

Signs of a year of eastern promise

Joseph Mariathasan looks at the economic conditions that have made investing in Asian, and particularly Chinese, private equity favourable

It is not surprising that the International Monetary Fund (IMF) in its World Economic Outlook for October cut projections for 2009 GDP growth for China and India. What might be more surprising is that the IMF's revised figures of 9.3% for China and 6.9% for India, the two giants of emerging Asia are still likely to experience levels of growth that are far beyond anything achievable in the developed world even in boom times.

Moreover, this holds true even for the far more pessimistic growth estimates of 6% for China that other commentators would argue are more realistic. There is however, a disconnect between the high GDP growth figures and the extreme volatility seen in the equity markets over the last few years.

But equities and debt are not the only ways to invest in these markets and one trend that has been apparent has been the growth of Asian alternative investments. The recent market crash has, however, caused an exodus from hedge funds of all types and, according to Eurekahedge, Asian hedge-fund closures for 2008 jumped 19% by the end of August compared with the same period last year. This trend is likely to increase over the next few months.

Private equity might still prove to be an interesting asset class to consider over the next year or so. The combination of strong underlying growth and low stock market valuations does lead to the view held by Chris Gradel, managing partner at Pacific Alliance, that 2009 should be a good vintage year for private equity investment in China, and this might also be true for India.

Valuations for new deals are moving down to much more attractive levels, albeit with a lag between the decline in the listed market valuations and expectations in the private equity market. Moreover, with the credit crunch making it more difficult to arrange banking finance, private equity funding becomes a more attractive proposition. The task is to select those companies that are likely to survive any coming recession and be in a position to grow rapidly when the global economy bounces back.

A long-term secular trend

The growth of Asian alternative investment opportunities has

resulted in strong growth for a number of firms that have targeted private equity and other alternative sectors during the last few years.

Pacific Alliance, for example, currently manages more than \$4.5bn, according to Gradel. The firm started in 2002 with just \$10m. Asia Alternatives, a specialist Asian private equity fund of funds was launched in early 2006 and closed its debut fund at \$515m. It has just completed fundraising for its second fund, according to Rebecca Xu, a co-founder and managing director based in Hong Kong.

The evolution of Pacific Alliance illustrates the opportunities that can arise in high growth economies for entrepreneurial investment firms. Gradel started in China working for the family owners of the Hyatt Hotel chain and ended up teaming with Horst Geicke, a German entre-

preneur and also some private equity funds looking to close out enabling them to purchase assets at a discount.

"One of the funds was a Vietnam fund at a high discount," Gradel says. "Horst was very enthusiastic but I was more sceptical. But when I went in 2002, I saw that conditions were similar to China in the mid-1990s, so at the end of 2003 we launched a Vietnam fund with \$19.5m." Having started as a pan-Asian hybrid, they increased their exposure to both private equity and real estate, leading the firm to split activities into specialist areas of hedge funds, private equity and real estate. The firm currently has more than 200 staff based in Hong Kong, Shanghai, Beijing, Hangzhou, Ho Chi Minh City and Hanoi.

Gradel says there are strong synergies between the different activities of the company. "We ask our staff to keep their eyes open for multiple opportunities that we can examine further during due diligence," he says. "This has worked really well and has produced a lot of cross fertilisation."

Geographically, the focus on China and Vietnam is likely to continue. "They are the countries we like," Gradel explains. "We understand their political systems and starting point. We like their relatively more stable political framework. There is much more political risk elsewhere. We are pretty cautious on other markets although we do keep our eyes open."

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exited through capital markets and realised gains of multiple times the initial investment.

Several high profile post-Asia crisis restructuring and buyout deals in Japan and Korea had also demonstrated attractive returns. As a result, according to Xu: "When investors saw the realised returns and an increasingly strong market momentum in Asia, they realised they could no longer ignore Asia. "Before that, when I was at the International Finance Corporation [the private sector investment arm of the World Bank Group], very few institutional investors looked at Asian private equity at all, let alone having dedicated resources to track it."

