



ASIA ROUNDTABLE

Value in a slowdown

Four Asia private equity veterans explain what Asia's slowdown means to the investment community.

By *Drew Wilson*

Asia's fundraising, deals and exits are down year-on-year, realisations continue to be particularly difficult and GDP growth is slowing in the region's two giants, China and India. How are GPs and LPs responding to these weakening indicators? To get a better picture, *Private Equity International* gathered four executives in Hong Kong who have deep experience in Asia's private equity industry.

FUNDRAISING

PEI: Have LPs lost faith in China and India?

Hugh Dyus: It's obvious there's been a very dramatic cooling of sentiment. If you look at the statistics for the first half of 2013 versus 2011, fundraising is down about 35 percent for the whole of Asia-Pacific. But for China, it's down 60 percent and for India it's down 85 percent.

That's really driven by concerns over the existing exposure LPs have. A lot of portfolio companies are not travelling well and there is a lack of visibility over exits, particularly with China and India being heavily dependent on growth capital strategies and IPO markets being very unresponsive. LPs are really waiting for distributions to come [back] before making substantial new commitment decisions.

LP sentiment in aggregate has actually proved to be a good contrarian indicator of where you should invest. The best vintages for Asian private equity were the five years after the Asian financial crisis, when LP sentiment toward Asia was absolutely terrible. The best multiples of money across funds came from those vintages. So if LP sentiment is dramatically cooling, then that could be good for vintages 2014 and 2015. »

MEET THE ROUNDTABLE



HUGH DYUS
MACQUARIE FUNDS GROUP
Dyus heads Macquarie Funds Group's private equity investment activities in the Asian region. He has over 19 years of M&A and private equity experience in Asia Pacific.



WILLIAM SHEN
HEADLAND CAPITAL PARTNERS
Shen is senior partner, head of Greater China, and a member of Headland's investment committees. Prior to joining Headland in 2004, he worked at Vertex China Investment, managing its PRC private equity investments.



ANDREW OSTROGNAI
DEBEVOISE & PLIMPTON
Ostrognai is a corporate partner and chair of the law firm's private equity practice in Asia. He focuses on fund formation and downstream investment in Asia-Pacific.



WENDY ZHU
ALPINVEST PARTNERS
Zhu is a partner in Alpinvest Partners' Fund Investments team and focuses on Asian markets. She joined the firm in 2007 from Macquarie, where she was senior vice-president of Asia-Pacific private equity fund investments.

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“ **LP sentiment in aggregate has actually proved to be a good contrarian indicator of where you should invest** ”

Hugh Dyus

» **Wendy Zhu:** You do have LP sentiment cooling off. The number of firms that are actually fundraising is quite a bit less than before as well, so that's also driving down the dollar amount being raised and it shows in the data. GPs are more cautious in terms of target fund size. We're seeing people raising the same amount as last time or slightly higher. The sentiment is more negative for India than China. Jokingly, you can say that a China fund manager can still get a meeting with an LP. An Indian manager can't even get a meeting right now. That's the contrast [between] the two markets.

But the lack of fresh capital being raised is actually much better for returns in the long term. Overall, we have seen way too much capital over the past few years, and any cooling off is good news.

Andrew Ostrognai: What I've seen over time is a broadening of the investor base. Every time we have a new fundraise, we're often also seeing investors who were never in the market before. A lot of the US pension fund investors who've never been out in Asia are now coming. The other phenomenon is that a lot of the major investors are beginning to double down. Six, seven years ago, nobody knew who the top managers would be, so you saw a lot more spreading across funds. Now you see a flight to perceived quality. So a major investor is not going to be investing in six



China managers, they're going into two that they know.

Chinese insurers now have regulatory approval to invest in overseas private equity. There's a large pool of capital there. Given that it's a completely new pool, every major fund is going to want some Chinese insurance capital. Has anybody heard any rumblings of Chinese insurance money? We're beginning to see it around the edges. There really is no regulatory structure yet. The first few people who make it all the way to the finish line are going to say, 'that's the path forward' and that's going to change things.

William Shen: The insurance companies are very cautious and also it seems like they're building their own investment teams. They may just want to invest themselves.

VALUE CREATION

How significant has value creation work become in this slower-growth environment?

Zhu: It's critical going forward to have operational capabilities. In a slow growth environment, it will be difficult to deliver double-digit type of growth on the top line – and given increasing margin pressure, I really need to see operational capability from a GP. I agree that everyone says they do it. But who really has done it and has the real capabilities?

Increasingly, entrepreneurs recognise that they need help. And that's important, especially for a minority shareholder. Before the growth started to slow, entrepreneurs were headstrong because they had done very well by themselves. But with a slowing market and increasing »

» competition, grabbing market share is no longer profitable – so they do need lots of help and there is more receptivity to help from private equity fund managers. Obviously it's much easier if you have control. But in markets like China and India, that's just not yet widely available.

