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Worlds apart

The Asian private equity market was grappling with geopolitical rifts even prior to the introduction of global travel bans, yet there are reasons to be optimistic. Alex Lynn reports

It seemed likely in January that Asia was destined for a troubled year relative to the western markets – a dynamic that has been turned on its head in recent months. Several countries in the region – notably China – are now serving as bellwethers of economic recovery for those still grappling with various stages of lockdown caused by the global coronavirus pandemic.

Yet it would be an overstatement to say Asia is enjoying business as usual. Not only are these markets just starting to understand the implications of the pandemic, but escalating geopolitical tensions also threaten to have a profound impact on regional private equity.

In late August, five Hong Kong-based executives gathered over Zoom to discuss how global and local trends are helping to shape the Asian markets.

“When this started back in January it seemed isolated to Asia, so our colleagues in Europe and the US could not really relate to the issues we were facing,” says Doug Coulter, partner and head of Asian private equity investments

\$29.1bn

Capital dedicated to Asia-Pacific raised by private equity funds in H1 2020

\$17.5bn

Amount collected by pan-regional giants MBK Partners, Baring Private Equity Asia and CVC Capital Partners in H1 2020

0.8x

DPI generated by China venture capital vintages between 2007-11, versus 1.35x for their US peers

at LGT Capital Partners. “And then it went global pretty quickly.”

Private equity rainmakers have had to adapt to global travel bans that have made the traditionally people-oriented fundraising process often entirely digital.

“We made a call quite early on that we didn’t think this was going to go away any time soon and instead of waiting for markets to normalise we were going to have to sort of pivot to being a specialist in virtual fundraising,” says Ian Bell, a partner at placement agent Evercore.

“We’ve found after some initial inertia from LPs, generally people are embracing this new virtual world. We’ve even had an LP on the day before an IC meeting ask if we can take a current photo of the GP’s team so they can say, “These are the people we are investing hundreds of millions of dollars with.”

Fundraising in the first half of 2020 was barely impacted by the pandemic as the bulk of money gathered reflected efforts that preceded the crisis. Private equity funds collected \$243 billion through June, \$9.3 billion more than

Mingchen Xia

Managing director and co-head of Asia investments, Hamilton Lane

Based in Hong Kong, Mingchen Xia has responsibility for primary and secondaries investments. Prior to joining Hamilton Lane in 2014, he was a senior fund manager at Tokio Marine Asset Management in Japan responsible for private equity fund investment globally.



Ian Bell

Managing director and head of private funds group in Asia-Pacific, Evercore

Prior to joining Evercore, Ian Bell spent eight years at Credit Suisse in both its Hong Kong and Sydney offices.



Gavin Anderson

Partner, Debevoise & Plimpton

Based in Hong Kong, Gavin Anderson is a member of the firm's investment funds and investment management group, advising sponsors and investors on issues including fund formation, co-investment, fund restructurings and carried interest arrangements.



Kyle Shaw

Founding partner and managing director, ShawKwei & Partners

Kyle Shaw founded ShawKwei & Partners, an Asian buyout and strategic growth capital firm, in 1999. Based in Hong Kong, he has more than 25 years of private equity experience in Asia, including at Security Pacific National Bank.



Doug Coulter

Partner and head of private equity for Asia-Pacific, LGT Capital Partners

Doug Coulter joined the firm in 2007 and has more than 20 years' experience in private equity and investment banking.

the equivalent period last year, according to *PEI* data. Of this, \$29.1 billion was dedicated to Asia-Pacific, dwarfing the \$19.2 billion raised for Europe.

“We feel more confident about Asia’s private equity market,” says Mingchen Xia, co-head of Asia investments at Hamilton Lane.

“Generally speaking, Asian businesses are more driven by underlying growth and don’t use as much leverage, so I think long-term this market will be more resilient. The handling of covid-19, which was better relative to many other countries and regions, plus the quicker economic recovery in Asia has also given us comfort. Of

course, we have some concerns such as the geopolitical tension between US and China in the short term, but fundamentally we still feel very confident.”

The large sum raised for Asia reflects an ongoing trend of capital flowing to pan-regional giants, with MBK Partners, Baring Private Equity Asia and CVC Capital Partners collecting more than \$17 billion between them in the first half. The pandemic could exacerbate this dynamic.

“There’s been an acceleration of a trend that’s been there for a while, in terms of a flight to quality or people going to managers they’re comfortable with in existing relationships,”

says Gavin Anderson, a fund formation partner at Debevoise & Plimpton.

