

Private Equity & Principal Investing



What we talk about when we talk about...

Private equity in Asia

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What we talk about when we talk about... private equity in Asia*

Introduction

Private equity firms have long been interested in Asia. And since the revival of Asia's export economies after the 1997–98 currency crises, that interest has only grown. Many of the largest Western firms have opened offices in Asia's leading money centers—Tokyo, Seoul, Singapore, Hong Kong—and have set out to find the kinds of undermanaged, underleveraged, and underdeveloped companies that have proven so rewarding in the US, the UK, and Europe.

Some of these firms have succeeded in places, and most have had a spectacular deal or two. But none have enjoyed the kind of consistent success that they envisioned when they first embarked on their Asian adventure. The problems of investing in Asia are legion. “Asia” is an incredibly diverse set of countries, some ancient, some modern, straddling ten time zones and ten thousand miles and each with unique laws, languages, business cultures, and traditions. Getting one or another of these details wrong has tripped up almost all of the world's best investors at one time or another.

Today, the global recession has cast private equity in Asia in a new light. While PE has been adversely affected everywhere, in Asia the slowdown has afforded investors a chance to rethink their strategy. To aid that process and help PE firms sort through the complexities of investing in Asia, McKinsey has conducted an exhaustive research effort. We studied the six markets that together represent almost the entirety of PE investment in Asia: Australia/New Zealand, Greater China, India, Japan, Korea, and Southeast Asia.¹ We gathered and verified data on deals, fund-raising, and exits, and, for the first time ever to our knowledge, aggregated, and reclassified it so that investors can make sensible comparisons of size, growth, and potential among these very different economies. To this we added the collective experience of our senior partners, gained from serving the largest PE firms globally, as well as many of the biggest limited partners in Asia.

The research shows that during the years 2003 to 2008, private equity² in Asia grew as never before, fueled by

rapidly expanding economies and an influx of foreign capital. In this summary paper, we examine—both for Asia broadly speaking and for each of the six markets—the forces that lie behind that growth, the obstacles that have held back PE from achieving its aspirations, and the hallmarks of a successful Asian PE strategy. As might be imagined, these are vast topics, and so we have limited our remarks here to a high-level overview.

As reports for 2009 come in, it is clear that the pace of investment and growth has slowed. The research points, however, to a set of conditions that will likely lead to a resumption of long-term growth. The lessons learned in the past few years still apply, and can, we hope, provide a useful guide to today's unpredictable markets.

Up and up

Rapid growth has been the signature of the six Asian private equity markets we studied. From 2003 to 2008, growth of PE investments in dollar terms³ in these markets averaged nearly 22 percent compounded annually (Exhibit 1), led by headlong growth in the two emerging giants: Greater China (47 percent compound annual growth rate) and India (59 percent). Across the six markets, the number of PE deals more than doubled in aggregate during these years—an astounding record of growth.

Growth in the underlying economy has played a leading role in the development of Asian PE. Across the region, GDP growth of close to 10 percent is not unusual. During these years China grew at 11 percent compounded annually, India at 9 percent, and Southeast Asia at between 5 percent and 8 percent. Rapid economic growth boosted capital markets: by 2009, the total market cap of all publicly traded Asian companies had for the first time surpassed that of Europe.⁴ Naturally, supercharged growth caught the eye of PE investors; with Western economies expanding much more slowly (3 percent or less) PE firms were drawn to Asian economies by the promise of attractive IRRs. Another important driver of

* With appreciation to the Japanese writer Haruki Murakami and his nonfiction book, “What I talk about when I talk about running.”

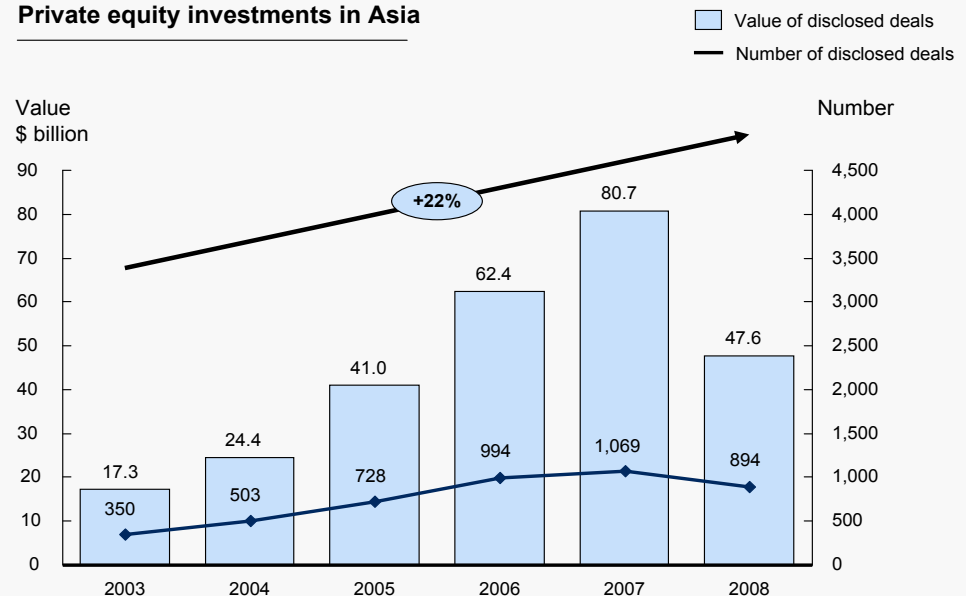
1 Greater China includes the People's Republic of China, Taiwan, and Hong Kong. Southeast Asia includes Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.
 2 Including investments for buyout, turnaround, private investment in public equity (PIPE), growth or expansion, pre-IPO, and mezzanine.
 3 Unless otherwise noted, all currency figures in this paper are US dollars.
 4 Nippon Keizai Shimbun, July 1, 2009.

