DM Capital's friendly activist blueprint lays out the building blocks for success

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A focus on value creation combined with a consultant-style approach has helped Lixin Zheng's Harmony Fund make its mark among activist portfolios in Asia

When he founded DM Capital in 2003, Lixin Zheng already had a wealth of experience from his days as senior consultant at McKinsey & Co to base his investment strategy upon.

Shortly after finishing his MBA in 1994 from the Richard Ivey School of Business in Canada, he joined McKinsey, where he first applied the concept of helping companies grow in value terms through strategic recommendations.

Cracking a case and figuring out answers to issues and problems faced by clients was something that fascinated Lixin. "That is where I developed the idea that if I were to become a shareholder of a company, I can deliver better results, more than just handing in a strategy report," says Lixin.

It's no surprise then that his $45 million China-focused Harmony Fund is up 43.32% in the first five months this year, and has delivered an impressive 233.77% since inception in July 2010. The fund has a gross annualised return of 36%. Overall, DM Capital currently manages around $100 million in assets.

To illustrate the power of creating value, Lixin points to DM Capital's first major investment, Weigao Group. He knew the medical business well, and understood the potential of transforming the Chinese single-use medical device maker Weigao, then a company with around $5 million in profit, into a multi-billion dollar business. In 2003, he convinced Weigao's chairman, Chen Xue Li, to agree to a plan that would put Weigao on a high-growth path, and toward the $4.2 billion company that it is today.

CV: Lixin Zheng

2003 to present: DM Capital, chairman

- BVI-based investment company
- July 2010, launched Harmony Fund
- 2007-2010, invested in seven private companies, mostly Chinese medical products
- 2008-2010, purchased major stake and served as chairman and CEO of a listed company, Long Life Holdings
- 2003-2010, managed private accounts and invested in Hong Kong-listed Chinese companies

2001-2003: DM Research, chairman

- Served as executive consultant to several Hong Kong-listed companies for capital enhancing strategies
- Conducted independent equity research for American investment institutions

"Chairman Chen only wanted to meet me for 30 minutes, but that meeting lasted two days. We hashed out a 10-year vision for Weigao from its Hong Kong listing to a company that could compete with the likes of Johnson & Johnson, Medtronic or BD," says Lixin. He, along with DM Capital co-founders Kelly Li and Frank Gao, invested in Weigao as cornerstone investors in the months leading up to the company's listing on the Hong Kong stock exchange in 2004.

"We put our money where our mouth is, so to speak. We borrowed $1 million from a friend to make the investment and were greatly rewarded," says Lixin.

Over the next five years, Weigao grew in value more than 100 times. In plotting its future strategy, Lixin benchmarked the company against the world's largest medical device makers and analysed each of Weigao's product categories, ensuring that each of them met the so-called "three Highs and a Big" criteria.

Weigao stuck to producing what it did best: single-use devices such as syringes, medical needles, orthopaedic materials, blood bags and equipment. "All of these are high-tech, high-margin products used in high-end hospitals and can be manufactured in big volumes," explains Lixin.

Learning lessons the hard way

While Weigao would serve as the blueprint for DM Capital's 'friendly-activist strategy', the firm's approach harkens to the hard lessons learned when DM was starting out as a research and advisory provider to Hong Kong-listed companies.

In 2001, Lixin extended his industrial and consulting expertise to three Chinese public companies in exchange for stock options. Despite Lixin's recommendations that tripled the value of the companies in less than three years, the owners reneged on their promise. "We concluded that option schemes don't work," notes Lixin. "That drove us to set a much higher standard on all of our investments in terms of corporate governance. We told ourselves that we will only deal with trustworthy companies."

Lixin exited the public markets and detoured into private equity in 2007 when markets were trading at their peak and investible ideas were scarce. He then invested in private Chinese makers of dental care products, stakes in some of which DM Capital still owns today.

Lixin returned to the Hong Kong market in 2010 and launched the Harmony Fund. By then, he was convinced that DM Capital could play to its strength in the public markets as an activist investor with private equity approaches.

"It was clear to us that we are not so-called stock-pickers. We are business analysts and business managers. We take a long-term perspective on a company. We work with the company as business partners," says Lixin.

Activist approach brings strong gains

Like most activist funds, Harmony runs a concentrated portfolio. It will own stakes of 5% or more in a company, but hold no more than five to eight stocks.

Over the long haul, the fund becomes a partner with management in the businesses in which it invests.

Company management's willingness to work with activist funds such as DM Capital can improve corporate management, enhance the potential for positive change within the company, and in many cases, boost long-term shareholder returns, believes DM Capital.

A good example of this was when Harmony Fund announced its first core investment in 2010. It bought a 5.5% stake in Chinese media firm Modern Media, which competes with overseas news providers Forbes Media and New York Times for Chinese-language news, features and analysis. Lixin believed that Modern Media's strong presence in China and its emerging digital media strength, to cite a couple of its attributes, made it a compelling buy.

Sure enough, the share price of Modern Media more than doubled to HK$3 in less than two years. And although the stock has retreated over the past year amid a fall in advertising of luxury goods in China, Lixin remains unfazed. In fact, Harmony has been actively helping the company to become the best mobile media player in China.

