be difficult in markets where information is patchy or unreliable. Those who hope to prosper must learn to judge data carefully

BY THE END OF LAST YEAR LIVE streaming had taken China's millennial population by storm. More than 300 million users had downloaded one of the ubiquitous apps available for viewing or broadcasting user-generated content, and investors were casting covetous eyes at start-ups like Asia Innovations. Media reports had the developer of streaming app UpLive raising capital at a valuation of over $400 million.

But when Edward Liu, a Beijing-based partner at WI Harper Group, looks at the live streaming craze, he suspects he already knows how the story will end.

"I don't know why people would engage in that, but there's so much money going through it," he says. "They're such gigantic numbers, and I can't get comfortable with it. It reminds me a lot of the Groupon clone space in China, and then the O2O [online-to-offline] hype in China after Uber and all the ride hailing apps came out, and all of the failures there."

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For Liu the tech fads of the past, and the investors who scrambled to profit off of them only to wind up burned, exemplify one of the most important and hardest lessons for a GP to learn: know your market. An individual company's strong growth story so far means nothing if the industry where it operates could disintegrate as so many have before.

However, building industry intelligence in Asia is complicated by the fact that in much of the region's data, particularly for emerging areas, is hard to come by, and what does exist is often of dubious quality. In these markets, investors who can find their own methods of gathering information and putting together an accurate picture of companies and industries will have a considerable advantage.

Dodgy numbers

It is no secret that data in emerging markets is not always reliable. China's government in particular is often criticized for publishing misleading or outright fabricated economic data, and members of India's investing community have complained that the authorities are similarly willing to manipulate public information to support policy goals, as in the case of the recent demonetization initiative.

Southeast Asia, with its fragmented political landscape, presents additional challenges. While some governments exhibit the same tendencies toward information control, in other cases the opposite is true: the government lacks the power or resources to collect economic data, and regulators cannot compel listed companies to release accurate information.

"We get many kinds of information from China. The reliability is a different question, but they do provide a lot of information," says Yasunori Naito, head of consulting services at Singapore-based market research firm Uzabase. "On the other hand, I was in Thailand last week, and the government and stock exchange are quite weak. They're not helping to provide information to the public."

Such highly visible dysfunction has naturally led to calls for reform, with the Organization for Economic Cooperation & Development noting in a report last year the difficulties that inaccurate information poses for economic planning and asking governments to help improve reporting standards. But such arguments, while compelling, are unlikely to prevail as long as the perverse incentives that encourage statistical misrepresentation continue.

Blaming gaps in market data entirely on policymakers and regulators would be a mistake. In many cases information deficits are due not to a conscious decision to withhold information but rather to researchers' desire to focus on areas that are more likely to be used by their clients. This is an understandable tendency, but it often frustrates investors whose strategy requires betting on industries before they are widely known or trendy.

"If you look at industries like pharmaceuticals, cement, financial services, or IT or BPO [business process outsourcing] services, coverage is deep largely because of the size and scale of the industry and the economics of covering it," says Vivek Pandit, a senior partner in McKinsey & Company's Mumbai office. "Industries that are highly fragmented, like textiles or auto ancillaries or logistics, are not that well-covered because you don't have large companies and it doesn't meet the needs of banks to cover them."

Investors often turn to outside consultancy firms to supplement their own understanding of an industry, but market professionals warn that even prominent firms can slip up.

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Shaun Rein, managing director of market intelligence firm China Market Research Group (CMR), recalls being asked by an investor to verify the research it had done on a recent acquisition of a Chinese consumer goods brand. The company had claimed a 40% market share, which the investor had verified through its own research based on data from Nielsen and Euromonitor International, but when CMR surveyed consumers in department stores and retail outlets it discovered that their purchasing habits were far below the claimed figure.

"We went to Nielsen and said, 'How did you come up with this market share?' and they said, 'We based it off numbers from Euromonitor the year before,'" Rein remembers. "So then we called up Euromonitor and they said, 'We based it off of numbers from Nielsen the year before.'"

While this is an uncommon occurrence, and investors say most consultants' information is reliable, there is still a limit on the usefulness of data that they can provide. Southern Capital recently commissioned a local research firm to report on the temporary power solutions space in Southeast Asia, but found the results disappointingly light on specific details.

"They gave us a lot of data that we didn't have, but it was still relatively high level because unfortunately it's such a fragmented space that there's not enough public information. So sometimes you just can't solve that problem," says Eugene Lai, managing director and co-managing partner of Southern.

Out of the box

This does not mean that investors have no means of accessing market intelligence. However, industry players say that in the absence of reliable data, creativity and outside-the-box thinking are needed to ensure that investors are making prudent decisions.