Exhibit 1

An era of growth

Both value and number of deals grew quickly before pausing in 2008

Private equity investments in Asia



Source: Asian Venture Capital Journal; Marr

PE growth was economic liberalization. Governments in Vietnam and Indonesia have loosened restrictions on foreign ownership and have begun to privatize a number of state-owned enterprises—a move that is full of promise, as the economy there is dominated by SOEs. In Taiwan the government went further and welcomed private equity, a move that culminated in the 2007 buyout of Fu Sheng, a golf equipment maker. Some governments experimented with incentives for manufacturers of certain goods for export. Many governments in Southeast Asia have begun to offer incentives for foreign investment in property, including headquarters facilities. In Japan, the sale of Shinsei Bank and other nationalized assets also played a part in piquing private equity interest. Finally, intergovernmental cooperation has loosened restrictions on investing. The ASEAN free-trade agreement matured over the years in question and, as of 2008, is in full force and effect.

A third factor is the breakup of family-owned businesses, long a dominant business model in many Asian countries. As the third generation of leaders ascends to the top, many are deciding that they do not want to run the family business. Several big family-owned groups in Indonesia, Malaysia, and the Philippines were broken up between 2003 and 2007.

Finally, in recent months, many companies have been put in play because their owners cannot meet creditors' demands. In Korea, for example, big conglomerates have been forced by regulators to put 9 business units up for sale; another 450 are under scrutiny by the regulator.

As a result, in five short years PE has become an important part of these Asian economies. To be sure, it is not nearly as entrenched as in the big Western markets; to take an extreme example, PE in China accounts for only 0.22 percent of GDP; in Japan, the figure is 0.15 percent (Exhibit 2). Compare that with the UK, where PE accounts for almost 1.87 percent of GDP. Nonetheless, PE has gained a secure foothold across Asia and made a name for itself globally: Asia now accounts for fully 14 percent of the global PE market. And of course the limited penetration to date means that the potential for growth remains enormous.

Challenges abound

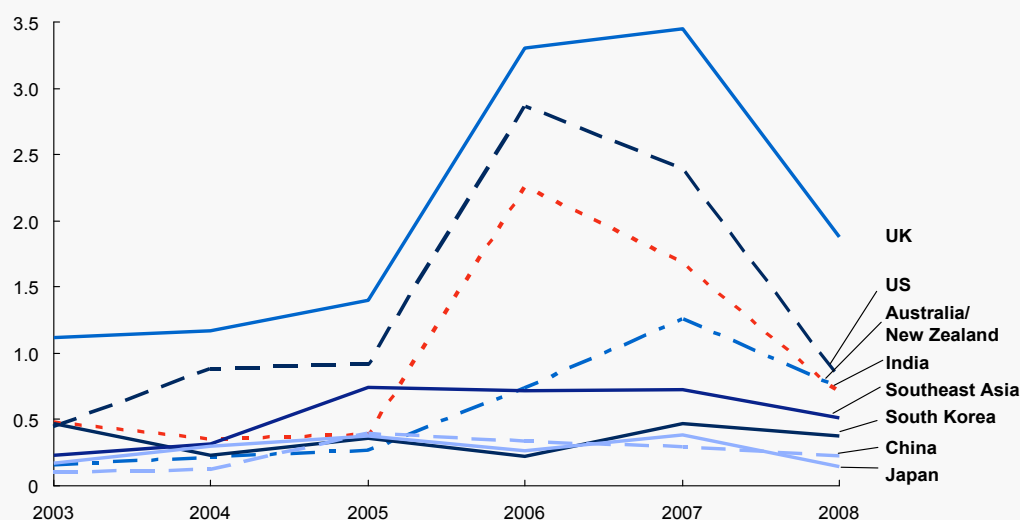
For all its success, however, it is worth noting that PE in Asia has not grown nearly as fast as many expected just a few years ago. In the boom years, the confluence of a rapidly expanding private equity industry and a handful of the

Exhibit 2

Room to grow

Private equity is not as widespread in Asian economies as it is in the UK and US

Ratio of private equity investments to nominal GDP
%



Source: *Asian Venture Capital Journal*; Marr; Capital IQ; Economist Intelligence Unit

world's fastest-growing economies was thought likely to produce a regional PE industry that would soon rival its Western peers.

Why have things moved more slowly than expected? We see five reasons. One is the relative difficulty of sourcing deals. While there are many companies available, few meet the criteria of adequate size and attractiveness of foreign GPs. Consider how few Asian companies are sold at auction. While there have been a few well-publicized auctions in recent months (such as Gome in China, and in Japan, Kanebo's noncosmetics business, Daiei), these are still the exception rather than the rule. A company's willingness to sell itself is a more carefully guarded secret than it is in North America and Europe. Would-be dealmakers frequently have to create opportunities for themselves—but many foreign firms are handicapped by a lack of access to local networks and knowledge, and sometimes even by a lack of local language skills; as a result, they sometimes cannot even find the right doors to knock on.

Once they do find a suitable target, another pair of typical problems arises: owners' unwillingness to sell the entire company—and regulators' unwillingness to let them sell to foreign buyers. While in Western markets most

PE investment (86 percent in Europe, 93 percent in the US) goes into buyouts, in Asia the figure is only around 60 percent (Exhibit 3). Much of the remainder of Asian investment is made by PE firms that, because of intractable owners and restrictive governments, must settle for partial stakes in privately held companies. These partial stakes are taken variously to support management's growth aspirations, to help turn a company around, or to stabilize a company before an IPO. Without adequate whole-company investment opportunities, firms also invest in public companies, through PIPEs (private investment in public equity), and provide mezzanine financing to both public and private companies. PE investors have been satisfied with these investments as they represent an opportunity to capture value without having either to extensively restructure companies or to use financial engineering and leverage to magnify returns.

