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# The calm before the storm

*Headline risks and recession fears in the Asia-Pacific private equity markets have put a greater onus on managers to pursue growth levers, Alex Lynn writes*

Storm clouds weigh heavy over the Hong Kong offices of Debevoise & Plimpton as five private equity professionals gather on a Friday morning to discuss the Asian markets.

The ominous skies are fitting given recent events. At the time of writing, Hong Kong had entered its 13th consecutive week of protests, the most recent of which saw barricades torched in the streets, passengers tear gassed at close quarters on the MTR system and Chinese military vehicles enter the special administrative region as part of a “routine” rotation.

Dramatic headlines have become a mainstay of Asian private equity over the past 18 months. Before Hong Kong’s extradition crisis, it was the ongoing Sino-US trade war that dominated much of the discourse.

“In an average CIO’s office or investment committee, headline risks take time to come to the table as something to discuss and then linger before they’re swept away,” says George Maltezos, co-head of Asia at advisory firm Campbell Lutyens.

“We’ve been talking about trade wars for quite a long time and now the CIOs are acutely aware of it; they can’t avoid the headlines so they’re asking questions that

are going downstream to professionals on the ground. It’ll take some time for that to leave the system, and it has a very real possibility of slowing down one’s deployment, allocations or investment pace.”

Certain sectors are already feeling the heat. “What we hear from our portfolio companies is that some sectors, like auto in China, seem to be heavily impacted,” says Wooseok Jun, head of Asia-Pacific and fund manager for Asia subordinated and equity funds at Intermediate Capital Group.

The impact on private equity could be mitigated by a movement away from those industries most at risk, with manufacturing and exporting businesses having played a less significant role in recent years.

“On the industrial side we’ve not really touched anything that’s based on cost exporting since 2010 because the direct workforce has been shrinking in China for years,” Martin Mok, head of mid-market Asia at EQT, notes. “If you listen to most industrialists nowadays, you don’t make cheap things in China – that game’s long gone.”

The focus in Asia has instead shifted to the tech-related sectors, financial services and those linked to domestic consumption, such as healthcare, according to Bain & Co’s *Asia-Pacific Private Equity Report 2019*.

PHOTOGRAPHY: GARRIDGE HO



### George Maltezos

Partner,  
Campbell Lutyens

Based in Hong Kong, Maltezos heads Campbell Lutyens' Asia-Pacific activities and looks after institutional investors in Australia and New Zealand.

### Wooseok Jun

Head of Asia-Pacific,  
Intermediate Capital  
Group

Based in Hong Kong, Jun serves as head of Asia-Pacific and fund manager for Asia subordinated and equity funds. He joined the firm in 2013 as head of Korea following an 18-year stint leading financings and acquisitions of companies across the Asia-Pacific region.

### Gavin Anderson

Partner,  
Debevoise & Plimpton

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

### Martin Mok

Partner,  
EQT

Mok is an 18-year veteran of EQT who serves as partner and head of EQT mid-market Asia. He is a member of the mid-market partners investment committee and the Greater China II investment committee.

### Sunil Mishra

Partner,  
Adams Street Partners

Based in Singapore, Mishra is responsible for the sourcing and execution of Asian investments ex-China, specifically in India, Australia, Japan, South-East Asia and Korea. He joined the firm in 2007 following spells at Tata Group and Standard Chartered.



The internet and technology sectors, which make up China's new economy, have accounted for almost 85 percent of the growth in Greater China private equity since 2010.

"When we first started 20 years ago, a lot of the capital demand across Asia was for building capacity," Sunil Mishra, a Singapore-based partner at global fund of funds Adams Street Partners, adds.

"We quickly moved to a domestic consumption economy and innovation investment themes, which has been driving our portfolio growth in recent years. Consumption is a big part of our investment thesis today across Asia – especially in India, Australia and increasingly China, where they've gradually shifted the economy over a period of time."

### Holding the horse

Asian dealmaking slumped in the first half of 2019. Asia-Pacific M&A activity, excluding Japan, fell 22 percent year-on-year in H1 to \$341.3 billion across 4,095 deals, the lowest level since H1 2013, according to Dealogic. The decline was driven in no small part by China and India, where deal values fell 31 percent and 52 percent year-on-year to \$175.6 billion and \$31.2 billion, respectively.

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**GEORGE MALTEZOS**  
Campbell Lutyens

Private equity firms deployed \$87 billion across 580 transactions in Greater China in H1, compared with \$130 billion in 1,069 deals in H2 2018, according to PwC.

"We've been late cycle for the last two to three years now, so there's broad consensus that there is a recession coming," Mishra says. "We're starting to see GPs being very cautious about what they're buying and what they are paying, in terms of asset quality, sectors they're in and valuations. Most people think that during the life of this fund they'll see the recession and want to deploy the capital gradually so they still have part of the fund to invest during the recession."

China is not immune to recession fears – its GDP growth plummeted to 6.2 percent in Q2 2019, a 27-year low – but the room remains bullish.

