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Private equity Asia-Pacific: Is the boom back?

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Private equity Asia-Pacific: Is the boom back?

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Introduction

By many measures, 2011 provided long-awaited proof of a rebound in the Asia-Pacific private-equity (PE) business[1] after the protracted downturn of 2008 through 2010. While in the United States and Europe, the industry's recovery remained muted in the face of debt worries and weak employment data, the Asia-Pacific region's total PE investment values have returned to 2006 levels, or some $65 billion.[2]

China alone accounted for almost 45 percent of the new activity, indicating that the expansion has not been uniform. But even more mature markets, such as Japan and Australia/New Zealand, showed some signs of life. On the whole, the region is now in its strongest position since the global economic crisis.

Moreover, although the Asia-Pacific region now accounts for 21 percent of the global PE industry, that level is still lower than its share of global GDP, which has reached 28 percent. The region's low PE penetration rate[3] also confirms the likelihood of room for further growth.

The nature of the opportunity is changing quickly and will require industry players to develop new flexibility and capabilities. For example, although China continues to show long-term promise, its slowing growth and rising sophistication will create openings very different from those that arose in even the recent past. Throughout Asia, local players are acquiring new skills that make them sharper competitors and more valuable partners. And new frontiers, such as Indonesia, Vietnam, and a rapidly reforming Myanmar are promising rapid growth; whether these countries can keep that promise (which for Myanmar would require further lifting of sanctions) remains in question.

We began our ongoing research on Asia's PE industry in 2009, with this white paper representing the third edition of our annual "state of the nation."[4] As in the previous papers, we focused on the six markets that together account for virtually all PE investments in Asia: Australia/New Zealand, Greater China, India, Japan, South Korea, and Southeast Asia.[5] Given the diversity among (and even within) these markets, our goal is not just to validate the data we gather but to refine that data so that the figures are truly comparable and can yield reliable insights for investors.

The first section therefore provides a summary of our review, covering deal volumes and aggregate values, investor nationalities, exits, and fund-raising, both in the aggregate and for each of the six constituent markets. We also include a brief overview of the top Asian deals for 2011, as well as some of the larger Asia-focused funds raised in the year. In analyzing fund-raising, we recognized the importance of distinguishing between funds raised for a market, regardless of geographic source, and funds raised within a market. For comparisons between Asia and other geographies, we focus on funds raised for Asia from all sources. For comparisons within Asia, our data look to fund-raising within each individual market.

Expanding our work from 2011, we again conducted interviews with leaders from a wide range of global and regional general partners (GPs), as well as local and foreign limited partners (LPs). We then incorporated an analysis based on our experience in serving industry players across the region. The result, detailed in the second chapter, is a series of industry-wide themes, including changing deal structures, maturing secondary markets, questions about China, and the rise of Southeast Asia. Together, these insights can help guide industry players seeking to take full advantage of the market's promise.

2011: First-half promise yields to second-half softness

Initially, 2011 appeared to fulfill hopes for a sustained recovery in the global economy, but the ongoing uncertainty in Europe eventually depressed both global GDP figures and market performance. By year end, worldwide real GDP growth had noticeably slowed, hitting 2.7 percent as all geographies began to falter. Asia and Latin America came in at just under 4 percent, while in Europe and the United States, growth fell to a paltry 1.9 percent and 1.5 percent respectively. Similarly, most major financial indexes (with the notable exception of the Dow) failed to recover from sharp midyear downturns and instead finished 2011 much lower, with losses hovering around 7 percent for the

1 For this paper, the PE business encompasses buyouts, turnarounds, private investments in public equity (PIPEs), expansion investments, and mezzanine/pre-IPO deals; except where otherwise noted, information on private-equity activity has been supplied by Capital IQ, *The Asian Venture Capital Journal* (AVCJ), Recof M&A, and Preqin. For more detailed definitions, please see the appendix.

2 All currency figures in this report are in US dollars unless otherwise noted.

3 We define "PE penetration rate" as the ratio of PE investments to nominal GDP (as supplied by Global Insight).

4 Keiko Honda, Bruno Roy et al., "Private equity Asia-Pacific: Rebounds, glocalization, and other tales," March 2011; Keiko Honda, Bruno Roy et al., "What we talk about when we talk about … private equity in Asia," January 2010.

5 Greater China comprises the People's Republic of China (mainland China), Taiwan, Hong Kong, and Macau. Southeast Asia comprises Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

FTSE 100, 15 percent for the DAX, and exceeding 20 percent in Hong Kong, Shanghai, and Mumbai.

The eurozone's protracted debt crisis thus appears to be weighing on the rest of the world, encouraging banks to hoard capital and leaving businesses struggling to overcome reduced credit availability.

Paradoxically, even though the tight credit environment has made fund-raising somewhat more difficult for Asia's PE players, it has also increased demand for PE capital and is expected to generate more opportunities for distressed-debt and restructuring deals. Together, these factors are a major reason that investments appear to be moving to Asia (Exhibit 1), and PE firms appear to be undertaking a corresponding reallocation of global talent.

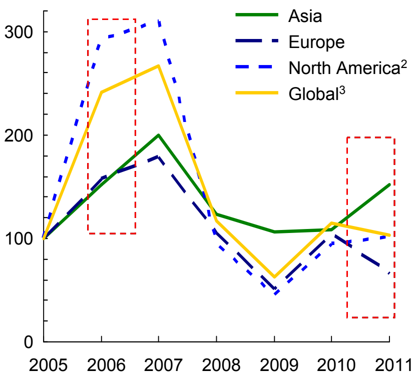
Furthermore, there seems to be little risk that the market will soon become saturated. As a percentage of GDP, PE penetration rates remain low in comparison with those in PE's traditional homelands of the United States and United Kingdom—even in the mature economies of Japan and Australia/New Zealand, and even in hot spots such as mainland China and Southeast Asia. The ratio of PE investments to M&A activity shows a similar pattern in these Asia-Pacific markets, with only Greater China's figure of 23 percent approaching the 25 percent shown in the United Kingdom or the 28 percent in the United States (Exhibit 2).

Yet within Asia, the six principal markets show vastly different growth trajectories. The expansion of Greater China's PE industry—currently almost 45 percent of the Asia market by total investment value—has only accelerated since 2008, while recovery elsewhere remains comparatively modest (Exhibit 3).

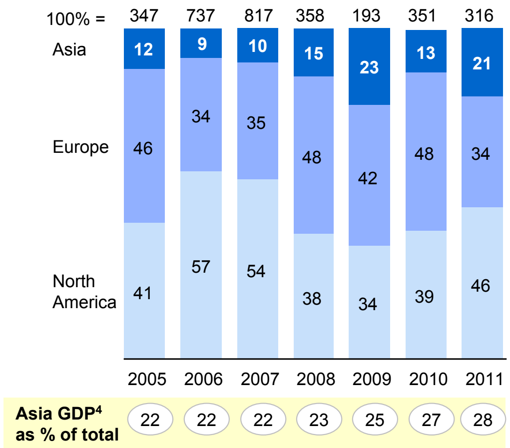
These differences, combined with the wide range in the PE industry's maturity across Asia, have a significant effect on the investment stages that prevail in each Asian market. In Japan and Australia/New Zealand, the two most developed PE markets, buyouts predominate. At the other extreme, 60 percent of India's investments are at the expansion stage. In between, China's investments are divided almost equally among mezzanine/pre-IPOs, expansions, and private investments in public equity (PIPEs) (Exhibit 4).

Exhibit 1 Asia is back to 2006 levels and is gaining share.

Asia is back to 2006 levels: total PE investments[1] by value, rebased to 2005
%, 2005 = 100%

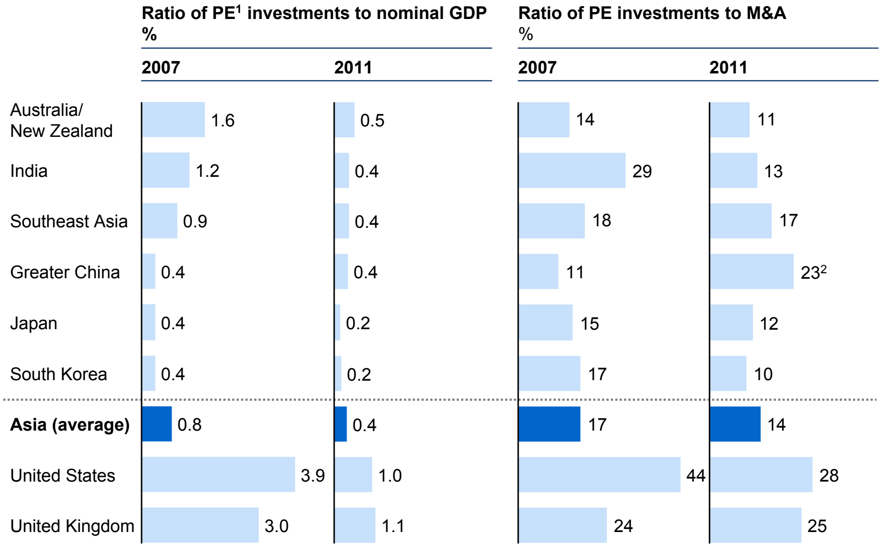


And Asia is gaining share: total PE investments[1] by region
$ billion, %



1 Includes buyouts, turnaround, private investments in public equity, expansion, pre-IPO, and mezzanine.
2 United States and Canada.
3 Includes Asia, Europe, and North America.
4 Nominal GDP.
Source: AVCJ; Capital IQ; Global Insight; Recof M&A; McKinsey analysis

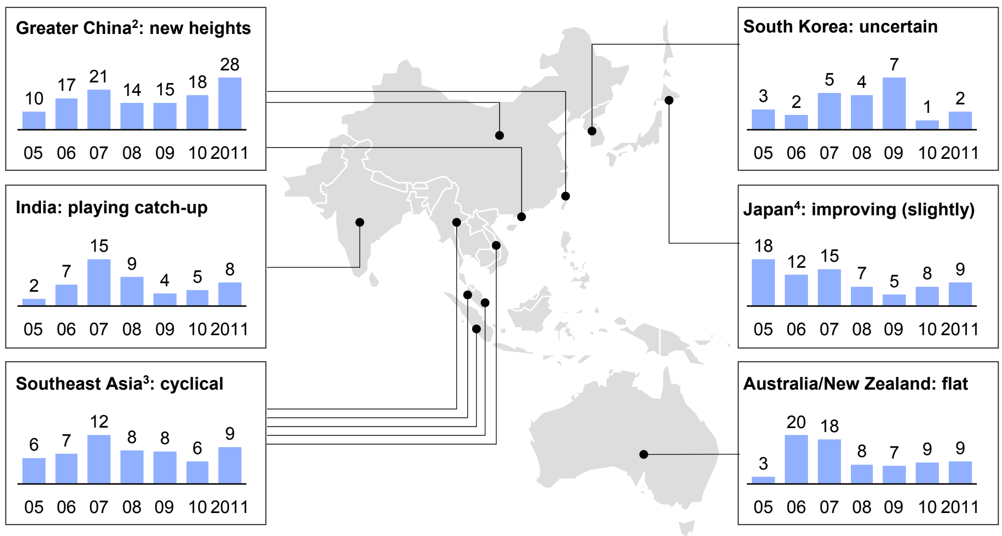
Exhibit 2 There is ample room for growth.