"We are in it for the long haul. We will always see some market fluctuations in the course of an investment. But what is important to us is the intrinsic value of the company, and how much value we can create within our investments," he says.

Lixin explains that the fund started seeing value accretion accelerate following its announced investment, currently a 7.5% stake, in TSC Group Holdings, a global equipment and service provider in the offshore oil and gas drilling industry. The TSC share price has surged nearly four times in the past three years.

In 2013, the fund also announced a 5% stake in China Grand Pharmaceutical and Healthcare Holdings, which is engaged in the manufacture and sale of bulk pharmaceuticals, intermediaries and pharmaceutical preparations.

Deep industry analysis proves critical
"We are still within our portfolio construction stage," says Lixin, adding that the fund's current target capacity is $500 million to about $1 billion. Harmony Fund is in the process of making its fourth and fifth investments this year, eyeing holdings in companies in the financial services and healthcare sectors.

Lixin is a stickler for making sure that would-be holdings meet certain criteria. For one, they must be in one of China's growth sectors: healthcare and pharmaceutical; energy and alternative energy; technology, media and telecommunications, or the service industry. Based on their strong balance sheet, sound management and history of profitability, they must exhibit a potential to double in value in less than three years. In addition, they are strictly judged by management's adherence to corporate governance norms and their receptiveness to advice.

Up to this point, the Harmony team has just completed the first round of screening stocks. Out of a pool of 200, 20 names have been shortlisted, with five stocks representing each of the four sectors that the firm likes.

Next, analysts at DM Capital will undertake a 'venture-capital' style of deep due diligence over the next six months, which will involve repeated visits, sometimes up to 100, to a target company's facilities, and dozens of interviews with stakeholders and experts. At the end of the review period, teams hand in a 180-page McKinsey-style industry intelligence report on each target company, covering industry value chain reports, competitive analysis, typical asset manager's valuation reports and, most importantly, a unique Harmony Value Creation Report.

"We ask ourselves at the end of each review session questions such as: Do we have the necessary knowledge and competencies to understand the industry and the business? Do we have a realistic solution to the company's problems? Do we have the execution expertise and resources? Can we grow the company 10 times in a five to 10-year period? That whole internal due diligence and strategising process can last up to two years," says Lixin.

Harmony puts in place a team of three people comprising a senior partner, an analyst and a business consultant for each of its holdings. They will serve the company on a long-term basis, with a clear set of objectives of enhancing the value of the business.

"Our investors are long-term investors. If you're looking for liquidity, we are not your fund manager," says Lixin. "The fund is 75% owned by DM Capital and staff, and over 90% by ex-McKinsey consultants. Harmony is now engaged in in-depth fundraising discussions with global activist funds and several family offices who share the same long-term, business-owner type of investment philosophy."

Outside Harmony Fund, DM Capital has a team engaged in private equity investing, also targeting the same sectors: healthcare, TMT, energy and services. Lixin is joined by former McKinsey colleagues in running some of these funds. Recently, DM Capital launched a private equity fund, the Essence-DM Dental Fund, which invests exclusively in private companies, suppliers and hospitals engaged in the dental business in China.

While Lixin has his hands full managing Harmony, his private equity colleagues are busy launching venture funds in areas such as healthcare and clean technology. "There are clear advantages in running both public stock and private equity funds. 'You will double your chances of getting a date on Saturday night by being bisexual'," quips Lixin, quoting Warren Buffett.

Sticking to growth sectors
"The optimal portfolio for us [Harmony] is eight stocks. With a bigger AUM, we could move up from micro to small to medium caps. I would like to own more than 10% in a great company to gain stronger influence over the firm. This way, we also benefit more from our team's work," notes Lixin.

Unlike many activist funds who look for and create short-term value by restructuring and cost cutting, the key for Harmony is to remain invested in sectors that are still growing in China and to expand the business of each company in the portfolio sustainably, he adds. "If you're in the wrong sector, you're dead."

China's healthcare sector has been growing by 20% annually over the past 10 years, and Lixin believes it has another decade to go to generate 20% annual growth. "Given the demographics - an ageing population and wealthier residents - healthcare remains a high-growth sector. People already own houses and cars. They will spend more on healthcare," he says, adding that his fund would be open to investing a third to half its capital in this sector. Biotechnology is another niche sub-sector that DM Capital is interested in.

In defence of energy and alternative power, Lixin believes that a scarcity of energy resources is the main driver in the industry. "China is willing to put its international reputation on the line, in a sign that it is serious in securing as much oil and gas to fuel its economy."

Industries, including TMT and services, are potential gold mines too. In China, digital technology is fast-evolving and could potentially be a 'revolutionary force' in the economy going forward. Meanwhile, as China migrates from manufacturing towards a more service-oriented economy, financial services and other service sectors are winners in the long term. The service industry accounts for only 30% of China's economy and its share is predicted to more than double in a decade or two.

Out of the 45 major industries in China, nearly half will suffer amid a slowdown, Lixin predicts.

"For us, we don't need to focus on a hundred stocks. What we need to see is that the 10 to 20 names we will own will one day be on the Fortune 500 list."

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