"The Chinese government did say it won't go below 6 percent and, without a more escalated trade war or the Hong Kong protests blowing up into a national issue, it doesn't look like it will," Mok says.

"Everybody's holding the horse a bit and recession fears may cause a temporary falling off the cliff in speed of deployment and exits, but 6 percent growth is still very respectable compared to where other countries were at this stage of development."

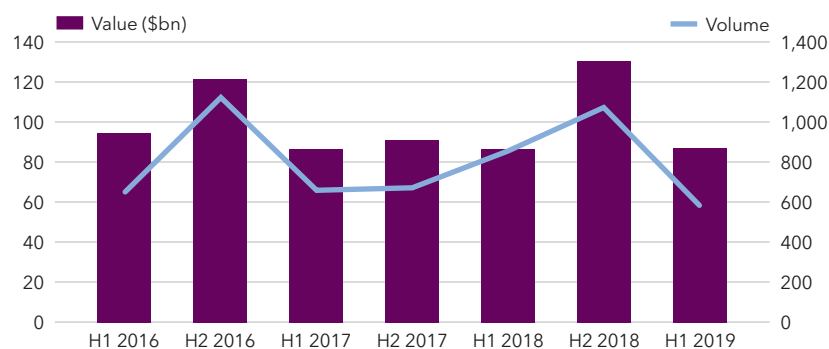
Recession talk may be at least partly to blame for a moderate slowdown in Asia-Pacific fundraising this year. Private equity firms had raised \$33.6 billion for the region across 67 funds as of early September, compared with \$63 billion across 149 vehicles throughout 2018, according to PEI data.

Last year saw Hillhouse Capital Group raise \$10.6 billion for Fund IV, the largest ever private equity fund dedicated to the region, followed by The Carlyle Group, which raised \$6.55 billion for Asia Partners V, and Hong Kong-headquartered PAG, which collected \$6.1 billion for its Asia III.

"You have a longer-term trend of the big getting bigger, with capital flowing to a handful of brand-name firms," Gavin Anderson, partner at Debevoise & Plimpton, notes.

"We've seen smaller fund managers can find it harder and it can take longer to raise

China M&A fell by 18% in the first six months of 2019, the largest single-period decline over the last decade



Source: PwC

funds, particularly if they don't have much of a track record behind them. There's also a creative destruction process, so if the smaller fund fails to raise capital, it probably still has good people and assets that can look for a home elsewhere."

But this two-speed fundraising environment could – in time – present opportunities for those hunting lower down the food chain.

"The trend of money flowing into the larger funds has been happening for the last couple of years, but recently a lot of opportunities are brought to us by the second generation of funds," Jun says. "From what we see in the mid-market space, there are tonnes of deals, whereas in the large multi-billion space in South Korea and Australia the brand names don't have enough deals."

Firms have completed just 20 private equity deals in Australia in 2019, well below the 107 signed last year, according to a report by the Australian Investment Council and EY. Spending could end broadly similarly though, with \$10.1 billion deployed so far, compared with \$17.5 billion last year.

### Levers of growth

The possibility of an impending recession has changed the way some firms pursue growth.

"A lot of managers are actually expecting some multiple contraction related to recession and that means the better firms are focusing on higher-growth EBITDA companies to offset that," Jun says. "If we see a meaningful terminal value risk then we'd try to structure the transaction with a larger debt portion so we're less exposed to the multiple."

As the market matures, so too has the way firms consider value creation. Ander-

son recalls a time when fund private placement memoranda were primarily focused on Asia's growth story, rather than operational improvement.

"The focus on operational partners and sector expertise has really evolved and you have new tools in terms of analytics to help portfolio companies to look at markets, options and strategies," he says. "There's enormous opportunity to add value there."

Market conditions are likely to favour those with a strong focus on value creation.

"The long tail of managers that are not

*"We're starting to see GPs being very cautious about what they're buying and what they are paying, in terms of asset quality, sectors they're in and valuations"*

**SUNIL MISHRA**  
Adams Street Partners



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**GAVIN ANDERSON**  
Debevoise & Plimpton

quite as experienced or don't have the teams and the skill set to focus on operational improvements are going to really suffer,” Maltezos says. “A significant portion of the market needs to catch up, which is not easy.”

In China, only 44 percent of private equity investments completed in H1 2019 were buyouts, according to investment advisory BDA. Limited ownership means firms don't always have the ability to implement drivers of growth.

“A lot in the market today are saying they can do buyouts in China – a statement most LPs love to hear – but we all understand on the ground that taking full control, having the right personnel and enacting the right strategy from an operational perspective is difficult to execute in China,” Maltezos says.

EQT navigates this issue by opting for co-control deals alongside company found-

ers in China, Mok notes. It pursues 40 percent to 50 percent ownership stakes but retains the ability to replace the chief executive and trigger an exit.

