

Stefan Hepp summarises the findings of SCM Strategic Capital Management's second State of the Asian-Pacific Private Equity Markets survey

Asian private equity: an alternative emerging market

Stefan Hepp is CEO and founder of Switzerland-based SCM Strategic Capital Management AG

For more information go to www.scmag.com

As the credit crunch and housing downturn spread through the broader economy, their impact on institutional portfolios is becoming increasingly apparent. Concerns about price inflation, stemming from rising food and energy prices, will prevent central banks from cutting interest rates anytime soon. In fact, recent trends are actually now moving in the opposite direction, which suggests a continued weak outlook for bond markets while equity markets remain volatile with earnings declining and margins being under pressure from weakening demand and higher cost of production. In those uncertain times, institutional investors reevaluate their current investment

strategy, looking for further possibilities to reduce risks by diversifying their assets even more. While the slowdown in the global economy will dampen growth in Asia in 2008, projections are only slightly below the historical average of the past five years. Due to Asia's exceptional economic growth during the last decade, private equity investments in the region have become a topic of interest for many investors.

The macro-perspective: Asian economies at a glance

Asia has been the fastest growing economic region for the last ten years. The nominal GDP growth rate of Asia (ex Japan) is 7.6% p.a., compared to Europe's 4.4% p.a. On an individual country level, China's economy (incl. Hong Kong) grew 9.7% p.a., Vietnam's 8.5% p.a. and India's 8.3% p.a. over the last decade.

The structural fundamentals behind these strong growth patterns are rising urbanisation (especially in China and India) and increasing manufacturing and spending power, which results in consumerism. The International Monetary Fund (IMF) predicts growth rates of 8% to 9% for India and 10% to 11% for China for the coming years.

The Asian region built on its historical export and manufacturing advantages also become a major consumer market with a strong base of fixed assets. China is already the fourth largest economy behind the US, Japan and Germany, and is expected to become the world's number two by 2015.

Private equity as part of M&A activity

Given the above-average economic growth of the Asian countries, it is of little surprise that the Asian M&A market grew in 2007 with +37% above the global average of +27%. Despite those record amounts, Asian M&A activity is still, compared to other regions, rather low.

Regional shifts

2007 witnessed a striking regional shift in terms of private equity, with India replacing Australia/New Zealand as the country with the largest transaction volume and a 23% share of the total Asian transaction volume. India is followed closely by China (22% share). India and China were each home to one of the five largest buyout deals in Asia in 2007. However, it is important to note that

the relative strength of China and India is a result of a contraction in deal activities in Australia/New Zealand and Japan.

Investment and fund raising trends

2007 set a new fundraising record for the Asian market. More than US\$33bn was raised last year alone, which is an increase of about 30% compared to 2006. Last year, five country-specific mega funds (> US\$1bn) were raised, the biggest with a target size of \$4bn. Although there is no general capital overhang in the region, there are areas of concern: new money raised for buyouts in 2006 to 2007 represented just 1.7x the money invested during that period, while new money raised for venture capital funds was more than 10x the investment amount during that same period. This indicates a continued massive capital overhang in the venture capital segment.

Asia's exit patterns

The key driver for the heightened interest of investors in Asia is the attractive investment returns that many private equity funds have delivered in recent years.

The average exit multiple in 2007 was 3.0x invested capital, a slight increase compared to 2006. It must be noted that this number does not include write-offs and reflects also many small exits from venture and growth funds that took advantage of the stock market boom.

Nearly 80% of all exits were realised through IPOs, however, when considering the realised volume, IPOs only represent about a 40% share.

This finding corresponds with the observation that most IPOs result from venture or growth financing transactions, rather than buyout deals, which leaves those funds more exposed to the closing IPO window in 2008 than buyout funds.

How to invest in Asia

Overall, the SCM research shows that the Asian private equity industry is maturing and that there is ample room to grow and to do well as many companies and sectors remain attractive on a global basis. It would seem Asian buyouts and growth financings are the place to be for the foreseeable future.