1 Private equity.
2 Driven by large direct investments in financial services by sovereign wealth funds and pensions.
Source: AVCJ; Capital IQ; Recof M&A; McKinsey analysis; Global Insight

Exhibit 3 Six markets display different growth profiles.

Value of private-equity investments[1]
$ billion



1 Includes buyouts, expansion, private investments in public equity, pre-IPO, mezzanine, and turnaround.
2 Greater China consists of China, Hong Kong, Macau, and Taiwan.
3 Southeast Asia includes Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.
4 For Japan, only data for buyouts and private investments in public equity are available.
Source: AVCJ; Recof M&A; McKinsey analysis

Deal flow: Growth from small deals

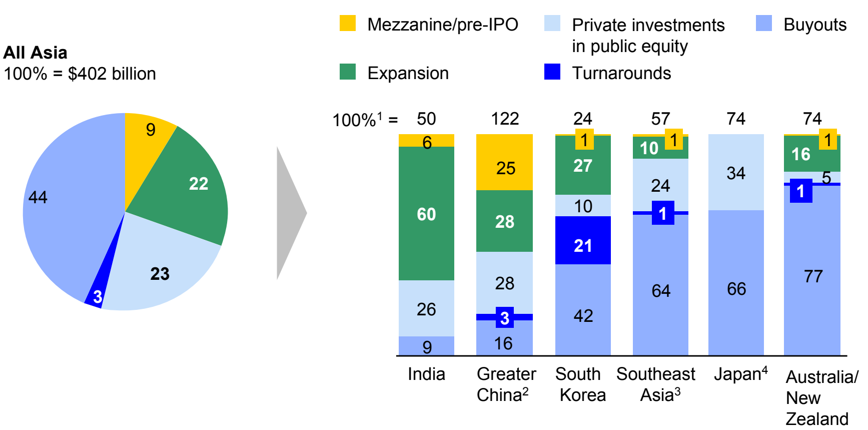
If there is an overarching conclusion from the Asian PE deal data for 2011, it is that smaller deals are driving much of the industry's growth. Across Asia as a whole, PE deal volume—the number of PE deals completed in a given year—has more than doubled over 2010. But the average deal size is substantially smaller.

Deal volume: Recovery comes to Asia. Outside Asia, PE deal volume remained largely stagnant in 2011, after a partial recovery in 2010 from the lean years of 2008 and 2009. Europe's 2011 volume rose only 2.1 percent and North America's an even smaller 1.3 percent over 2010, leaving both regions still somewhat behind their 2007 figures.

Asia's story has been different. Its deal-volume decline was deeper and longer, lasting through 2010. But in 2011, the region's volume figures more than doubled (Exhibit 5), mainly the result of a sixfold rise in expansion-stage deals. Although Asia is still down almost 30 percent compared with before the 2008–09 economic crisis, the dramatic turnaround may mark the beginnings of a deeper shift in global deal flows.

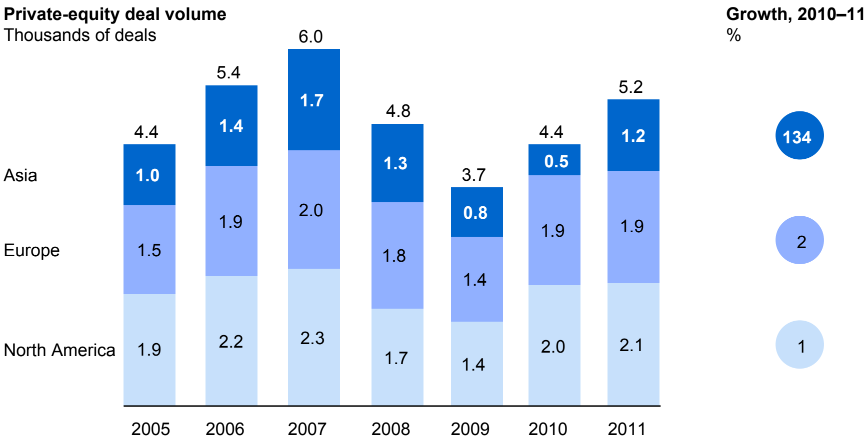
Exhibit 4 PE markets across Asia are at different levels of maturity.

Value of private-equity investments by financing stage, 2005–11
%, $ billion



1 Columns may not sum due to rounding.
2 Greater China consists of China, Hong Kong, Macau, and Taiwan.
3 Southeast Asia includes Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.
4 For Japan, only data for buyouts and private investments in public equity are available.
Source: AVCJ; Recof M&A; McKinsey analysis

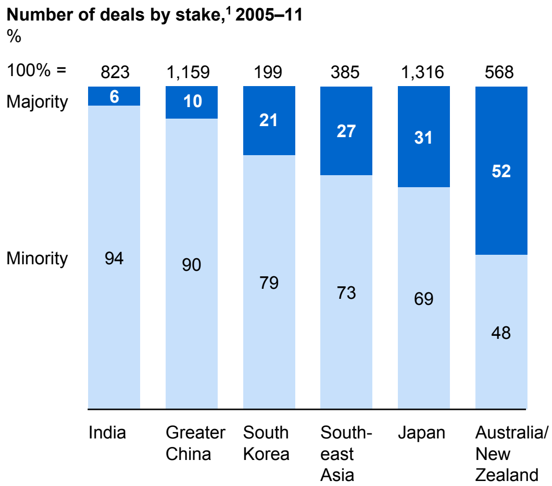
Exhibit 5 Deal flow is returning to Asia.



Source: AVCJ; Capital IQ; Recof M&A; McKinsey analysis

Within that increased volume, one distinctly Asian characteristic showed few signs of change in 2011: minority deals continue to dominate the landscape in most Asian markets. With the exception of Australia/New Zealand, across Asia minority deals account for at least two-thirds of all PE deals, rising to a high of 94 percent in India (Exhibit 6). Even in advanced-market Japan, the minority-deal share is 69 percent. GPs that invest in Asia must therefore remember that taking effective control of a company is still difficult in most Asian countries, whether because of market dynamics or regulatory controls.

Exhibit 6 Minority deals dominate most Asian markets.



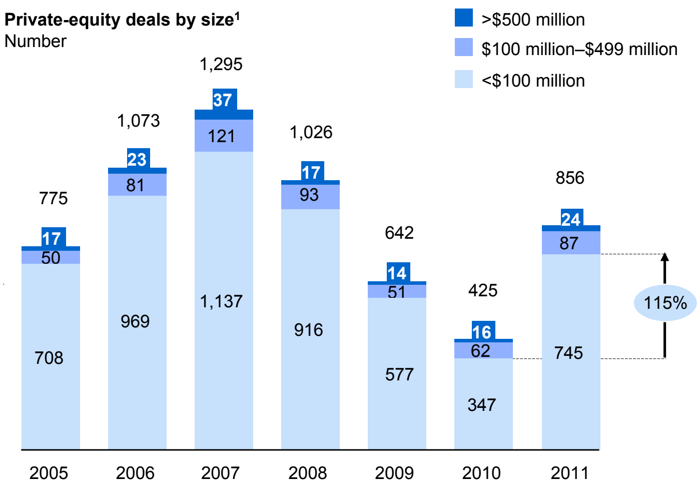
1 Excludes deals with undisclosed stake.
Source: AVCJ; Recof M&A; McKinsey analysis

Deal values: Small caps dominate. As welcome as the recovery in deal volumes has been, however, the total value of PE deals around the world in 2011 remained far below that in 2007. Asia was in better shape than Europe or North America, but only by comparison. Europe's total deal values, after doubling between 2009 and 2010, sank in 2011 by one-third, leaving it at more than 60 percent below the 2007 figure. North America eked out 6 percent growth in 2011, but the final result was two-thirds lower than in 2007. Asia's much healthier growth figure—40 percent—brought the region closer to its 2007 performance, although the gap between the two years was a still-large 24 percentage points.

Asia's percentage of the total global deal value has therefore doubled, from 10 percent in 2007 to 21 percent in 2011. But the more important lesson for the PE industry is that growth in value is lagging behind growth in deal numbers in almost every Asian market.

Accordingly, one of the year's most striking changes was the proliferation of smaller transactions. The number of Asian deals valued at less than $100 million more than doubled. Meanwhile, the larger deals that garner the most attention (that is, those valued at more than $500 million) showed much less dramatic growth, rising from 16 in 2010 to 24 in 2011, a total that remains well below the 2007 peak of 37 (Exhibit 7).

Exhibit 7 Strong growth in Asia was fueled by smaller deals (<$100 million).



1 Does not include transactions with undisclosed deal size.
Source: AVCJ; Recof M&A; McKinsey analysis

Should this trend toward smaller deals continue, GPs will need to undertake several strategic and operational changes. The initial question is to decide whether to pursue deals that do not meet traditional investment criteria. GPs that answer yes will need stronger networks with "rainmakers," reaching beyond the traditional circle of investment banks. GPs may also need to examine their business models to find economies of scale in a higher-volume, lower-value approach. Finally, they will also need to assess more deeply the types of opportunities they pursue given changing deal structures, both at initial investment and at exits.

Whether players should target any broad industry categories is less clear. A review of available data going back to 2006 shows few patterns emerging. By volume, the six sectors into which we have classified the data have remained remarkably stable, despite huge variations in the total number of deals completed in Asia over the past several years. The value data show greater fluctuation by sector, but the services (including financial and nonfinancial) and consumer sectors are clear favorites (Exhibit 8).