“If you do a buyout in China, some LPs will say you're doing people a favour by picking up the lemons from their private owners, so this is a more refined version we use,” he adds. “It's an improved version of having many growth assets in your portfolio that you cannot manage.”

EQT's buyout team has also started collaborating with its venture capital and digitisation teams to assess the disruption risk of investment targets before it writes a deal.

“Things are moving faster here and the ‘venturisation’ of everything is disrupting all businesses,” Mok says. “After EQT has invested, we then focus on improving consumer engagement, operating efficiency and expanding into adjacent products or services.”

### The land of opportunity

On the subject of growth, talk turns to Japan, which is becoming the destination of choice for global private equity firms. Apollo Global Management, Pantheon and Tikehau Capital have all opened Tokyo offices in the past 18 months, while EQT is planning an outpost in the city.

A global presence could benefit those attempting to crack the market, Jun says. “A lot of Japanese companies are looking for an international brand and want to break out of the local market, so they're asking how many offices you have around the world.”

With around 10 Japanese firms raising funds this year – according to Maltezos – establishing a local team will likely prove integral to their success.

“It's now the market to watch for due to the development of local talent at mid-market firms run by domestic professionals and also the international firms building very strong local teams who can unlock transactions and do value creation without stepping on toes,” Mishra says. “In our mind, the key ingredient is experienced local professionals who have been in private equity for a while





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**MARTIN MOK**  
EQT

and know what it takes to drive successful outcomes.”

Part of Japan’s appeal lies in its favourable lending environment and ageing demographics, Jun adds. More than half (53 percent) of companies with a CEO in their 60s do not have a successor lined up and the same can be said for 34 percent of those with a CEO in their 80s, according to BDA.

But implementing the necessary changes is not without its challenges, Maltezos says.

“Culturally, they’re not all ready for what many of us from outside of Japan may see as obvious low-hanging fruit in terms of improving operations, rationalising teams and digitising some of the businesses. They could handle a fraction of what we might dream up as a game plan, so the ability to pull the levers that private equity professionals have in their toolkit feels limited.”

**Expanded toolbox**

Although the toolkit in Japan might be limited, Asia-Pacific managers have a greater number of solutions available when it comes to liquidity.

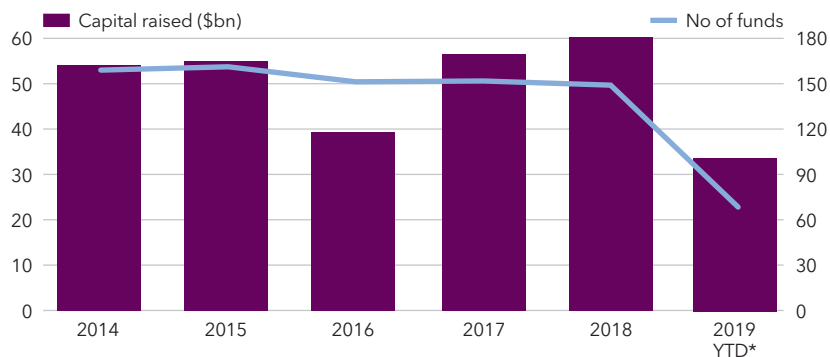
“If you’ve got an old fund that many people want to get out of, people were his-

torically stuck or perhaps unhappy, but now we’re seeing a lot more solutions available in terms of being able to offer liquidity through some sort of tender process or restructuring,” Anderson says.

“People can now set up continuation funds and keep managing them; there’s a lot more in the toolbox.”

The region has seen some prominent secondaries deals over the past 18 months. In February, TPG closed its seventh Asia flagship fund on \$4.6 billion with the help

Asia-Pacific fundraising has slowed in 2019 after a peak last year



Source: PEI  
\*data as of 13 September

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**WOOSEOK JUN**  
Intermediate Capital Group



of a stapled secondaries transaction involving Lexington Partners, Adams Street and Partners Group.

Last August, Government of Singapore Investment Corporation and NewQuest Capital Partners backed a transaction that involved restructuring a portfolio of assets held in a yuan-denominated vehicle managed by Loyal Valley Capital. Meanwhile, Japan's Norinchukin Bank sold a \$5 billion portfolio to Ardian earlier this year – the largest transaction to date.

“There is increasing awareness globally for secondaries as a tool for liquidity management,” Mishra says.

“With some of the franchise names globally embracing the secondaries market, some of the Asian firms are coming

onboard with that idea too and proactively thinking about it as the asset class matures.”

Performance concerns have been a key driver in Asia's adoption of secondaries.

“If there is one frustration people have about investing in Asia it's that IRRs look great and DPIs look weak,” Maltezos notes.

“At the end of the day we're dealing with emerging markets where liquidity is available during various windows, things may take longer and exits are not as buoyant as we have seen in the US. We have tools that can help a set of stakeholders around an existing portfolio generate some liquidity, short of a forced fire sale or taking on financial leverage, and we've seen a lot of this in Asia over the past three years.” ■