Weathering the storms

China's volatile markets may dominate the headlines, but Matthew Goodburn meets some of Asia's key players still finding opportunities in a region that is increasingly attractive

Private Equity International arrived at the AIA Tower near Hong Kong's imposing harbourfront in the middle of a dramatic rain storm. The meteorological pyrotechnics certainly seemed appropriate, given renewed growth slowdown fears and the dramatic sell-off afflicting China's public markets in recent days.

On the 21st floor, in the boardroom of Debevoise & Plimpton's offices, *PEI*'s five roundtable participants were relatively sanguine about recent events on the mainland, despite acknowledging it was likely to slow the pace of limited partner capital deployment, at least in the near term.

Gavin Anderson, international counsel at law firm Debevoise, says: "Short term there is volatility but longer term China is such an incredibly big market that it is not somewhere you can ignore as there will always be opportunities."

While China still makes up by far the biggest component of the private equity sector in Asia alongside India, there was general agreement from the five that limited partners' appetite for China-only funds was gradually being replaced by a shift toward pan Asian vehicles with a more flexible allocation policy. For Samena Capital Hong Kong managing director Kenyon Lee recent plunging stock markets and fears over Chinese growth have not discouraged local promoters looking to GPs such as Samena for opportunities in the country. Samena owns a Singapore logistics firm with a China-focused business model, and Lee believes there is a disparity between what the media is reporting and what is happening on the ground in China. He says his firm has experienced a greater number of calls from entrepreneurs over recent weeks. "Volatile markets benefit our origination efforts as entrepreneurs value the long-term nature of our investment in their companies," he says. »

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We look for managers who can demonstrate a strong portfolio dynamic. The market has some excellent performers

Dennis Kwan

» Peter Kim, investment principal responsible for origination and execution at secondaries specialist Coller Capital, points out that in investment terms the volatility presents a good buying opportunity, but that there has been a marked trend away from pure China funds recently.

"A lot of people are moving away from a China-only private equity fund towards pan-Asian funds, so, in that sense, the recent market volatility does not have much effect other than on the immediate entry point."

Anderson agrees that the volatility presents buying opportunities for GPs looking for attractive entry points.

"Rationally it should be a good time to raise funds, because you can buy companies more cheaply," he says. "The flipside is, if you are fundraising it may make your track record look less exciting than a month or two ago, but it is still too early to say if this is a big change for China or a little hiccup."

From the perspective of LPs, Dennis Kwan, managing director at fundraising adviser MVision Strategic (Asia) Ltd, acknowledges that the volatile stock market has prompted extra questions to his firm, and some have slowed their reviewing process for that reason.

"We regularly see investors express a lot of interest in Chinese funds. However, their reviewing process has slowed down with the current stock market volatility."

He also expects the recent dislocation may create a "slowdown" in funding coming from overseas investors into China. But he points out that the largest funds outside the US and Europe are in China and there are many of them. For that reason, he says his firm "strongly believes in China's future and is committed to it".

But the crucial criteria for LPs, Kwan says, is whether a manager can demonstrate a successful performance track record, irrespective of what the public markets are doing, through driving value and ownership.

"Many of the Chinese managers had some challenges with exits, especially two years ago when the IPO market was closed. From our point of view, we look for managers who can demonstrate a strong portfolio dynamic. The market has some excellent performers."

Miranda Tang, CLSA Capital Partners' managing director of private equity, is a 20-year veteran of the Asian PE market, and her firm's four funds have a pan-Asian focus with China and India accounting for roughly a third each of the funds, and the rest allocated across the region.

She believes there has been an overreaction to the public equity sell off, and, given the inflated level of many Chinese companies, current valuations are a more realistic reflection of their true worth.

Tang admits that the China segment of her funds' portfolio companies endured a 2.3 percent net asset value drop quarter on quarter, purely because of the devaluation of the Chinese currency, but that by taking a close look at selective consumer sub-sectors linked to the country's ageing population, she can find growth that is still intact. Many such firms are now trading at more attractive valuations, she says.

"As the population continues to age some of the sub-sectors within health care are providing good opportunities."

LP APPETITE

Japanese sovereign wealth fund GPIF, one of a number of major LPs in the region, recently signalled its intention to begin allocating to private equity for the first time.

Anderson points out that only a relatively small number of Japanese institutions invest on a repeated basis. "Japan is a massive economy, so there is huge scope for private equity investing to be enlarged."

The panelists agreed that in terms of Asian LPs new to the sector, the majority would focus on allocating to western GPs before considering local players.

Kwan says: "If you look at Asian LPs in countries like Japan and Korea, the main focus is still US and Europe. Eventually that will expand towards Asian countries, and some Japanese LPs are already moving in that direction."

From a GP perspective, Lee believes around half of Japanese LPs are focused on Japan's domestic market and within that just a quarter are focused on Japan-only private equity vehicles.

