

A playbook for private equity success: An interview with Jean Salata, CEO and Founding Partner, Baring Private Equity Asia

by Ivo Naumann and Wouter Baan



Jean Salata has watched China liberalize and open up from his office in Hong Kong for more than 30 years, in the process turning Baring Private Equity Asia (BPEA) from a small private equity firm with about \$300 million in its first fund to a \$20-billion business.

Over that period, BPEA has evolved a distinctive operational approach involving deep sectoral knowledge of the healthcare, logistics, media, education, financial services, and retail businesses it invests in, controlled development of scale, cross-border expansions, and bolt-on acquisitions.

Amid a shifting geopolitical environment in Hong Kong and the unwinding of the COVID-19 crisis across Asia, Salata spoke with Ivo Naumann, a Shanghai-based Partner who heads McKinsey's private equity practice in Greater China, and Wouter Baan, an Associate Partner in Hong Kong, about the state of PE in China, including the development of an increasingly active secondary market for private assets.

The conversation covers key trends in the evolution of PE deal flow, how digitalization is affecting not just invested businesses but PE firms themselves, and why leadership and talent are key to unlocking outsized returns.

McKinsey: Private equity has risen rapidly in China, which is now the third-largest PE market in the world, but as a percentage of GDP it remains relatively small. What is your view on the future of the market?

Jean Salata: We're seeing more buyout transactions and larger deals. Digital transformation and technology are growing in importance, reflecting the Chinese government's embrace of the internet, mobile, data, and artificial intelligence – technologies that are transforming the way people do business. China is at the forefront of adapting technology to just about every business in the marketplace.

China is the source of the majority of global growth at the moment, and is still attractive for investors if you want to be exposed to growth in earnings, productivity, innovation, and capital formation, as well as returns on invested capital. This is all building

momentum as the economy further liberalizes, and as more of the rural economy transforms into the urban economy, amid a focus on consumption and the consumer sector.

Previously, the economy was largely driven by government investment, but now consumption has a much more important role. That is a long-term theme that will continue to play out: growth in consumption, growth in the middle class, in technology, and transformation. There's also a lot of capital chasing these ideas in China. The challenge for businesses and PE investors is figuring out how to invest in an environment where you need to react very quickly to changes, and locating the intersection between growth, opportunity, valuations, and returns on capital.

McKinsey: There's a lot of dry powder in the market. Is the industry disciplined enough to avoid driving up prices as it deploys that capital?

Jean Salata: Most GPs are very disciplined investors. It's a Darwinian business. If you're not disciplined, it shows up in your returns and you go out of business. The world today is different in that we have a very low interest rate environment. The returns on capital are low. The US Treasury market, something like a \$20 trillion market, is generating about a 1 percent return for investors. There's a lot of capital that used to earn, say, 4-5 percent that's now getting 1 percent, and so is looking for other places to invest. That filters through the entire chain of investors, and the investment returns that people are seeking to generate.

The way you generate that return needs to be suited to the environment that we're in today, where valuations are high. It needs to encompass buying the right company in the right sector with the right profile and growth, but also a plan to drive extra growth, margin, and exit multiple once you own and have repositioned the business. Investors need to consider how they can benefit from placing better leadership into a company, or by implementing digital transformation.

Overall, the industry will continue to thrive because there is such demand for generating returns above



Jean Eric Salata

Vital statistics

Education

Received a Bachelor of Business Administration from the Wharton School of the University of Pennsylvania

Career highlights

Oversees all investment and divestment decisions, as well as strategic direction, as CEO of Baring Private Equity Asia (BPEA), a firm he started as the regional Asian private equity investment program for UK-based Baring Private Equity Partners in 1997.

Took Nord Anglia Education private in 2008 and over eight years drove a 20 times expansion in EBITDA to more than \$200 million, before relisting the company in the US, and privatizing it once again in a \$4.3 billion deal that involved multiple BPEA funds.

Led a management buyout of Baring Private Equity Partners' Asia program to establish BPEA in 2000.

Served as a director of Hong Kong based AIG Global Investment Corporation (Asia) Ltd., the Asian private equity investment arm of AIG.

Acted as Executive Vice President of Finance of Shiu Wing Steel, a Hong Kong based industrial concern.