Less established firms, of which there are a plethora in the more nascent emerging Asian markets, and those who are not cycle-tested may suffer as a result.

“We’re generally cautious about new relationships in this environment,” Xia adds. “We’ve moved most of our due diligence sessions online and for diligence work on the GPs we know very well or existing GPs it’s had less of an impact because we have known these people for some time. If the managers have just started to raise Fund I or Fund II and we haven’t met them before, then we would take some more time to get to know the team.”

Asia’s uncertain fundraising environment has prompted some creativity, Anderson adds.

“We’ve done, for example, some separately managed accounts that have been set up specifically to take advantage of dislocations created by the covid situation in the debt space,” he says. “We’ve also seen interest in things like annex funds and co-investment funds because people who maybe aren’t able to raise new capital as quickly as they wanted to are trying to eke out the old fund as a result.”

Conscious decoupling

Pandemic aside, politics might also impact LP activity in Asia during the second half of 2020 and beyond.

US-China relations have deteriorated to their lowest point in nearly 50 years, Beijing’s ambassador to Washington Cui Tiankai told NBC News in August. The situation has prompted concerns in Asia that US investors will face government and public pressure to reduce their exposure or allocations to Chinese private equity funds.

This dynamic is already playing out in public markets: in May, US president Donald Trump ordered the Federal Retirement Thrift Investment Board, a government agency managing \$594 billion, not to back an index

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GAVIN ANDERSON
Debevoise & Plimpton

containing Chinese stocks over national security concerns. In August, the US State Department warned university endowments to divest from Chinese stocks lest enhanced listing standards spark a wave of de-listings from US exchanges.

Technology has been at the heart of much of this decoupling, with concerns over Huawei’s ties to the Chinese government and ByteDance’s use of consumer data both touchpoints.

“For Chinese private equity funds, the technology decoupling can lead to another wave of investment opportunities because Chinese companies will have to use local suppliers in terms of hardware and software,” Xia says, noting the dynamic is unlikely to impact exits.

“For exits, Chinese entrepreneurs might be more thoughtful on the IPO market selection given US listing can be under a stricter scrutiny going forward, but we still see successful IPOs of Chinese companies continue to happen there. In addition, HKSE and Chinese

domestic STAR board have become good IPO markets for Chinese tech companies, which have been proven in the last two years.”

Tensions aren’t isolated to the US and China; several other nations, including Germany, the UK and Australia, have also ramped up scrutiny of Chinese investors in certain sectors.

“There’s been a lot happening beside covid-19 in Asia this year that our LPs want to know about,” says Kyle Shaw, founding partner of Asian mid-market firm ShawKwei & Partners. “North American and European LPs also want to speak to us about what’s happening in the geopolitical arena regarding China.”

Investor responses to these tensions are likely to be mixed.

“I would say there’s probably a correlation between the sophistication of the investor and the current willingness to stay the course,” Bell notes. “Larger institutions are generally continuing to deploy but for the private bank or high-net-worth channel it was perhaps a bit

more impacted by these headlines and it’s become a little bit harder.”

Endowments don’t appear fazed by the recent public markets warning.

“I was recently on a Zoom call with a US university endowment that’s very interested in dialing up China exposure because they feel underexposed relative to the domestic market,” Coulter recalls.

US institutions have been active participants in Chinese private equity. Hong Kong-headquartered Boyu Capital and Beijing’s Primavera Capital, DCP Capital and Centurium Capital, which raised four of the five-largest China-based funds last year, between them collected at least \$540 million from five US public plans, *PEI* data show. New York State Teachers’ Retirement System was particularly bullish, committing \$100 million to each of the \$3.4 billion Primavera Capital Fund III and \$2.5 billion DCP Capital Partners I.

“The first new GP relationship Evercore signed up post-lockdown has



Protests: China's proposed extradition law is prompting fears Hong Kong may lose its reputation as Asia's pre-eminent asset management hub

Spotlight: Hong Kong

Last year's Asia roundtable was held against a backdrop of social unrest in Hong Kong, with protesters having taken to the streets in opposition to China's proposed extradition bill.

The situation in 2020 is much changed following Beijing's introduction of the national security law in June criminalising acts of secession, subversion, terrorist activities and collusion with a foreign country. The move has sparked reports of a potential exodus of capital and talent overseas – fears which may be unfounded.

"You couldn't possibly move the financial services sector of Hong Kong and all the people involved with it," Coulter says. "There's not enough housing stock or school spaces. From that perspective it's a bit like London post-Brexit; absolutely there are individual decisions being made to move locations, but I think the general viewpoint would be London remains the financial capital of Europe."

