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THE PRIVATE EQUITY MARKET AFTER THE SUBPRIME CRISIS IN THE ASIA-PACIFIC REGION

Introduction

Business minds today are increasingly thinking in terms of Asia Pacific and how economies in the region will shape the world in an era of increasing globalization. Certainly, Asia Pacific is playing a larger role today than it has in the past, and the influence of the region is steadily rising. Regardless of the pace of its rise, staggering statistics regarding population and development lead to an almost inevitable conclusion that the region is set to become a powerful force in the world economy. Accordingly, private equity investors have extremely compelling reasons to sink capital into growth opportunities in this vast region – one comprised of unique cultures and economies in varying stages of development. With an aptitude for identifying inefficiency yielding opportunity, private equity investors are increasingly ramping up activity in Asia Pacific by opening offices, raising capital and executing transactions. And for those struggling to find yield in traditional markets, a thriving economy, a growing middle class, and infrastructure investments are likely to continue pushing Chinese cities toward a larger global presence¹. Asia Pacific is host to a world of opportunity for those with the resolve. By many measures, 2011 provided long-awaited proof of a rebound in the Asia-Pacific private-equity (PE) business 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. China alone accounted for almost 45% of the new activity, indicating

¹ M. Jałowiecki: *Asian Cities as Future Potential Financial Centers of the World*. In: *Competitiveness of Economies in the Asia-Pacific Region. Selected Problems*. Ed. by P. Skulski. UE, Wrocław 2011, p. 47.

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% of the global PE industry, that level is still lower than its share of global GDP, which has reached 28%. The region's low PE penetration rate also confirms the likelihood of room for further growth².

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 partners³.

1. Changes on private equities

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% as all geographies began to falter. Asia and Latin America came in at just under 4%, while in Europe and the United States, growth fell to a paltry 1,9% and 1,5% 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% for the FTSE⁴ 100, 15% for the DAX⁵, and exceeding 20% 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 restructur-

² K. Honda, B. Roy et al.: *Private Equity Asia-Pacific: Rebounds, Globalization, and Other Tales*. March 2011; K. Honda, B. Roy et al.: *What we Talk About When we Talk About... Private Equity in Asia*. January 2010.

³ New frontiers, such as Indonesia, Vietnam.

⁴ More on: www.ftse.com.

⁵ More on: www.bloomberg.com/quote/DAX.

ing deals. Together, these factors are a major reason that investments appear to be moving to Asia, and PE firms appear to be undertaking a corresponding reallocation of global talent⁶.