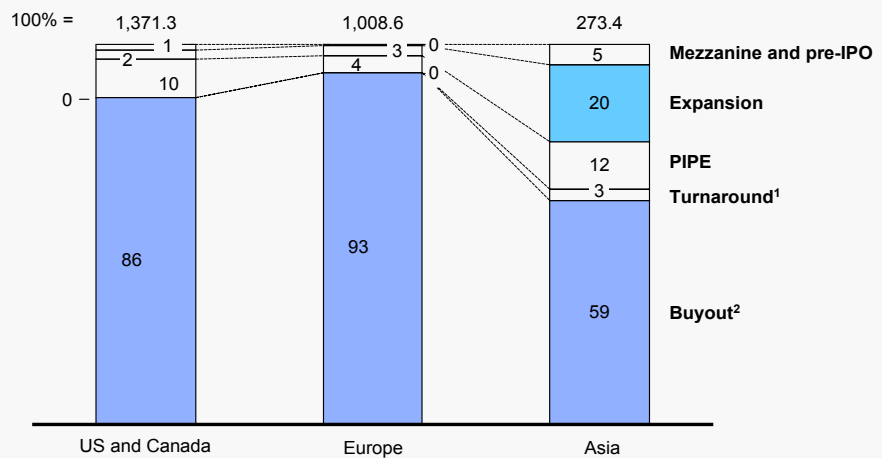
The smaller scale of Asian companies has also presented challenges: PE deals in Asia are smaller than those in Western markets. Ninety percent of all PE deals in Asia from 2003 to 2008 were for less than \$100 million; smaller deals are especially common in the biggest countries, China and India. The prevailing business model of Western buyout firms, designed to source and execute

Exhibit 3

In pursuit of growth

Western markets are dominated by buyouts, while Asian investments often target expansion

Private equity investment by type, 2003–2008
%, \$ billion



¹ For US, Canada, and Europe, buyout includes turnaround financing.

² For Japan, only buyout data are available.

Source: Capital IQ; *Asian Venture Capital Journal*; Marr

the biggest and most difficult transactions, may not be as effective in Asia.

A fourth factor inhibiting PE's growth is that, in many parts of Asia, especially the emerging countries, business is characterized by an unfamiliar complexity in corporate structures, a lack of transparent bookkeeping, and inaccurate market information. Firms must be prepared for thorough and time-consuming due diligence, which can be prohibitively expensive on the kind of small deals routinely found in Asia.

Finally, Western firms venturing into Asia may face a different kind of competitor. Sovereign wealth funds (SWFs) and large conglomerates dominate principal investment markets in many parts of Asia. SWFs in Asia have stepped on to the global stage in recent years. Conglomerates, too, are active in principal investment, not only as sellers, as mentioned above, but also as buyers making about 80 to 100 deals each year from 2003 to 2008. The value of those deals increased 26 percent annually. To be sure, SWFs and conglomerates are not always competitors; sometimes they are co-investors. But when they do compete, as has happened recently, these investors may have different

strategic and financial objectives, which may give them an inside track in Asia's opaque markets for companies.

To these structural difficulties must be added the effects of the global financial crisis. Asian economies have suffered to varying degrees; India and Indonesia are driven mainly by internal demand and have held up well, while export-dependent Singapore and Taiwan have not. As a business, every aspect of private equity has been affected: fund-raising, deal sourcing and closing (Exhibit 4), and finding exit opportunities for current investments.

On the other hand, and despite the recent rally in share prices, many public and private companies appear to be undervalued. Any urge to rush in and take advantage, however, must be tempered by the realization that deals have become harder to complete. Buyers and sellers fundamentally disagree about valuations. This has exacerbated the trend away from buyouts and toward PIPEs and growth investments.

Further, the crisis has intensified competition from SWFs and conglomerates; many of these, badly burned by their Western investments in 2007–2008, are renewing their

Exhibit 4

Asia private equity was not spared by the crisis

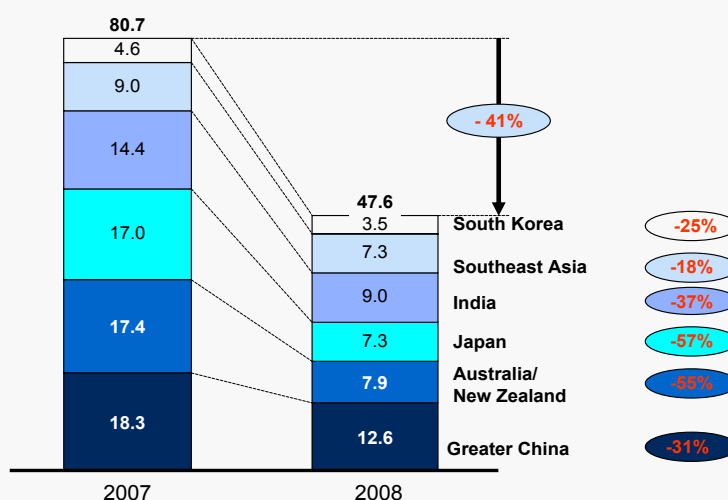
Value of investments declined by 41% in 2008

Private equity investments, 2007–2008

\$ billion

2007–08

%



Source: Asian Venture Capital Journal; Marr

focus on Asian investment. Finally, the crisis has made profitable exits harder to come by. With share prices depressed, exiting the market through an IPO had been nearly impossible until recently.

Six unique markets

So far we have discussed many of the opportunities and challenges that are common to Asia's private equity markets. But it bears repeating that there is no pan-Asian private equity market; each national or subregional economy is a unique market, with its own economic, regulatory, political, and legal systems, and its own financial culture. Local knowledge is crucial, and firms cannot cover the "Asian market" through an office in Hong Kong or Tokyo, as some have tried. The successful firms have been those that respected the idiosyncrasies and nuances of local markets and individual sectors.

With that in mind, we present a snapshot of growth in the six largest PE markets (Exhibit 5) and a brief summary of their unique risks and rewards, beginning with the three most advanced economies.

Japan: Standing tall

As the region's most mature PE market, Japan has been holding its own even as other Asian markets have grown more rapidly. Japan represented the biggest portion (27 percent) of regional PE activity during 2003–2008, though in the last year of that period it was surpassed by China, India, and Australia/New Zealand. Like Western countries such as the US and Germany, Japan is a buyout market. Japan has also seen many successful PE exits, evidence of a market that is not short of buyers, both local and global. For example, the recent sale of Nikko Asset Management by Citigroup saw eight bidders, including global firms as well as local Japanese firms.