Post 2005 saw a number of Asian private equity firms being set up with reputedly 30 alone in India in 2005. Global alternatives firms such as Blackstone have operated across a range of assets embracing both private equity, hedge funds, real estate and debt vehicles. But their success has been limited. with Blackstone only completing one China deal so far.

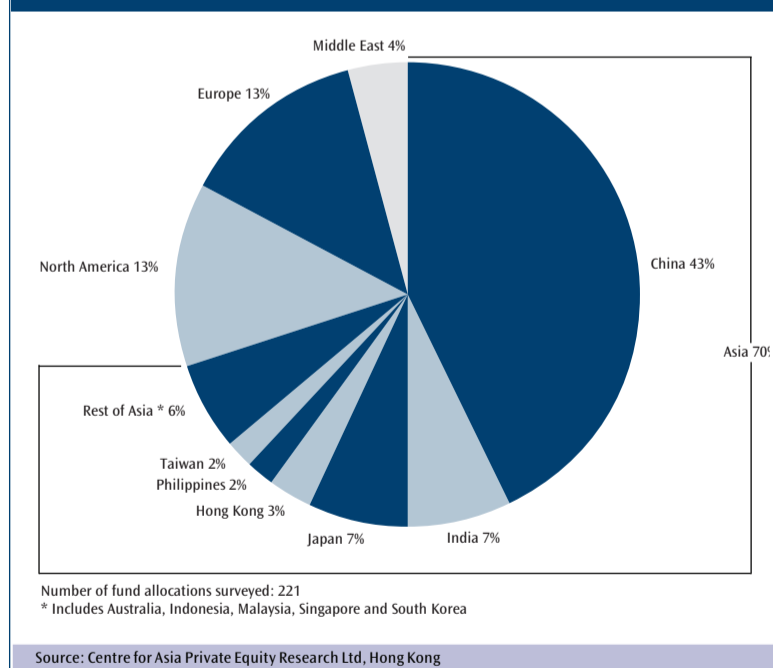
Despite his firm also operating across a range of asset classes, Gradel sees it as having a very different approach: "We position ourselves at a very local level and have a number of ex-entrepreneurs and have ex-CEOs of large corporations in China. We can bring more industry people. Local funds generally are more competitive." Independent China-based firms are stronger on the private equity side, Xu adds.

The growth of the number of private equity firms and in the size of the market has also led to a tremendous growth in Asian private equity fund of funds with more than 25 set up in the last few years, according to Xu. Some like Asia Alternatives are independent dedicated Asia specialists. There have also been a number of Asia funds set up by global private equity fund of funds such as Partners Group. Also many large banks, such as ING, JP Morgan, and Goldman Sachs, have launched Asia funds of funds.

Asian opportunities

Asia is not a monolithic market and each country is different. Fund of fund players such as Asia Alternatives have to look at which markets are most attractive and offer the best risk/return profile. Their first fund was predominately exposed to two types of deals – growth capital (mostly in China and India) and buy-

Distribution of LPs (January to June 2008) by number of fund allocations



preneur and long-term resident of China, to launch a fund management firm with an initial \$10m.

Gradel explains that their objective was to invest in anything that would make them money, primarily with a China focus. Their initial strategy was to invest in listed closed-end investment trusts trading at a

For Xu, 2005 marked an inflexion point for private equity in Asia, both in terms of the amount of capital raised and the amount of capital actually invested on the ground. The year also saw strong returns coming out of Asia deals completed in previous years. A number of growth capital deals in India and China had

outs, and this is probably a fair reflection of the private equity opportunity set in the region.

In China and India, growth capital is the major opportunity. Investors take a minority stake and Xu finds that managers are favoured if they not only provide capital but can also bring in other value additions.