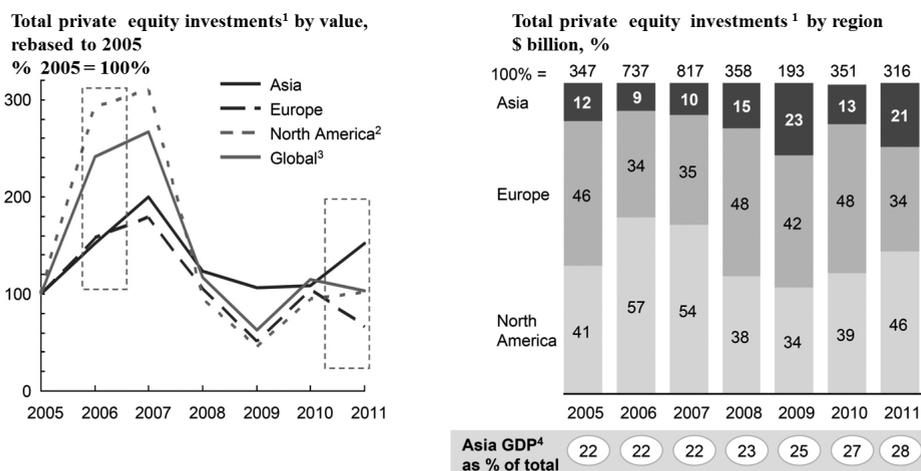


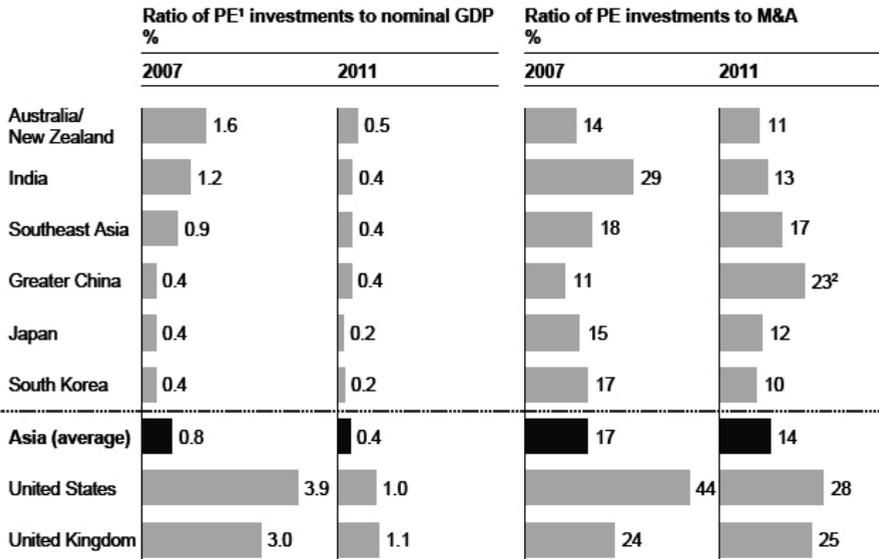
Figure 1. Private equity investments by value and region 2005-2011

Source: AVCJ, www.avcj.com; Capital IQ, www.capitaliq.com; Global Insight, www.insightglobal.net; Refco M&A, www.refco.co.jp; McKinsey analysis, In: Ch. Bhagat, K. Honda, V. Pandit, G. Pinshaw, B. Roy, Y. Yoo, Private Equity Asia-Pacific: Is the Boom Back? McKinsey & Company, Beijing 2012, p. 2.

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% approaching the 25% shown in the United Kingdom or the 28% in the United States⁷.

⁶ The search for growth Global Private Equity Report 2012. Grant Thornton International, London 2012, p. 28-29.

⁷ Investment Report towards a New Generation of Investment Policies 2012, Towards a New Generation of Investment Policies. United Nations Conference on Trade and Development, Geneva 2012, p. 149.



¹ Private equity.

² Driven by large direct investments in financial services by sovereign wealth funds and pensions.

Figure 2. Private equity investments to nominal GDP and to M&A

Source: AVCJ; Capital IQ; Recof M&A; Global Insight, McKinsey analysisin, op. cit., p. 3.

Yet within Asia, the six principal markets show vastly different growth trajectories. The expansion of Greater China's PE industry – currently almost 45% of the Asia market by total investment value – has only accelerated since 2008, while recovery elsewhere remains comparatively modest⁸.

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% of India's investments are at the expansion stage⁹. In between, China's investments are divided almost equally among mezzanine/pre-IPOs, expansions, and private investments in public equity (PIPEs).

⁸ Ch. Bhagat, K. Honda, V. Pandit, G. Pinshaw, B. Roy, Y. Yoo: *Private Equity Asia-Pacific: Is the Boom Back?* McKinsey & Company, Beijing 2012, p. 3.

⁹ www.forbes.com/sites/kenrapoza/2012/10/22/private-equity-prefers-india-but-regulatory-uncertainty-still-worrisome/the-private-equity-market-after-the-subprime-crisis-in-the-asia-pacific-region.

