

# The Future of Private Equity in Asia

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## Discussion Participants

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## Moderator: Bee Ong, Contributing Editor of IPA

Youth can be enthralling, and the same can be said of a relatively adolescent asset class. Private equity in Asia, like any maturing industry, was growing in spurts, primarily from North American and European investors trying to diversify away from home markets. Asia Pacific private equity deals, excluding Japan, trebled to US\$26 billion in 2007 from US\$7 billion the previous year, according to data from Dealogic.

In 2008, Asia's relatively vivacious economies continued to lure fresh capital of US\$47.8 billion, 16.8% more than in 2007, according to the Centre for Asia Private Equity Research. Last year, US\$46.3 billion changed hands via 789 transactions. Although the number of deals was 13% lower than in 2007, the Asian private equity market was livelier than US markets, which had just about frozen over.

But the latter months of 2008 and first quarter of 2009 were tetchy. Anecdotal evidence pointed to difficulties in fundraising, reneges from some investors, concerns over asset and credit quality, lack of liquidity, a dearth of credit, amid other challenges. In the miasma, a few private equity groups closed their

regional offices; 3i consolidated its Shanghai and Hong Kong premises into the Beijing operation.

Some say just US\$2 billion of new deals were transacted in the Asia Pacific in early 2009. But by some estimates, US\$20 billion is waiting to buy Asian assets. In an industry steeped in secrecy, the data is best taken with a pinch of salt. Even so, it is clear that Asia's private equity landscape is shifting with the quakes in the global economy.

What will it look like in the foreseeable future? To answer this question, Investment and Pensions Asia, Sungard and the Singapore Venture Capital and Private Equity Association co-hosted a discussion with five private equity limited partners (LPs) and general partners (GPs) to get a feel of the ground.

### **Recent Market Events' Effect On GPs and LPs**

**Kelvin Chan:** Activity in the private equity industry has slowed down dramatically in the past year or so. GPs with existing portfolio companies are, one way or the other, affected by the global financial crisis and economic slowdown. The large-cap buyout sector is most affected due to previous high leverage and regional and global business factors.

Investors are generally more cautious, spending more time on due diligence and negotiation. Some LPs are asking GPs not to invest too quickly because they are tight on their own cash flows and they would like to see more visibility in external economic conditions.

LPs are also demanding for more regular portfolio updates from GPs and are paying closer scrutiny to the basis for valuation. Some LPs are defaulting on capital calls, especially of young vintage funds. Others are trying to sell their commitments in the secondary market, which resulted in a very substantial increase in secondary deal flows. Generally, investors are preferring China and India and defensive sectors such as consumer products, healthcare, education, and infrastructure.

**John Dahlberg:** Our investors are high-networth individuals and family offices. Many have big holes in their balance sheets and their immediate focus is on preserving capital rather than on growing it. This makes it challenging to raise funds. We closed the offering document for our first fund between the Bear Stearns and Lehman Brothers events.

The number of investment opportunities has remained fairly similar to levels before the crisis. But there is not so much dross and drama in business plans now. The people who are still standing are serious about building great companies. These are the sorts of entrepreneurs we characterise as focused on creating value rather than focused on their valuations.

Two recent investments offer examples of value creation. One is a Singapore-based biotechnology company with operations in China. Another is an India-based high-end investment-research outsourcing company. In pre-crisis days, big investment houses typically didn't manage their costs tightly. Now, they have much greater interest to outsource functions like investment research, software development and so on. This presents opportunities for private equity investing in outsourcing companies that can fulfill these demands.

## **Valuations In Perspective**

**Low Han Seng:** The pace of investment has slowed down as managers have found it difficult to value companies, given the significant uncertainty in earnings and the fact that valuations in private companies have also not decreased as much as listed companies.

With regards to valuation of existing investments, we have seen only a small proportion — about 10% to 15% — having markdowns of more than 50% in Asia. Numerous factors are involved, including weak earnings, lower comparable multiples and foreign exchange factors, especially in markets like India.

We expect a bottoming out of markdowns in the March 2009 or June 2009 quarter if there is no double dip in the economy. As for companies with high debt levels, it's anyone's call

Genevieve Heng: Valuations have generally fallen, but good companies, especially those with well-capitalised balance sheets, may be reluctant to accept investments at lower valuations because they have several private equity funds interested to invest. Others may choose to accept lower valuations in difficult markets as it provides them with a chance to capture business opportunities. Moreover, some companies look beyond valuation to factors such as value addition when selecting an investor.

## **Managing Lower Leverage, Reduced Liquidity**

**Chan:** Leverage has come down substantially from pre-crisis levels of seven to 10 times to about two to four times currently.

Debt/mezzanine financing is still available (up to US\$200 million on average) for good defensive companies, but on more expensive terms and tight covenants.

Expansion of multiples will not be a high contribution to returns in the short to mid term. This means GPs have to buy cheap and create or add value to improve top and bottomline figures. Good and disciplined GPs or companies

that are not badly affected could take this opportunity to become stronger and distance themselves from their competitors who are suffering.