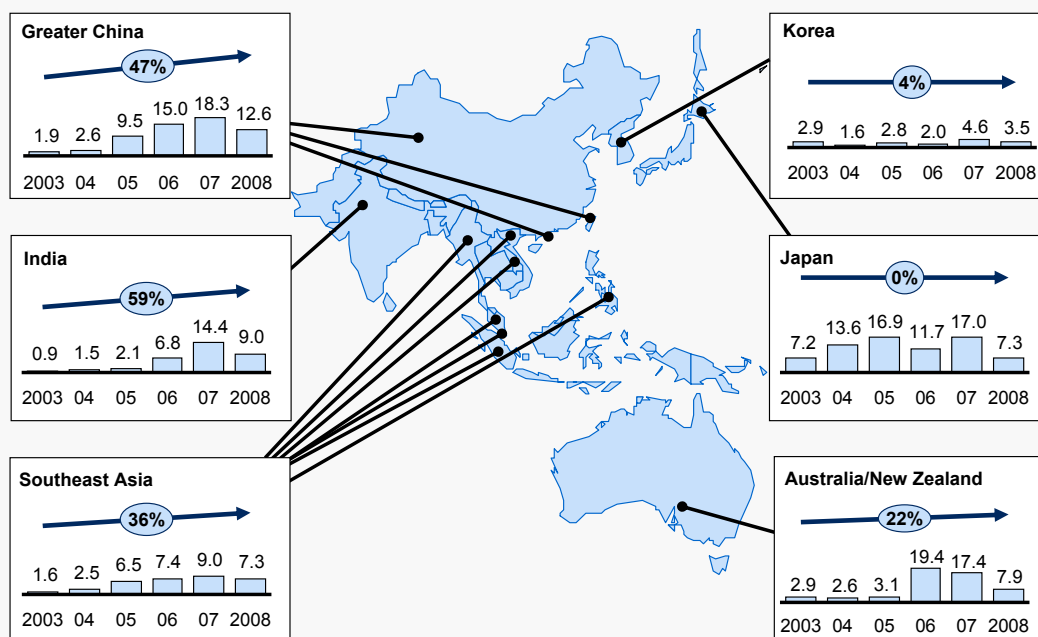
However, deals in Japan can be especially hard to source, due to, among other things, the softening but still strong cultural resistance to buyouts, and corporate governance issues. As a result, M&A penetration (2.3 percent of GDP since 2001) is extremely low compared with the US (9.5 percent) and UK (11.7 percent) (Exhibit 6). Firms will need to be extremely patient when sourcing deals and must build good relationships with both their banks and the target company's management to placate reservations about takeovers.

Exhibit 5

Six unique markets

Each has its own trajectory

Annual private equity investments \$ billion



Source: Asian Venture Capital Journal; Marr

The news on corporate governance is better. Japan's Financial Services Agencies recently increased the disclosure requirements with respect to cross-shareholding. Listed firms must now provide detailed information on their cross-shareholding arrangements. This practice, very common in Japan, is designed to strengthen business alliances. But because of the drastic declines in stock values in the last year it may cause Japanese banks and some nonfinancial companies to take massive write-downs on their stock portfolios. With the new rules, more information on cross-shareholding will need to be published. As shareholders, many of them institutional investors, become aware of the underperforming companies they hold indirectly, they may push companies to sell these stakes.

Another boon to PE firms may come with a potential regulatory change. The Japanese government is considering requiring banks to use International Accounting Standards. This would mean that banks must use mark-to-market to value their portfolio of shareholdings. Like the cross-shareholding rules, this could result in more companies being put up for sale. Banks may prefer to sell their stakes in

underperforming companies rather than see their income statement severely affected.

Australia and New Zealand: Late bloomers

After several years of slow growth, PE investment in Australia and New Zealand surged in 2006–07; by our estimate, the number of investments in 2008 was a threefold increase from 2003. For the period 2003 to 2008, Australia/New Zealand accounted for 19.5 percent of Asian private equity. Divestitures by some big corporations of weak businesses, particularly in health care and retail, and liberalization in media and other sectors like residential real estate created opportunities.

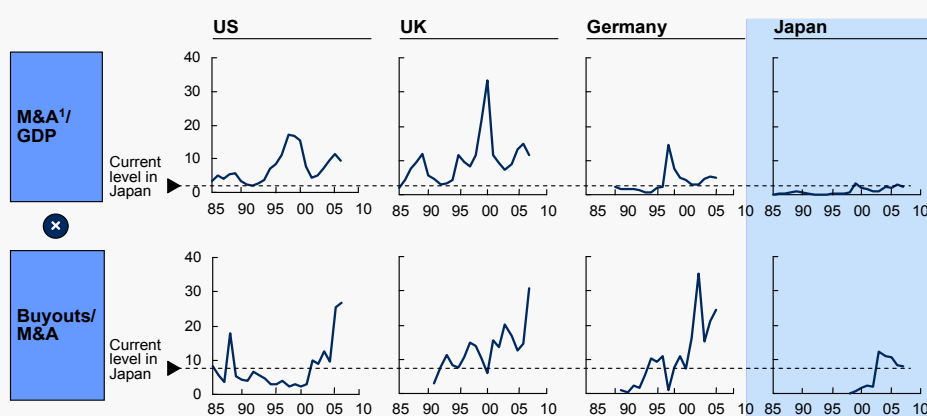
Of late, private equity has been helped by the strength of the national economies. Australia and New Zealand have proved resilient through the crisis as compared with other developed economies such as the US, the UK, and Japan. Recently, the Economist Intelligence Unit has revised its forecast of GDP growth for 2009 from -1.6 percent to -0.4 percent. In particular, analysts expect the mining sector to

Exhibit 6

Comparing M&A styles in four big economies

M&A is still rare in Japan—but when deals happen, they are often buyouts

Value of M&A in the national economy %



¹ Figures for M&A in Germany in 1990–94 were calculated using \$1 = €1.25; figures for the UK in 1980–94 were calculated using annual average currency rates vs. the dollar.
Source: Dealogic; Global Insight Co. Ltd.; Refco Corp; Capital IQ; Private Equity Insight; M&A International; U.K. Office for National Statistics; Investment in JAPAN Information Center; Yamaichi Securities Co., Ltd.

pick up dramatically thanks to tremendous demand from India and China.

Local players were responsible for most of the PE deal flow during the years we studied, but foreign players captured the biggest targets and thus represented most of the value. The industry is dominated by midsize deals (i.e., less than \$100 million), leavened with a handful of megadeals such as the 2006 sale of PBL Media (\$4.1 billion) and the 2007 deal for Investa Property (\$5.4 billion).