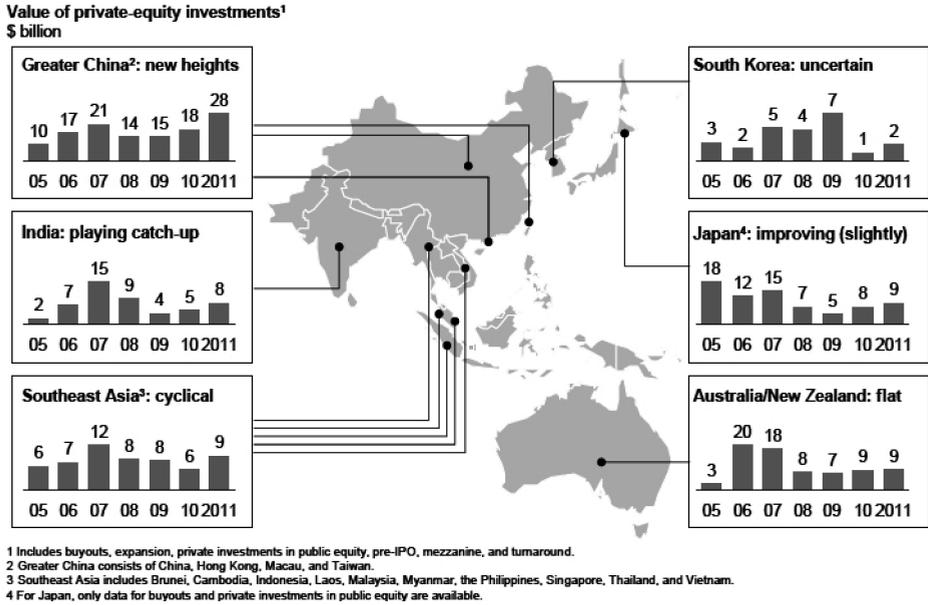


Figure 3. Value of private equity investments in six markets

Source: AVCJ; Refcof M&A; McKinsey analysis, op. cit.

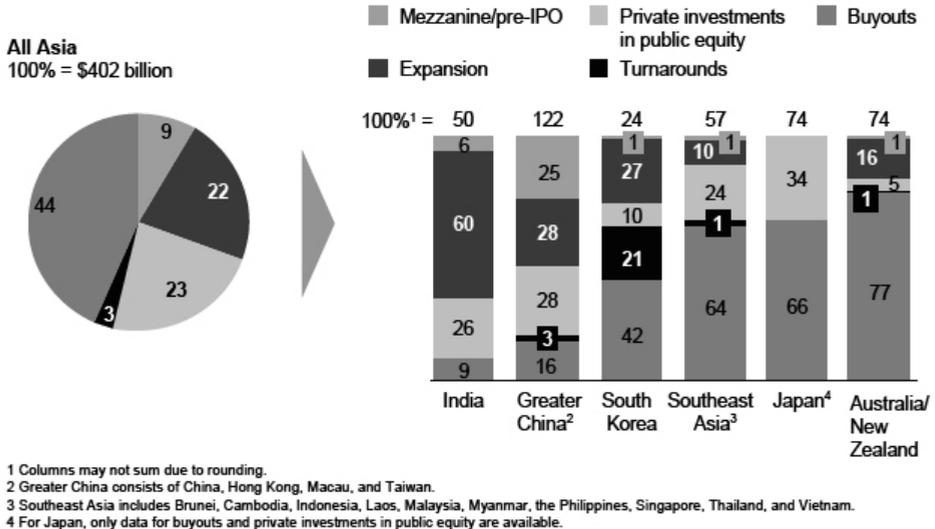


Figure 4. Value of private-equity investments by financing stage in year 2005-2011

Source: AVCJ; Refcof M&A; McKinsey analysis, op. cit., p. 4.

2. Details of the transaction

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% and North America's an even smaller 1,3% over 2010, leaving both regions still somewhat behind their 2007 figures¹⁰. 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, mainly the result of a six fold rise in expansion - stage deals. Although Asia is still down almost 30% compared with before the 2008-2009 economic crisis, the dramatic turnaround may mark the beginnings of a deeper shift in global deal flows¹¹.

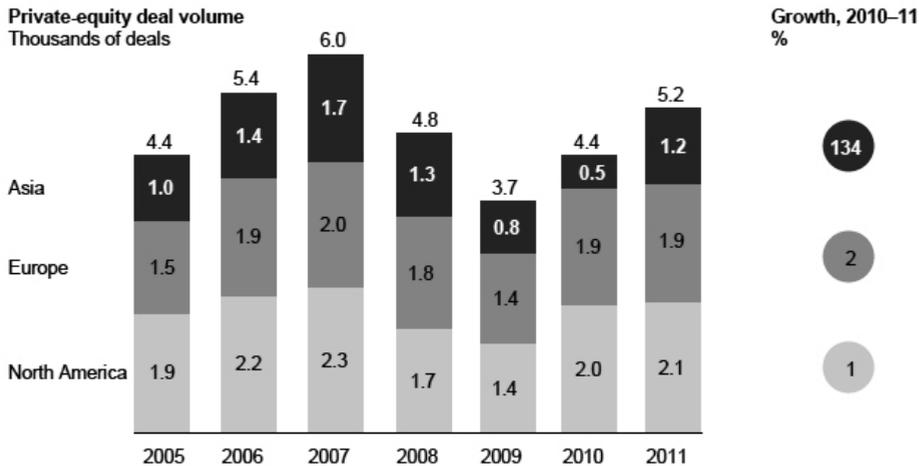


Figure 5. Private equities deal volume in year 2005-2011

Source: AVCJ; Capital IQ; Recof M&A; McKinsey analysis, op. cit.