Consulted with Bain & Company based in Hong Kong, Sydney and Boston.

and beyond what is available to public market investors. If PE can continue to add value to the companies that they invest in, then investors will still benefit from the kind of illiquidity and alpha creation that happens through a PE strategy, provided it's done in a disciplined way. The industry in Asia is far more sophisticated and advanced than it was 20-30 years ago, when it was really a cottage industry. Today, we have all the tools, as well as experienced GPs and service providers, that help support our investment decisions. We have a very well-developed financing market to provide, the financing for the investments. We're also seeing the emergence of more control-type investments where, as an investor, you can really have an impact on the business, rather than being a passive investor.

McKinsey: Over the past decade we've seen more control groups and majority stakes, compared with the previous decade. What are some of the other differences or opportunities you expect to see?

Jean Salata: We're very paranoid about falling behind, and making sure that we're doing things as well as anyone else, particularly if you look at global benchmarking. Historically, PE investing was very passive in Asia. That moved on from being minority-type passive investing to more activist, majority-type investment. The logical first thing was putting financial leverage into deals and companies where you can control cashflows and generate a better equity return than was previously the case.

People then developed capabilities to work with companies and improve operations, or shape the strategy of the business, including through better leadership. A lot of this boils down to who is running the company, what kind of management teams, independent chairman of the board, or non-executive directors do you have to help guide these companies? Leadership has been an area where we've seen a lot of development and improvements.

The other related point is we're seeing more CEOs and management teams that have previously worked for sponsor-backed companies. This is their second or third deal. It's refreshing to work with people like that, because they understand the drill. They understand our playbook, and what our objectives are. They're totally aligned. Many of these people have already become fairly wealthy as management or successful CEOs, so they're able to co-invest with us in our deals as principals. We're all thinking about the same issues. That's been a big change that will continue.

We're already seeing more trade sales rather than IPOs, alongside the impact of digitalization. COVID-19 has accelerated what was already an ongoing digital transformation in the US, and the rest of the world, including Asia. That's going to continue. You're probably going to see more use of data and data analytics in both the way we run our business, as well as the way that companies run their businesses.

We've recently brought onboard internal resources that understand both the data analytics side, but also the infrastructure, the piping that's required in order to collect the correct data, and to evaluate a company when you're buying it, and whether or not you have the systems in place to collect the information that you need to be competitive.

It's that transformation from being just a digital business where you sell stuff online, to actually using information that you're collecting from your customers, suppliers, and competitors in a way that enables you to make better decisions. We're at the very infant stages of that as an industry, and we are pushing ourselves to do more.

Sector focus is also becoming increasingly important. The generalist approach is the logical way to start a business in our industry. But as we become more sophisticated, as the businesses become more competitive, you need to have those deep insights that you get from being a sector specialist, as well as the industry relationships that enable you to quickly bring in the right management teams, advisors, and diligence experts; all the people that help you make the decisions in order to be competitive in buying a company, and to hit the ground running once you have bought the business.

McKinsey: How well equipped are firms to deal with these shifting requirements?

Jean Salata: We're in a difficult environment now, as we were in 2008-09 and in 1999-2000. Those environments come and go, but generally businesses thrive, or fail, because of internal issues. Culture, people, and the way you run your business is so important. It's all about your people and the capabilities that you're developing. As a learning organization, one of our values is humility. We need to admit that we don't know it all, and that everybody's making mistakes relatively frequently. The point is to understand those mistakes and how we can do things differently going forward, and transmit that learning across the organization. We emphasize having an open culture and discussions around learning. Learning from mistakes, and celebrating successes.

Agility at the organizational level is also important. I've always believed in diversity in an organization because of the way we operate across so many countries and different jurisdictions. It's almost imperative that we have language skills and different cultural backgrounds. We have a large number of female partners in our firm, both junior, mid-level and senior-level, who bring a different perspective, and make us a more effective organization.

We have also embraced working with industry experts. Coming from a consulting background myself, I think the consulting framework—defining a problem and how you're going to approach an

issue, before pulling together all the data and the resources to address that—is very important.

In addition to that, there's so much value in finding people that have worked in industry who are operators in a particular kind of business, or country environment. That can really help you to manage the business.

We work with a lot of industry people pre-deal, as well as post-investment, to do the due diligence, to get a view on the business, and also to help us find the right management team. COVID-19 is going to be a defining period for a lot of firms and companies. How did you manage through it? What steps did you take? How are you coming out of it? The bottom line is people and organizational culture, and how you get the best out of people in your organization.