Investor nationality: Foreign-local partnerships increasing

Whereas foreign GPs' share of Asia's PE market rose in 2010, 2011 saw a resurgence among local players. Across Asia, local entities are now the sole GPs for 28 percent of all deals by value, up from 18 percent the year before. "Mixed" deals involving both foreign and local players also increased in value from 19 percent in 2010 to 31 percent in 2011, as the parties continued to integrate their respective capabilities more closely. Exhibit 9 shows local investors' prominence across the different markets, particularly in Australia/New Zealand, Greater China, and Japan.

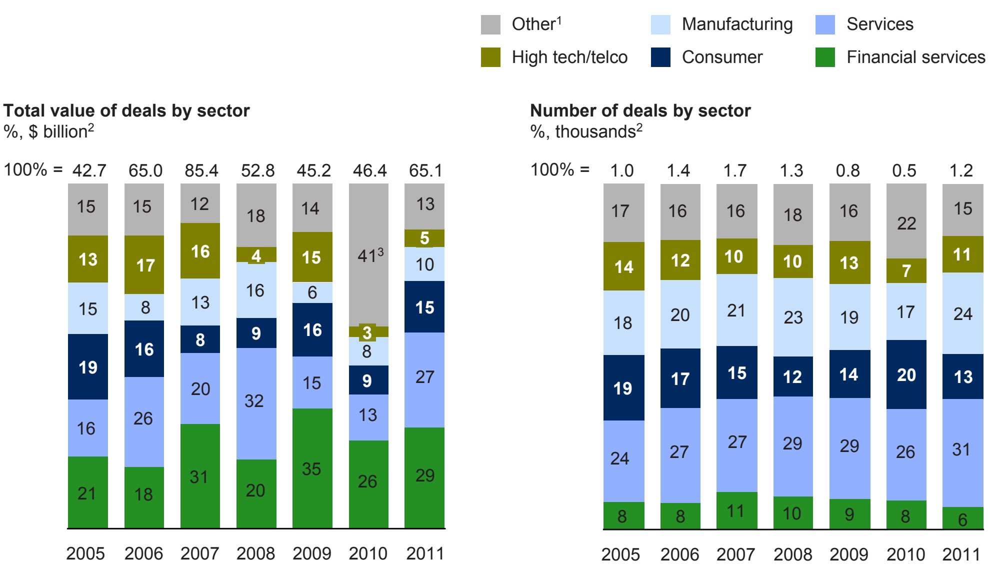
A look at the top deals for the year

The largest deals of the year did not necessarily occur in the highest-growth markets. A review of Asia's top 10 PE investments for 2011 shows that although Greater China (which includes Hong Kong) took five slots, (comparatively) slow-growing Japan and Australia/New Zealand each took two, with a Japanese deal taking the top position (Exhibit 10). Accordingly, much of the sector's expansion across Asia appears to result from smaller transactions that attract less notice.

Exits: Asia down, IPOs down, secondary deals constant

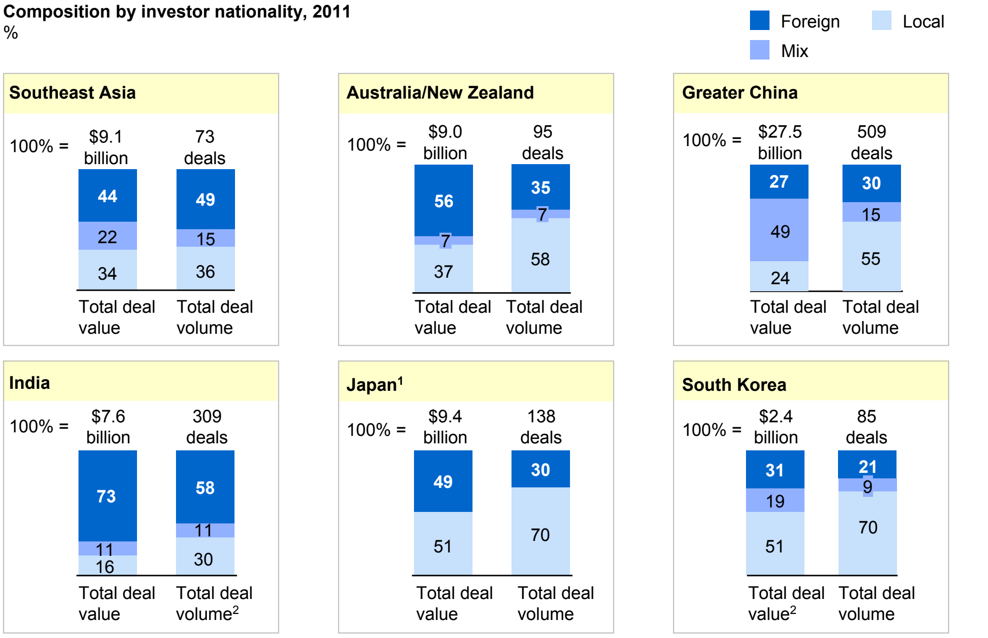
In North America and Europe, both the volume and value of exits continued a recovery that started in 2010. In Asia, however, both the volume and value of exits dropped as a

Exhibit 8 Consumer and services sectors lead in private-equity investments.



1 Includes transportation, infrastructure, medical, and other sectors.
2 Columns may not sum due to rounding.
3 Spike in value of "other" category due to large deals in medical and transportation sectors.
Source: AVCJ; Recof M&A; McKinsey analysis

Exhibit 9 Local investors account for a large share of many Asian markets.



1 Japan data only provides breakdown for foreign and local deals.
2 Columns may not sum due to rounding.
Source: AVCJ; Recof M&A; McKinsey analysis

Exhibit 10 The region's top deals in 2011 offer a snapshot of the landscape.[1]

Target	Investor	Deal size $ million[2]	Industry	Country
1 Skylark	Bain Capital	2,072	Services	Japan
2 KFC Holdings	CVC Capital Partners; Johor Corp.	1,649	Consumer	Malaysia
3 Alibaba Group	DST Advisors; Silver Lake; Temasek Holdings; Yunfeng Capital; undisclosed investors	1,600	Services	China
4 MYOB	Bain Capital	1,253	High tech/ telecom	Australia
5 Grand China Air	Hangzhou Jiuzhi Investment Management; Zhejiang Longsheng Group	1,232	Transport	China
6 360buy.com/ JingDong Online	DST Advisors; Tiger Global Management; undisclosed investors	1,000	Services	China
7 New China Life Insurance	AXA PE; CICC Investment Management; CITIC PE; Hony Capital	984	Financial services	China
8 Tsubaki Nakashima	Carlyle	807	Manufacturing	Japan
9 Television Broadcasts	Charles Chan Kwok Keung; Madam Cher Wang; Providence Equity Partners	806	High tech/telecom	Hong Kong
10 Valad Property Group	Blackstone	753	Financial services	Australia

1 Does not include private-equity investments by non-private-equity players.
2 Total deal size as reported in AVCJ.
Source: AVCJ; Recof M&A; McKinsey analysis

consequence of the unusually poor performance in local public equities markets (Exhibit 11).

At the same time, the nature of those exits has changed. Market volatility has reduced the attractiveness of IPOs around the world. And in Asia, notwithstanding such notable flotations as Samsonite International and Sinovel Wind, the total value of IPOs halved in 2011 over 2010, and volume dropped 17 percent. Trade sales became the leading form of exit deal, accounting for 51 percent of the total exit volume.

By contrast, the proportion of secondary sales across Asia has remained relatively constant over time, averaging 7 percent of total volume over the 2005–11 period—a figure we believe has the potential to increase in the coming years. Roughly $220 billion worth of deals were made between 2006 and 2008, and GPs adhering to the usual five-to-seven-year holding period are naturally in selling mode. For GPs interested in larger deals, the direct-secondary[6] market could help to fill a need.

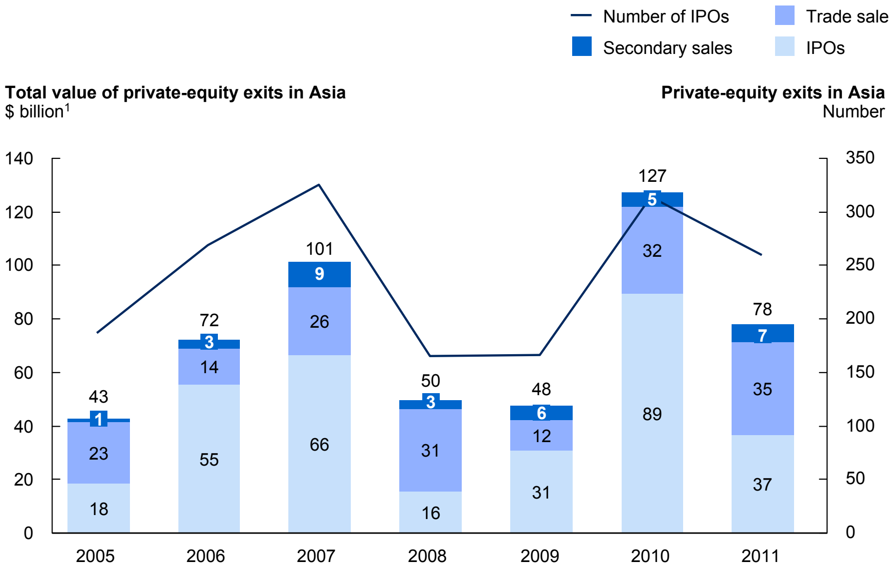
Macroeconomic issues may also raise total exit numbers; in Japan, for example, the strong yen is an important driver as GPs take advantage of the yen's appreciation against other major currencies to make profitable exits from Japanese investments. European uncertainties are a factor as well, with some European GPs looking to sell Asian portfolio companies to bolster their balance sheets back home.

Fund-raising: Steadily stronger

As we noted in the introduction, our analysis of fund-raising across Asia as a whole looks at funds raised for Asia regardless of their source. By that measure, the fund-raising picture for Asia does not seem very encouraging at first glance. Although Asia's economy had the strongest growth of the major geographies, its fund-raising increased the least, climbing 31 percent above 2010 levels, while Europe rose 111 percent, and the United States 87 percent. But Asia's very resilience is a large part of the reason the increase is so small: Europe and the United States posted larger percentage gains only because their declines from 2008 to 2010 were so much worse.

Fundamentally, even with these caveats, the year 2011 solidified Asia's earlier fund-raising gains to reach a level that was actually higher than in the flush years of 2006 or 2007. Europe and the United States straggled far behind at only about one-third

Exhibit 11 Falling public-market valuations caused drops in both the volume and value of IPO exits in 2011.



