

Into the unknown

LPs harden selection criteria
amid climate of uncertainty



- ▶ Sport: Why GPs want a piece of the action
- ▶ Q&As: CPPIB, BlackRock, Northwestern University
- ▶ China: Are US dollar funds losing their local cachet?



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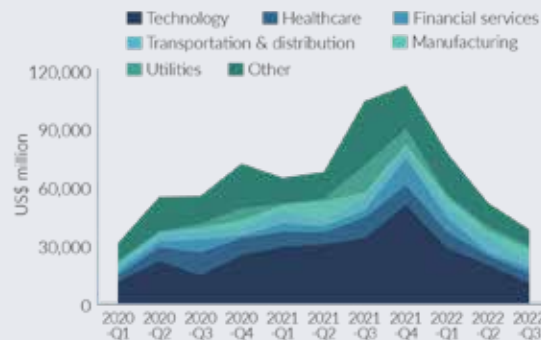
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Asia in six trends

1 A sector shake-up

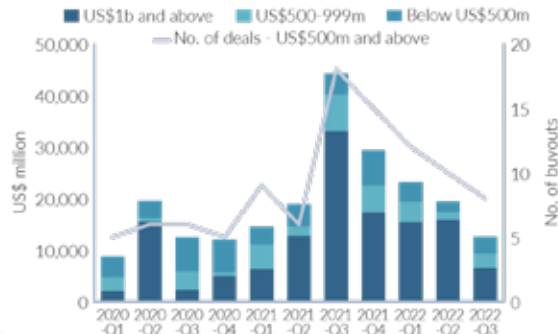
With corrections in listed technology stocks, growth-stage investment in the sector has inevitably taken a substantial hit. Nearly USD 28bn has been deployed year-to-date, compared to USD 69.6bn for the full 12 months of 2021. This has led to a rebalancing of the sectors for private equity investment in Asia as a whole. Technology is still the biggest player, but it fell from USD 28.5bn in the first quarter to USD 10.5bn in the third. Healthcare dropped from USD 8.3bn to USD 4.9bn, ceding second place to manufacturing (USD 7.2bn).

Asia private equity investment by sector



Source: AVCJ Research

Asia private equity buyouts by quarter



Source: AVCJ Research

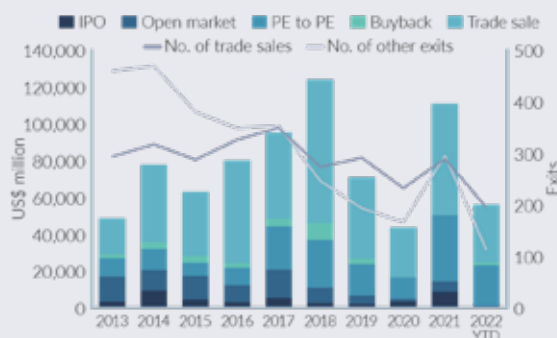
2 Looking for conviction

Asia buyout activity has tailed off predictably over the course of 2022, with the conflict in Ukraine, runaway inflation and a deteriorating global economy taking turns to strike at investor sentiment. The third quarter total of USD 12.5bn is the lowest since early in the pandemic. Financing costs – and how they impact the ability to underwrite transactions at a time when valuations are also uncertain – is a major concern. But at least Asia is getting deals done, often relying on in-region financing. Thirty USD 500m-plus buyouts were announced in the first nine months, on par with 2021.

3 Passing the parcel

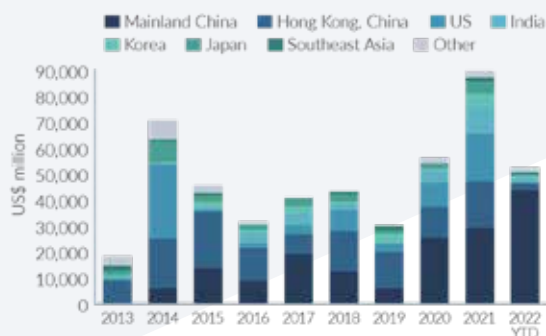
Private equity firms have generated USD 56.1bn in exit proceeds so far this year, approximately half the 12-month total for 2021. The number of liquidity events – around 300 – is the lowest in more than a decade. Trade sales are down by half, while public market exits have collapsed. Sponsor-to-sponsor transactions, however, are only one-third off the record pace set in 2021. Ten of the year's 16 USD 1bn-plus announced exits fit this profile, with Australia and New Zealand proving particularly fertile territory. BPEA EQT has a hand five of the 12 largest PE-to-PE deals – three as seller, two as buyer.

