

Asia is at a turning point



Insurers, family offices and sector-focused managers all play a significant role in the region's private equity. But, as **Carmela Mendoza** finds, markets are changing, and only the nimblest and most resilient can realise the high return potential

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From left:
Chris Lerner, global partner and head of Asia, Eaton Partners
Willa Hong, vice-president, Allianz Capital Partners
Gavin Anderson, partner, Debevoise & Plimpton
Vincent Chan, senior managing director and head of Asia, Samena Capital

It was just a few minutes before 9.30am in Hong Kong when four illustrious Asia-based private equity specialists walked into Debevoise & Plimpton’s boardroom, overlooking the city’s iconic Victoria Harbour. The topic at hand: what’s driving the Asia private equity scene and how different it could look in a few years’ time.

The make-up of the room was as varied as one might expect for a conversation about Asia private equity. Around the table were two Shanghai-based veterans: a fund placement specialist and an in-house asset manager for Allianz Group; and two Hong Kong-based experts: a fund formation

lawyer and an Asia, India and MENA-focused fund manager.

Asia continues to be a magnet for private equity and venture capital. Despite a dip in fundraising in the first half of the year – from \$22.6 billion a year ago to \$18.2 billion as of end-June 2018 – fundraising remains robust, given the positive economic backdrop and underlying fundamentals of the region.

Our panel is certainly positive about the region’s future.

Willa Hong, vice-president at Allianz Capital Partners, the in-house investment manager for alternatives for German

insurer Allianz, says the opportunity set in the region has broadened, with buyout deals, cross-border, complex take-privates and roll-out deals becoming more prevalent.

“We also see interesting dynamics in the mid-market in Australia, *chaebol* deals in Korea, while in Japan and South-East Asia, deals are getting pricier,” she says.

With global fundraising as robust as ever, Chris Lerner, global partner and head of Asia at Eaton Partners, says it all comes down to discipline and performance. “While there is ample dry powder, I do feel there’s an imbalance in where the capital is going as global institutional investors come to Asia and commit capital to a limited number of large brand names,” he notes. “That needs to shake out – where we come to see that bias reflected in the distribution of returns and less pricing inefficiency in the upper segment of the market followed by a correction or reversion to more acceptance at the sweet spot of the market.”

“The private equity model of fund investing is antiquated in that it looks at the world in discrete geographic segments. The reality is that the modern value chain and the global economy do not work that way

Chris Lerner





Vincent Chan, senior managing director and head of Asia at Samena Capital, meanwhile, notes competition has intensified, even among Asia's big players.

"You need to have scale; things are getting expensive in the market. If, for example you want to build Asia's next unicorn in three to five years' time, you will need about \$300 million-\$500 million, as well as the ability to quickly raise and deploy that capital."

FRAMING THE CHINA GROWTH STORY

The longer-term themes for China – "a consumer-led economy" and "a maturing

private equity market" – are still very much intact, all participants agree.

Shanghai-based Lerner says the outlook for China and its private equity is positive and notes several structural and fundamental reasons.

"First, we've now been through a full private equity cycle in China – the talent pool is there, the experience set is there. We haven't hit a true market downturn, which is the one key market cycle that we need to go through, but I feel there has been a noticeable maturation of the market and GPs are prepared for the new normal in China. It feels to me that we are at a turning point," he says.

“I think LPs’ co-investment portfolios are looking really good, it’s been a good time for returns. But at some point, the markets may start to change and then there might be some retrenchment

Gavin Anderson

"The digital infrastructure and the pillars of the new economy are already built. But if you look at the underlying composition of the middle market it still has a way to go. There's still a significant under-representation of consumer and business services. This is an opportunity for new businesses to be produced, to serve more specific market segments – that's what I refer to as the middle market gap in China."

Offering his general partner perspective, Chan says for limited partners, capturing returns entails selecting the right manager based on its ability to source deals and knowledge of the market. "I think Chinese GPs that are able to adapt to the new world, with their investment skill in technology and services assets, will be able to keep their returns."

But China private equity needs more time before it can produce a truly global firm like KKR or Carlyle, he adds. "When the industry thinks about CDH Investments, Hony Capital, Boyu Capital or »

» FountainVest Partners, there's no doubt they are top-performing firms. Yet, China is still very much profitable – why would a China-focused firm distract itself to trying to be global when there are so many attractive opportunities in the home market?”

Private equity returns in China compare well with the US and Europe, according to data from eFront. China-focused firms generated an average internal rate of return of 10.0 percent from 2011 to 2017, against 9.5 percent for US funds and 12.9 percent for funds in Western Europe.