The competition with local firms for midsize deals can put pressure on global players' returns, a pressure made worse by the high cost of debt. The depreciating Australian dollar makes the cost of borrowing in this region the highest among the developed countries of Asia, such as Japan and Singapore, and almost as high as that of developing countries like India and China. Dealmaking has also been slowed by a mismatch of expectations in pricing; current asking prices are based on ideas formed during the boom in 2006 and may take some time to come down to a more realistic level. To compete with savvy local players,

foreign firms will need a strong local team of investment professionals.

South Korea: Two steps forward ...

The private equity market in Korea began in earnest only in the 1990s, and by the early 2000s the country had become an established center for buyouts. By 2003, 17 percent of all Asian private equity investment took place within its borders. The Asian financial crisis of 1997 helped get private equity in Korea off the ground, as many large corporates were forced to sell noncore businesses and distressed assets. Private equity firms answered the call, through both traditional buyouts and PIPEs.

One of the worst-hit sectors was financial services. Many banks failed and required recapitalization, which in several cases was provided by PE players. These bank deals include the purchase of Korea First by TPG Newbridge in 1999 and KorAm's sale to Carlyle in 2000. PIPE deals include the stakes in Kookmin Bank and Hana Bank, bought by Goldman Sachs in 1998 and 2005, respectively.

Over the last few years, however, the Korean market has become a victim of its own success. After several high-profile, profitable exits, public sentiment by 2006 had turned against private equity and foreign investors. Unlike in Japan and elsewhere, the mood in Korea prompted regulators to act. The resulting backlash is epitomized by the challenges Lone Star faced in exiting its investment in Korea Exchange Bank, and the investigations that have since taken place.

Today, Korea lags behind other Asian markets, ending 2008 with the least capital invested in PE in all of Asia—just 7 percent of the total. We see several reasons behind the decline apart from cultural resistance. Shareholders' incentive metrics, which are mainly based on top-line figures, and employee loyalty to the *chaebols* have both created a tough environment for foreign PE players in Korea, especially in deal sourcing.

Further, a disruption that PE firms had hoped for has not come to pass. Many believed that the top-tier *chaebols* would be forced by the crisis to dispose of some assets, as happened after 1997. This time, however, thanks to the *chaebols*' stronger financial structure (i.e., lower leverage) and a weaker Won (which depreciated from a high near 900/dollar to 1,600/dollar, and now appears to be stabilizing between 1,100–1,200/dollar), Korean exports have done better. For the top-tier conglomerates, the current crisis and the depreciating Won have actually made them more competitive than their main rivals from Japan, in products such as consumer electronics and automobiles.

However, the picture is not entirely bleak for Korean private equity. As we write, about ten midsize conglomerates have been designated by creditors as “restructuring candidates”; these *chaebols* have been forced to sell assets, and we expect more divestitures to come in the next 12 to 18 months. This promises to be an exciting chapter for PE players. For instance, the Kumho Asiana group has come under pressure from its creditors to sell its stake in Daewoo Engineering and Construction; many local and foreign firms are showing interest in this high-profile deal. Additionally, KKR and Affinity Equity Partners successfully closed one of the biggest deals in Asia in 2009, acquiring Oriental Brewery from AB InBev for \$1.8 billion.

Other signs of life include the joint ventures that some foreign PE firms have set up with local players, and the new funds raised. Blackstone recently set up a new office in Korea and entered into an alliance with the National Pension Service to raise a \$2 billion fund. KKR has similarly partnered with the Korea Development Bank.

Homegrown funds will have a head start as private equity in Korea again takes off. One fact of life here is that Korean sellers have shown a preference to sell to Korean buyers. Since 2004 the government has introduced new regulations that encourage the establishment of domestic PE funds. In response, new local funds have been set up by firms such as MBK Partners, Vogo Fund, Woori Private Equity, and Shinhan Private Equity. Some of these firms have raised multibillion dollar funds and have completed more than ten deals over the past two years. They have shown the ability to hire some of the best talent in the local market. Their teams have both local and international experience. As a result, local players have played an important role in the PE market, with more than 79.6 percent of deals in 2008 (measured by number of transactions), up from only 18.7 percent in 2003.

To capture the opportunities in Korea, foreign firms will need to address several other challenges. First, the local talent pool has been tapped out; it is difficult to find investment professionals with both local market knowledge and deal skills. Second, the deal flow is stronger in the midsize and small (i.e., \$100 million and below)⁵ markets than in the large-deal markets favored in Europe and North America. This requires firms to lower their sights a bit and be more creative and effective in scanning and filtering small deals.

Third, the need for operational skills is coming to the fore. Timing the market cycle and seizing on distressed assets—favored approaches of foreign firms—are not the only valid ways to create value. Now that those games are less viable today than before, PE firms must build true operational capabilities to drive the organic growth of their portfolio companies. But most PE firms in Korea still lack operational turnaround skills. Very few firms have operating professionals in their management teams, and while many firms claim to add operational expertise to their portfolio companies, most of them continue to provide guidance and direction from a seat in the boardroom rather than “getting their hands dirty.”

5 81.3 percent of total disclosed deals in South Korea during 2003–2008 were below \$100 million.

Lastly, PE firms may face greater difficulties than in the past in obtaining financing from local banks. Although Korean banks have been bullish on leveraged finance, offering more than four times EBITDA at attractive rates to top funds, the problems of overstretched householders in consumer-finance businesses may cause local banks to pull back on leveraged lending as well.

China: Rapid growth, challenging environment

The Greater China market (primarily the People's Republic of China (PRC), and also Taiwan and Hong Kong) still presents a challenging operating environment for PE investors, despite its strong historical growth.

The market recorded one of the strongest rates of growth (47 percent CAGR) in Asia from 2003 to 2008. Driving this surge were growth investments, which accounted for 64 percent of the 271 private equity deals in 2008 (or 34 percent of the \$12.6 billion invested—higher than the total buyout value). PIPEs represented 14 percent of the 271 deals, and buyouts a mere 7 percent. Transaction size remains modest, with the vast majority of deals (91 percent) valued at under \$100 million.

PE investments in mainland China represented more than 70 percent of total investment value and 80 percent of the number of deals done in Greater China during 2003–2008. The PRC continues to command most of the interest and attention from GPs and LPs. Large global private equity firms such as Goldman Sachs PIA, Blackstone, TPG, Carlyle, Bain Capital, and Warburg Pincus have all established footholds in mainland China. They are competing against an increasingly prominent cast of local firms, including Hony Capital, CDH, New Horizon, Citic Capital and Citic Securities Private Equity, FountainVest, and Hopu.