1 Columns may not sum due to rounding.
Source: AVCJ; McKinsey analysis

6 We define "direct secondary" as the sale of a portfolio company from one GP to another GP.

of their 2007 peaks. Asia's share of global fund-raising has therefore risen from 7 percent in 2007 to 21 percent in 2011 (Exhibit 12).

In 2011, China was the focus of many of the major Asian funds that closed (Exhibit 13). Early indications are that Southeast Asia and India may attract additional attention this year, with China continuing to play a leading role.

A closer look at six markets

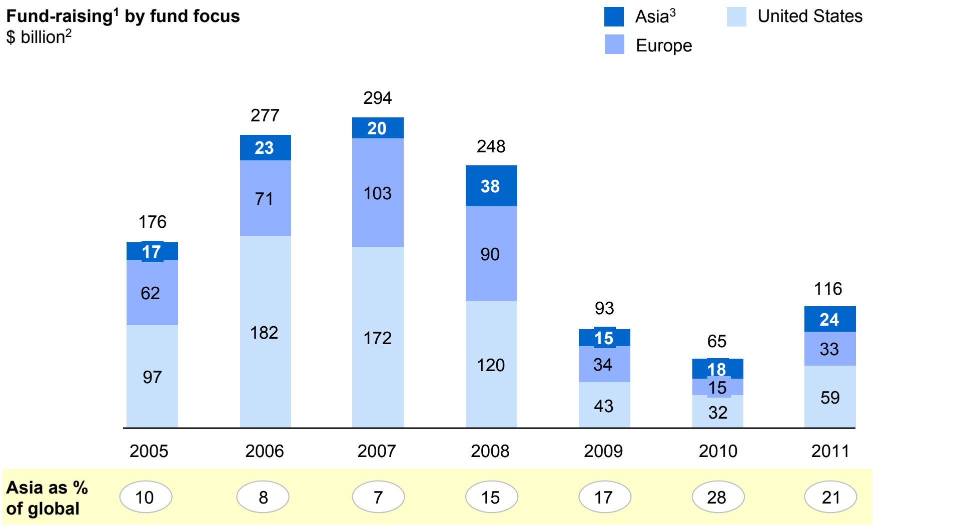
As in previous years, our 2011 research concentrates on the six major geographic markets that dominate Asia's PE industry: Greater China, India, Southeast Asia, Japan, South Korea, and Australia/New Zealand. For each major market, our analysis covers the five indicators discussed in the preceding section on a continent-wide basis: deal volumes, deal values, exits, investor nationality, and fund-raising (as we noted in the introduction, at the country level our fund-raising analysis focuses on funds raised within the country and excludes funds raised for the country from outside sources).

Greater China: Private equity shines as IPOs are left in the shade

China's[7] economy cooled slightly in 2011, with GDP growth falling to 9.2 percent from 2010's figure of 10.4 percent. But compared with growth of less than 2 percent in the European Union and the United States, China's resilience was all the more remarkable. And China achieved that record notwithstanding inflation-fighting measures such as higher interest rates, tighter credit controls, and larger bank-reserve requirements—along with a 4 percent rise in the RMB against the US dollar.

In tandem, Greater China's deal volume more than tripled over 2010. The chief contributor was a large increase in expansion deals, which accounted for some 82 percent of the total. Among the more prominent transactions was the $1.6 billion investment in Alibaba Group by a consortium including Silver Lake. The net result is that deal flow in China is now as strong as ever. As one large GP in China told us, "We're busier than we have been in the last eight or nine years."

Exhibit 12 Asia's share of fund-raising has also increased.



1 Includes balanced, buyout, coinvestment, direct-secondary, growth, late-stage, special-situation, and turnaround funds.
2 Columns may not sum due to rounding.
3 Data regarding the geographic focus of funds raised by private-equity firms are available only for the United States, Europe, and a broad "rest of the world" category that includes Asia. However, data for the geographic focus of investments made by private-equity firms are available for Asia. To estimate funds raised for Asia, we calculated the ratio of Asia to non-Asia private-equity investments and applied it to the geographic funding data.
Source: Preqin; McKinsey analysis

7 Although Greater China comprises China, Taiwan, Hong Kong, and Macau, China alone accounts for 94 percent of deal activity.

Exhibit 13 A few top funds closed in 2011.

Fund[1]	Fund manager	Final size, $ million	Type	Location focus
Baring Asia Private Equity Fund V	Baring Private Equity Asia	2,460	Growth	Greater China, India, Japan, Singapore, South Korea, rest of Asia
RRJ Capital Master Fund I	RRJ Management	2,300	Buyout	Asia
Shanghai Ruili Emerging Industries Parallel Fund I	Real Power Capital	1,108	Growth	China
New Horizon Capital IV	New Horizon Capital	1,050	Growth	China
Primavera Capital Fund I	Primavera	1,000	Buyout	China
CPE China Fund	CITIC Private Equity Funds Management Co., Ltd.	990	Growth	China
Northstar Equity Partners III	Northstar Capital LLC	820	Buyout	Indonesia
Zheshang Industrial Investment Fund	BOCGI Zheshang Investment Fund Management (Zhejiang)	782	Balanced	China
Shanghai Prosperity Fund	Shanghai Prosperity Fund Management	760	Buyout	China
Guangdong SME Direct Equity Investment Fund	BOC Yuecai Private Equity	759	Buyout	China

1 Includes only funds with vintages 2011; list is not exhaustive; excludes Hony Fund V, which closed in 2012, and Hony Capital RMB Fund II, whose vintage was 2010.
Source: Preqin; McKinsey analysis

Three factors explain much of the current growth. The first is sagging domestic public equities markets, leaving public capital more difficult to obtain for not only IPOs but also later-stage equity offerings. At the same time, overseas markets are now more difficult to tap, with US-listed Chinese companies having underperformed since mid-2011 (as described in more detail in Chapter 2). Finally, the pricking of China's property bubble has reduced land sales by Chinese cities, forcing them to find additional sources of financing to support major infrastructure projects.

By sector, almost half the value of all investments is now channeled toward financial services, with manufacturing's share decreasing from 28 percent in 2007 to just 11 percent in 2011. A review of the major GPs' investments reaching back to 2004 reveals that opportunism remains the dominant force. One leading foreign GP told us quite bluntly, "We don't have a clear sector strategy in China right now. We would consider all deals with a high potential return."

For all its growth, Greater China nevertheless follows the pattern seen in the rest of Asia, where deal values have failed to keep up with deal volume: the total value of all PE deals in Greater China increased only 52 percent. The average size of a deal has therefore fallen significantly, from $150 million in 2010 to $90 million in 2011.

As for locking in those returns, the number of exits held relatively constant, dropping by just 15 percent in 2011 after rising 60 percent in 2010. But they halved in value, consistent with the overall drop in valuations. IPOs continue to take the majority of exits, at 68 percent of value, but poor public-market performance meant that this 2011 figure reflected a significant drop from the 86 percent recorded in 2010.

A review of investor nationalities shows that local players are becoming more important than ever in Greater China, at least as measured by their share of the region's deal values. Local GPs now control almost one-quarter of Greater China's total PE deal values—a small rise above the 20 percent logged in 2010, but almost triple the 9 percent they controlled in 2007 (Exhibit 14). An even more potent sign of the local players' prominence is the 133 percent increase in mixed deals. This figure has been volatile since 2007 but ended 2011 at an unprecedented 49 percent of total deal values.

Fund-raising, the last critical ingredient in the PE market mix, showed a consolidation of the previous years' gains. After an extraordinary 2010, in which funds raised in Greater China almost tripled over 2009, 2011 saw a much smaller increase of 16 percent. Yet even this narrow gain leaves the area well ahead of its position in 2007—the only area in Asia to achieve that distinction other than South Korea. The rising prominence of locals was notable in this indicator as well: both the value and volume of RMB funds have risen significantly, from some 52 funds worth about $3.4 billion in 2008 to some 80 funds worth about $13.7 billion in 2011 (Exhibit 15). As a corollary to the growth in RMB funds, in 2011 dollar funds accounted for only 19 percent of the total—down from 51 percent in 2007—but the average size of dollar funds increased to almost $500 million.

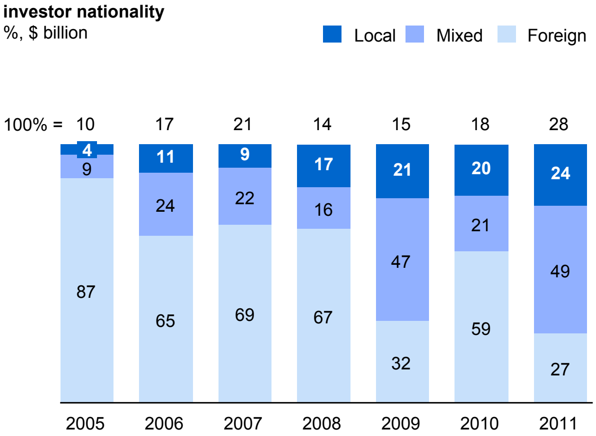
Whether China will be able to maintain its current trajectory has become a paramount concern to the industry worldwide. Chapter 2 discusses the currents shaping China, and how industry players may need to recalibrate their strategies for the country.

India: High growth powered by small deals

From a high-level perspective, India's PE results in 2011 were largely positive. After logging the largest increase in deal value among the six major Asian regions in 2010, momentum continued in 2011, with aggregate volumes and values both finishing higher. But most of the growth came from very small deals. Combined with rising dry-powder levels, greater local competition, and persistent regulatory uncertainty, the emerging picture is that of a traditional operating model under greater pressure than ever.

Exhibit 14 Local investors in Greater China are growing in prominence.

