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Private equity market in Southeast Asia

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Executive Summary

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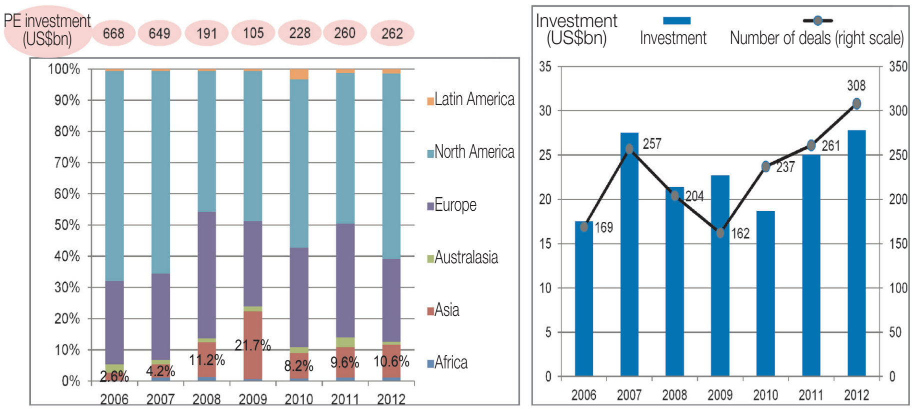
Private equity (PE) investment is growing in Asia. Southeast Asia in particular is attracting investors' attention as an attractive PE investment destination. While Southeast Asia has promising growth prospects from the standpoint of macroeconomic potential and strong demand for growth capital, competition for investment deals is intensifying in still-immature Southeast Asian markets. Such competition has led to concerns about soaring valuations according to some observers. Amid such an environment, PE investors need to adequately manage beta risk when investing in Southeast Asia.

Overview of recent Asian private equity market

Private equity (PE) investment[1)] has been increasing steadily in rapidly growing Asian economies. According to Preqin, a PE-related data provider, PE funds' share of investment in Asia[2)] has grown from a mere 2.6% in 2006 to 10.6% in 2012, when PE funds invested a total of US$27.8 billion in Asia. Although this increase in share was largely attributable to a decline in PE investment in North America and Europe, where PE market growth had been driven by mega-deals until the global financial crisis, PE investment in Asia grew at an average annual rate of 8% from 2006 through 2012. Asia was the only region in which PE investment grew over this timeframe.

Exhibit 1: Breakdown of global PE investment by region (left) and trend in Asian PE investment (right)



Source: NRI, based on Preqin data

Within Asia, the number of PE-fund investment deals is growing particularly rapidly in emerging Asia. One factor behind this growth is emerging Asia's favorable

NOTE

1) As used herein, "PE investment" means investments by PE funds managed by PE firms as a general partner.

2) As used herein, Asia excludes Australasia.

macroeconomic growth story, including relatively high economic growth rates, ample populations, and personal consumption growth driven by expansion of the middle class. Another contributing factor is that capital markets in emerging Asian countries are generally underdeveloped and predominantly revolve around indirect finance. In other words, capital market financing is not necessarily readily accessible to companies except for a subset of large companies. PE funds have consequently emerged as a source of growth capital for growing companies in need of financing. These factors are presumably shared by other emerging market economies outside of Asia, but PE investors[3] seem to have a preference for Asia. In a June 2013 Preqin survey of PE fund limited partners, more respondents cited Asia as an attractive emerging-market investment destination than any other region.

3) As used herein, "PE investor" means a limited partner that invests in a PE fund.

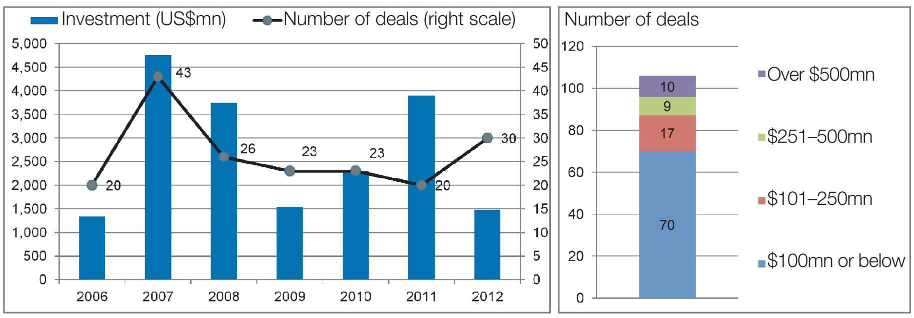
China and India have led the PE investment in emerging Asia since the mid-2000s, but PE funds have recently encountered challenges in these two countries. The main challenge common to both countries is difficulty exiting investments (selling investee companies). IPOs in China and India are currently inhibited by the regulatory and market environments. PE funds' exit options are consequently limited. PE funds can of course sell investee companies to other PE funds or strategic buyers, but PE funds are reportedly having difficulty negotiating attractive sales prices with prospective purchasers, particularly in India in the wake of its recent economic slowdown and precipitous rupee depreciation.

