

Private equity faces problematic 2009 in Asia Pacific

Market leaders prognosticate for New Year

As the New Year is ushered in, the private equity industry is bracing for some harsh new realities and battles for survival among marginal players. But optimism springs eternal, and bets are that vintage 2009 investments will produce some winners now that quality deals are easier to find and market valuations are down.

Asia Pacific a global highlight

From a macroeconomic perspective, the emerging growth story of Asia continues to be a beacon. In an otherwise depressed global economy, opportunities for profitable and productive investing abound in China, renewable energy, domestic consumption and infrastructure.

"Importantly, the private equity model is not broken and the business is not dead as some would like you to believe," said [Paul Carbone](#), managing partner at [Baird Capital Partners](#).

Even so, it's safe to say that the golden era of private equity is gone and won't be back any time soon. The dearth of private equity deals is likely to continue for the next 12 months, as financial engineering and leverage for investment deals disappear with the credit tightening, a poll of *AVCJ* sources indicated.

"Obviously, across the buyout industry and around the world, limitations on available credit have had a dramatic effect on the global economy and the pace of

new investing. I expect that economic difficulty and the malaise in the deal business will continue well into 2009," said Carbone, who directs the US firm's private equity group.

A shortage of capital to close deals is the greatest obstacle for Asian private equity insiders. "Capital-raising is clearly a challenge and the market environment will remain tough in 2009. It is clear that not all funds will have the necessary liquidity to take advantage of opportunities," said David Nott, outgoing regional leader, Asia Pacific, of KPMG's private equity group.

The new year squeeze

As January gets under way, private equity and venture capital firms will continue to be squeezed by a lack of exits through the usual routes – public listings and mergers and acquisitions – and an inability to raise new funds due to suppressed investment returns.

Postponements of IPOs in poorly performing stock markets will continue for much of the first half of 2009 while M&A will not pick up until strategic buyers can tap financing, *AVCJ* sources said.

According to Greg Peterson, a partner in PricewaterhouseCoopers' transaction services group: "Private equity players will be challenged to find new and innovative ways to put their money to work and to find deal mechanisms that can drive the kinds of returns their limited partners

expect. Historically, it has been during a downturn when strategic buyers and private equity firms have their best buying opportunities, yielding the best returns. The key will be the availability of financing."

As companies brace themselves for slower growth and industry consolidation, the better capitalized players should emerge as winners, pointed out [Shiv Dalvie](#) of [AEA Investors](#) in Hong Kong. "I expect attractive investment opportunities to emerge in providing capital to players seeking to deleverage or position themselves for industry consolidation during the upcoming years."

One of the biggest hurdles that private equity investors face comes from institutional investors. Pension funds and endowments that saw assets shrink in global equities last year with market volatility are now reducing their exposure to private equity.

Survival of the fittest

The new realities will most certainly lead to a test of survival strategies, with only the fittest firms able to withstand the current depressed environment, according to private equity investors, fund of funds groups, limited partners and advisers.

"There will be a number of managers in need for a restructuring, as they have made too many investments to properly manage and at too high

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Ernest Lambers

p5>> continued valuations,” said [Ernest Lambers](#), managing partner and chief investment officer at private equity fund investor [EMA Alternatives](#).

After the huge ramp-up of the business in recent years and the entry of many new players in Asia – both regionally and abroad – capital for new funds will be severely strained and will now go only to top-tier, brand name firms.

“I would not want to be a new fund trying to raise money from limited partners. It would be very difficult,” said KPMG’s Nott. “At a time of economic uncertainty there is inevitably a flight to quality and to those funds with a sound track record. In such an environment, a new fund would struggle for a good hearing.”

The onus is on general partners to differentiate their funds and rise above averages by offering value in operating and growing portfolio companies profitably.

[Chris Meads](#), partner at [Pantheon Ventures](#) in Hong Kong, said he was “pleasantly surprised by the discipline and patience being demonstrated by most of the Asian fund managers we back in being prepared to wait for the process of economic adjustment to play itself out, and not be in a rush to deploy capital in a falling market. We expect they will be in good shape to eventually step in and acquire some really exceptional businesses at bargain prices.”

Meanwhile, [Melissa Ma](#), managing director of [Asia Alternatives Management](#), said that “as in prior financial downturns, we believe that this will be an opportunity for winners to separate themselves from the pack. Experienced local investors not only should be able to help their companies navigate this challenging economic environment, but also make attractive new investments,” Ma’s group recently raised a new Asia-focused fund as did Partners Group and EMA Alternatives.

Asia and the global fund drought

From a global perspective, prospects for Asia are seen as the most attractive, and the region is likely to continue to be immune from the worst effects of the belt-tightening.

Ma said that “over the long term, private equity and venture capital will continue to be a meaningful part of LPs’ portfolios. What this downturn may do is heighten the longer-term importance of allocations to emerging markets, especially Asia, and call into question over-weighting on large, mega-buyout holdings in the US and Western Europe.”

The capital crunch will nevertheless lead to a winnowing out of marginal funds and put a dampener on newcomer groups to Asia. Funds with plenty of so-called “dry powder” to invest will be in the best position to act on opportunities to grab quality companies at attractive valuations this year. By contrast, those who entered the market in the recent go-go years despite limited private

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- Greg Peterson, PricewaterhouseCoopers

equity experience will likely be forced to withdraw.

Pantheon’s Meads cited the benefit of long experience, including previous downturns such as the 1997 Asian financial crisis. “Since many of us in Asia recall only too well the painful experiences of the Asian financial crisis, maybe we are in a slightly better position than our peers in more developed markets, where most private equity professionals have never experienced a recession, let alone the type of downturn we are going through at present, during their entire working careers. Unfortunately there is no room for complacency, and even if the crisis did not originate in Asia for once, we are clearly as affected as everywhere else.”