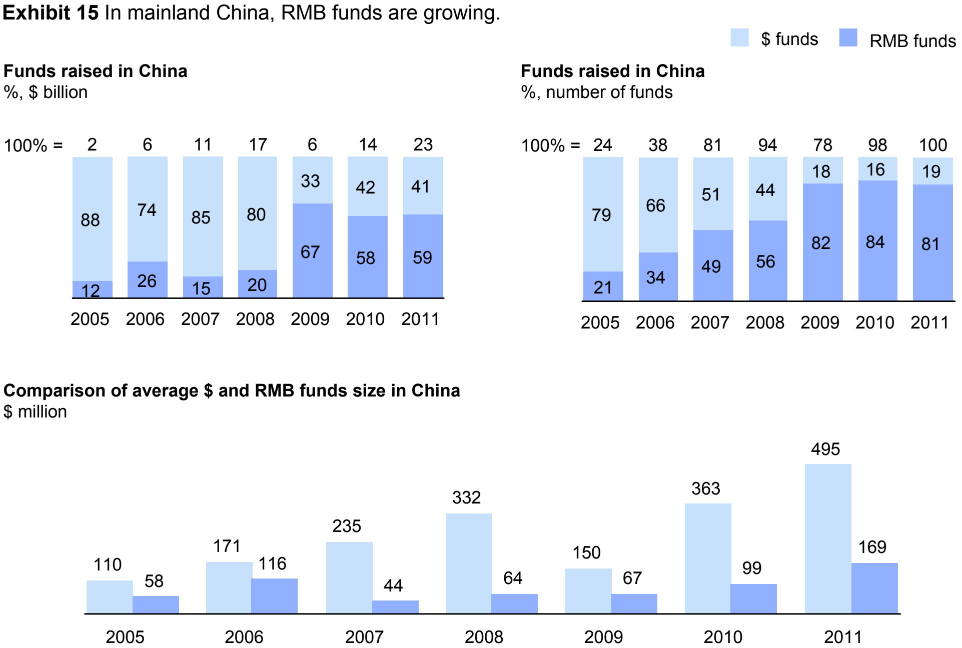
Value of private-equity investments in Greater China by investor nationality
%, $ billion



Source: AVCJ; McKinsey analysis

After falling 64 percent between 2007 and 2010, deal volumes finally recovered, rising 181 percent to just exceed their 2007 levels. Notwithstanding the dramatic return in volumes, the 44 percent increase in cumulative deal values in India still left

Exhibit 15 In mainland China, RMB funds are growing.



Source: AVCJ; McKinsey analysis

the total, $7.6 billion, at just over half of its 2007 peak of $14.7 billion—a direct result of smaller deal sizes (Exhibit 16). As might be expected given the composition of India's economy, nearly half of all investments by value—48 percent—are in service sectors, with 13 percent in financial services and 35 percent in other services.

Regardless of sector, large investments are now increasingly rare in India. One of the reasons, investors have told us, is rising value expectations. Private-company owners have lately been seeking prices that would require buyers to achieve higher returns than India's PE sector has historically afforded. What remains are small deals: average deal size in 2011 fell from an already-small $50 million in 2010 to only $30 million in 2011, and the number of deals valued at less than $10 million increased more than fourfold.

Expansion deals were the major volume driver: investments at this stage more than tripled over 2010 and now account for 72 percent of all transactions, including the $290 million investment in Welspun by Apollo Management and the $270 million investment in Patni by Apax Partners. Minority stakes constitute almost the entire market, typically accounting for more than 90 percent of deals.[8]

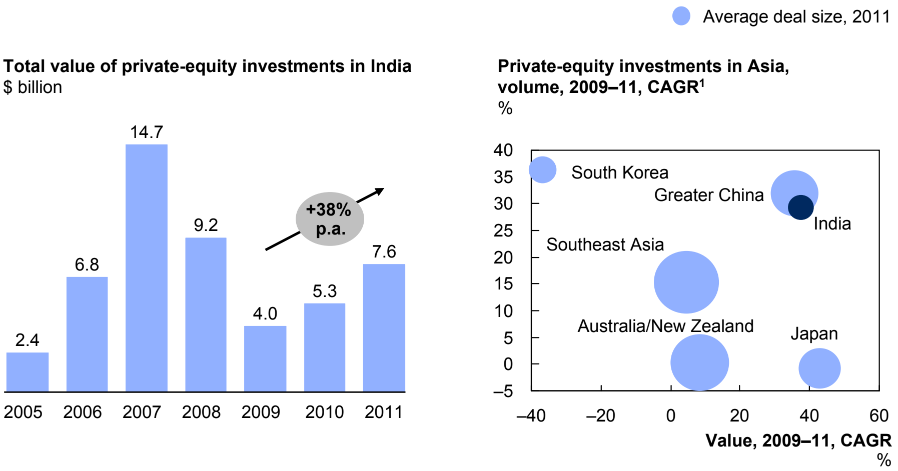
As in China, the role of the local player is growing in importance in India. Foreign GPs have long dominated the Indian market, leaving the country's local GPs to start from a low base: their share of total deal value was just 8 percent in 2007 and 9 percent in 2010, but jumped to 16 percent in 2011. More generally, our sources see more local funds being established, with veterans from international firms stepping out and setting up their own operations.

A note of caution arises in the exit data for India: the total number of exits decreased 43 percent in 2011, following strong 2010 growth during which exits almost doubled over 2009. Correspondingly, exit values also fell, dropping by a slightly higher 47 percent. Continuing a post-2007 trend, trade sales dominated India's exit landscape—accounting for 58 percent of the total value, with little indication of any longer-term recovery in the IPO market.

On the fund-raising side, India's results rose 21 percent after a near collapse in 2010 (when the total fell by 69 percent). Despite this encouraging news, 2011's total is a mere 66 percent of the 2007 peak. Many funds are now sitting on such large stores of unused capital—estimates reach as high as $20 billion—that some GPs have expanded their focus beyond PE, turning to public transactions to make up for shortfalls in private opportunities.

Still, Indian sources report that more promoters are viewing PE as a potential source of capital. But because tensions can arise between promoters and GPs, building advisory relationships with management may be more advantageous

Exhibit 16 In India, growth is fueled by small deals.



1 Compound annual growth rate.
Source: AVCJ; McKinsey analysis

8 Analysis excludes deals with undisclosed stakes.

than attempting to exert control. And those seeking to meet the new demand for capital must also contend with regulatory changes. Newly adopted provisions have been decidedly mixed for the PE industry, while further proposals could pose even greater threat, particularly for foreign players.

In sum, India poses an unusual mixture of high promise and real uncertainty for the PE industry. Plummeting deal values alone suggest that GPs should consider adopting an unusually lean operating model. Given the predominance of minority acquisitions, greater competition for investment opportunities, a fluid regulatory context, and increased industry localization, finding the right local partners has become urgent as well.

Southeast Asia: Bright spots in a diverse region

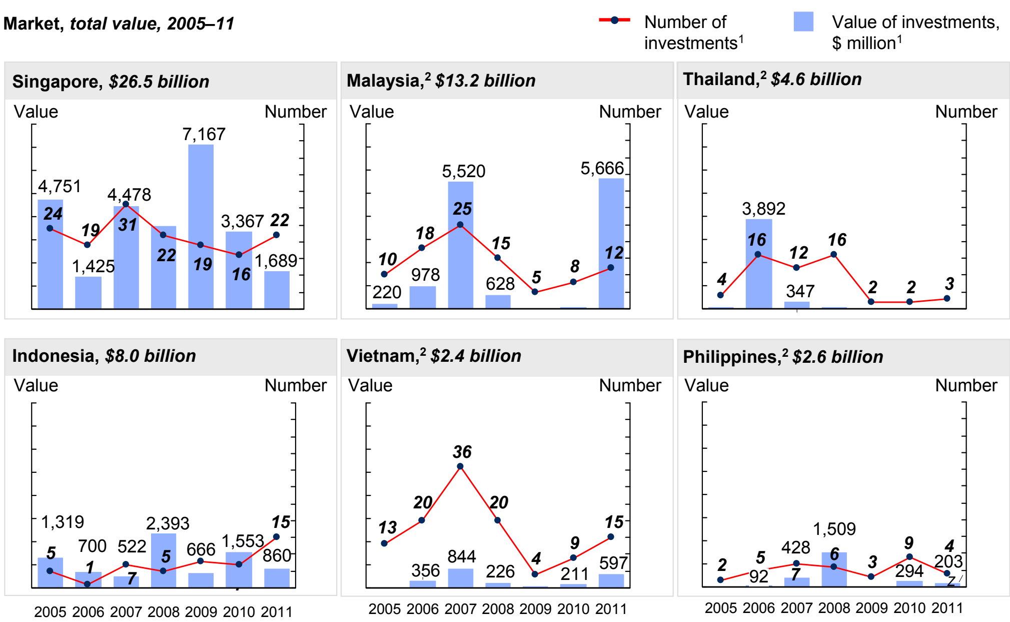
Often overshadowed by its two giant neighbors, Southeast Asia has started to earn its share of attention. Although the six countries that together constitute almost all of Southeast Asia's PE industry—Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam—remain at vastly different stages of development, 2011's data show several region-wide shifts in activity. The most developed of the six, Singapore, continues to claim a large share of the total pie.

But in 2011, Malaysia, Indonesia, and Vietnam each saw a number of high-profile deals. Indonesia and Vietnam have been generating particular excitement, as discussed in depth in Chapter 2—as is Myanmar, whose attempts to emerge from decades of sanction-enforced isolation have caught many observers by surprise.

Deal volumes in Southeast Asia increased 39 percent in 2011, fueled by a doubling of deals in Indonesia and a 67 percent rise in Vietnam. (Both of these numbers could well be underestimates, as small deals in less developed countries tend to slip under the radar.) Of the recorded deals, almost half of the volume was in expansion-stage investments. But from a value perspective the buyout stage was more prominent, accounting for about 52 percent of the total value compared with expansion's mere 12 percent.

By valuation, Southeast Asia's 2011 performance was unique: the region was the only major one in Asia, other than Japan, where deal values grew faster than deal volumes, with the average deal size increasing by 33 percent. However, Singapore saw its second consecutive year of decreasing investment, and Thailand and the Philippines continue to lag behind (Exhibit 17). By sector, financial services and other

Exhibit 17 Southeast Asia is a diverse market; Malaysia, Indonesia, and Vietnam are growing quickly.



1 Select data points shown.
2 Total annual deal values were less than $150 million in Malaysia for 2009 and 2010; Thailand for 2004, 2008, 2009, 2010, and 2011; Vietnam for 2005, 2008, and 2009; and the Philippines for 2005, 2006, and 2009.
Source: AVCJ; McKinsey analysis

service industries led the way, absorbing 60 percent of the total investment value.

Southeast Asia's investor nationality data have been volatile over the past four years. Foreign investors' share of the total spiked to 90 percent in 2010 from just over 60 percent in 2009. But in 2011 this percentage dropped to 43 percent, with significant increases in investments involving local players. Leading foreign players nevertheless remain active in the region, as shown by KKR's $159 million investment in Vietnam's Masan Consumer Corporation.