Southeast Asian PE market

Against such a backdrop, Southeast Asian countries are gaining favor as PE investment destinations in emerging Asia. In an investor survey[4] conducted by

4) Source: *Asia-Pacific private equity outlook 2013* (Ernst & Young). The survey's respondents included both general and limited partners.

Exhibit 2: Southeast Asian PE investment (left) and number of deals by size (right) (2006-12)

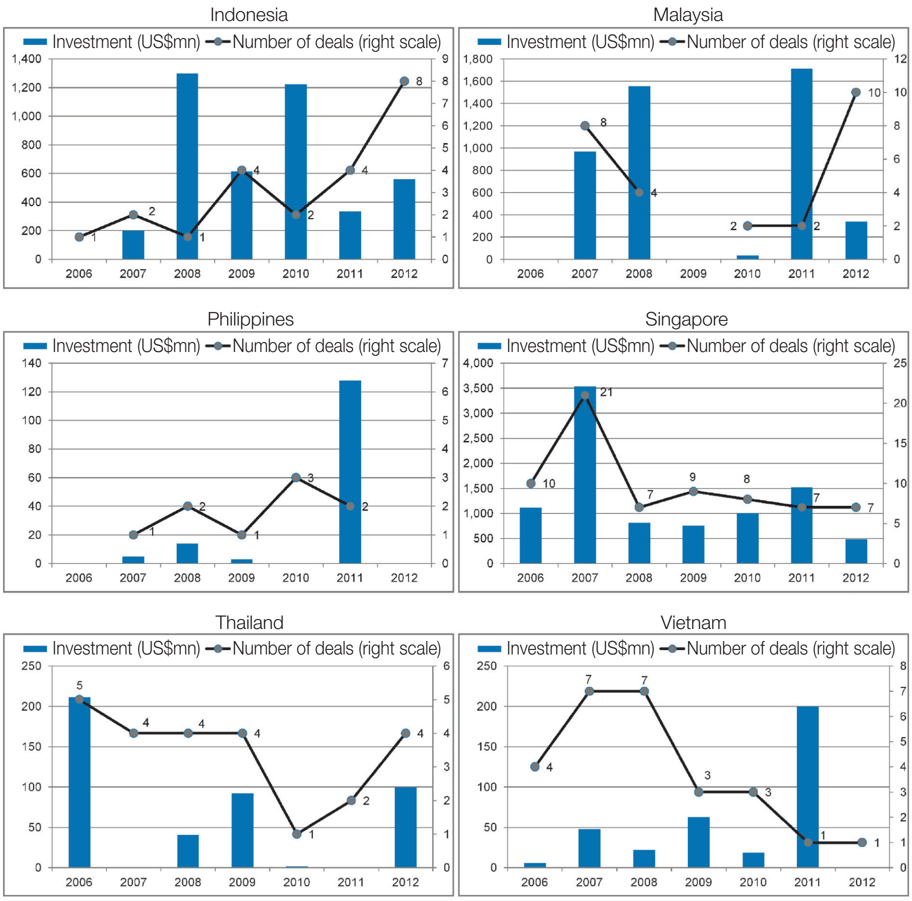


Note: Investments denominated in other currencies were converted to US dollars at year-end 2012 exchange rates.
Source: NRI, based on Preqin and Bloomberg data

Mergermarket in July-August 2012, 46% of respondents projected that PE investment activity would "expand significantly" in Southeast Asia. Greater China was the only other region for which a higher percentage of respondents (47%) project significant expansion of PE investment. The survey results are indicative of strong interest in Southeast Asia.