We found it energizing to be in crisis mode as a team, working much more closely together than we do during normal times. In a way, it pulls people together and enables you to make decisions that would have otherwise taken months or years. You're able to do it immediately, because there is a sense of urgency. Now we're trying to capture that sense of urgency and redirect it at the recovery, and the new alpha. Where do you go from here without losing that intensity? That intensity is very powerful, if you can mobilize and harness it.

McKinsey: You referred to creating alpha by being more involved in value creation, compared to minority/growth-type investments in the past. One element that people always ask is, “How do you actually build operating groups or value-creation portfolio groups?”

Jean Salata: There's no silver bullet, but you start with a framework. We have a playbook, we call it the Baring Management System, the BMS, that has six different modules. The key is to focus on one, or two, or three important levers rather than trying to do too many things at once. There's a saying that we have: “Think big, but start small.” So, have big ambitions, but start with some relatively small initial steps that you can accomplish quickly. It's generally

in one or two areas that there's an opportunity to show some results. Then it's about getting the right people and matching those objectives with talent. The other issue is how quickly you're able to do this. Oftentimes, it's a year before you've gotten the right people into the right positions, and the right plan in place. That's too long.

You need to develop a thesis, and have a very detailed blueprint ready, pre-investment. Post-investment, you quickly get the management team on board, modify the plan and start implementing, getting the right people in place within the first three to six months. If you hit the ground running and are at takeoff speed in the first year, then generally the investment is off to a good start, and that helps a lot.

Getting the digital and data piece right is also going to be an important part of alpha creation for most businesses. Some of this relates to how you're going to exit the company, and whether you can scale the business up dramatically through bolt-ons, or create a larger scale business with better operating leverage, margins, and valuation multiple as a result of organic growth. Maybe you will need to reposition the business.

We've invested in companies where we went into a lower growth, more commoditized-type business. We shed some of the lower-margin business lines, and focused on areas like electric vehicle supply chain, or aerospace, or medical equipment. Higher margin, high growth.

You not only change the margin structure of the business, you also change the multiple by entering higher margin, higher growth businesses. The rubber meets the road on the actual implementation of these plans. How you execute, and how long it takes you to execute, because we're all operating against the clock.

McKinsey: One thing that we observe is an increasing concentration of fundraising in a smaller set of funds. LPs are trying to narrow down the number of funds they are investing in. What's your

outlook for this, and what are some of the things that GPs should be doing in order to be on the positive side of this trend?

Jean Salata: It's the evolution of the industry to some extent. It's a bit of a bubble. You're always going to have some very specialized, entrepreneurial, younger, newer firms that are on the first or second fund, or more boutique-type operations, where younger teams are growing and generating great returns, and are doing more niche strategies perhaps, or smaller deals. Then there is a lot of movement towards, and benefits from, a concentration of larger funds that are able to build scale in their own organizations, but also go after scale assets and drive change in the businesses that they invest in. The mid to large end of the market in some respects is less competitive, because there are fewer buyers for those assets. They tend to be extremely disciplined buyers. When you have billions of dollars at stake, you are not creating a very diversified portfolio where some are going to fail. You make sure every single investment is going to be fine or good. Generally, most players at that end of the market are pretty careful about the way they underwrite, which creates a self-regulating discipline in the market. As the deal size increases, you generally have fewer players. The deals are more intermediated, but you'd be surprised at the number of deals that we see that are not intermediated for a variety of reasons. It's a more bilateral-type situation. It could be a take-private, it could be a company where there is a pre-existing relationship, or it could be a strategic discussion where you have an asset that you could combine with the business. There's lots of reasons why things don't always go the auction route.

You need some scale in order to do things like building internal, sector, operating, or technology capability. For example, we have a very large debt capital markets team, internally. It does a lot of the

debt capital raising for our portfolio companies, as well as the exit strategy planning.

We have a weekly meeting where we discuss signals we are receiving from our teams around the region, which enable us to decide whether to lean in to certain situations, or to avoid things that don't feel right. Then there is the move the needle point: If you are an LP and you have a large program, you need to have relatively large commitments in order to move the needle on your own program. You also want to avoid being overly exposed to any one fund, so you generally need to be in larger funds, larger programs in order to accommodate the size of commitment that you want to make. Most LPs are resource constrained, so from a productivity standpoint, they want to have larger relationships with your GPs. Increasing productivity works in everyone's benefit, including ours. There are benefits to scale, and I think this trend will continue.