If investments showed pockets of strength, the region's exit data showed greater weakness. As in much of Asia, public-market stumbles in 2011 meant that exit volume dropped by 10 percent, and values dropped some 30 percent. Tellingly, our data show that, by value, 99 percent of all exits were completed as trade sales, with no IPOs at all in 2011. Large deals dominated the data, with Malaysia accounting for about 49 percent of total exit value (thanks in part to Mitsui's purchase of Integrated Healthcare from Khazanah for $1.09 billion), followed by Singapore with 19 percent.

Continuing its slump from a high point in 2009, domestic fund-raising fell a further 22 percent in 2011, after a 48 percent drop in 2010. However, reflecting the growing interest in the region, external fund-raising[9] picked up after a 90 percent decline from 2008 to 2010. In 2011 the total reached $3.8 billion, a 200 percent year-on-year increase.

Players looking toward Southeast Asia have had good reason for optimism, given recent stability and performance. And the region's many unwieldy conglomerates present a particular opportunity for PE firms with advanced skills in carve-out deals. But Chapter 2's discussion of Indonesia, Vietnam, and Myanmar also underscores the many issues that investors must confront before plunging into what remain truly "emerging" markets.

Japan: Rising yen drives exits

As in so many other respects, Japan is an outlier in Asia's PE world. Even before the shock of the Tohoku earthquake and tsunami, the rising yen and decreasing population were inhibiting economic growth. Deal making also slowed as a lagging stock market discouraged potential sellers from divesting their businesses, a trend that more than offset the higher yen's potential to increase returns for those sellers who can reinvest elsewhere. Instead, a primary effect of currency pressures was to make investments more expensive for foreign firms. But those same forces resulted in a sharp increase in exits both by volume and, even more apparently, by value, as foreign GPs locked in yen-denominated gains.

Deal volumes in Japan remained stagnant in 2011, rising by only 1 percent—the only market in Asia where volumes did not increase significantly. But a genuine bright spot is that in contrast to most of Asia, those deals occurred at a higher value, with total deal values rising by 22 percent. Japan has traditionally been a buyout market, and it continues to be so, with buyouts taking up 91 percent of investments.

The rising yen was also a factor in sector allocations. With currency pressures especially acute in manufacturing, many GPs instead emphasized services, whose share jumped from only 7 percent in 2010 to 42 percent in 2011. The consumer sector, which has traditionally seen strong interest, absorbed a further 32 percent of the pie.

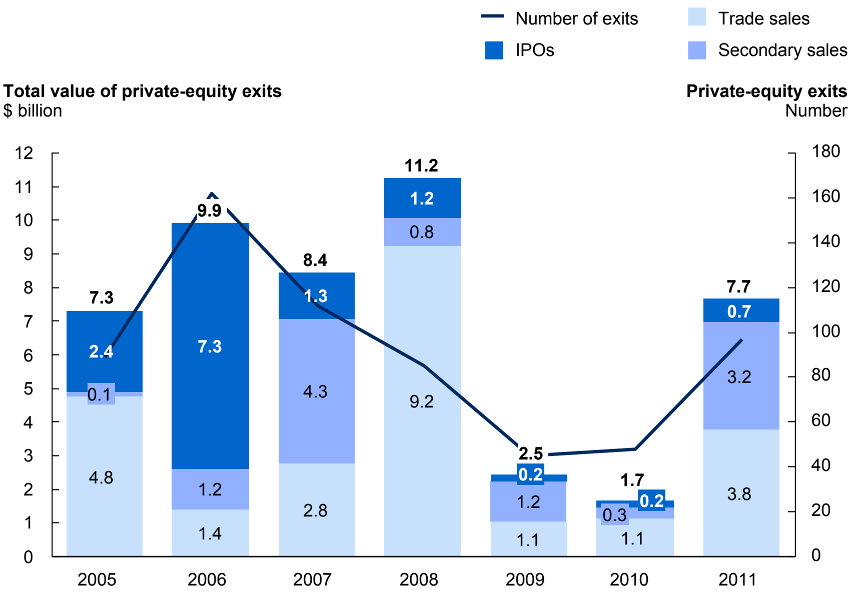
By nationality, the data show a renewal of interest from foreign players, suggesting a brightening outlook for them. Investments were split roughly in half between foreign players and locals in 2011, compared with 85 percent of investments that were made by locals in 2010.

In further contrast to most of Asia, Japan's exits showed real strength, as a rising currency overwhelmed a falling Nikkei. Consequently, 2011 was an attractive year for foreign investors to realize returns in euros, dollars, and other nonyen currencies. The number of exits doubled from 48 in 2010 to 97 in 2011, and their collective value increased more than fourfold (Exhibit 18).

Of this total, secondary sales accounted for 42 percent of the value, but this result was driven mainly by a single deal: Nomura's sale of Skylark for $2 billion. Most of the remaining total value (49 percent) was realized in trade sales, which traditionally have been the dominant exit strategy. Indeed, in volume terms, trade sales have become even more important, rising from 43 percent of exit transactions in 2007–08 to 67 percent in 2009–11. Industry players tell us that corporate buyers have been drawn to PE portfolio companies' reputation for superior management, clear reporting lines, and high staff-performance indicators. According to Thomson Reuters, Japanese corporations acquired $44.3 billion worth of PE-owned companies in 2011.

9 Funds raised globally that include Southeast Asian countries in their focus.

Exhibit 18 In Japan, exits are on the rise.



Source: AVCJ; McKinsey analysis

The final distinction between Japan and the rest of Asia in 2011 was in fund-raising. After a solid year in 2010, when fund-raising almost returned its 2007 levels, no funds were opened in the country in 2011. In recent years, only the drop of 98 percent in 2009 came close to the complete collapse in 2011.

For players reviewing their Japan strategies, the crucial question is whether the country's record of exceptionalism will continue. In several important respects, the answer appears to be yes, as the opportunities will reflect Japan's unique demographic and economic challenges. For example, companies in industries that are going through tough times and need to divest unprofitable businesses will provide an especially large target pool, as are companies seeking greater scale and looking to expand internationally. Japan also boasts a large number of family-owned businesses that have insufficient management staff and require succession planning.

Several factors could make Japan a promising place to do business. Local banks with excess liquidity are a ready source of funding, while the high number of exits underscores the fact that many potential buyers are looking for deals. At the same time, it is difficult to estimate the cultural hurdles that can arise to acquisitions in Japan, especially as to corporate governance issues. Deal makers will need particularly acute sensitivity to such local concerns such as these, both in making their initial investments and in managing their portfolio companies.

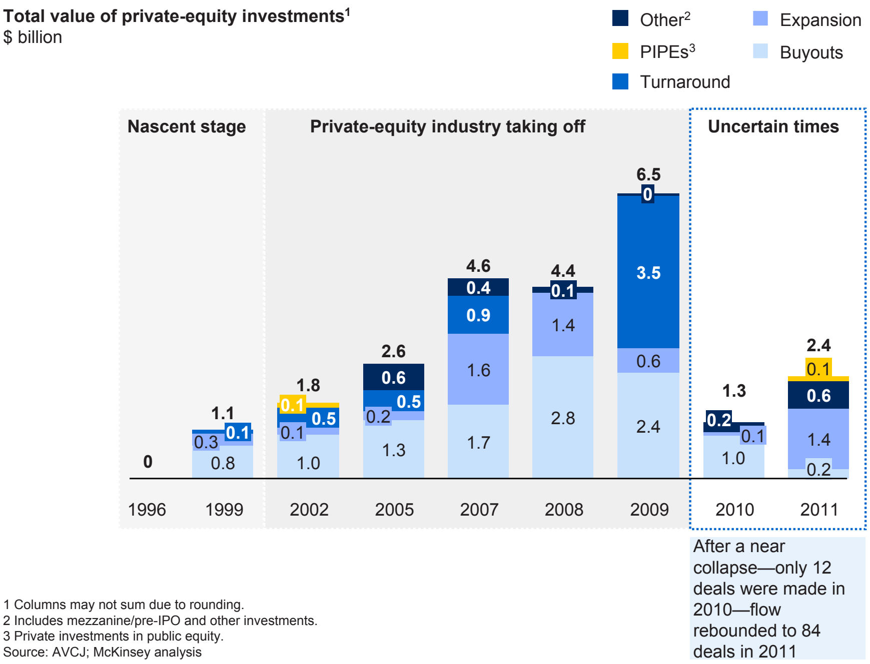
South Korea: The comeback kid?

Facing pressures that are similar in some respects to those affecting Japan, Korea presents a contradictory story. By some measures, 2011 marked a healthy recovery from wild swings in the preceding years. But optimism remains tempered, especially for foreign players, by the need to adapt to Korea's unique business environment.

Total deal values increased smartly, by 83 percent over 2010 (Exhibit 19). Because this rebound was still substantially lower than the surge in deal volume, average deal size plummeted 78 percent, from $144 million in 2010 to $32 million in 2011. By sector, Korea differed from most of Asia in 2011 in that manufacturing took the top spot for investments by value, followed by financial services.

Korea's exit volumes decreased slightly, down by 13 percent, and dropped in value by 43 percent. Both figures showed

Exhibit 19 South Korea is facing uncertain times.



1 Columns may not sum due to rounding.
2 Includes mezzanine/pre-IPO and other investments.
3 Private investments in public equity.
Source: AVCJ; McKinsey analysis

surprising resilience considering that by midyear the benchmark KOSPI index had lost about 25 percent of its value, before partial recovery at year-end. Even more encouragingly, IPOs tripled in value, driven in part by Nexon's successful listing for more than $1.2 billion.

Yet foreign players remain wary. Since 2007, foreign GPs have accounted for an average of only 21 percent of deals by volume, compared with 46 percent from 2002 to 2006. Lone Star's protracted legal battle over its investment in Korea Exchange Bank is only a symptom of a much deeper set of challenges pervading Korea's PE market. Chief among them is local management teams' unusually strong resistance to selling their companies. PE players therefore see a shortage of quality deals and fierce competition for those that arise. Given that, it seems unlikely that there will be a repeat of the last decade's buyout boom.

Likewise, after tripling in 2010 over 2009, total fund-raising in South Korea shrank by about 5 percent, remaining well below the 2008 peak. Yet after an extremely poor year in 2010 for deals—only 12 were recorded—the South Korean market made a huge comeback in 2011: 85 deals, exceeding the record set in 2008. Expansion deals led the way, jumping from 4 in 2010 to 49 in 2011; PIPEs also increased sixfold (although from a low base): to 25, from 4. Major deals included the $460 million investment in Daekyung Oil & Transportation by Korea Development Bank and Tstone.