Within the region, China also dominates both fundraising and dealflow. In the first half of 2018, 11 private equity funds focused on the country closed on a combined \$3.6 billion, representing 20 percent of total regional fundraising, according to PEI data.

A total of \$55.1 billion of China-backed private equity and venture deals were recorded in the first half of the year, according to S&P Global Market Intelligence, despite regulatory and political headwinds. This dwarfs the \$7.2 billion in Australia and \$5 billion in India.

While it may be a step too far to characterise China GPs as the dominant force in global private equity in 10 years' time, all roundtable participants agree they will play a bigger role in the global scene.

Hong says: “We are already seeing that some of the Chinese GPs are becoming more active in cross-border deals. In addition, the Chinese GPs are learning best practices from their global peers.”

Gavin Anderson, a partner at Debevoise & Plimpton, adds: “I think if you compared where China firms were 10 years ago, the progress is incredible in terms of how much bigger the funds are and how much more outward-looking they are. You see them on the global stage, in the big buyouts and the complex take-privates. It will be interesting

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Vincent Chan

to see in another 10 years where that goes.”

There are, however, a few China market misconceptions to ponder, says Lerner.

“One, there is a perception because of recent history that China is a winner-take-all market. That used to be true and linked to that is the derivative argument of too much capital chasing too few deals. However, with the core pillars of the new economy built we are going to see more mid-size transactions and more ability to create businesses that serve distinct consumer sets, link technologies and distribution channels, or offer customised solutions for businesses.”





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Willa Hong

Another is around buyouts. Global institutional investors have had such a strong desire to see more buyouts in China that they are almost pushing that narrative because that is how they made money in their home markets.

Lerner says: “I think that’s a bit of a false notion. Chinese LPs and GPs are quick studies and they are happy to talk about any market opportunity that will put them in a better position to raise capital. There will be big take-privates, there will be some succession opportunities, but I just don’t think we will see a massive trend in buyouts over the next couple of years and I don’t

think those deals will necessarily outperform. M&A is on the rise in China, but it’s been driven by ecosystem consolidation of growth companies and reorganisation of state-owned enterprises and traditional industries.”

THE CO-INVESTMENT PLAY

About a third of Allianz’s new capital allocation every year goes to Asia, a vast majority of which is in fund commitments, followed by co-investments and secondaries.

“We do like Asia and we are deliberately overweight to the region, because we are long-term investors here,” Hong says. “Private equity is an attractive asset class for insurers in general because of the long duration; it matches with the long liabilities.”

Hong adds co-investments is the approach Allianz prefers to take when investing in the region. The investor started making co-investments globally in 2008 and in Asia in 2013.

“It’s a good way for us to do due diligence on the GP because we have first-hand experience of how the team works,” she says.

As is common for global institutional investors’ investment teams in the region, Allianz’s is small, with six people, managing the regional allocation of the firm’s €10 billion private equity portfolio.

She notes that investing in Asia requires a more forward-looking mindset, especially when assessing GPs, because it is still a relatively young market compared with the US and Europe.

Lerner observes that as the Asia private equity market grows, deal sizes and fund sizes have become bigger, which has created more opportunities for co-investments.

“Many of our GP clients will look for LPs who are capable of supporting them in a co-investment, but they have to have a real capability because a lot of times »

MEET THE ROUNDTABLE



CHRIS LERNER

Lerner is the global partner and head of Asia at Eaton Partners. He leads Eaton’s origination and execution of fundraises, secondaries and strategic advisory. He has more than 18 years of experience in private markets investments and investment banking with more than \$15 billion in completed transactions. Prior to joining Eaton, he was managing partner for Mercer Street Capital. Lerner worked at Citigroup, Salomon Brothers and Smith Barney earlier in his career.

WILLA HONG

Hong is vice-president at Allianz Capital Partners, where she manages the firm’s private equity and venture capital funds, as well as co-investments and secondaries investments in Asia. Before joining Allianz in 2015, Hong spent four years at GIC focusing on Asia fund private equity and venture capital investments and co-investments, and three years at DB Private Equity, specialising in secondaries and co-investments.

GAVIN ANDERSON

Anderson is a partner at Debevoise & Plimpton and a member of the firm’s investment funds and investment management group. He has broad experience in advising sponsors and investors on a variety of issues, including fund formation, co-investment and carried interest arrangements. He has acted for clients including Baring Private Equity Asia, CDH Investments, Morgan Stanley and Navis Capital Partners.

VINCENT CHAN

Chan is the senior managing director and head of Asia at Samena Capital Hong Kong. He was the founding chief executive and is now the non-executive chairman of Spring Capital, an independent private equity firm that invests exclusively in China. Chan has 24 years of experience in private equity, and has made more than 45 investments in growth companies in China.

these are pressure situations where time is of the essence.”