But while mainland China has made strides and become increasingly PE-friendly, doing deals there remains challenging. Our recent work with GPs indicates that the vast majority of deal activity is still sourced from proprietary networks and intermediaries in mainland China. Due diligence is made challenging by the unreliability of much financial information. The support

infrastructure (e.g., expert networks, third-party industry data providers) is still a work in progress. Both of these elements—sound data and solid infrastructure—are taken for granted in more developed markets. Being an active owner in China is also very difficult, as PE investors typically do not have management control. Moreover, while local banks are now allowed to provide leveraged finance for M&A to domestic firms, the region has not yet seen any true leveraged buyouts.

Foreign firms face additional difficulties. First and foremost, their local teams still have a difficult time defending their proposed transactions to global investment-review committees, which usually have only a limited understanding of the Chinese marketplace. Closing a deal remains tough, as obtaining regulatory approvals can take years. For instance, Carlyle's proposed acquisition of Xugong, a construction machinery maker, was held up for three years before eventually being cancelled.

To overcome these difficulties, many foreign firms are exploring ways to “go native”—that is, setting up local teams with local networks and raising RMB-denominated funds. Funds denominated in renminbi can help foreign firms clear M&A regulatory hurdles. In August 2009, the Blackstone Group and First Eastern Investment Group became the first international private equity firms to set up RMB-denominated funds in Shanghai. Hong Kong-based First Eastern said it intends to raise RMB 6 billion in the next 12 months, while Blackstone has said it will raise up to RMB 5 billion for the Blackstone Zhonghua Development Investment Fund, a joint venture with the Pudong government.

Capital for RMB funds will come from the burgeoning growth of some state-related LPs. Atop the list stands the National Social Security Fund⁶, which was allowed to allocate 10 percent of its funds to private equity last year. It invested in domestic private equity funds such as CDH Investments and Hony Capital. In 2009, it aims to invest about \$1.5 billion in three to five private equity funds, looking for those with expertise in the fast-paced service industry, as well as health care and culture. The NSSF has asked for approval from the authorities to invest in foreign private equity funds. Another boost will come with the expected liberalization by CIRC, the insurance regulator,

⁶ The National Social Security Fund is the government's pension fund; it manages about \$82.4 billion. It invests mostly in domestic public equity. Recently, it was allowed to invest about 10 percent in private equity and plans to allocate up to 20 percent of the fund in foreign investment through external managers.

of the asset allocation guidelines it gives to life insurance companies⁷. Still more intriguing is the broad swath of provincial and municipal institutions that manage both pension and economic-development funds. While little is known about these would-be investors, already some are emerging as potential capital sources for PE firms.

Local PE firms, on the other hand, do not have the same set of problems as their foreign counterparts, thanks to their local knowledge and networks. The biggest challenge for local firms in this young and fast-growing industry is to organize their deal sourcing and investment-committee processes effectively, such that they develop a structured and proactive approach to deal origination. A second challenge for local PE firms is the need to invest in human resources to retain top performers as well as build the skills and capabilities of their investment teams. Third, many local firms still lack experience in managing portfolio companies, often failing to generate good returns or to manage their portfolio risks. After a few years of thinking only about the next deal, over-relying on local networks and relationships, and riding the wave of China's astounding growth, some large local PE firms, especially those with ambitions to expand overseas, will have to give more serious consideration to these issues.

In this context, what should PE investors, global and local, do? We believe they should keep developing their deal-sourcing networks, invest in their due diligence infrastructure (e.g., data providers, expert networks, management team assessment approaches) and front-load their management team assessment. GPs should think long and hard about ways to achieve more influence in minority positions (e.g., through deal terms, personal relationships, incentives). They should also invest more in stakeholder relations, by working with other firms to help shape the industry's reputation with policymakers. They can, for example, highlight the benefits of PE to national productivity, as industry associations have done in North America and Europe, and eventually help shape regulatory evolution.

India: Enormous potential

The subcontinent continues to sparkle. Between fiscal⁸ 2004 and 2008 PE investments soared at a CAGR of more than 100 percent, to \$14.4 billion, making it the fastest-growing PE market in Asia. With a 21 percent median return on invested capital, Indian companies continue to deliver some of the highest returns to shareholders. After a drop of about 60 percent in the Sensex in late 2008, the index is now (October 2009) trading at an all-time high—arguably not great for finding attractive valuations but a clear expression of confidence in India's domestic growth story. In this section we will explore the factors that make India attractive, why we believe the attraction will endure, the issues PE investors face today, and the lessons that successful PE investors in India can offer.

Chief among the historical attractions are the low barriers to entry for PE firms. India has a well-developed legal system, widespread use of English as the language of business, capable investment banks, and active equity capital markets. Second, similar to China, the PE market in India is dominated by growth and expansion deals that correlate well with highly reliable macroeconomic and demographic factors, such as GDP growth and exports of IT and business-process outsourcing (BPO) services; 50 percent of the \$14.4 billion invested in fiscal 2008 and 72 percent of the \$9.0 billion invested in fiscal 2009 were growth investments. Third, over 50 percent of the 231 deals concluded in fiscal 2009 (and over 50 percent of their value) were in financial services, consumer goods, and IT and BPO services—all areas where investors (especially foreign firms) have expertise. Finally, the outlook on infrastructure and real estate remains strong, with government spending and urbanization set to continue.

India's homegrown specialty in IT and BPO continues to provide outstanding growth for PE firms. Warburg Pincus' acquisition of 64 percent of WNS (2002), Oak Hill Capital Partners and General Atlantic Partners acquisition of 60 percent of Genpact (2005), Blackstone's acquisition of 80 percent of Intelenet (2007), and the same firm's majority

⁷ If an insurance company has a solvency-adequacy ratio of at least 150 percent, it may under Chinese regulation invest normally in stocks. If its solvency-adequacy ratio falls between 100 percent and 150 percent for four quarters in succession, it must revise its stock investment strategy. If its solvency-adequacy ratio falls below 100 percent for two quarters in succession, it may not increase its stock investments.