On the other hand, there are reasons that South Korea would be attractive for PE firms with the right set of skills. At the smaller end of the market, many fundamentally competitive Korean small and midsize companies in sectors such as food processing and machine tools are facing liquidity shortages, which PE investors could help overcome by improving operational and managerial practices quickly to generate cash. Meanwhile, large conglomerates are considering divestitures of noncore businesses in the refining and equipment-maintenance fields, creating opportunities to acquire asset-heavy units. And all big companies are under increasing pressure to become true regional and global players, yet many lack the international capabilities needed to succeed on a larger stage—the sort of gap that a global PE firm can fill.

Moreover, in a boost to the industry, Korea's National Pension Service selected eight domestic PE and venture-capital firms to manage its $800 million Pan-Asian fund. The three PE firms include an SBI consortium, IMM Private Equity, and MBK Partners.[10]

Success in Korea will now depend on three value propositions. First, PE firms will need to offer a cadre of professionals who combine deep expertise in global markets with strong local relationships to the *chaebol* and individual business owners. Second, Korea's complicated relationships will require astute stakeholder management. Finally, local sensitivities about foreign acquirers mean that investors should stay well under the radar until the necessary consensus has been reached.

Australia/New Zealand: A sluggish recovery

With China's growth beginning to slacken, international players turned some of their attention to Australia, home to 2 of the top 10 deals recorded in Asia-Pacific. Yet the market's recovery is still in its early stages. In addition, PE firms are still evaluating the potential impact of the Australian Tax Office ruling that would require them to treat gains from asset sales not as capital gains but as income, and therefore subject to a higher tax rate.

Deal volumes rose by 28 percent, of which 42 percent were buyouts and 39 percent were expansion deals. The market's total deal value held relatively stable, increasing by only 5 percent, forcing average deal values down 18 percent, to $140 million from $170 million. About half of all investments were directed to the services and consumer sectors.

Foreign players continue to lead in Australia/New Zealand by deal values, including in such headline deals as Bain Capital's $1.3 billion investment in MYOB and Blackstone's $833 million deal for Valad Property Group. But local players took more share in 2011 than they did in 2010. Local-only investments accounted for 37 percent of the 2011 total, up from 16 percent in 2010. Mixed local-foreign deals fell significantly, to 7 percent, down from 28 percent.

The number of exits decreased by 20 percent, following gains in previous years. Yet the value of those exits jumped some 62 percent, propelled by two large acquisitions: CP2 taking Connecteast private and Asahi swallowing Independent Distillers Group. Those two transactions helped compensate for a dearth of IPOs. In 2011 Australia/New Zealand recorded only two, which raised just $320 million in a market that remains highly skeptical after the lackluster trading performance of Myers, the retail group formerly backed by TPG.

Fund-raising provided greater basis for optimism. Following a 73 percent decrease over the period from 2008 to 2010, Australia/New Zealand saw a 19 percent increase in 2011.

10 *Private Equity Korea*, translated from *Money Today*.

Emerging themes

Underlying 2011's favorable results—especially the return of deal flow to a higher level than at any time since the 2008–09 financial crisis—are several deeper shifts that will guide the evolution of the private-equity industry across Asia for the coming years. The real opportunity therefore lies in understanding the many transformations currently under way. For example, Asia is becoming a larger source of outbound M&A activity, and partnerships with strategic acquirers are proliferating. "Cornerstone" deals, in which a fund gets into an IPO by agreeing to hold its shares for a certain time, have also continued to grow, although from a small base and at a moderate pace compared with earlier years. And on the exit front, LPs have found that a maturing market for secondary funds has increased investment liquidity and flexibility.

At the same time, other recent developments underscore the need to temper optimism about the much-heralded "Asian decade" with China at its center. Most important, questions about the sustainability of China's expansion grew louder in 2011. Nevertheless, those players willing to adjust their strategies and develop new capabilities will continue to find opportunities, both in China and elsewhere. Southeast Asia shows particular promise. Although some observers remain skeptical about Vietnam, others see long-term potential despite considerable hurdles. Meanwhile, Indonesia's size, stability, and economic health are quickly turning it into a magnet for prudent investor attention. And the long-awaited opening of Myanmar could offer a new frontier to investors with an appetite for early-mover advantage.

PE deal flavors: Vaulting past vanilla

To understand the deeper changes affecting PE in Asia, we must look to the broader financial landscape as well. Two factors are having a particular impact. The first is a spike in the number and value of corporate outbound M&A deals[11] across Asia as companies globalize: from 1,593 deals in 2009 for a total $113 billion to 2,527 in 2011, valued at $251 billion. The second is volatile stock-market performance, which has reduced valuations for many potential targets. Each change is providing PE players with new investment strategies. Rising M&A activity encourages cooperation between PE houses and corporate acquirers, while low valuations let PE players take the cornerstone position in well-timed IPOs.

Strategic investors and PE: A potential marriage?

The nuances differ in each country, but across Asia local companies are coming to recognize that future growth will depend on their ability to expand their operations regionally and globally. Several leading PE executives in Asia have confirmed that as a crucial—and in some circumstances, the only—ready source of needed expertise, PE players are assuming an increasingly pivotal position in facilitating cross-border acquisitions. In Japan, for example, local economic constraints and a rising yen are forcing companies to seek growth elsewhere, within Asia (excluding Japan) and globally. This reality is reflected clearly in the data—in 2011, Japanese corporations' outbound deals reached $85 billion, almost triple their total value in 2010 and a surprising 23 percent more than the 2008 pre-crisis peak of $69 billion. One local market participant told us that "without skills to help portfolio companies regionalize, Japanese GPs cannot survive."

But the concept of outbound deals holds attractions for GPs in the rest of Asia as well: in exchange for providing expertise, the GP gains a strategic partner and additional sources of capital. Indeed, several GPs have started to rethink their investment philosophies in the face of a lower-growth environment, and partnerships with corporations seem like a fitting opportunity. As one global GP told us, "slowing growth means that in much of the world, including Asia, economic expansion alone no longer sufficiently justifies the basis for an investment. Instead, the opportunities now lie in cost improvement and in synergies." While GPs in North America or Europe would probably rely solely on their own operational capabilities to improve a portfolio company's efficiencies, in many Asian markets GPs need additional connections to reach the right targets, weighting the argument toward cooperation with strategic players. The global GP went on to say that "these combinations are potentially very good, especially if both sides can create value for the partnership."

The need for funds is also becoming more acute. For larger deals, one respected international GP told us that the smaller fund sizes in Asia have left PE firms unable to provide all of the equity. But, as another player commented more succinctly, "companies in Japan and state-owned enterprises in China have a lot of money" available to invest. Recent deals seem to reflect a deeper phenomenon: in November, KKR partnered with Itochu of Japan in a $7 billion leveraged buyout of Samson Investment Company, a US oil-and-gas explorer, in

11 Comprising corporate M&A activity that is either cross-border within Asia or outbound from Asia to non-Asian countries.

the world's second-largest PE deal for the year. Itochu took a 25 percent stake, KKR a 60 percent stake, and two smaller PE firms together took a 15 percent stake.

Chinese companies have been particularly aggressive in seeking support from PE firms. Although China's 2011 cross-border M&A data showed relatively little new growth, the market continued the strong pace set in 2010, when the total value of outbound deals doubled over 2009. Many domestic companies are looking toward PE firms to aid in making and managing these cross-border acquisitions. For example, when Chinese construction-equipment manufacturer Sany launched its first reported acquisition outside its home market, the company brought in CITIC's PE unit to act as interface with the target, German cement-pump maker Putzmeister. Sany emerged as majority shareholder and CITIC PE Advisors as minority.

Competition for strategic players' interest is already intensifying. The Chinese government itself is entering the fray: it recently launched an RMB 50 billion ($8 billion) fund in Shanghai, Sailing Capital International, to support Chinese companies pursuing international acquisitions. And late in 2011, CDB Capital (a unit of China Development Bank) signed a partnership agreement with PE houses Permira, KKR, and TPG to launch an outbound investment scheme.

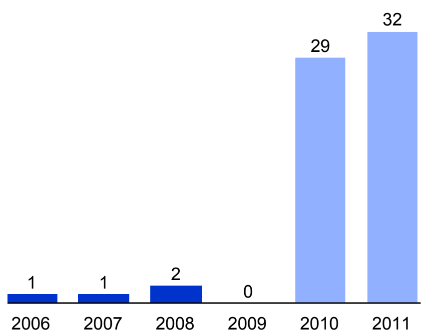
Building on a cornerstone

Given constraints on fund-raising, one short-term option for PE players is to take advantage of reduced valuations by assuming the cornerstone position in IPOs. Several recent transactions, such as investments by KKR in China Outfitters or MBK in New China Life, illustrate how this alternative can give PE firms the potential to deploy significant capital. Addressing the divergence from the usual PE transactions, one global GP maintained that "the investment theme remains unchanged for these firms; they are simply trying to capture the opportunity in public markets since valuations have dropped significantly."

According to one pan-Asian financial institution, "certain investment banks are proposing 'dual path' structures that further diminish risk for the GP by allowing it to convert a failed cornerstone IPO into a pre-IPO investment." Accordingly, the number of cornerstone investments in Asia continued to rise in 2011 to 32, after an explosion of activity in which the estimated number of these deals shot up from 2 in 2008 to 29 in 2010

Exhibit 20 The number of cornerstone investments has increased substantially in the last two years.

Cornerstone investing in Asia
Number of IPOs[1]



1 Based on IPOs described as having cornerstone investors; figures are estimates.
Source: Capital IQ; McKinsey analysis

(Exhibit 20). Hong Kong was a particular focus, with six such deals in just two weeks in late 2011.

But LPs may question having to pay the usual 2/20 fee structure for public-market deals that they could invest in on their own. One international LP that we interviewed therefore questioned the relevance of PE firms doing such deals.

Making an exit: A maturing secondary market for LP interests

Both a sign and a facilitator of PE's growth in Asia, more robust secondary markets are providing LPs with an additional portfolio-management tool. For LPs the change is especially noticeable; between 2008–09 and 2010–11 the number of secondary funds (that is, funds targeting secondary-market purchases of LP interests) with an Asian focus has tripled, with one PE firm we spoke to tentatively estimating the total amount raised at $20 billion.

This development is truly instrumental in less developed economies, where investors need greater assurances that they will be able to exit their commitments readily if they need to do so. Accordingly, the World Bank's International Finance

Corporation has established its own emerging-markets secondary fund centered on Asia.