Firms that can find and mine a niche – either by sector, stage or geography – will do the best going forward.

“In this environment, it is imperative that general partners differentiate themselves through geographic focus, sourcing capabilities and product competence,” said Grant Kelley, the former Asia CEO at [Colony Capital](#) who now focuses on Australia as managing partner of Holdfast Capital.

Andrew Ostrognai, corporate partner and chair of the Asia private equity practice at law firm Debevoise & Plimpton, noted: “I think there will still be an appetite among investors for private equity in Asia,

but now more than ever for only the top funds. So while the top funds will prosper, I expect there will be a shakeout among the lesser performing funds.”

Bright areas for investment

The gloomy outlook hovers over nearly all types of private equity and venture capital funds – with few rays of hope.

Baird’s Carbone predicted that “the number of buyout deals valued at \$250 million or less will continue to drop in 2009, but not as significantly as in the large-cap market [which] will be down for a number of years.”

An exception to the bleak prospects may be funds that target mid-market growth capital in emerging countries, according to Lambers of EMA Alternatives. “In these emerging economies, investments are typically unlevered, with value creation coming from top line growth and better governance.” One other positive indicator is that Asian corporations increasingly are receptive to private equity and its role in providing finance to transform a business.

KMPG’s Nott said that “while some private equity funds may take a wait-and-see approach in the current climate, there are many well-priced opportunities for investors to take advantage of.” Citing a recent study by the firm, he added: “The fact that the Asian

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Paul Carbone



Melissa Ma

p7>> continued corporate sector is more receptive to private equity funds will facilitate the sector's development in the region."

Ostrognai noted: "Once there is a correction of the valuation expectations of potential portfolio companies, I think you will see robust activity among the leading funds."

Basil Hwang, partner and head of Asia private equity at law firm Dechert, highlighted some favorable aspects of the current situation for investors. "Assets in most classes are at historically low valuations – many good companies are trading at fractions of their book values and in many cases, at less than the value of their bank cash balances." He added that "on the private equity and venture capital side of things, many fund managers are looking closely at PIPE deals and other public company deals, as public company valuations compare very favorably with private companies' asking valuations, but with less liquidity risk."

Overall, though, the year promises many more hurdles than opportunities, even in once supercharged segments as China venture capital.

"The global financial crisis and credit crunch will have a big impact on our industry," said [Kathy Xu](#), who runs Chinese venture capital firm [Capital Today Group](#). "General partners with clear vision, focus, and discipline will stand out," said Xu, who is based in Shanghai and makes investments mostly in early-stage tech deals.

"The valuation expectation of entrepreneurs has come down a bit now and it will come down a lot more when entrepreneurs are running out of choices of raising capital to fund their growth," said Xu. "For our portfolio companies, year 2009 will continue to the year of growth but with more caution and focus on driving profit growth and cash flow."

No doubt, the challenging environment will separate winners from losers and put a focus on the fundamentals of investing and less leverage to get deals done.

"The period 2009-11 will be a time when the strong will eat the weak," said Joseph Ferrigno, managing partner of Asia Mezzanine Capital Group in Hong Kong. "Scavengers and amalgamators will benefit," he noted.

Ferrigno predicted a return to "basic values in lending and investment, faith and trust. The 'five C's' of credit: character, capacity, capital, cash flow and collateral,

need to be applied to investment and lending evaluations. A lot more sacrifice and suffering will be needed to restore credit in the system."

New fundraising dynamics

Given the challenged state of the industry, institutional investors' appetite for private equity funds has lessened – which ultimately may be a healthy indicator.

"The effort and process of raising a private equity fund has changed. The old days of spray and pray are over," said Paul Denning of private equity advisory and placement agent Denning & Co in San Francisco.

Over the coming months, look for more limited partners to further reduce their exposure to private equity due to over-allocations to the asset class and a need to rebalance portfolios, according to Lambers. For institutional investors, "the difficult part is to convince their committees to commit new capital today in an uncertain environment."

He added that "manager selection is more critical now than ever before. There is a need for a greater understanding of local markets as well as issues and concerns by institutional investors."

Lambers predicted that institutional investors will ask for – and get – new fund terms that are more favorable and that reflect the environment. Indeed, after suffering losses in the volatile markets last year, pension funds and endowments may once again need to adjust their expectations and face additional shortcomings.

KPMG's Nott noted: "The velocity has gone out the deal market and so limited partners will see that private equity funds will take longer to invest funds, longer to work on the development of the portfolio companies and longer to exit. The LPs will need to factor these longer investment horizons into their projected returns."

Even so, bullish fund managers warn institutional investors that those who withdraw now from private equity and venture capital funds may regret that decision later on. If they move out completely now, said Finian Tan, chairman of Vickers Financial Group, "they may not be able to get back in when the best managers are oversubscribed."

The crystal ball for 2009

Certainly don't count private equity out. Peering into his crystal ball, Nott observes that "private equity is alive and well. Sure, it is a tough market in which to finance deals, but middle-market deals continue to be completed around the region.

Nott also noted that "in times of economic crisis, private equity funding can be a savior of companies needing cash to expand and take advantage of opportunities that emerge, such as acquiring their weaker competitors. Private equity will also step in and buy unwanted businesses from larger corporations that are stressed and need to sell assets to survive. With the IPO market closed, private equity funds are one of the few outlets for such sales."

Through crisis, opportunity always rises.

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Joseph Ferrigno



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