Following is a brief overview of the Southeast Asian PE market in recent years. First, Southeast Asian PE investment most recently peaked in terms of both investment value and number of deals in 2007, before the global financial crisis, but the number of deals is currently recovering. By country, PE investment deals are increasing in Indonesia and Malaysia in particular and recovering in Thailand also. In Singapore, the number of PE investments has been holding steady but remains below its 2007 level. In Vietnam, PE investments have recently been decreasing. In sum, PE investment

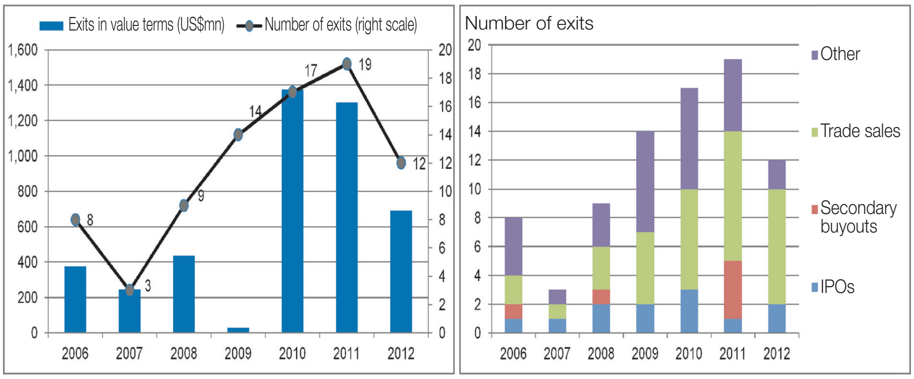
Exhibit 3: PE investment in major Southeast Asian countries



N o t e: Investments denominated in other currencies were converted to US dollars at year-end 2012 exchange rates.
Source: NRI, based on Preqin and Bloomberg data

activity trends vary considerably among Southeast Asian countries. In value terms, most Southeast Asian PE investments are relatively small. Investments of US$100

Exhibit 4: Trend in exits in Southeast Asia (left) and number of exits by type (right)



Note: Investments denominated in other currencies were converted to US dollars at year-end 2012 exchange rates.
Source: Source: NRI, based on Preqin and Bloomberg data

million or less account for some two-thirds of Southeast Asian PE investment deals. In contrast, relatively large investments of US$500 million or more accounted for only 10 of 106 deals for which the requisite data are available.

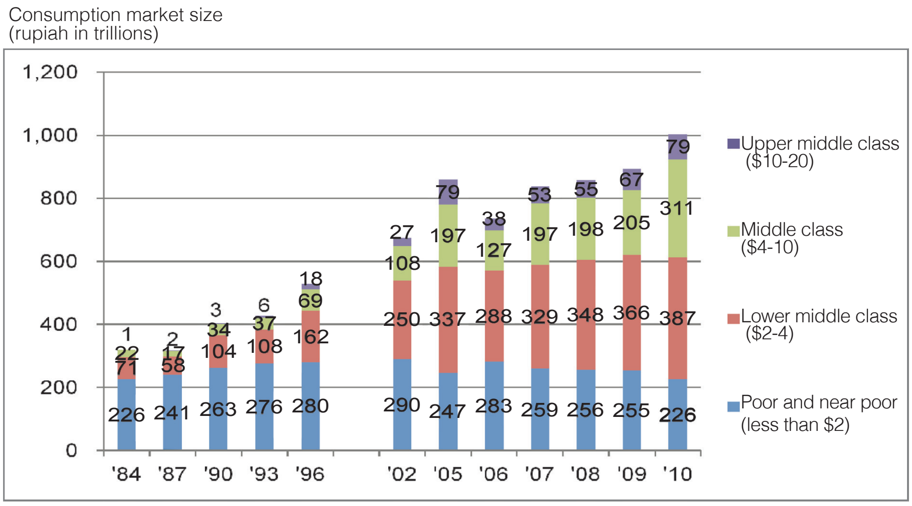
Next, PE fund exits in Southeast Asia are generally on the rise, though the number of exits decreased in 2012. The most prevalent form of exit is trade sales (sales to strategic acquirers), which are generally growing in number.

To supplement the above overview of Southeast Asian PE investment based on quantitative data, the following qualitative information was largely obtained from interviews with general partners of PE funds that mainly provide growth capital to Southeast Asian companies.

