ASIA ROUNDTABLE

A new dawn?

While Asia is now home to many experienced GPs, the private equity industry is waking up to the fact that strategies which have worked in the past may no longer be a feasible way to generate returns in the region.

By Clare Burrows

Stepping into the AIA Tower in Hong Kong's Central district, the aggressively air-conditioned lobby was a welcome relief from the sweltering August heat. Upstairs, in the offices of Debevoise & Plimpton on the 27th floor, *Private Equity International* found its six roundtablers chatting amongst themselves about their latest activities in Asia-Pacific.

As their thoughts, hopes and concerns unfolded during the two-hour discussion that followed, it quickly emerged that the stark contrast between street and lobby was something of a metaphor for the region's private equity markets. In Asia, some places are hot, others are not.

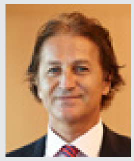
In recent years, there has been widespread LP disillusionment about the performance of Asia funds: the returns GPs have delivered are, on the whole, barely a patch on what investors had been expecting.

That doesn't mean that LPs have written off the region as a no-go zone – but they have learned some important lessons.

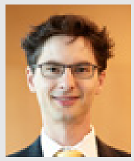
According to Martin Mok, a partner at EQT Partners Asia, which advises the EQT fund, there is now a "smarter breed" of LPs, who know how to question their fund managers. They're asking questions like: 'Can you really make money without control?' – a common concern for investors in Asia.

Happily, their questions are being answered increasingly honestly by GPs – most of whom argue that you need to be doing buyouts or at least significant minority deals for an investment to be worthwhile. Our three GP representatives – EQT's »

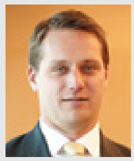
MEET THE ROUNDTABLE



Markus Ableitinger is a managing director and co-head of investment management Asia at **Capital Dynamics.** He has 17 years of private equity direct and fund of funds investment experience. Prior to Capital Dynamics, he was investment manager at RMF's private equity division.

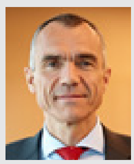


Gavin Anderson is international counsel with **Debevoise & Plimpton.** Based in the Hong Kong Office, he is a member of the firm's private equity practice group, and advises sponsors and investors on fund formation, co-investment and related activities.



Michael Lukin is a managing director of **ROC Capital Partners,** which was recently formed following a management buy-out of the Macquarie Investment Management Private Markets business.

Martin Mok joined **EQT Partners** in December 2001. He is a partner and managing director for China. Prior to EQT, he worked for Goldman Sachs and McKinsey & Co. in Hong Kong.



Bruno Seghin is a partner and investment committee member at **Navis Capital Partners,** based in Hong Kong. He joined the firm in 2003, where he focuses on originating, executing and enhancing investments in Greater China and India.

Marcus Thompson is the CEO of **Headland Capital Partners.** He joined the firm in 1992 and has been a member of the firm's investment committees since 1993. He began his career in private equity in 1988 with Prudential Venture Managers in the UK.

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>
> **Markus Ableitinger**

» Mok, Headland Capital Partners chief executive Marcus Thompson and Bruno Seghin, partner at Navis Capital Partners – all hailed the importance of control deals, while Gavin Anderson, Debevoise international counsel and the legal expert at the table, agreed that buyout funds have been becoming more popular.

Nevertheless, investors continue to be cautious – perhaps even cynical – towards strategies in the region.

THE BIG BUYOUT QUESTION

Markus Ableitinger, managing director and co-head of Asia investment management at Capital Dynamics and Michael Lukin, co-founder of ROC Capital Partners (formerly the funds of funds unit at Macquarie Bank), offered an LP perspective, talking about investors' ability to spot the real, credible managers (operational capability is seen as one of the most important factors here).

They agreed, however, that history suggests investing in minority deals is not always a feasible strategy.

"I think over the years most have realised that . . . it is extraordinarily difficult to divest a minority growth capital deal – to get out of those deals where you have e.g. 8, 10 or 20 percent, in particular in China and India," Ableitinger explains. "We are always looking at GPs and thinking about what their credentials are in exiting companies and [how much] experience [they have] in this. That is always one of the most important things to find out during due diligence."