"Of the Japanese LPs that I know, those that have been investing in funds for five or six years have developed sufficient comfort to broaden their focus beyond the typical path of domestic funds and fund of funds, and are now looking at additional engagement and exposure through co-investments," he says.

"They also like to second one of their team members into the GP as part of a relationship development and commitment to the GP as a long-term partner. It can take them time to come to make that commitment but once they do, they are fantastic long-term partners."

However, while the potential for greater allocations from Japanese investors was viewed positively, the participants agreed that a more significant source of further near-term inflows will be European and North American LPs.

Kim cites recent Coller research on the capital deployment appetite from global LPs, which showed that over the next three years US LPs planned to almost double their Asia allocations from 20 to 38 percent, while the European LPs were looking to boost Asia exposure from 15 percent to 29 percent.

He says: "What that shows is that potentially more and more money is going into private equity, but that many US and European LPs that never took Asia as seriously are now doing so as part of their global portfolios."

Kwan agrees that North American and European LPs will be looking to increase their allocations to Asia, as it remains, relatively, the most attractive emerging markets destination.

He says: "Most US and European LPs do have an allocation to emerging markets, so where should they deposit capital right now? Latin America is going through some changes and Africa is still somewhat new. The Middle East can be interesting, but there are only a handful of regularly performing GPs there, so realistically most of the money is likely to channel back to Asia."

The vast majority of that he believes is likely to end up back in China and, in the future, India.

"We expect Asia will be an important part of a portfolio, which is why MVision is very much focused on Asia right now," Kwan adds.

Despite sovereign wealth funds becoming an increasingly important part of the private equity landscape, the panelists did not expect more than three or four to increase their direct investing capabilities in the region any time soon for a number of reasons. »

"Japan is a massive economy, so there is huge scope for private equity investing to be enlarged

Gavin Anderson

» One of Samena Capital's portfolio companies partnered with two Gulf sovereign wealth funds, which was a positive experience according to Lee, but he believes that from a reputational point of view there are caveats for sovereigns that chose to go it alone.

"From a sovereign fund's perspective, taking a direct stake in a portfolio business does bring up additional questions from the public if the company runs into difficulties."

Tang agrees: "Most are also government employees and are very risk averse, so to take that great leap of faith with a certain management team is very difficult."

Kwan points out that TMT still remains an attractive sector, while all agreed that healthcare and consumer facing sectors still offered attractive opportunities despite current volatility. Kwan noted that healthcare was becoming a hot area of growth, with two recent healthcare-only fund launches in Asia.

Anderson agrees that healthcare funds are gaining traction in Asia, and described the sector as a "nice niche".

"It makes a neat story for private equity. On the one hand there is the demographic growth story, but it is also relatively easy to show where you are adding value if you have specialists within your company who understand the medical products.

Lee adds logistics as another attractive sector for private equity investment.

"It is not just on the ecommerce side, but also where multinationals are outsourcing their entire logistics division to specialists to drive quality and costs. We see that momentum picking up over the past 12 to 18 months. This is an acquisitive sector, not just by strategic players but also established private equity sponsors.

"A lot of ecommerce companies are well funded and have a strong focus on the user experience, and they don't mind paying a touch more to the right logistics provider that really delivers."

With much of the focus remaining on China and India, Kim points out that Korea remains an attractive market. It is a beneficiary of capital from some LPs concerned over corporate governance issues in China, he says.

"In terms of economic stability Korea depends on Chinese growth, but also has its own consumer market and its own economy. There are a number of conglomerates in Korea starting to finally divest their non-core businesses so some of the large buyout deals are happening in that particular market.

"The general economic environment for China is deteriorating while India is improving. The tax structure in India was improved at the start of the year and under Modi they are opening up some new sectors like retail, insurance and construction to foreign investors."

From a secondaries point of view, however, China, Korea and pan-Asian activity are all still more developed markets than India in terms of opportunities, Kim believes.

Kwan also mentioned the Japanese mid and lower mid-market as an attractive area. While the very large deals are being done by the big international GPs, there is a lot more opportunity further down the market cap scale for smaller players. Saying this, he added that some of the local GPs were very strongly positioned to invest across the spectrum.

"From a cross border M&A perspective, Japanese corporates have the highest

> ***Volatile markets benefit our origination efforts as entrepreneurs value the long-term nature of our investment in their companies***
>
> **Kenyon Lee**

number of transaction numbers in Southeast Asia, so there are a lot of Japan angles to consider.

"A Japan-Asian fund or a Korean-Asian fund makes sense."

EXIT STRATEGY

With the recent volatility in the market, *PEI* asked the panelists if exit strategy was being adversely impacted.

Tang has experience of raising four generations of funds over two decades. She argues that patient investors will still see the benefit over the longer term, as short-term results are often driven by temporal events that don't necessarily reflect the true value of the underlying portfolio.

Lee points out that data from Bain & Company show that the first half of 2014 witnessed distributions to LPs from Asia-Pacific-focused funds that exceeded capital calls for the first time since 2005.