(1) Main investee sectors

Many general partners said that they are mainly targeting consumer sectors for PE investments in Southeast Asia. Their interest in such sectors is in response to growth in middle-class populations and growing consumption fueled by growth in consumer lending. The biggest beneficiary country of consumption growth driven by growth in the middle class is probably Indonesia, Southeast Asia's most populous country, with a population of over 240 million. Until around 2005, Indonesia's consumption growth was mainly confined to its lower middle class, but in recent years its middle and upper middle class markets have grown markedly. However, personal consumption growth in Indonesia and other Southeast Asian countries is an obvious investment theme. Competition is consequently intensifying as many investors hunt for deals. Many general partners mentioned high valuations and difficulty finding attractive investments. In response to these challenges, PE funds are starting to eschew companies in sectors that directly benefit from consumer market growth (e.g., food, beverages) and focus on consumer-related sectors such as healthcare, financial services and Internet/ media.

Exhibit 5: Indonesian consumption market size of middle and poor/near poor class (based on daily consumption expenditures)



Note: To disaggregate data by income class, consumption expenditures are converted to US dollars on a 2005 purchasing power parity.
Source: Bank Indonesia, World Bank

Aside from consumer sectors, some general partners are interested in the agricultural sector. One reason for their interest is an expectation that many companies in the sector will generate relatively stable cash flows by virtue of Southeast Asia's geographic advantages. Another reason is that many companies in the sector are relatively small, family-run businesses that offer substantial opportunity for valuation enhancement through post-investment corporate governance reforms.

(2) Post-investment operational value-add

Post-investment operational value-add is a key source of PE investment returns. Its importance is especially emphasized in emerging Asia, including Southeast Asia. In emerging Asia, there are said to be many companies with room for improvement in governance related to managing the company. If PE funds invest in such companies and are able to impose discipline through appropriate involvement in management, they are likely to reap relatively large returns. PE investment returns can generally be

5) Valuation multiples are ratios calculated by dividing a company's enterprise value (EV) or share price by an income or other metric. For PE investments, the EV/EBITDA multiple is often used.

attributed to four factors: sales growth, profit margin expansion, debt repayment, and valuation multiple[5] expansion. Given the limited degree to which leverage is typically utilized in Southeast Asian PE investments, debt repayment is usually not a major source of returns. Valuation multiples are largely a function of market conditions. Thus, the main sources of returns that are most under the control of PE funds are therefore sales growth and margin expansion. PE funds endeavor to help their investee companies grow sales and increase margins through strategies, organizational reforms and various other means. For example, cross-border M&A within Southeast Asia by investee companies is often cited as one means of boosting investees' valuations. Such investee M&A is mainly aimed at capturing growth opportunities that should ensue from intraregional economic vitalization in the wake of prospective regional economic integration in the form of the ASEAN Economic Community, which is currently under discussion for its targeted integration in 2015.

(3) PE fund investment styles: majority control or minority interest?

Whether PE funds seek to acquire majority control of investee companies is frequently cited as a key issue in terms of investment style. Preqin data indicates that Southeast Asian PE investments mainly take the form of minority interests. The percentage of Southeast Asian PE investments that involve majority control remains low. In this regard, some PE funds have adopted more or less explicit policies on control of investees. Some funds acquire majority control as a general rule while others generally acquire minority interests. What are the reasons behind this difference in investment style?

One reason that some PE funds insist on acquiring control is that management control enables them to exert substantial influence over investees' management decisions, giving them more latitude to implement measures to boost the investee's valuation. To the extent that they do so, the PE fund is expected to reap higher investment returns. A second reason is that some PE funds see management control as an important factor from an exit standpoint. Such funds believe that they must acquire management control to ensure that they will have enough say in important exit-related decisions such as timing, sales price, and selection of the acquirer. This reason is considered especially important in emerging markets, given the oft-cited difficulty of exiting emerging-market PE investments, including the aforementioned prohibitively adverse IPO market conditions in countries such as China and India.

Meanwhile, the main reason that some PE funds prefer minority interests is a shortage of prospective investee companies willing to be majority-acquired. Owners of growing companies tend to be loath to cede management control to a PE fund, even if their companies are in need of capital. Such an attitude is likely to be particularly pronounced in the case of owners of companies in regions with promising growth prospects, like Southeast Asia. Additionally, concerns about adverse selection could also come into play. Specifically, owners of high-quality companies generally tend to be reluctant to give up majority control. Given owners' informational advantage over prospective buyers, those owners that are readily willing to give up control may possess negative information about their companies that is unknown to PE funds seeking to acquire the company.