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

¹⁰ Investment Report towards a New Generation of Investment Policies 2012..., op. cit., p. 163.

¹¹ Ibid., p. 4.

minority deals account for at least two – thirds of all PE deals, rising to a high of 94% in India¹². Even in advanced – market Japan, the minority – deal share is 69%. 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 controls¹³.

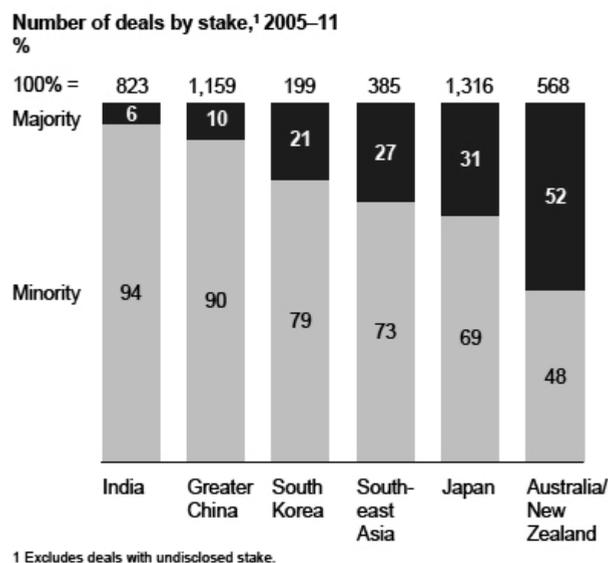


Figure 6. Details of the transaction in year 2005-2011

Source: AVCJ; Refcof M&A; McKinsey analysis, op. cit., p. 5.

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% below the 2007 figure. North America eked out 6% growth in 2011, but the final result was two – thirds lower than in 2007. Asia's much healthier growth figure – 40% – brought the region closer to its 2007 performance, although the gap between the two years was a still – large 24%. Asia's percentage of the total global deal value has therefore doubled, from 10% in 2007 to 21% 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.

¹² More on: www.indiavca.org

¹³ Ibid.

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 attention¹⁴ showed much less dramatic growth, rising from 16 in 2010 to 24 in 2011, a total that remains well below the 2007 peak of 37¹⁵.