"Overall, the private equity industry in emerging markets is maturing and we are getting better at structuring different paths for investment exits."

He says that while the volatility of the past month has been dramatic, both GPs and LPs have been living with volatility in the region for some time.

"The market volatility that has been happening, not just over recent days but also over the past several years, has brought exit strategy and execution to the forefront for both GPs and our LPs.

"LPs are evaluating GPs on putting structures in place from day one to cater for different market conditions in the future when the business is ready for an exit, rather than being over-reliant on the capital markets being accommodating."

Kwan points out that the Asian market is still relatively young, so there are few examples of smaller private equity firms selling to bigger rivals, but he believes that option will become more prevalent as the local market matures. "Potentially that remains another way of exit for the smaller players, along with the increasing Asian corporate activity."

PEI's Hong Kong forum in May featured a survey from AlixPartners highlighting the desirability of the operating partner model in terms of adding value. But at the roundtable, many of the participants were unclear as to how they could provide proof to prospective investors of where they had executed genuine value creation.

Tang says: "The companies that we work with are normally family-owned or run by entrepreneurs. To grow beyond their domestic market, they need help. Most of the time when we stepped in, we usually do a 360-degree with them to identify the human and management resource gaps in the company. The company will make the decision at the end of the day, but when we place the operating expert with the company, they stay for good."

Lee says that sometimes operating partners in the public sector will approach his firm to match their skills up with a smaller privately-owned company in a sector where they already have a level of expertise.

> ***As the population continues to age some of the sub-sectors within health care are providing good opportunities***
>
> **Miranda Tang**

"They are seeing the potential impact they can bring from focusing on the transformation of a business over a three- to five-year period.

"They see some of their friends in industry that have done very well, professionally and financially, working for a private equity-backed company. And so it has definitely given them a higher level »

> **Many US and European LPs that never took Asia as seriously are now doing so as part of their global portfolios**
>
> Peter Kim

» of awareness in working with private equity firms and the value of the operating partner model."

Most large Asian GPs already have the same level of expertise and capabilities as their western counterparts in terms of operating partners, Kim says, whereas many smaller firms will not have the same level of resource so will look to develop their own operating expertise in-house.

"The larger houses have a whole team that goes into the portfolio companies to focus on operational improvement."

Anderson agrees: "My sense is that it's a pretty deep market here now in terms of talent and realistically if you are looking for someone to be a change agent in terms of operations, you probably want someone with local knowledge, unless it is a particularly specialised role."

Lee and Tang points out that tracking and measuring operational improvements is often tricky when LPs ask to see evidence.

Tang says: "We show the numbers and the financials are tracking the growth of the company but other qualitative operational improvements like good corporate governance … are more difficult to benchmark."

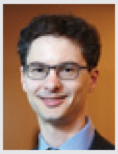
Lee adds: "It is not difficult to show it on a company by company basis, but I think it is less easy to aggregate how you work and what you do with 12 to 15 companies to form a discrete set of metrics."

Kim says: "Operational improvement is particularly important in companies that do not expect a big boost from economic growth. In these companies it can make a very significant difference." ■

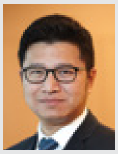
MEET THE ROUNDTABLE

PETER KIM
Principal
COLLER CAPITAL
Kim is an investment principal responsible for origination and execution and established his firm's Hong Kong office in 2011. A graduate of Imperial College London and Cambridge, Kim previously worked at Merrill Lynch and Barclays Capital.

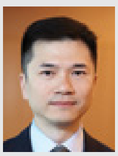
MIRANDA TANG
Managing director
CLSA CAPITAL PARTNERS
Tang joined CLSA Capital Partners in 1995 and heads a series of pan-Asia growth funds, ARIA Investment Partners. She possesses private equity expertise in China, India, Indonesia, South Korea, Taiwan and Vietnam, and started her career with Ernst & Young in the US.



GAVIN ANDERSON
International counsel
DEBEVOISE & PLIMPTON
Anderson has experience in advising on a variety of investment management issues, and acts for a range of sponsors in their fund formation, co-investment and related activities. He has acted for clients including Baring Private Equity Asia, CDH Investments, HarbourVest and Morgan Stanley.



DENNIS KWAN
Managing director
MVISION STRATEGIC (ASIA)
Kwan is involved in deal co-ordination and execution, as well as developing and maintaining relationships with investors. Previously, he spent seven years with Sumitomo Mitsui Trust (Hong Kong), where he focused on private equity and infrastructure funds investments. Prior to that, Kwan worked at KPMG.



KENYON LEE
Managing director
SAMENA CAPITAL
Based in Hong Kong, Lee leads the firm's private equity investments in Asia. He has 14 years of direct investment experience in the region, covering growth capital and buyout opportunities. Prior to Samena Capital, he was an investment director at Navis Capital Partners.