⁸ Fiscal year in India runs from April 1 of the previous year to March 31 of the current year; i.e., fiscal 2009 is April 1, 2008–March 31, 2009.

acquisition of CMS Computers (2008) are all plays on the vibrant growth of IT and business services.

Why will India remain attractive? There is much more opportunity ahead. By current estimates of inflation and capital productivity, India will require approximately \$1.3 trillion of broad-based investment from government and business during the next three years to sustain 7 percent growth in GDP. The funds will be raised in a number of ways: domestic debt, credits from both banks and nonbanking financial companies (NBFCs), foreign debt, public equity—and of course private equity, which will come in for a significant share of the new investment. Including retained earnings and depreciation at its portfolio companies, we estimate that private equity, both domestic and foreign, has the potential to fund between \$80 billion and \$100 billion of equity over the next three years. This would represent a surge in investment of twice to 2.5 times the peak rate of Indian private equity investment, \$14.4 billion in fiscal 2008—an enormous increase. The next step appears even further away, given that PE investment fell dramatically in fiscal 2009, to \$9 billion. PE firms will have to find new sources of capital if they are to capture their share of new investment.

Perhaps the biggest opportunity awaits in building the new India. The government expects to spend over \$500 billion on new infrastructure—roads, rail, power plants, and ports, among other investments—over the next five years. Several PE firms have launched funds earmarked for infrastructure, and have also invested in other ways. Blackstone's investment in Nagarjuna Construction, Goldman Sachs's investment in Sudhir Gensets, and 3i's investment in Adani Power are all minority stakeholdings poised to take advantage of the growth in demand for infrastructure.

To be sure, PE firms in India face a slew of challenges. First, booming capital markets have pegged valuations once again at an all-time high, and the short-term expectations of “promoters” (the local term for owner/entrepreneurs) have risen commensurately. Second, caps on FDI (foreign direct investment) in several sectors continue to limit investment. Third, several other regulatory issues persist. One problem is that if investors are deemed to be promoters, under Indian law their holdings are locked in for three years after the IPO. Another problem is the restriction on the use of leverage for acquisitions. Investors can also encounter an “insider status” issue while conducting due diligences on

publicly listed companies; Indian law offers no safe-harbor provision from insider trading penalties. The Foreign Investment Promotion Board's approval process is often slow. Finally, there are restrictions on the investments that insurance companies and pension funds can make in PE funds. While PE firms continue to manage these and other obstacles as they steer each deal to completion, collectively these challenges dampen the enthusiasm and restrain the assertiveness of the private equity industry in India.

Private equity has to make the case to government that the numerous restrictions constitute an onerous burden. That case should emphasize the importance of private equity to domestic capital stocks. Over the past three years foreign institutional investors (FIIs) have more than doubled their contribution to India's capital requirements, from 5.4 percent of total capital to 11.6 percent, even as total capital increased threefold. Private equity's contribution to these inflows increased from less than 15 percent to over 40 percent. The sooner the government recognizes private equity's increasing importance as strategic long-term capital, the sooner it will find small ways to accommodate this increasingly important asset class.

How have the top PE investors in India achieved their success? They adapt. First, they recognize that larger opportunities lie in growth investments, not the buyouts they are more familiar with. Most deals that offer control require investors to apply a growth-oriented view of valuation, value creation, and management capabilities. Second, although there are many private enterprises seeking capital, the promoters who head them often have a strong bias against both selling out and structures that transfer management control. Successful PE investors find ways to exercise significant influence without shareholder control. One such way is to build strong trust-based relationships early in the investment process, well before “term-sheet” negotiations.

Finally, PE investors compete with well-developed capital markets in India, and promoters increasingly seek other forms of value beyond mere access to a spreadsheet and checkbook. PE firms that build capabilities that deliver tangible value to portfolio companies will be well positioned to flourish in India's second era of private equity—one that rewards investors that organize their investing and operating activities as active partners to build and grow great companies. To this must be added the necessity of

regulatory change. Until regulators recognize and support private equity as strategic long-term capital, we will still likely be writing about the industry's enormous potential.

Southeast Asia: Up and coming

Southeast Asia (which we define as Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam, along with smaller markets in Brunei, Cambodia, Laos, and Myanmar) accounts for a relatively small part of PE in Asia (13 percent during 2003–2008). But it is growing quickly; the region's private investment grew at a rate of 36 percent annually during 2003–2008. And it rewards investors who are flexible and opportunistic in their approach. Potential deals appear seemingly at random, driven by changes in regulation, privatization of government-owned companies, and institutionalization of family-owned conglomerates. Vietnam privatized over 1,300 SOEs during the period we studied and plans to do the same for another 900 by 2010. Indonesia, too, planned to privatize 44 of its 139 SOEs in 2008 (though at the time of this writing, the rate of privatization was running slightly slower). As for family-owned businesses, over a third of those surveyed across the region in 2007 said that they expected a change of ownership sometime within ten years.

Unfortunately, with the exception of Singapore, these markets are also full of difficulties. In many regions companies keep double accounts. Ownership structures are complex, with some parent companies sitting atop sprawling structures of dozens or hundreds of holdings. Regulations seem to be written in water, with revisions often fundamentally changing the governed industry, such as the telecom industry in Indonesia. Severe limitations on foreign ownership have been placed on several sectors in Indonesia and Malaysia. Several of these countries are troubled by persistent corruption, lack of local talent, and high rates of inflation. And of course most of these markets are quite small.

In the wake of the crisis, global PE players in Southeast Asia are facing an additional set of challenges. Many deals were cancelled because of the mismatch between the seller's projected value and the buyer's view of current implied value. Several global PE firms are still reeling from the impact of the crisis on their existing investments and have chosen to focus on their portfolio companies while carefully scanning for new deals. They are unwilling to trade into a troubled market, preferring to wait until an upswing in the economy is confirmed. Finally, PE firms have found it very

difficult to deal or negotiate with the management team of target companies, many of whom had never experienced a crisis before.