GPs acknowledge these challenges. "If you've 10 percent or 20 percent of a company, it is hard work generating an exit if the IPO markets shut down," Headland's Thompson says. "You can't expect a fairy godmother to arrange for a strategic investor to turn up and say, 'OK that's interesting, we'll [buy] it.' As a result of our 25 years of experience of investing in Asia, our focus outside of China has very much switched to control deals. For minority deals, you have to be highly selective in terms of the type of companies you're investing into – because the IPO markets do ebb and flow, and you really need to have a compelling story to take a company to market [with] the IPO markets as they are today, [i.e.] selective. Unless you are also selective, it could be very difficult getting out. It's been an evolution, because the development of the buyout market has been quite slow. But we're seeing it take off today."

Navis, which has a strict buyout-only policy, has noticed a growth in the number of control deals available due to the increasing number of corporate carve-outs in the region, as well as entrepreneurs facing succession issues, Seghin explains. "The market has evolved a lot and we've had to adapt a lot. Now we invest in bigger companies, so we had to raise bigger funds. If you don't grow, you die."

Nevertheless, Asia's private equity model – minority stakes with less leverage – can be a welcome change for LPs, says Mok. "In Europe you're growing at 2 percent, but you're levering up by 6x, 7x or 8x EBITDA. In Asia, you're only levering up one to two times and the exit is very different as well. [But LPs] know it's a very different animal."

However, there are concerns over whether there are enough buyouts for the pile of money that has been raised for Asia in recent years.

Kohlberg Kravis Roberts raised its $6 billion Asia fund last July, precipitating 14 months of big fund closes. CVC Capital Partners, The Carlyle Group and TPG Capital all closed their funds at between $3 billion and $3.5 billion during this time, while pan-regional players Affinity Equity Partners and MBK Partners raised $3.8 billion and $2.7 billion respectively.

That may sound like good news. But it also means Asia's level of dry powder has jumped to record highs.

At the end of 2013, Asia's dry powder totalled $138 billion, 9 percent up on the $127 billion remaining at the end of 2012, according to data by Bain & Company. China accounted for a large proportion of that bulk: its domestic market was sitting on about $65 billion in undeployed capital as of the end of 2013, up about 20 percent on 2012.

The general feeling in Asia is that buyout supply has been lagging demand. However, Thompson believes this is changing. "The bright spot that we see is the growth in buyouts across the region – [though] less so in China, I have to say. This is being driven by two main factors: one is family or shareholder succession issues and the other is corporate spin-offs of non-core business assets. To LPs investing in Europe and North America, these drivers will be familiar – but in Asia, it's historically been somewhat of a taboo for a family company to sell control."

Debevoise's Anderson agrees, with the caveat that firms generally reserve the right to do minority deals. "I think there has been a move towards buyout and control-oriented transactions. Obviously different managers have different strategies but I think there is definitely a move towards that."

However, Ableitinger argues that in some cases, GPs are just adapting their messaging to please LPs. "There comes an element of marketing as well. People realise it's difficult to take growth capital deals to the end – not investing into them, but exiting them. The reality is simply that it is difficult and the return expectations are, [based on what has] come across over the past few years, unmet on an average basis."

As such, it's hard for growth capital funds to raise money in the current climate, he says. "So often, the manager goes back and thinks about what they can do. And we all understand private equity is very inventive, [so GPs/managers] right now are trying to market 'buyout' strategies. That's what we find many growth capital managers have tried to do in the recent period, in many cases purely because it appeals to the LP better. LPs in general like managers doing more buyout/control investing."

BACK TO DIVERSITY

Many LPs will admit that their Asia strategies have wavered somewhat over the past decade. Having originally preferred pan-regional vehicles, investors then got excited about specific countries or sub-regions, pouring money into China-, India- or Southeast Asia-focused funds.

"Firstly I think there are more LPs looking at Asia today than there were five or six years ago," Thompson says. "Secondly, [since] 2008, there has been a swing back to regional-focused funds."