Shen: Portfolio companies are experiencing challenges because the landscape has significantly changed. Five years ago in China, to build an apparel brand you'd put a lot of advertising on TV and then sell your products through the wholesalers. You really didn't need to manage the retail network. Therefore it wasn't capital intensive. Now, however, H&M, Zara, Uniqlo and The Gap and more high-end women's wear have moved into China. Consumers just have many more choices, so unless you can continue to offer a strong value proposition to your shoppers, they're not going to come back to you. That's why it's prime time for private equity to really roll up their sleeves and work closely with the companies which genuinely need their help.

Dyus: Everybody claims to have very strong operational capabilities, so it's a question of 'shades of grey'. You have to do a lot of work to understand how real the capabilities are. Funds can't easily be put into buckets – [i.e.] one has the capability and the other doesn't.

There has been more value creation by the control-oriented managers and the

reason is fairly simple. If you're a minority stake investor, it's not obvious your controlling shareholder will welcome operating value-add. He might say: 'No, that's my responsibility. I don't want you doing that'. Secondly, say you own 20 percent of a business and you create a huge amount of value. Eighty percent of that value goes to somebody else, only 20 percent to you, because you're a minority shareholder. So, if you're a minority investor, you have less of an interest in operational value-add.

Shen: About this whole control issue and whether a GP would have more or less incentive to focus on value creation – that's where I disagree. Because whether I own 20 percent or 80 percent of a company

in which I invested \$100 million, I still have \$100 million at risk. So, I generate additional value and the owner captures 80 percent of it. But the value also grows my \$100 million. So a majority or minority stake does not influence value creation.

I would rather back someone who I think is charismatic, very driven and is going to take this company somewhere and let him get 80 cents on every dollar made. All his net worth is in the company. Don't you think he's going to be more incentivised and more aligned with the GP than a guy I hired to run the company and give a 5 percent stake to? He's doing all the driving, but he's getting paid 5 percent. Just because the GP has capital, he gets the other 95 percent. How well aligned are their interests?

“ In a slow-growth environment ... and given increasing margin pressure, I really need to see operational capability from a GP

Wendy Zhu



I totally understand the cynical view on value added, because everyone claims they do operational change and sometimes it takes a long time to find out what that really means. It's not about just hiring a consultant to go in and say, okay, you have these problems. Take for example, our investment in [Chinese down apparel company] Bosideng. I worked closely with the chairman to suggest changes to the products and retail management that weren't accepted right away. In some cases it took years. You've got to be patient. You've got to establish that rapport with management. I agree that most people cannot influence while holding a minority stake, but there are certain GPs who can.

CHINA

How is the continued closure of China's IPOs impacting the private equity ecosystem?

Zhu: The IPO market, when it re-opens, will favour quality companies – larger companies that have scale already. Going forward, where can the money be made in China? That's the key question. It's going to be challenging because the multiple arbitrage play is diminishing quickly and economic growth is slowing. There needs to be a serious effort to create real value in portfolio companies, which is what companies in China need. A lot of entrepreneurs have gotten to where they are based on instinct, based on their entrepreneurship. But that's no longer enough to get their companies to the next level. So true operational value-add, the ability to upgrade a business to the next level, scaling companies, is where a lot of the money can be made going forward.

Shen: The shutdown of the IPO market is a great period for GPs in China to really focus on working with their portfolio companies to grow their businesses. Because if you can continue growing the business, at some point the capital markets will be open.



Other companies do not have that growth trajectory, so you need to come to terms with the owner and think about a strategic sale, and we've seen quite a few strategic sale exits. As a lot of Chinese companies get larger in size, they become acquirers of these smaller companies. So the M&A exit route is becoming more real and credible.

Are RMB funds still important for offshore firms?

Dyus: The alleged advantage of having an RMB fund is the ability to do deals quickly. [But] compressed deal timetables in China are actually a big risk. It's not something to be embraced, it's a problem. You should do as much due diligence over as long a period of time as possible.

“Most people cannot influence while holding a minority stake, but there are certain GPs who can”

William Shen

Shen: It does create conflicts of interest. From the LP perspective, what currency are you going to invest in a deal, RMB or US dollars? Five or 10 years ago, you could have argued that from an entrepreneur's point of view, yes you have got to run »



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Andrew Ostrognai

disadvantage if they don’t raise an RMB fund. Because when the regulations do liberalise, there will be five, six, seven other major offshore investors who are ahead of the game in dealing with the Chinese investor base. But they can be a challenging investor base. Part of it is just people not understanding the product. They ask, “What do you mean I have to give cash to the fund? I don’t like that [particular] deal.”

Shen: Domestic LPs may say, ‘I can double my money myself, so why are you giving me 2-and-20 percent carry? And by the way, I want to sit on your investment committee.’

Ostrognai: The problem is due to the fact that there’s been a lot of hype around private equity in China. Can you imagine in the US, your average person on the street getting hyped up about private equity and wanting to invest in it? In China you actually do see that. It really is perceived to be the next get-rich-quick scheme, so that influences the way the domestic investor base looks at funds.

INDIA

Sentiment towards India is bleak. Does that make it a good time to invest?