Transaction volumes are bound to rise further due to a growing acceptance of private equity investing in many markets as well as growing transaction sizes.



The biggest bottleneck for investors is the relatively scarce supply of seasoned teams and the ultimate difficulty to deploy capital with private equity firms that are on par with top-tier firms in Europe and the US.

The recent stock market boom in many Asian markets has allowed for attractive exits through IPOs that provided liquidity for private equity investors who held minority stakes in fast growing companies where entrepreneurs looked for additional capital but were not willing to surrender control of their companies.

While those situations provided good investment opportunities, there is a risk that if an IPO fails there is no other exit alternative as the majority shareholder will not sell out to a trade buyer.

Investors have thus to analyse track records very carefully in order to understand whether a private equity manager just benefited from a favourable stock market environment or was able to add operational value and negotiate control and protection clauses that would have enabled it to pursue other exit alternatives in the event that an IPO would not have been possible.

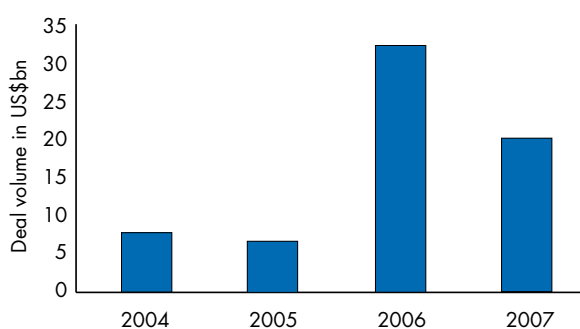
Most pension funds will find it hard to survey the deal flow and the track record date that is a prerequisite to determining both the performance of a manager relative to his peers and whether results are indicative of a broader skill set that justifies the assumption that a manager can continue to produce results in a more competitive and challenging environment.

Investors who seek to exploit the attractive diversification and return properties of Asian private equity investments should therefore opt for a systematic approach to the asset class and the region.

This approach includes sufficient time, manager diversification and an investment process that is founded on internal or outsourced resources, enabling the identification of the few robust investment offerings that exist in the region and access to those funds that offer the potential for superior future returns.

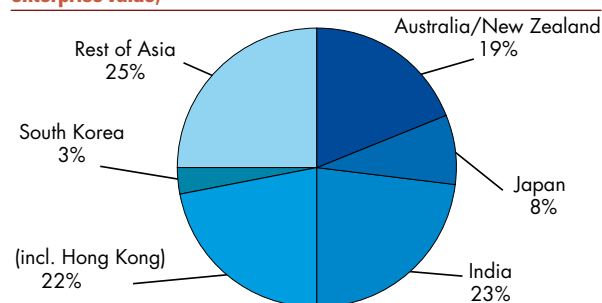
In many instances this will require work with external specialists, right from the planning stage for such an investment programme, in order to ensure that proposals made to the trustees are based on a sound analysis of the realities of the Asian private equity marketplace.

Chart 1: Asian buyout market by deal value in US\$bn



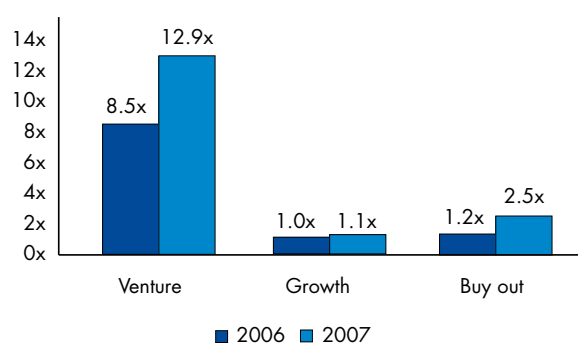
Source: Asia PE Review 2007 / SCM

Chart 2: Geographic breakdown of Asian PE investments in 2007 (by enterprise value)



Source: Asia PE Review 2007 / SCM

Chart 3: Multiple of new capital raised vs. annual investment (equity) in 2006-07



Source: Asia PE Review 2007 / SCM