In contrast, the last two years have seen some exciting buyout developments in Japan, Korea and Australia, while China and India have seen a smaller, although a growing, number of buyouts. "In China, the most popular buyouts to date are state owned enterprises that are restructuring," says Xu. "Often this is through a management buyout, but there is little leverage compared with buyouts in the US and Europe and after you have gone to a shift in ownership and a restructuring of the balance sheet, the outsized returns generally come from the growth of the company."

Asia Alternatives is also a believer in early stage venture for China and India. China has a very active and vibrant venture market, according to Xu. Valuations for later-stage deals have been pushed up a lot in the last two years because of competition by a large number of newly formed venture funds, while for early stage deals, there is much less competition. As she explains: "Beijing has turned out to be the hub for venture capital in China. For example, over 60% of venture deals completed during 2007 were done in Beijing. Shanghai on the other hand, is a hub for semiconductor-related businesses, internet and media driven opportunities, and clean tech and a whole local technology ecosystem has been created. Shenzhen is the third centre and together with Guangzhou province is the most significant manufacturing base in China."

Later stage venture, Xu finds, has been very competitive and often driven by foreign firms, predominantly from Silicon Valley, which have set up local teams. "In China there is not a long history of venture investing and people who can be hands on," she says. "Venture capitalists often do not have proven entrepreneurial and/or operational backgrounds, and tend to focus on late stage, pre-IPO deals." In spite of this, Xu believes in the longer-term growth story in China and is convinced that a lot of strong new technologies will emerge from China. The positive factors for China include a large and fast developing end-user home market, so that a strategy focusing on exporting to the US is not required.

Moreover, as Xu points out: "In certain industries such as semi-conductors, an entire supply chain has been built up on the ground in China with chip design, component manufacturers,

Asian private equity

Institutional Investors

187 limited partners (LPs) were known to have made allocations to 101 Asian private equity funds in the first half of 2008. The number of LPs participating in fund allocations has increased by 30.8%.

LPs based in Asia dominated, accounting for 70% of the allocations, while the number for those based in the USA has declined by 55.1%.

LPs in China have emerged as the main source of capital, accounting for 43% of the allocations that have been focused on domestic funds only.

LPs favoured growth/expansion and venture capital funds, which accounted for a combined 70.6% of the allocations.

Funds

\$26.5bn (€21bn) of fresh capital has come into the market in the first half of 2008, representing an increase of 33.3%.

The average fund size has increased by 45.6% to \$304.1m, from \$208.9m.

Buyout funds dominated the capital pool in the first half of 2008, accounting for US\$10.2bn, or 38.5%.

Infrastructure funds boasted the biggest increase, attract-

ing US\$3bn, representing a 13.5 multiple to the \$222.8m recorded 12 months ago.

Investments

The first half of 2008 witnessed \$30.5bn in commitments, a 52.6% increase compared with the first six months of 2007.

404 transactions are known to have been consummated, a slight, 3.8%, increase compared with the same period in 2007.

The average deal size has increased to \$86.5m in the first half of 2008, compared with \$55.6m in the same period in 2007.

Divestments

103 divestment processes were initiated by investors, a 34.8% decrease compared with 158 for the same period in 2007.

\$6.9bn has been returned to investors for aggregate invested capital \$1.95bn.

Initial public offerings (IPOs) and/or sales through the secondary public market accounted for 70.9% of the divestment movements, while trade sales took up the balance.

IPOs, however, only accounted for a mere 8.5% of the realised capital, while trade sales returned over \$6.3bn to investors.

Source: Centre for Asia Private Equity Research Ltd, Hong Kong

service providers, end user markets, and so on, so for a start-up company, the support is there. China is unique in that a home-grown company can become a multi-billion dollar company in the local market."

India is also a favoured destination for early stage venture capital for Asia alternatives but, as Xu says, it is a very different market to China. Opportunities have been centred around the IT service industries, business outsourcing, mobile value added services, and biotech/life sciences.