Dyus: There’s lots of bad news, lots of fundamental problems, a lot of disillusionment – but the situation has further to play out before India becomes sufficiently attractive and pricing starts »

» an RMB fund because a US dollar fund could take a year to get the money through regulatory approval – and that’s a problem, because that capital is needed and the clock is ticking. But these days, the Chinese regulators are quite reasonable; a foreign investment that’s less than \$300 million only requires provincial-level approval. That approval could be speedy if you have a legitimate business and, let’s say, your company is quite reputable in that province.

Of course, some US dollar private equity funds may want to have RMB funds for an additional source of management fee revenue. Simple as that.

Ostrognai: I have a number of clients who run joint funds and we’ve developed, over

the years, ways to deal with the conflict of interest in managing offshore and onshore funds in China. Part of it has been resolved with a track record that the investors have been comfortable with. These managers have done the right thing and so there is less worry.

From a lawyer’s perspective, there is going to be increased regulatory convergence. In five to ten years, I would expect we’re going to be able to form vehicles within China – Chinese limited partnerships that will have both foreign and domestic money in them and still get domestic treatment. Ultimately there is going to be a community of domestic investors that you’re going to want in your fund and you have to start cultivating them now. People may feel it’s a competitive

to fall. What's surprising is that valuations for many deals that are being done today are still high. When valuations come down, I'll be willing to go back and look again.

The other big problem with India is currency risk. People have taken a big hit on currency. There's a lot more concern about currency risk in India than there is for China. And the cost of hedging is prohibitive – that's another major negative that keeps investors back.

Zhu: It's difficult to be optimistic about India at this point. I haven't seen sufficient policy support over the past few years, and scaling businesses has proven to be challenging in India. Of course in certain sectors, such as business process outsourcing where infrastructure is less of a hurdle, you can scale businesses. But in general, that is difficult. I agree that valuations still need to come down further. Anything of any scale is still trading at really high multiples. We also need to see more regulatory stability in many sectors.

FUND OF FUNDS

Do Asia's funds of funds really offer value to LPs?

Dyus: There is no significant differentiation between most of the funds of funds, who are basically promoting their 'superior' ability to select managers. It's just a commodity service. You can't charge high fees for it, at least not in today's market. So in general there is insufficient differentiation. You see that in the fact that there have been a lot of M&A transactions in the fund of funds industry.

What is the value that the funds of funds do provide? They often do it with things like education and training and high levels of customer service and that's how they try to differentiate themselves. For ourselves, we go about it a different way and we obtain a lot of our exposure to the market through

secondaries and co-investment. Primary fund selection is only a small proportion of our overall business.

Zhu: There is a selection benefit of investing through someone that has a team on the ground that is closer to the market and has the experience and the network. There are issues that you just don't know if you are not based here. I look at the portfolio of someone who invests from outside of the region and then I compare that to a locally-vetted fund portfolio and I can see the difference.

Identifying emerging managers and sponsoring spin-offs are some of the real value the fund of funds can provide. They can help to identify and support a new generation of GPs that are more institutionalised, which is what this market needs. In terms of what differentiates the Asian fund of funds among themselves, going forward scale and funding and stability of the team will matter.

Dyus: I've done extensive research on the available performance data comparing median fund of funds private equity net returns to median private equity net returns and I've never found data where fund of funds returns actually outperformed private equity. Typically the fund of funds returns were lower. That doesn't mean that individual managers cannot outperform. It means the industry as a whole isn't achieving the superior returns they promise after fees.

The whole idea that people can foresee the top quartile of funds is actually not borne out. Of course, every fund of funds will say, 'we back these managers, because we can pick the top quartile' but the return data hasn't proven that they can. What it does show is they can avoid the bottom quartile and there is merit in that. But because of their double layer of fees they actually don't provide compelling net returns. And

of course returns from fund of funds take longer to come back as well. So their value proposition has to come from something other than just pure fund selection.

Ostrognai: Looking at it from the general partner perspective, fund of funds – the good ones – are among the most valuable investors to have in the fund for vetting commercial terms. You tend to find that they're very professional. Some pension funds and sovereign wealth funds do not necessarily have purely commercial agendas. Family offices sometimes have family-oriented agendas. At least with the fund of funds it's purely a commercial agenda. There is not a whole lot of window dressing around other motives. They just want to get good terms and they generally tend to hire smart lawyers. Having a really top quality fund of funds as one of your investors can be both helpful and a signal to the market that it's a vetted fund.

EXITS

Will the exit environment improve in 2014?

Zhu: IPOs seem like they will continue to be fairly slow this year and next. So GPs need to think through what is the likely exit scenario if it's not IPO. This becomes very important in terms of knowing how you get the money out of the investment in a downside scenario. GPs have to ask » this question for every single investment they make. If it's not IPO, if it's not trade sale, can they realistically get money back through redemptions or put options? And in those cases does the entrepreneur have the willingness and the capability to pay? That has to be a big focus.

Ostrognai: What we're beginning to see is fund life extensions. There is a lot more discussion of that, which of course goes back to fees during fund life extensions. But the dialogue has started. ■