But much of the secondary markets' emergence is attributable simply to rising interest among Asia's own investors. According to Coller Capital's mid-2011 investor survey[12] about projected secondary-market activity, two-thirds of Asian respondents said they plan to make investments in secondary markets over the next two years, compared with just 30 to 35 percent of their North American and European peers. For example, in Japan one player we spoke to remarked that "[the] fundamental force behind secondary deals ... is the strong yen," with the secondary markets enabling investors to maximize the impact of currency appreciation. And across Asia, the current slow fund-raising pace is leaving the secondary markets as the sole access point for LPs determined to enter the region's PE market.

Of course, more buyers in the secondary markets mean more sellers as well. The Coller survey also recorded that 42 percent of LPs in Asia-Pacific said they plan to sell assets in the secondary markets within the next two years. A prominent example from early 2012 is GIC's reported sale of an estimated $750 million portion of its PE portfolio on the secondary market.

China: Nervous investors

Over the course of 2011, investor optimism about China began to fade in the face of increasing concerns about the sustainability of the country's remarkable rise. And at mid-year Muddy Waters Research, a short-selling firm, issued a much-publicized series of reports raising questions about the reliability of the financial reports filed by selected Chinese companies listed in North America. Disappointing macroeconomic data further weighed on the performance of US-listed Chinese companies, which as a group underperformed for the rest of the year (Exhibit 21).

Many GPs and LPs we interviewed have expressed the need to be cautious when investing in Chinese companies. "People became much more skeptical about listed Chinese companies this year," said a representative of a major domestic Chinese player. A large foreign LP concluded, "we need to ensure that managers do sufficient due diligence to mitigate these concerns."

Enhanced due diligence will be even more important should China's economy slow down enough to lead to widespread distress. One regional LP commented that "there is some nervousness toward China over possible accounting issues, along with slowing growth and the possibility of a nonperforming-loans situation."

Spotlight on Southeast Asia: Beginning to blossom

For GPs seeking new horizons in Asia, the good news is that more options are emerging beyond China. More attention is now turning to Southeast Asia, where real GDP grew 4.7 percent in 2011, compared with just 1.9 percent for Europe and 1.5 percent for the United States. Admittedly, the base is still small; the region's per capita GDP of approximately $2,300 is still firmly in emerging-market territory. But expanding middle classes mean that domestic consumption may help local economies better withstand global disruptions.

Certain openings appear especially attractive, such as the large, growing consumer sectors of Southeast Asia's most populous countries, Indonesia and Vietnam. The recent reemergence of Myanmar from its isolation is also garnering attention as investors watch to see how much reform the new government manages to push through, and whether the new measures are sufficient for sanctions to end entirely. And for Southeast Asia as a whole, the ratio of PE investments to GDP is only half that of leading Western economies, with little risk of saturation any time soon.

There are, of course, significant caveats. Corporate structures in the region tend to be highly complex. Regulatory structures and accounting standards are evolving. Finally, although the region has withstood global economic crises, such continued resilience is impossible to predict should demand in Europe, North America, and potentially China begin to ebb at the same time.

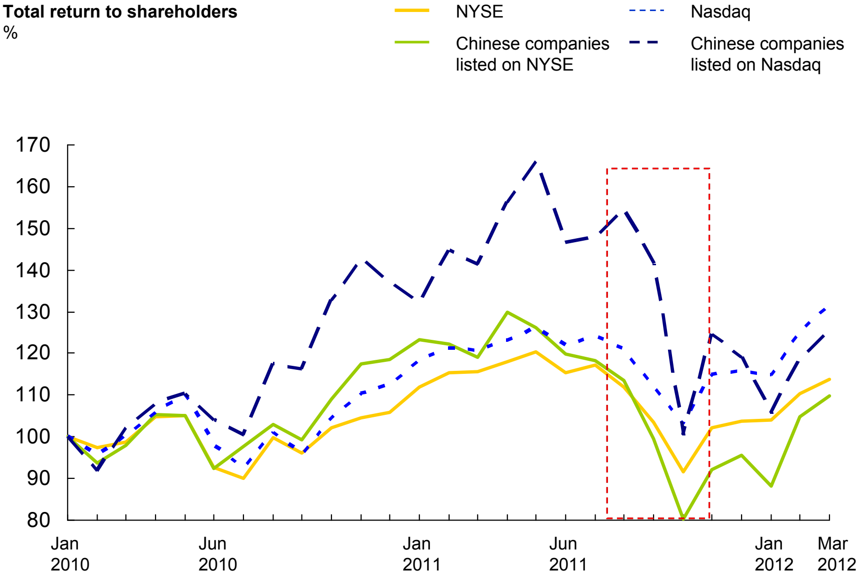
Vietnam: Ready to rev—or rest?

The principal question about Vietnam is whether the country can continue its current trajectory. Industry players who spoke to us had divergent views about whether the country's prospects are becoming stronger or fading fast.

Vietnam's appeal has rested to a great degree on its strong growth over the last two decades, a result of profound economic reforms, favorable demographics, and rapid urbanization. But the country's recent record has some worrisome aspects. In 2011 inflation hit a punishing 18.6 percent; the Vietnamese dong depreciated more than 7 percent; and the country's sovereign debt was downgraded. Longer-term issues are also starting to emerge. A recent

12 Global Private Equity Barometer, Summer 2011, Coller Capital.

Exhibit 21 Returns of Chinese companies listed on NYSE and Nasdaq have fared worse than both indexes since mid-2011.



Source: Datastream; McKinsey analysis

analysis by the McKinsey Global Institute[13] suggests that Vietnam's "demographic dividend" is quickly reaching an end. Official statistics predict that over the next decade, growth in the labor force will decline to around 0.6 percent a year, compared with a rate of 2.8 percent from 2000 to 2010. For Vietnam to meet the government's targeted 7 to 8 percent economic-growth rate, the report estimates that labor productivity in the service and manufacturing sectors will need to accelerate by more than 50 percent.

At least one global PE firm that spoke to us commented, "interest in Vietnam has proved short-lived." Yet other sources countered that "although Vietnam's ecosystem is yet undeveloped, it appears on course to duplicate China's achievements in the past decade." Recent news stories indicate that good deals are still to be found in the country. KKR's purchase of a 10 percent stake in Masan Consumer Corporation, the buyout giant's first recorded foray into Vietnam, is a potential harbinger of more investments to come.

Indonesia: Still the darling of the region?

As divided as opinion may be over Vietnam, opinion about Indonesia is nearly unanimous. Citing the country's stability and economic potential, industry insiders report widespread interest in Indonesia: as one global GP put it, "Indonesia is on everyone's radar at the moment." A regional LP we spoke to compared the country's demographic profile with that of China, commenting that "[Indonesia] is the third-largest country in Asia by population, with a rapidly growing middle class, similar to the situation in China a few years ago."

Widespread interest notwithstanding, the PE sector remains small, with 2011 penetration rates equivalent to just 0.10 percent of GDP. Over the year, a total of 15 PE deals were recorded in Indonesia, with an estimated total value of about $860 million. That level leaves substantial room for growth. For example, in several sectors, M&A activity in the country is already quite high. PE, however, accounted for only 14 percent of M&A participation in the financial-services industry (which is 7 percent of GDP) and less than 1 percent in the crucial mining industry (12 percent of GDP).

Several recent developments underscore the challenges that foreign investments still face in Indonesia. There are legal obstacles facing investors, such as new restrictions on foreign ownership in the mining sector. Indonesia lags others in the region in the area of corporate governance, as highlighted by the World Bank's corporate-governance report, and

13 Marco Breu, Richard Dobbs, Jaana Remes, David Skilling, and Jinwook Kim, *Sustaining Vietnam's growth: The productivity challenge*, McKinsey Global Institute, February 2012.

Indonesia's companies can sometimes be challenging for investors to navigate.

Nevertheless, international GPs such as TPG and CVC are increasing their activity in the Indonesian market: CVC alone made two investments during 2011, one in PT Link Net and the other in PT First Media. Others, such as Blackstone and KKR, are not yet reported to have entered the market but may come under increasing pressure to do so as the earlier movers press their advantage.

Myanmar: A new frontier?

Myanmar, often still referred to as Burma, is one of the last large, undeveloped markets remaining in Asia. With an estimated population of 54.5 million and Southeast Asia's second-largest land area, the country is rich in natural resources including oil, gas, timber, metals, and gemstones. But the country's political woes have left it trapped in years of stagnation. Although sources conflict, the *CIA Factbook* estimates Myanmar's nominal 2011 GDP at only $50.2 billion—for a per capita figure of just below $1,000.

The story finally began to change after new political leadership quickly started liberalizing Myanmar both politically and economically. After legalizing the leading opposition party in late 2011, the government held a parliamentary by-election in early April 2012. The result was an overwhelming victory for the opposition and a seat in parliament for noted opposition figure and democracy activist Aung San Suu Kyi. At the same time, the country announced a major reform of its complex foreign-exchange controls, while a package of tax holidays and incentives for foreign investment was awaiting final approval. Other proposals reportedly under consideration included plans to increase the central bank's independence and open the country to foreign telecommunications and banking companies. Partly in response, the US government restored diplomatic ties with the country in January 2012, although legislation will be required to fully repeal existing sanctions.

Not surprisingly, some of the world's largest multinationals are already monitoring local developments, considering entry (or, for the few already operating legally in Myanmar, expansion) when the time is right. Private- equity players should likewise watch the situation closely: should Myanmar manage to maintain the current reform pace and succeed in persuading the European Union, the United States, Australia, and other international actors to lift remaining sanctions, the country could quickly become a magnet for firms seeking an early edge.

Appendix

Sources

Except where otherwise noted, macroeconomic data such as GDP have been supplied by Global Insight; information on private-equity activity has been supplied by Capital IQ, *The Asian Venture Capital Journal*, Recof M&A, and Preqin.

Definitions

Buyouts: Purchases of stakes large enough for the investor to become the target's largest shareholder

Direct secondary: The sale of a portfolio company from one GP to another GP

Expansion: Provision of capital to a private company in a growth stage

Mezzanine/pre-IPO: Investment in a private company that will be listed on the open market in one to two years (most investors will purchase convertible debt or preferred shares in that period)

PE penetration rate: The ratio of PE investment to nominal GDP, as supplied by Global Insight

PIPEs: Private investments in public equity

Private equity: Private investments, including buyouts, turnarounds, PIPEs, expansion investments, and mezzanine/pre-IPO deals

Turnaround: Capital injection to support a company's turnaround plan

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