(4) QE tapering in US and Southeast Asian PE investment

A shorter-term issue recently garnering attention is the impact on PE investment of increased volatility in Southeast Asian financial markets since May 2013, when global markets started to anticipate the tapering of quantitative easing by Fed in US. To varying degrees, Southeast Asian countries, most notably Indonesia, have recently experienced equity market selloffs and currency depreciation. The equity market selloffs' negative impact on prospective exits is a concern for PE funds. From an investment standpoint, however, some funds take the positive view that the selloffs are a correction of previously excessive valuations. For funds denominated in foreign currencies, another concern is currency depreciation's impact on returns. Nonetheless, we did not hear of any funds that are utilizing derivatives to hedge currency risk at the fund level. The reason for the lack of such hedging is that emerging market currency exposure is relatively costly to hedge. PE funds generally seek to reduce the impact of exchange rate volatility on their overall investment portfolios by investing in a diversified basket of companies after ascertaining individual companies and sectors' exchange rate sensitivity and the directionality thereof.

(5) Mezzanine funds in Southeast Asia

With the emergence of PE funds in Southeast Asia, some funds are starting to provide mezzanine financing, albeit on a limited scale. Mezzanine financing is a general term for financing that is between common equity and senior debt (which in Japan is typically bank loans or straight bonds) in the investee company's capital structure. Mezzanine financing's advantages include that it avoids dilution of common shareholders and supplies risk capital that would not be available in the form of senior financing.

The emergence of mezzanine funds in Southeast Asia is driven by demand for growth capital from company owners that want to avoid equity dilution. Such owners prefer not to obtain PE capital, even in exchange for minority ownership. However, their financing needs are not necessarily being adequately met by the banking sector. While bank lending practices vary to some extent among countries, the supply of credit from the Southeast Asian banking sector is generally said to be insufficient in the case of funding that poses more risk than ordinary loans (e.g., growth capital). This insufficiency is particularly pronounced for SMEs and mid-sized companies. Some local Southeast Asian financial institutions are reportedly expanding their presence in this market segment, but with European financial institutions that have historically been big players in this market now retreating, mezzanine funds are steadily emerging to plug the gap between growth-capital supply and demand.

Despite strong demand for non-dilutive growth capital as discussed above, mezzanine investment deals are reportedly not easy to find in Southeast Asia, largely because Southeast Asian companies are generally not very knowledgeable about mezzanine financing. Mezzanine funds consequently must endeavor to increase prospective investees' understanding of mezzanine finance, including deal structures and terms, while attempting to negotiate deals. In fact, we heard that many investment deals involve PE funds well-versed in mezzanine finance. In addition to finding investment deals, another key point is structuring of mezzanine financing. With protection of creditor rights seen as a concern in some Southeast Asian countries, ensuring repayment can be problematic for offshore lenders in particular. Mezzanine fund managers must have the ability to optimize deals' risk/return profile through appropriate structuring, which could involve combining equity warrants with a subordinated loan to gain upside commensurate with risk or negotiating with not only the investee but also related parties such as its parent company or bank to obtain credit enhancement (e.g., parent company's guarantee) to mitigate downside risk.

Closing

The Southeast Asian PE market is growing as explained above and expected to continue growing in parallel with economic development over the medium/long term. With economic growth slowing in China and India, hitherto the twin growth drivers of the PE market in emerging Asia, conditions are ripe for investors bullish on the emerging Asian growth story to shift their focus to Southeast Asia. Fundraising of PE funds targeting Southeast Asia is consequently growing. Although such increased availability of investment capital based on future expectations is likely necessary for medium/long-term market development, it is not without drawbacks. The Southeast Asian PE market is still in an early stage of development and currently relatively small.

There are consequently concerns that competition among multiple PE funds for a limited pool of deals could inflate valuations to the detriment of the PE industry. Many of the general partners of PE funds investing in Southeast Asia that I interviewed at the end of last year expressed the opinion that valuations had become quite expensive due to competition for deals among PE funds, although more recently speculation that the Fed is tapering QE3 in the US has recently sparked concerns about capital flight from emerging market economies' financial markets.

Amid such an environment, investors interested in Southeast Asian PE investments need to appropriately manage beta risk. The importance of individual manager selection of course goes without saying given PE investment's primary aim of capturing alpha. However, in light of the difficulty of exiting PE investments made in 2006-07 before the global financial crisis, I believe that managing beta risk is also important. Such risk could be averted through such means as PE-fund vintage diversification, PE-investment vintage diversification, and asset class diversification such as between PE and mezzanine funds.

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