The law comes as Hong Kong pushes hard to consolidate its position as Asia's pre-eminent asset management hub. Measures included the launch of a new Limited Partnership Regime on 31 August and assurances that it will become one of the most competitive globally on carried interest taxation.

"Singapore has for a long time, very aggressively and very successfully, promoted itself as an investment hub

in a way that frankly Hong Kong hasn't had to, because it has natural advantages of being the gateway to China and the community of investment managers and service providers," Anderson says. "It was the natural default choice, but Singapore has been eating some of Hong Kong's lunch."

Hong Kong's new limited partnership structure is intended to lure fund managers who were previously using Cayman structures, which are now subject to economic substance requirements.

"It's maybe not quite as light-touch as Cayman – you've got to appoint an auditor for example – but overall it works," Anderson says. "The question is whether they have done enough to move people away from Cayman or Singapore to Hong Kong, and I think it will get some business. The big unknown actually is the carried interest."

Hong Kong's consultation on carried interest tax was launched on 7 August and ended on 4 September. How sweeping these changes are could prove key to the Special Administrative Region's appeal.

"I've been living in Hong Kong for 30 years and it was an excellent choice to come here in the first place," Shaw adds. "There's nothing wrong with Hong Kong, but if you're going to initiate your career today, Shanghai or Singapore might be a better choice. In the future there will likely be fewer foreigners in Hong Kong, but there is still a great labour pool of local people here in Hong Kong who we can rely on while expanding our capabilities in Singapore and Shanghai."

actually been with a Chinese GP, which I think is a little contrarian to what we're hearing anecdotally from our peers, who are de-emphasising China because of all the covid issues as well as the broader US-China tensions," Bell adds.

"Ultimately, Americans are capitalists and will try to get the best returns they can. Obviously an economy of China's scale is still going to be a source of huge amounts of growth and opportunity."

Indirect access

Neighbouring Asian markets, particularly those in South-East Asia, could benefit from escalating US-Sino tensions.

"The net effect of trade war tariffs raised the cost of Chinese products

exported to the US and created about a 25 percent headroom for other countries to compete against China manufacturing," Shaw says.

"There are a number of US companies that have been deeply entrenched in China, and they're not necessarily looking to divest and exit China, but they're looking for an alternative. We spent a good part of this year with our portfolio companies working with European and North American customers who wanted to move products from China down to South-East Asia, whether it was because of tariffs reasons or to protect their technology."

ShawKwei & Partners targets buy-outs and strategic growth capital investments in business-to-business companies across the precision engineering and manufacturing, automotive, medical

equipment, maritime, oil and gas services and renewable energy sectors. The firm was established in 1999 in Hong Kong with offices in Singapore and Shanghai.

"It's not going to mean people leave China – they'll still want to do business in China – but they will not use China as an exporter of products or services," Shaw adds.

"My prediction is that Singapore is going to have a renaissance of advanced manufacturing. The ability to put in robotics, automation and data management has basically neutralised low-cost labour – what's more important is precision, supply chain management, technology, knowhow, all of which Singapore has in abundance."

For investors, South-East Asia could represent an opportunity to access China's growth prospects without the perceived risk associated with the market.

"A couple of weeks ago, a large pension fund was talking to us about a separate account that's more focused on South-East Asia because the very highest levels of that organisation don't necessarily want to be putting additional money into China right now," Coulter says. "They're thinking South-East Asia is a way to tap into the same China growth story but in a more indirect fashion."

The pandemic and political tensions are also driving private equity appetites for India.

"One of the things we think is interesting coming out of covid in places like China and India is really the rise of local brands," Coulter adds. "When you think about the rise of Indian brands, whether it be a beer company or a cosmetics brand, there's a lot of potential there as consumers stick closer to home. And because India's consumer sector has historically been quite underdeveloped, it's an interesting opportunity to help build very local Indian brands in a market that's quite open."

Indian venture capital was identified as a particularly attractive strategy, given the boost to technology during

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KYLE SHAW
ShawKwei & Partners

Analysis

coronavirus. Debevoise & Plimpton completed a “very oversubscribed” fundraise for an Indian venture capital fund post-covid, Anderson notes.

However, generating new dealflow can be a challenge during the pandemic.

“There’s been some impact on deals already in our pipeline going into covid but the biggest challenge has been generating new dealflow since being unable to see people or see the operations has slowed down our ability to assess the attractiveness of new investment opportunities,” Shaw says.