A counter-argument is that if you get too large, you start to see diminishing returns as investors get too big. You can't manage so much money, it's hard to deploy, or you get too conservative, and take less risk. I have not seen that personally. There are certainly some smaller funds that generate really huge outperformance related to one or two home runs, or that sort of thing. But if you look at the expected return and the absolute return dollars generated in our industry, it's going to come from larger firms across the board. That ability to generate consistent returns on large amounts of capital, and to let that compound over time, will have the largest absolute dollar-weighted impact on investors' PE allocations, as opposed to a smaller outsized return, which doesn't have as big of an absolute impact on your program. That will continue.

The other thing we've seen is institutionalization of our asset class. It's not as much of a cottage industry anymore. We are still in the first generation of many firms. Even in the US, most founders are still

running their businesses. But you will see in the next 20 years a generational change happening pretty much across the board in the developed markets, and starting to happen in Asia as well. That is exciting – the idea that you can create an institution that outlives a founder generation and create a really lasting business, like McKinsey.

That means you have to think about how you institutionalize your management team, the depth you have, and the systematic approach that you take; how you systematically approach your business and build the lasting agility and ability to innovate while bringing in great, talented, young people into your organization. What sort of recruiting and training programs do you have? What sort of HR team do you have? How do you motivate, and share the economics with a younger generation? All of these things are critical. The bigger firms are in a better position to do that over time, and to grow and institutionalize.

McKinsey: How do you see the variety of deals being done and the amount of companies becoming available for PE investment changing in future?

Jean Salata: Deal flow developed from being a minority/growth capital industry where companies needed equity capital to expand their business to include everything from generational change to corporate divestitures. In the COVID-19 period, we've seen big market dislocations creating opportunities with take-private situations. That's an area we see cyclically in emerging markets such as Asia, which tend to go through periods of big. Liquidity comes in and then goes out in waves. When liquidity dries up, markets fall, and companies become distressed. For example, the banking sector in India at the moment is quite distressed.

There are a lot of public companies where evaluations have halved, or more, as a result of stress on the system. You also have people that own companies in their own portfolios that have become

public companies, or were originally public, that have been marked down dramatically in price, and where there's an opportunity to do a take-private with one of your own portfolio companies. We've seen that as well. As people do more buyouts, then one PE firm buying from another PE firm will become increasingly common. That sounds like a low-return strategy, or a hard to understand market, but it's not. Like in the stock market, people buy and sell stocks all day long from one another.

There are IPOs, which are primary issues. But most of the market trading is secondary in nature. The same thing happens in private markets. The assets get bought and sold for a variety of reasons. It's not always because one fund feels like the returns have been maximized so it's time to sell. It's generally to do with the lifecycle of an investment. You have a thesis, you go in and you build it and you have a fund life of say, 10 years. You have an investment horizon of five or six years. There comes a point when it's time to sell, you've made your money and you move on. Generally, those assets perform quite well through the second wave of ownership and even beyond. Related to that, there will be an increasing amount of transactions that involve companies where corporates decide that they have had a change in strategy and they want to divest.

In the current environment, there may be more carve-out opportunities because people may have liquidity or short-term dislocations on their balance sheet. That's quite interesting from a PE standpoint. Also, the geopolitical realities of the world today are a major issue for all of us. It creates opportunities in that people may want to decouple. People may want to refocus on one geography versus another, and maybe exit one geography as a result of geopolitical issues. You're certainly seeing deal flow from continuing generational change happening at the

large buyout end of the spectrum. You're seeing more cross-border-type deals where a company is starting to globalize, and needs to grow their footprint beyond Asia, and either become part of a global business, or themselves acquire something that's more global in nature.

PE is also better understood now than it used to be. Generally, there is increasing acceptance of the role that PE can play in rejuvenating and revitalizing industry; in helping conglomerates that have probably too many subsidiaries shed some of the non-core businesses, and allow those businesses to thrive under more concentrated ownership.

Management teams are very motivated by that. They see that they're going to get more attention, more capital support, and will become more efficient and competitive with an owner that's focusing on one asset, as opposed to being part of, say, 200 subsidiaries. There's a variety of areas around the region where we're seeing more and more deal flow, and I expect that to continue as our industry grows.

Ivo Naumann is a partner in McKinsey & Company's Shanghai office; **Wouter Baan** is an associate partner in Hong Kong.