"When many came into this region in the mid-2000s, a lot of LPs were not really sure what Asia was – [i.e.] what countries there were where you could successfully do private equity," Ableitinger explains. "I think it's going to turn out like it is in Europe, which is a relatively nice model for Asia. [Europe] has also a high degree of pan-regional perspectives with various countries and cultures."

Sub-regional funds are also getting traction. Navis, for example, enjoyed notable success with its latest $1.3 billion fundraise for its seventh vehicle, which is focused on Southeast Asia.

According to Seghin, there's still an education process that comes with fundraising – with an added requirement of managing the expectations of new LPs rushing into a hot market.

"You have to address LP expectations because everybody knows there's enthusiasm but the deals are not necessarily there – they are very expensive and small and you have to balance both. And then you could have good performance on the public market – and we have also a team focusing on that – but it doesn't translate automatically into the »

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» same thing on the buyout side. So yes, you have to manage the LPs a lot and [help them] understand, because the last thing you want is them to be disappointed."

That said, cross-continent vehicles have also enjoyed success. EQT's Mok believes greater diversity can be appealing for many LPs, as exemplified in the way EQT's fund covers both Asia and Europe (the funds merged in April 2013 ahead of launching a €1 billion vehicle).

"LPs are getting very, very educated about [Asia]," he suggests. "At the moment they are not really making up their mind about the region – in the sense of making an explicit comparison of deals across the three regions, [and] making up their mind about which one or two to favour. They are very different in growth and leverage ratios, in the complete buy-out versus joint venture type of deals."

"But one thing's for sure: if EQT were, as an alternative option, to split [the fund] up again, there would be those [LPs] on the Asian side that would come in, and those on the European side of things that would come in. So in theory, [a joint fund] should be able to afford investors more choices and therefore attract more LPs."

PAY-TO-PLAY

Macquarie's Lukin explains that generally, LPs just want the best opportunities – and they have started to realise that this may mean going against the general market trends.

"Our clients generally have a very broad focus," he says. "They want to be opportunistic; they want to be investing regionally; but they also want to be counter-cyclical and look for opportunities where others are passing. I think simply going with the crowd has been a thematic where people have got Asia wrong historically."

He expands: "Australia before the [GFC], Japan at a similar time, India in 2006 and 2007 and China in 2010 and 2011 – that's when the most capital was raised into each of those markets, but they were also the worst times to be investing. So I think what our clients are very focused on is trying to go against the grain and look for opportunities where others are pulling out of markets."

The good news is that as LPs look for opportunities, there are a growing number of worthy GPs to consider in Asia these days, Anderson argues.

"There are plenty of pan-Asian funds, a lot of them very, very established; there are many country funds that have been around for a long time; and then [there are] people in the middle who are concentrating on a specific region. So I think that there's really a lot more than there used to be in terms of what LPs can choose from for what they want to invest in."

Adds Lukin: "I think for the pan-regional managers, there is a benefit of raising larger pools of capital, which is akin to what they're doing in other markets. Globally, a lot of the sovereign wealth funds or larger investors are now looking at minimum [cheque] sizes that are well above what most funds would be able to absorb. So there is the propensity for some of those larger investors to look to deploy $400 million to $500 million of capital into an individual fund and get exposure to Asia that way, as opposed to breaking that down into maybe $40 or $50 million dollar bite-sizes for country funds."

However, the number of high-quality managers has not intensified competition to the extent that GPs are conceding on fees – something that's increasingly common in the West.

Anderson continues: "In Asia, there is a smaller group of funds that everyone wants to get into – to the extent that they're oversubscribed, and so have leverage and can hold a line on fees to a larger extent. People have also been able to sustain the argument that a pan-Asian fund with a number of offices and people flying around the region

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> **Michael Lukin**

is just going to have a higher cost base than some other models."

Lukin agrees that the choice is much more limited than in the US or Europe. "There's still not that breadth of proven track records in the Asian market broadly – so you don't have funds ten and eleven, where you'll be able to pick and choose between managers and play off their fee scenarios. I think people need to be focused on [getting] the investment right, and then trying to negotiate fees as best as they can. But that's difficult where there are still limited numbers of funds that have generated good returns for investors."