Heng: In the future, it is difficult to see private equity exits like the ones that occurred in the last bull run. Entry valuations and timing of exits are very important to generate returns. It takes discipline. You need a degree of luck too, to get all the right conditions.

**Low:** Without the benefit of good vintage and low entry valuations, managers who had invested in the recent boom years need to put in lots of effort to grow the company earnings in order to generate the required returns. That requires a range of specialized skills. Many private equity managers entered the industry without the appropriate range of skill sets; they are former investment bankers, brokers and others who heard that it's easy to make money in private equity. Maybe in the go-go days, it was. But not anymore.

The challenging environment since 2008 have allowed us to test the mettle of the managers. In China, for example, there was no meaningful private equity industry until 2002 or 2003, but it has developed very quickly since. However, there is no full-cycle track record because Chinese private equity has yet to go through a down cycle. In this downturn, private equity managers' true skills are revealed. For example, if a manager tells us that they are very hands-on and works closely with the investee companies and then an investee company runs into cashflow problems and the manager is caught by surprise, something is very wrong.

### **Improving Transparency**

**Chan:** As an LP, we'd like GPs to have clear plans and to increase dedicated resources to manage their portfolio, resolve problems such as under-performance issues. We'd also like improved transparency of valuation, incentive schemes and conflict of interest management. For GPs coming back to raise funds, they should make efforts to help potential LPs to dissect and get more visibility of the underlying portfolio and track record. For example, what portion of the gains/losses were due to foreign exchange, value creation, multiple expansion, leverage and so on.

**Low:** There is still too much opacity in the industry currently. There are no accepted industry benchmarks for performance, for example. A private equity fund manager might tell you that returns are x%, which might actually be decent in absolute terms but may be weak relative to what other managers with the same vintage and strategy are generating.

## **Strengthening Governance, Administration and Systems**

**Chan:** As an LP, I wish GPs with a critical mass of total asset under management (for example, more than US\$1 billion) would strengthen the core team capabilities and improve their internal investment process, portfolio monitoring, value creation, report quality, succession planning and carry allocation, instead of enriching a few partners or asking LPs to trust them. If you want serious and sustainable institutional money, you need to show superior performance and improve internal corporate governance to give more comfort to LPs that things will not blow up.

**Heng:** Speaking from a GP's perspective, we have adopted IFRS (International Financial Reporting Standards) to value our investments. We produce quarterly reports and have regular communication with our LPs. We understand that LPs have to report to their own committees and boards and they would like to be kept apprised of potential problems and issues. If you have a proper back-end infrastructure set up, you will be able to provide timely responses to queries raised by your LPs.

**Brian Sullivan:** I design and manage the back end for RREEF Alternative Investments global funds platform. (RREEF is the alternative investment management business of Deutsche Asset Management). To determine if a private equity firm has the appropriate infrastructure to support the level of transparency, accountability and timeliness that you want, ask to speak with someone who is knowledgeable about the firm's IT and operations platform. Sit with that person for 45 minutes, and ask them to describe their systems and processes. Ask them about their plans for the infrastructure in two to three years' time, resources allocated to projects, and their continuity plans. Someone should be able to explain these things. If the person you are speaking with cannot provide answers to these questions, you might want to be wary.

## **Future Landscape**

**Low:** This tough environment will likely shake the industry out. Over time, maybe a quarter of the current managers will drop out.

**Heng:** Asia is viewed as an attractive market to invest in, and funds from the US and Europe are setting up shop in Asia. So, even if there are some departures from the current group of managers, there will be new entrants.

**Low:** Overall, if you believe there is strong underlying economic growth, together with low interest rates and liquidity, the trend for private equity in Asia is up. Institutional investors in Asia have very little participation in private equity — this asset class may be less than 5% of their portfolios — so the allocation can only increase over time.

**Chan:** Asian institutions used to invest primarily in fixed income (government securities), public equity and real estate. In the future, as sovereign wealth funds, pension funds and other institutional investors in the region are warming up to private equity assets, the number of LPs will rise. They can be a powerful emerging force to reckon with; over the decades, Asian institutions have built up immense wealth, such as the China Investment Corporation and the provincial Chinese state funds, Korean Investment Corporation or National Pension Fund just to name a few institutions. While Western investors are generally still relatively optimistic about Asia due to strong economic fundamentals and growth over the long term, new Asian investors are also increasing their private equity investments overseas.

To cater for the rise of Asian LPs and the private equity market, the Singapore Venture Capital and Private Equity Association is working with the Singapore Management University to establish an Asian Private Equity Institute to harmonise GP standards, educate regulators and Asian LPs. The institute will facilitate allocation to this asset class and collect performance statistics for benchmarking and research. In addition, it would be useful to have an LP association catering to LPs investing in Asia for the long-term sustainability of this asset class in Asia.

In the US, private equity has developed into specializations, but in Asia, the specializations are still broad-based, such as infrastructure and real estate. In the future, Asia will follow a similar path toward finer specialization at both the LP and GP level.

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