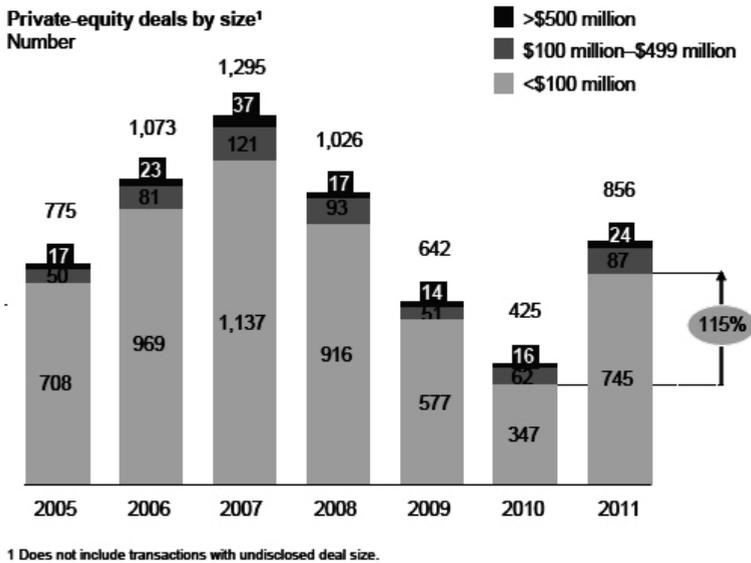


Figure 7. Private equities deals by size in year 2005-2011

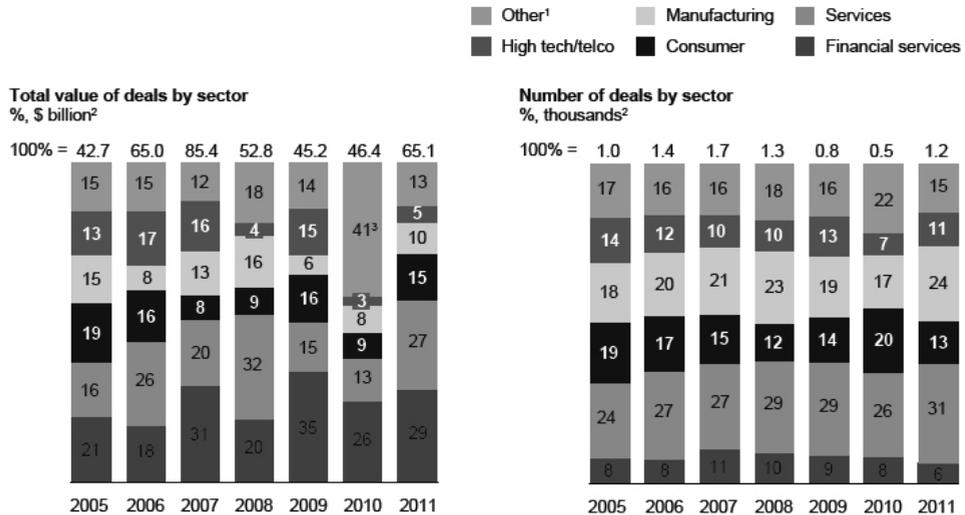
Source: AVCJ; Recof M&A; McKinsey analysis, *op. cit.*, p. 5.

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 it had classified the data have remained remarkably stable, despite huge variations in the total number of deals completed in Asia

¹⁴ That is, those valued at more than \$ 500 million.

¹⁵ *Ibid.*, p. 5.

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.



Figures 8. Value and number of deals by sector in year 2005-2011

Source: AVCJ; Recof M&A; McKinsey analysis, op. cit., p. 6.

3. Investor nationality

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% of all deals by value, up from 18% the year before. “Mixed” deals involving both foreign and local players also increased in value from 19% in 2010 to 31% in 2011, as the parties continued to integrate their respective capabilities more closely. Local investors’ prominence across the different markets, particularly in Australia/New Zealand, Greater China, and Japan¹⁶.

¹⁶ Private Equity & Principal Investors Practice, Private Equity’s New Asian Strength, McKinsey & Company, Beijing 2012, p. 3.

4. 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 Zealand¹⁷ each took two, with a Japanese deal taking the top position. Accordingly, much of the sector's expansion across Asia appears to result from smaller transactions that attract less notice¹⁸.

Table 1

The region's top deals in 2011

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.

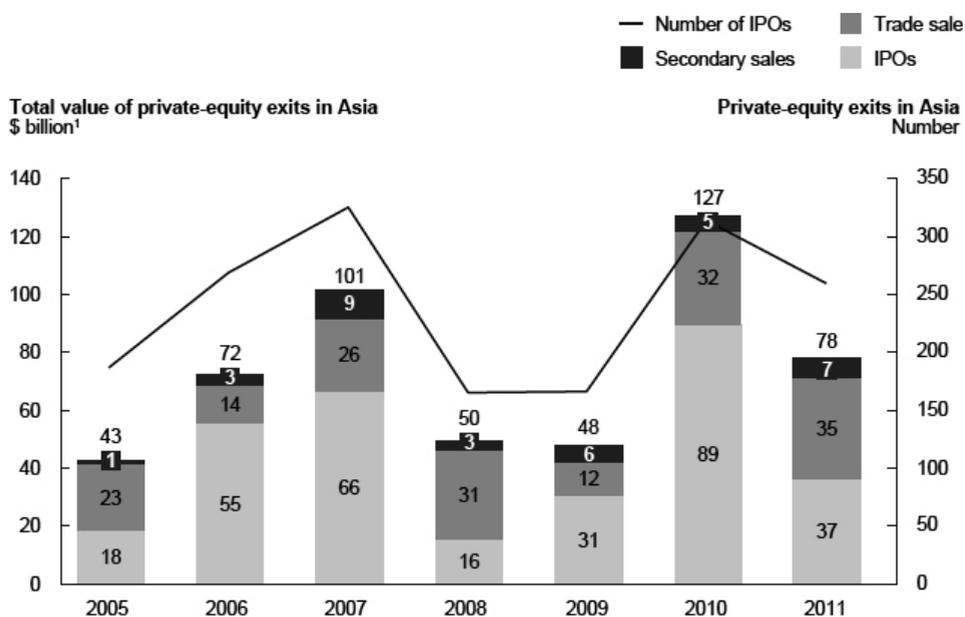
Source: AVCJ; Recof M&A; McKinsey analysis, op. cit. p. 7.