A frequently used approach to filling in these gaps is to look for parallel industries or companies in other markets such as the US and Australia. This can be particularly helpful in late stage or growth investments, such as Singapore-based self-storage business Lock & Store, which Southern acquired in 2010. At the time the industry was only a few years old in Southeast Asia, with very few players, so the firm directed its research outside of the region to areas where the industry was more established.

"We did a lot of work trying to understand this industry and what the dynamics were in the US and Australia, because we thought there were a lot of lessons we could learn from there to try to apply to Singapore," Lai says. "The industry in Singapore isn't 100% the same as in Australia and the US, but there are many areas of commonality which I think we benefited from."

Another method involves investigating outside markets for data that can be correlated to the desired information. This often requires more effort and ingenuity than simply researching similar industries, but computers can spot patterns more effectively than the human eye. Finding such parallels is an increasingly important part of operations, and McKinsey devotes a large part of its staff to investigating potential data matches in markets worldwide to help fill in the firm's missing information in India.

"Advanced analytics is helpful in identifying a bunch of non-obvious and highly predictive relationships," says McKinsey's Pandit. "For example, in the US you have numbers on new construction starts, from which you can regress a lot of data on things that actually get consumed by offices, such as projectors, office equipment, and office furniture. When you don't have anyone measuring new construction starts in India, that other information might be available."

As useful as these options are, they do have a high potential for false positives, which can pose considerable danger for investors. Basing expectations for investee companies on outcomes in other regions risks ignoring the unique aspects of the local market, and can lead to unrealistically high or low expectations. Likewise, looking for parallel data sets can result in assumptions about relationships that seem strong but are actually simply coincidental.

Pandit recalls such a situation several years ago when investors made large bets on electricity in India, expecting loosened coal restrictions to unlock pent-up demand for power. "The coal supply was solved and companies started generating and distributing power. But while there was demand for power, there wasn't demand for paid power," he explains. "The estimates that suggested we were power-short weren't wrong, but the idea that that would actually result in economic power generation investments was misplaced."

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>
> – Ben Mathias

Such risks are present in China, too. WI Harper's Liu remembers Alibaba Group being constantly misunderstood in its early days by investors who saddled it with inaccurate comparisons to content providers or e-commerce companies in Western markets, and missed out on the company's explosive growth due to unfair expectations.

However, a lack of information tends to be a lesser problem in China than the question of whether to trust the data one has. Industry professionals say even when government-issued data has not been deliberately doctored, verifying its claims is still necessary – for example, official measurements of retail sales for some time did not include e-commerce companies, giving a misleading impression of consumer appetites. Verifying and correcting official data can take considerable effort.

"If we were looking at steel output from mainland Chinese steel mills, we would go and talk to competitors from outside of China," says Chris Leahy, co-founder of China-focused research firm Blackpeak Group. "We would talk to major steel manufacturers and steel buyers in China to try to get a sense of volumes, and then to sample test it."

Early-stage issues

Early-stage investors face different challenges. Since they are often investing in industries that until recently did not exist, there are usually few or no valid points of comparison even in developed markets. In these cases the approach tends to be bottom-up, rather than top-down: building an impression of an industry by examining individual companies, meeting with the founders and asking to meet their business partners and customers.

While there is often little to distinguish one early-stage start-up from another, industry participants say they can still learn a great deal from meeting these stakeholders and \finding out what attracts them to the company.

"Very often, when these people have selected this company and the product, they've done it because they believe there's a need in the industry for something like that. So they have a very good point of view on what the trend is," says Ben Mathias, managing director and head of India at Vertex Ventures. "And if their customers have jumped in with both feet then you know they're convinced it's something they need to do."

An investor's network often comes in handy as well. Vertex is backed by Temasek Holdings and can draw on the diverse companies represented in the state-sponsored Singapore group's portfolio, while WI Harper maintains contacts with a wide range of scientists and technology professionals including Ahmad Bahai, CTO of Texas Instruments, who recently advised on a potential investment in a sensor developer.

While investments may result from this process, that is not its main purpose. The goal is to gather information about an industry and determine whether it is a space that the firm wants to be involved in. This can lead to awkward situations if an investor decides not to commit capital to a company that has given it access to its customers, but if the business is not viable then both will be better off in the long run.

Research techniques differ from one player to another, and an approach that works for one firm might not be appropriate for one in a different segment or market. But a common factor of successful firms is the ability to see opportunity where others see a defect, and to take advantage of that opportunity.

"A paucity of data creates a slightly inefficient market, which rewards those who have the ability to construct an independent point of view and take advantage of that inefficiency," says McKinsey's Pandit. "Things are often mispriced and misunderstood in an environment where everyone's dealing with the same paucity of data, so if you're able to access better information or construct it, you generally find that that should work to your advantage."