Navigating this minefield is hazardous but also very profitable. In one of the largest exits in these markets in recent years, Farallon Capital Partners sold its 51 percent stake in Bank Central Asia for \$3 billion; it had paid \$531 million less than four years previously. To match this kind of success during the coming wave of liberalizations, firms will need strong relationships with local regulators and good local knowledge. Many global PE firms apply three models to source for local deals: setting up local offices with local managers; entering into joint ventures with local companies or local PE firms; and hiring local personnel who have strong personal networks. It is clear that the model of waiting for deals to walk across the street from the investment banks and through the door does not work in Southeast Asia.

The immediate outlook is positive

Over the past few months, the crisis has appeared to be lifting. In particular, following a year (2009) focused largely on portfolio clean-up, we see Asian private-equity firms focusing once again on acquisitions. Moreover, we are already beginning to see early signs that firms are revising their approach to the region, as well as signs of a shift in emphasis in the deals that are getting done, a potential shake-out of market participants, and the rising importance of local funds.

The immediate effects of the crisis on valuations are receding. Throughout most of 2009, with the outlook uncertain, valuations were highly volatile. Public markets generally implied high prices, while valuations derived from projections were much lower. As a result, acquisitions fell significantly, with buyers and sellers unable to reach agreement on pricing and bank debt in short supply. There are signs that this is changing. Valuations have stabilized. Moreover, a pent-up supply of attractive private companies seeking capital is now coming to the market, representing perhaps a once-in-a-decade opportunity. As a result, we expect a significant rebound in deal activity over the next year.

A critical impact of the crisis on firms in Asia is that some were forced to rethink their approaches to the region, especially with respect to the size of the deals they

undertook, the kinds of stakes they accepted, and the governance of portfolio companies. There are two trends here: firms configured for large LBO deals—typically pursuing a “cut-and-paste” of a European model into Asia—discovered that the market is not as large as they thought, and the debt conditions are different. Many are now shaking up their strategies and teams. At the other end of the spectrum, firms that focus on taking smaller minority stakes, often in multiple markets, found the complexity, challenge, and cost of managing them through the downturn—and the attempts to exert influence—prohibitive. We expect to see a rethinking of this model, too. These firms will likely put more emphasis on localization and will more carefully structure deals to achieve greater influence in the company’s decision making.

Over the next couple of years we expect local funds to become more prominent and influential. The deeper localization just mentioned will bring significant benefits to local funds, including better investment management and a lowered risk of deals. Moreover, many governments and stakeholders across the region are now seeing the benefits of developing a strong local private-equity industry as a means to catalyze economic restructuring. Signs of this trend are clear, for example, in China and Indonesia. This represents both a great opportunity to “expand the pie” but also a threat to incumbent firms if they do not adapt their models, as we now discuss.

The multi-local, multi-sector strategy

The next few years will be an extremely interesting time for PE firms. Depending on how they play their cards, they may position themselves to take advantage of the hoped-for rebound and benefit enormously; or they may become stuck on one of these markets’ myriad challenges and miss the opportunity.

Attentive readers will have noted our core belief: Asia is not a single market, and investors who approach it as one will find it nearly impossible to succeed. Instead, PE firms should develop a “multi-local” approach and mindset. We see four essential elements of that approach.

First, PE firms must adopt a deliberate approach to country and sector selection and keep in mind the varying levels of development in each market, the market’s exposure to global economics, and its likelihood of rebounding from

the crisis. PE firms must then use that analysis to select individual countries and sectors as their focus. Certain sectors, such as financial services, were hit much harder by the crisis than less cyclical industries, such as telecom and pharmaceuticals. However, such industries can also be leaders in a market rebound. Alternatively, firms can try to capitalize on long-term trends, such as the growth of consumer goods in China; such trends represent a relative haven from the global economic crisis.

Second, PE firms must go back to basics when it comes to deal sourcing. PE firms need to be much more proactive in developing proprietary networks. Privatizations of SOEs in Vietnam, Indonesia, and elsewhere, as well as the other forces pushing companies into play—deregulation, free-trade agreements, the rationalization of conglomerates’ portfolios, and new incentives for foreign investment and export—must be carefully monitored.

Third, PE firms must adapt their “active ownership” approach to a minority context. Because regulatory constraints often leave them in minority positions, firms have too often thrown in the towel when it comes to reshaping portfolio companies. This does not need to be the case. Firms can pursue several paths to exert more influence. Here are three ideas:

Target management teams willing to play ball.

In Asia, being an active owner should start before the transaction has closed—even as early as the screening process. Atop the list of criteria should be management teams that have “the will to change.” In our experience, it is much easier to tackle managers’ skill challenges (by making additions to the management team, training, and using external experts) than the will challenge.

Negotiate terms that provide leverage. There are numerous contractual terms that can allow minority shareholders to punch above their economic weight. For instance, obtaining approval of key decisions, such as hiring and firing, and capital expenditures can go a long way toward facilitating productive dialogues with management teams. The inclusion of performance incentives should also make discussions more constructive.

Develop support for your views. There are many ways to do this. Organizing trainings on key topics (e.g., best practices in purchasing, pricing, lean operations) can go a long way. So can the cross-pollination of knowledge among portfolio companies, bringing together the management

teams of different companies to discuss common challenges. Similarly, many firms have also set up operations groups to manage portfolio-company performance effectively and creatively. PE firms can also influence the operations of a portfolio company by assuming the role of coach to the management team, on strategy creation as well as operational activities.

Finally, industry participants must get together to help stakeholders better understand the benefits of PE.

In many Asian markets the competition is fierce, and distrust of foreign investors runs high. PE firms must find ways to stand out from the crowd and project an image that reassures wary regulators. They must continue to demonstrate the ways the industry improves national productivity and creates jobs. For example, global and local PE firms in each country should band together to create a national association to proactively shape the playing

field and bring down the barriers that hinder investment. In many countries, such as Australia, Japan, Hong Kong, South Korea, Singapore, and even India, initial steps have been taken in this direction, but in some developing Asian countries, such as Vietnam, Indonesia or China, we are still a long way off.

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The attractiveness of Asia's PE markets to Western GPs is well founded. The growth prospects of many Asian countries continue to inspire confidence. Broadly speaking, Asia is also attractive when compared with markets in the West. The crisis is a cyclical event, and we believe it will not derail the long-term trends driving growth in Asia. But firms should not allow the allure of Asia to blind them to the many idiosyncratic challenges that can trap the unwary investor.

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