Hong agrees the execution capability of an LP is very important. “We try to give our GPs certainty as much as we can. It’s either a quick no or a firm yes, which could be as speedy as three weeks.”

In *Private Equity Market 2017*, fund services company Intertrust found the majority of Asian private equity professionals (74 percent) expect to see an increase in the number of co-investment partnerships and separate accounts offered by Asian GPs to LPs by 2019.

Lerner expects the trend to continue, adding the industry will see more interesting secondaries opportunities (for example, investors that have gotten into direct deals

without a viable exit plan), especially as we enter a slower period of growth.

Anderson also agrees LPs continue to be attracted by greater deal selectivity and the prospect of higher new returns through lower fees. “We’ve certainly seen a huge amount of co-investments as well as different structures. Some LPs come in after a syndication process, while others come directly into the portfolio company on the frontlines alongside the GP. And then you’ve got some investors these days like the Canadians and Singaporeans who might even be leading the deal and bringing in the GP.”

What’s more interesting, he notes, is how this trend will play out in the long term. “I think LPs’ co-investment portfolios

are looking really good, it's been a good time for returns. But at some point, the markets may start to change and then there might be some retrenchment."

IN THE FAMILY

Asked about the importance of family offices and private wealth in the region, Anderson says: "Certainly it's more active here in terms of bigger pools of capital allocated to the asset class, as well as these LPs being more involved in sourcing and investing in deals directly more than in some other places. I see them all across

the spectrum – some of them going into funds and a lot of them co-investing or doing deals alongside funds. A lot of that is perhaps fee-driven but also maybe more of a spirit that these people are pretty sophisticated and independent-minded. They want to be doing their own thing as opposed to investing in someone else's fund."

Chan, who has raised capital from Asian, European, American and Middle Eastern family offices, adds it's all about diversification. Family offices nowadays are also more sophisticated – many of them prefer to pick up stakes in GPs and co-invest alongside

them. It's crucial, he notes, that first-time funds attract family office money. "Family offices can add value in particular situations whether in deals or partnerships with GPs."

Hong notes most private family money or high-net-worth money still comes through the private banks. "Many private wealth investors are not used to the illiquidity of the typical 10-year fund, as well as the fee structure."

"From my own view I think Asian family offices are an important growing segment of the institutional investor ecosystem for private equity funds," Lerner says. "What I've observed is a return to fund investing. I think there was a period of time, particularly post-global financial crisis, where Asia-based families were disenchanted with funds, where they were put off by the fees and performance, and really focused on turning inward to build their own direct investment capabilities. Today, I think many have come around to the fact and the market has evolved to a point where you can't do everything in-house."

Lerner also asserts "the private equity model of fund investing is antiquated".

"We look at the world in discrete geographic segments. The reality is that the modern value chain and the global economy do not work that way."

Nevertheless, Asia private equity is evolving more quickly to become about domain expertise and value-add than geographic focus.

"I think an example of that is South-East Asia, which to some degree is becoming the next frontier for many China-based firms," Lerner says. "It's a neighbouring market, with cultural proximities across the whole region. And it's experiencing a development cycle that Chinese GPs have to some degree experienced before, and they'd be loath to relinquish that opportunity to global firms." ■

THE NEXT OPPORTUNITY

Vincent Chan: "Beyond China and India, the biggest markets in Asia are Indonesia and Vietnam. You may be a relatively new entrant to these two markets, so where do you go? For us, we look at the reputable and emerging promoters, and the strong local partners we can work with.

"Through our third fund we invested in an undervalued tourism company in Myanmar that is now becoming part of Memories Group, the first Myanmar tourism platform listed on the Singapore Stock Exchange. In Sri Lanka, we have backed a first-generation entrepreneur in growing his listed conglomerate, Softlogic Holdings, which operates across the fast-growing consumer, healthcare and financial sectors.

"However, access to liquidity in exiting investments in emerging markets remains a challenge. Equity markets in these regions can remain nascent. This is always on our mind – how can we exit in three to five years' time when liquidity is a challenge. Who can we potentially sell to?"

Willa Hong: "I think growth itself may not necessarily equate to good returns for private equity because especially in Asia, there are so many factors that can come into play – from macro-economic to geopolitical issues, to the structural workforce and demographics. Looking at size alone, markets like China, India and Indonesia in Asia are important ones that we cannot neglect."

Chris Lerner: "I think the vibrant and digitally native youth of the South-East Asian markets means that we are going to see more similarities in tastes and preferences across markets in South-East Asia than we've been previously used to, thinking about the region as a collection of very different countries and economies. I think that is going to create new opportunities for companies that can identify and serve the needs of that customer segment operating across those different markets."