However, says Ableitinger: "There aren't so many multibillion [dollar/euro/etc] funds here yet. But for those who are here, fee questions are already starting to become an issue. It's just that for the medium-sized funds it probably hasn't started yet; for those with multi-billions, it is already under discussion."

OUR VALUE-ADD

Be it regional or country funds, Asian GPs are now being forced to demonstrate their ability to make real and effective operational changes, particularly as growth in the region slows.

Debevoise's Anderson explains that this is driving the increasing number of buyout-focused funds coming to market.

"There are a lot more funds [that say]: 'We actually understand this business [and] we can make operational improvements; we don't just do deals but we also have these operational guys on our team. And, in order to achieve that, it can be helpful to have more control over the company – which can mean doing buyout-style deals. Now it's frankly pretty standard that you have people in there and that really is their job – they're not going out and finding the investments, they are actually making operational improvements, and they're from that sort of background instead."

Others agree that times are changing.

"Before, the private equity guys would just bring the bag of money and then

structure [a deal] in a highly-evolved, contractual way – and then everything in terms of the operating responsibility went back to the founder," EQT's Mok explains. "Now we're seeing firms say, 'We will share that risk and we will not [just] redeem you. We will take the common equity risks, but on the other hand you can't treat us as strangers. We'll come here every month and we'll spend a day with you, [and] open up [the business]; we're going to have a real discussion about things and we're going to [visit] overseas markets a couple of times during our ownership period, so we see other CEOs in other bigger companies.' All these things are happening."

LPs have been concerned about whether it's possible to effect operational changes without control. But while this remains a real issue for GPs, some have cracked the code.

"I'd say from our experience of investing as a minority that if you can present good ideas and be constructive in discussions with the entrepreneur or major shareholder, then there's no reason why they shouldn't listen to a minority investor," Headland's Thompson argues. "Because they're the major shareholders, they're

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>
> Marcus Thompson

going to be the biggest beneficiary of any operational improvements that can be implemented. So I think there's actually less of a divide between control deals and non-control deals than perhaps many people might think."

All agree that an operational improvement plan is important from the word go.

"I think 90 percent of your investment is done the day you invest," Navis' Seghin believes. "Now that implies that you have analysed very well what you buy and that you have also analysed the weaknesses of the company and where you can bring value. So it's important from day one »

» that you have it right. If you are, for example, dealing with the founder and he still has 25 percent, it [should be] part of the agreement when you made the investment – that you have identified those issues and you have said: 'This has to be different and I propose [these changes]; are you OK with that?"

But this is never easy, he adds. "You have to go very, very deep and identify the whole issues – that's critical. Human resources for instance, helping investee companies to find the people, is critical. As a company has been growing very fast from one factory to four factories in 3 years for instance, how could you optimise your gross margin instead of only pushing for the top line? And with every difficult issue, you still have to respect these people who have done it for 20 years."

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> **Martin Mok**

However, Mok highlights three big challenges for GPs with regards to operational improvement. "It really hinges upon the ease with which you can replace management – that's significantly easier in Europe, while it seems harder in Asia. [Another] component is the ease of getting really highly-qualified industry advisors to be your board members; again, that's easier in Europe than in Asia. The third thing is getting those board advisors or board members to co-invest a lot of money – and again, that is easier in Europe than in Asia."

As the discussion drew to a close, the participants ponder how Asian GPs should be integrating value-add capabilities into their strategy.

For example, Kohlberg Kravis Roberts has its KKR Capstone operational unit, separate from the firm but working almost exclusively for KKR-owned portfolio companies. Other firms, such as Creador in Southeast Asia, are launching in-house operating teams, while some are hiring a cross-breed of investment professionals with deep expertise in specific sectors or industry.

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> **Gavin Anderson**

Do LPs have a preference? "We want to see that [skill-set] – the ability to make operational improvement to the business – embedded within the GP," says Lukin. "Whether that's as a separate operating resource or as part of the core team, we just want to see that depth of operating experience across the board. We're not biased one way or the other [in terms of how it is done]; what we want to see is that [that] skill set is prevalent within the organisation." ■