
Navigating Asia's private equity markets



By Kevin Tan

Regional players debate issues such as the lack of corporate governance and the need for due diligence during a panel discussion on private equity in Asia.

Foreign private equity firms piling into China should beware the potential pitfalls of falling foul of their Chinese investors, warns **Veronica John**, President and CEO of IDFC Capital Singapore, an emerging markets private equity fund of funds firm.



Noting that a significant amount of China's local government investment funds are allocated by municipalities, foreign private equity firms "have to tread so carefully" and have to be "very concerned" about the composition of local LPs (limited partners or investors) in their funds, John told INSEAD's

second Asia Private Equity Conference in Singapore.

“You probably don’t want to go into a fund that’s dominated by Chinese LPs,” says John. “There’s a great story about a Chinese LP reading the limited partnership agreement and saying ‘yeah, well this is all fine and good, but there are no provisions in this contract, with respect to who we punish if we lose our money.’”



Nevertheless, private equity firms raised \$8 billion in the first nine months of this year to invest in China, some \$6 billion of this capital coming from domestic investors, according to **Mayukh Mitter**, a panellist at the INSEAD conference and executive vice president of GIC Special Investments, a unit of Singapore's sovereign wealth fund. "That's a very scary and very different kind of phenomenon which is happening now," says Mitter.

So this increased participation of local investors, who may not always be very sophisticated, has "huge implications" for foreign investors interested in China. There are all kinds of corporate governance issues around the collaboration of capital between foreign private equity firms and Chinese investors, says John.

It is therefore necessary for foreign investors to do due diligence on their prospective fund managers and their LPs in China, India and elsewhere, says John. For instance, high net worth investors in India have occasionally failed to honour their capital commitments despite signing investment contracts with their GPs (general partners or fund managers).

"We've had GPs who've found themselves in quite sticky situations when they had to go back to their institutional LPs and tell them they have to cover for the high net worth investors," says John.

IDFC Capital's initial fund of funds allocated 80 per cent of its investment funds to Asia, with the remaining 20 per cent allocated to emerging markets elsewhere. Of its investments in Asia, 25 per cent is invested in India, another 25 per cent in China, 15 per cent in Southeast Asia, and the rest in other parts of the region.

The fund is focusing primarily on private equity managers investing in middle markets, with fund sizes of between \$65 million and \$600 million.

John explains that IDFC does not invest in large private equity funds that manage more than \$600 million due to the "rather limited" opportunities in billion-dollar deals. She prefers to invest in fund managers in the early stage of their careers that are looking at middle market and distressed buyout deals.

In contrast to IDFC's fund of funds investment approach, **James Liu**, managing director of OAKS Family Office, a single-family investment firm, says it does not believe in investing in funds, preferring joint investments

with other major investors.

That would allow OAKS the ability to cherry-pick investment projects that might interest them, said Liu, also a panellist at the INSEAD conference.

Though OAKS invests across the spectrum of asset classes, Liu has a sceptical view of the private equity industry.



One reason is that PE firms are increasingly playing ‘pass the parcel’ with investments. “By definition, PE is supposed to discover companies that are undervalued; they go in there and extract value, optimise the value, then do a trade-sale or IPO,” said Liu. When one PE firm buys from another PE company, the first firm clearly “didn’t do a very good job because they didn’t optimise the value.” If a third PE firm then enters the picture, there must have been a lot of money left “behind on the table,” he said, adding: “There are too many deals going on among themselves, pushing the prices up.”

Private equity investments are long term in nature but personnel may come and go. “You know the guy who came to the pitch with a song and dance with a ‘great, look at me and my track record’. Two years down the road, where’s that guy?” says Liu.

Liu also laments that GPs provide their LPs with a general idea of what they’ll invest in, but do not provide absolute certainty about their future acquisition targets.

Consequently, Liu says he prefers co-investment projects because he’ll know what he’s investing in – one deal at a time and as an equal investment partner.

For instance, Liu has made joint investments in China with Singapore’s CapitaLand Group due to CapitaLand’s track record in China. “So we try and identify partners with expertise, who know what they’re doing ... then we don’t have to worry about (investment) style drift,” says Liu.

Responding to Liu’s criticism of the failure of some GPs in extracting value from their portfolio companies, IDFC’s John says GPs in emerging markets are creating value instead of extracting them, by providing expansion capital to the companies.

The role of the GPs, says John, is to work with owner entrepreneurs to grow their businesses and increase their value before subsequently securing a profitable exit.

“So they are not really leaving money on the table,” says John, as GPs in emerging markets have on occasion been able to achieve exit multiples of as much as between five and eight times.



On the topic of the compensation structure of the private equity industry, John says there should be significant change in how the investment fees are charged by large private equity firms.

The private equity industry usually levies a management fee of up to two per cent on assets under management, and 20 per cent on the carried interest (profits) after a certain rate of investment return.

Efforts should be made to ensure that PE firms managing between \$400 million and \$1 billion and above are putting their financial resources to work and are not just getting rich from the management fees, says John.

GIC's Mitter notes that some GPs levy unjustifiable 'monitoring fees' (or management consultancy fees) on their portfolio companies, which is unpopular with LPs. Especially over in the US, some private equity firms get rich by raising billions of dollars in funds but fail to find suitable investments, adds Mitter.

Asked whether deal opportunities in the secondary markets could spur investment interest in Asia, John says there are still not many secondary deals in Asia in the wake of the global financial crisis.

For example, IDFC bought the equity that a university endowment held in an Indian private equity fund, which was 90 per cent publicly traded, says John.

As the university endowment was in need of liquidity following the financial crisis, it sold its stake even though the net asset value was trading at a 25 per cent discount.

“We already knew we made money,” says John.

Secondary market investors wanted distressed investors to take large haircuts on their financial positions, John adds. But the distressed investors refused to do so.

“Basically the university endowment and a lot of investors who are over-committed effectively, they looked at the underlying portfolios, they look at Asia and they said ‘fundamentally there’s nothing wrong with these investments. We’re not willing to take that haircut, we’ll look for liquidity elsewhere’. And that’s what happened,” says John.

However, John says she believes that the secondary investment market in Asia will pick up in the next two to five years, with deal opportunities arising from the collapse of private equity funds that were launched before the global financial crisis.

Many of these funds were set up by Indian and Chinese GPs who had spent most of their careers outside their home countries, says John.

“They came back in and found they didn’t have the local networks. They weren’t really private equity investors, they were usually investment bankers, and there’ll be some fallout from that,” says John.

“But it’s just going to happen more slowly because after the financial crisis, these markets became buoyant again.”

This article was written by Kevin Tan based on a panel discussion at INSEAD’s second Asia Private Equity Conference. The forum was staged by the INSEAD Private Equity Club which is run by MBA students.

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