¹⁷ More on: www.kingsalmon.co.nz.

¹⁸ Ibid., p. 6.

5. The volume and value of private equities

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 consequence of the unusually poor performance in local public equities markets. 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 International¹⁹ and Sinovel Wind²⁰, the total value of IPOs halved in 2011 over 2010, and volume dropped 17%. Trade sales became the leading form of exit deal, accounting for 51% of the total exit volume²¹.



¹ Columns may not sum due to rounding.

Figure 9. Total value of IPO in 2005-2011

Source: AVCJ; McKinsey analysis, op. cit. p. 8.

¹⁹ More on: www.samsonite.com.

²⁰ More on: www.sinovel.com/en/index.aspx.

²¹ Investment Report towards a New Generation of Investment Policies 2012..., op. cit., pp. 23-24.

By contrast, the proportion of secondary sales across Asia has remained relatively constant over time, averaging 7% 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 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.

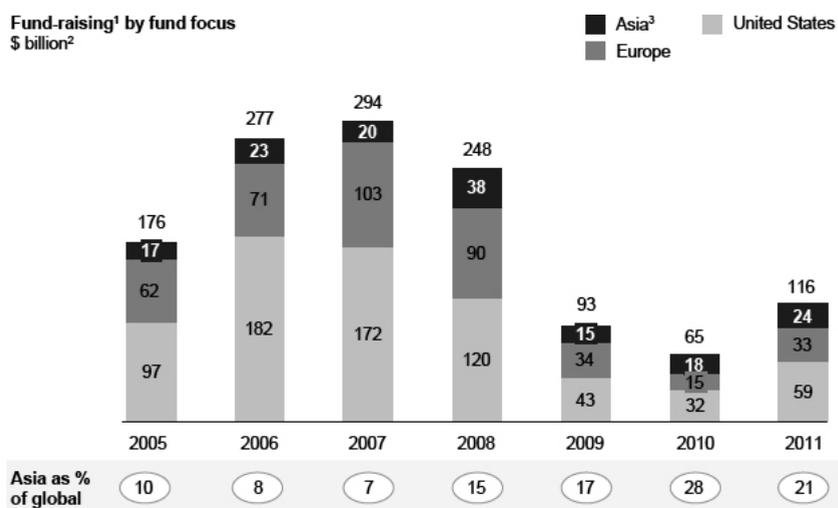
6. Fund-raising across Asia

The 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% above 2010 levels, while Europe rose 111%, and the United States 87%. 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 of their 2007 peaks. Asia’s share of global fund-raising has therefore risen from 7% in 2007 to 21%²².

In 2011, China was the focus of many of the major Asian funds that closed. Early indications are that Southeast Asia and India²³ may attract additional attention this year, with China continuing to play a leading role.

²² Ibid., p. 9.

²³ More on: www.indiape.com.



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.

Figure 9. Fund-raising by funds focus in 2005-2011

Source: Preqin, www.preqin.com; McKinsey analysis, op. cit., p. 9.

Table 2

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 Honey Fund V, which closed in 2012, and Honey Capital RMB Fund II, whose vintage was 2010.

Source: Preqin; McKinsey analysis, op. cit., p. 10.

Conclusions

Underlying 2011's favorable results – especially the return of deal flow to a higher level than at any time since the 2008-2009 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. The Chinese have taken to consumerism with ease, embracing thousands of new products, services, and brands²⁴. 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.

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 across Asia as companies globalize: from 1593,00 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.

²⁴ M. Jałowiecki: *China's Consumer Market by 2020*, In: *Innovation as a Factor of Development of the Asia-Pacific Region Selected Problems*. Ed. by P. Skulski. UE, Wrocław 2012, p. 182.

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% more than the 2008 pre-crisis peak of \$69 billion. 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. The 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. 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 PRIVATE EQUITY MARKET AFTER THE SUBPRIME CRISIS IN THE ASIA-PACIFIC REGION

Summary

By many measures, 2011 provided long-awaited proof of a rebound in the Asia-Pacific private-equity (PE) business 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. China alone accounted for almost 45% 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 eco-

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