“Travel restrictions are now slowing the overall brainstorming of creative ideas about what to do with a company that may not be an obvious fit with our investment strategy but with closer inspection may turn out to be an interesting new opportunity.”

What’s more, investors are unlikely to forget that India has been badly hit by the pandemic.

“We expect that India and South-East Asia will recover later than China, Japan or Korea in terms of managers fundraising because there is still some uncertainty around covid,” Xia adds. “Generally speaking, our GPs in those markets are being cautious, so they are more focused on portfolio management and making sure the portfolio can navigate this tough time.”

Second opinion

With the pandemic likely to prompt heightened scrutiny of managers on the fundraising trail, the secondaries market could see an uptick in activity from those seeking to bolster their distributions.

“We’ve seen a huge amount of interest particularly in continuation funds, which used to be a bit of a niche thing,” Anderson says. “Now we’ve got all sorts of GPs looking at them and that’s been even more accelerated post-covid where the exit environment is a little difficult and you’re trying to show distributions.”

Emerging Asia – classified as Greater China, Indonesia, Singapore and

India – funds historically have underwhelming distributions relative to their US peers due to a predilection for minority investments, which can be harder to exit than majority positions.

In emerging Asia, only 2007-vintages have distributed more than 100 percent of committed capital and just two vintage years since have distribution to paid in capital greater than 60 percent, according to data from software provider eFront. By comparison, only 2014 and 2015-vintage Europe and US funds have distributed less than 60 percent of committed capital.

“In emerging Asia, it’s a must that they increase distributions,” Bell says,

noting that Evercore has appointed three secondaries bankers in Asia during 2020. “We see it as an opportunity that has to eventuate, to be honest, because there is a need for increasing distributions that the secondary market can help to fulfill.”

Although the pandemic could exacerbate Asia’s exit problem, there are reasons to be optimistic.

“There does seem to be a lot of liquidity out here both for corporates and financial sponsors and of course the banks have money to lend against transactions, so it’s really not a bad exit environment,” Shaw says. “In fact, there’s strong appetite for the right

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DOUG COULTER
LGT Capital Partners



Building the future: Singapore could see a renaissance of advanced manufacturing

types of businesses outside of China today from North America.”

China was the best-performing venture capital market in terms of TVPI in 2018, delivering 1.72x versus 1.63x for US funds, according to eFront. As of May, China vintages between 2007-11 had generated a 0.8x DPI, versus 1.35x for their US peers, CEPRES data show. Likewise, 2011-14 vintages have distributed 0.21x in China and 0.69x in the US.

“Until the middle of 2019, Asia was really coming into its own in terms of its distributions really increasing not just on an absolute basis, but also on a

relative basis to Europe and the US,” Coulter adds.

“We think South-East Asia is a very interesting market, but quite honestly, it’s really hard to find very many GPs that at a fund-level have been very successful in putting a lot of DPI on the board. Not to say there haven’t been some really good exits coming out of South-East Asia but the jury is still a little bit out on whether it can compete in terms of DPI.”

Asian secondaries activity has been growing in recent years as LPs become more accepting of previously taboo fund solutions. One

notable trend has been the emergence of yuan-to-dollar fund restructurings by Chinese GPs.

In Q1, direct secondaries specialist TR Capital backed one such restructuring involving seven assets managed by Beijing-headquartered Kinzon Capital in a deal worth around \$100 million in net asset value, as reported by sister title *Secondaries Investor*. A similar deal was done in 2018 by Loyal Valley Capital, *Secondaries Investor* reported, and another by the same GP in 2019.

Such deals can allow Chinese GPs to approach international investors with a seeded, dollar-denominated fund, which could be perceived as less risky than a blind-pool investment. Yuan investors are also restricted from participating in initial public offerings outside China, creating an opportunity for secondaries investors to buy them out.

“You might see it as part of an evolution of Chinese fund managers,” Anderson notes. “They might have raised RMB funds but at some point want access to a bigger pool of capital or a USD fund, and one of the ways to do that is to put some assets in a USD structure first and people can see what they’re buying.”

Pricing, however, remains an uncertainty.

“We are focusing on both LP secondaries and GP-led situations, and post covid, our dealflow has been the strongest that it has ever been, perhaps because things have been delayed and there are a lot of pent up deals,” Coulter says.

“We certainly do not see the discounts and distressed sellers that we saw during the GFC with both volume and pricing having recovered very quickly.

“Just like in the public markets, earnings guidance for 2020 in the private markets right now is somewhat uncertain, but given we are close to both PE managers and assets, we are still able to underwrite deals.” ■