Effects of the financial turmoil

Despite the relatively low impact on GDP growth expected by the IMF, it is clear that the financial turmoil will have profound implications for the Asian alternative markets. Gradel believes that the key driver of

the markets in the short term is the withdrawal of liquidity from hedge fund redemptions and deleveraging while, globally, earnings are under pressure, even in China.

But he says certain sectors look strong, particularly consumption, in contrast to exports and real estate where earnings are being squeezed. He explains: "We have bought into defensive sectors like mass retail, education, and baby goods. Things that are nicely leveraged towards income growth but seen as essentials so they have less downside."

Looking to the future, Gradel is positioning his firm for more distressed debt with some of the initial opportunities coming from the deleveraging and redemptions seen in hedge funds that have been doing pre-IPO deals and so on. "Some peo-

ple need to get out in a hurry so we can buy things at attractive discounts," says Gradel. "This is pan-Asian but a lot is China-focused. Redemptions from hedge funds seem pretty significant, from what I am hearing, so for people with cash to invest, there are good opportunities."

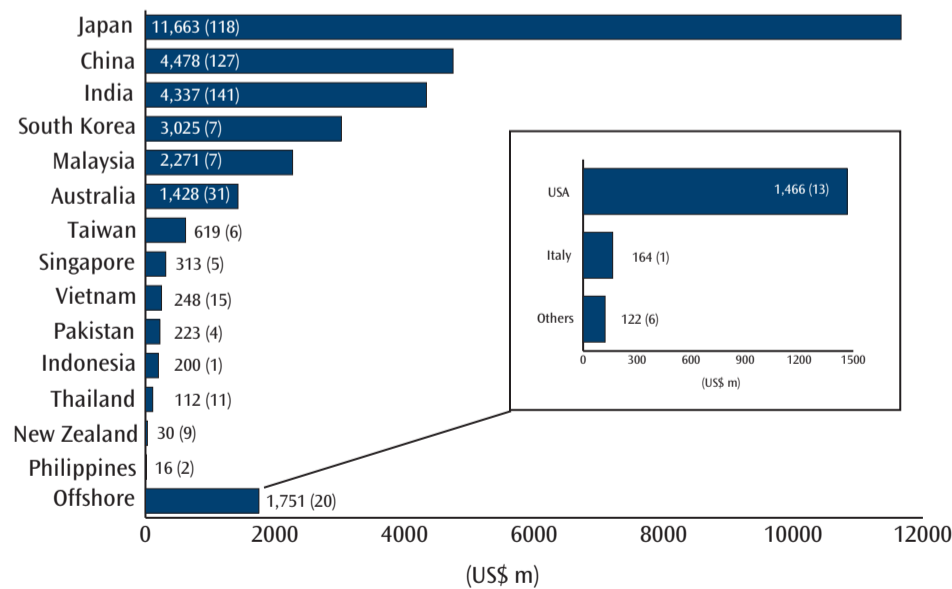
Deal closing has shown signs of slowing down though in the Asia private equity marketplace according to Xu. "Our own investment pace would be affected by the fundraising pace of general partners (GPs)," she says. "If you look at the data for the first half of this year, we are certainly starting to see a slowdown in buyout and venture investments, although less so in growth capital, but we expect to see a slowdown in growth capital as well going forward as there is a lag effect. This is not a bad thing as

GPs are taking their time to negotiate better prices and stronger terms." With valuations in the listed markets driving down expectations in the private equity marketplace and a more measured approach to investing, future returns for later vintages may be more attractive than for investments undertaken in previous years.

Investor base

The investor mix for Asian private equity has been predominantly North American and Asian-based. Gradel, for example, has a mix of investors that includes relatively few European mainstream pension funds. Given the turmoil experienced in other financial markets, investment in Asian private equity might still have a long way to run, which may encourage European institutional investors to emulate their North American peer group in the region.

Private equity investment destinations – Asia (Jan to Jun 2008)



Others include: Canada, Norway, Sweden, South Africa and UAE.

Number in () denotes the number of deals

Source: Centre for Asia Private Equity Research Ltd, Hong Kong