Asia private equity exits by type



Source: AVCJ Research

Asia PE-backed IPOs by jurisdiction of listing



Source: AVCJ Research

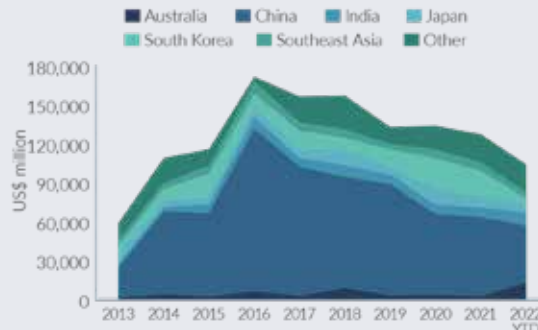
4 Mainland melody

More than USD 4 out of every USD 5 raised through IPOs by PE-backed Asian companies so far this year has come via mainland Chinese exchanges. While China is normally the dominant force in IPOs, Hong Kong and the US have always featured strongly as listing destinations. Prevailing global market conditions have stymied their flow, and the same applies to most other jurisdictions. At USD 8.7bn out of USD 52.5bn, the Asia ex-mainland share of IPO proceeds has never been lower, despite eye-catching IPOs by the likes of GoTo and Delhivery.

5 Fundraising woes

Asia private equity fundraising appears to be on course for its slowest year since 2014, with USD 104.1bn committed to funds targeting the region as of early November. It extends a general downward trend that started in 2017. Only two major markets have surpassed their 2021 totals: Australia and India. China has seen the sharpest decline – USD 44.3bn raised so far, putting the country on course for its first sub-USD 60bn year since 2013 – as LPs bide their time, waiting for greater clarity around pandemic-related restrictions and geopolitical disquiet.

Asia private equity fundraising by jurisdiction



Source: AVCJ Research

Largest Asia final closes, 2022 to date

Fund	Strategy	US\$m
Baring Asia Private Equity Fund VIII	Asia buyout	11,200
Sequoia Capital China – multi-fund vintage	China venture	8,800
Blackstone Capital Partners Asia II	Asia buyout	6,400
FountainVest Capital Partners Fund IV	China buyout	2,900
Qiming Venture Partners VIII	China venture	2,500
BGH Capital Fund II	Australia buyout	2,300
Asia Alternatives Capital Partners VI	Asia fund-of-funds	2,000
Bain Capital Asia Special Situations Fund II	Asia special situations	2,000
Sequoia Capital India Growth Fund IV	India venture	2,000
Crown Asia-Pacific Private Equity V	Asia fund-of-funds	1,650
ICG Asia Pacific Fund IV	Asia special situations	1,100

Source: AVCJ Research

6 Fleeing to the familiar

Asia has seen fewer than 600 incremental or final closes so far this year, compared to an eight-year average of 820, underlining how LPs are placing their trust in managers that are proven or familiar. Eleven funds have achieved final closes of USD 1bn or more, led by BPEA EQT, which raised USD 11.2bn. Sequoia Capital China takes second place on USD 8.8bn if its latest collection of funds is amalgamated. With FountainVest Partners and Qiming Venture Partners also in the top five, it is clear some China managers are still in favour. Special situations funds are another notable inclusion.

GP selection: Discriminating customers

Sizeable LPs are hardening their criteria for fund commitments in reaction to a tougher investment environment. But going with fewer, deeper relationships is an uphill climb

LPs have a long list of reasons to believe their job selecting GPs is getting more difficult. Much of this can be blamed on opportunism around COVID-19 dislocation and the rapid deceleration amidst downturn expectations in more recent months. Overarching it all is the idea that higher employee turnover within fund managers as a result of these shifts has elevated the need to re-test relationships.

Uncertainty has slowed pacing of commitments and raised the bar in terms of transparency, sustainability, and sweeteners like co-investment. At the same time, LPs say they're seeing less continuity in returns, which increases the relative weight of less measurable factors around process, team, philosophy, and deal flow. GP selection was always a judgment call, but now it's foggier. Or is it?

"Institutional investors say it's getting harder to pick GPs, but I think the last several years have been hard and it's about to get easier because the tide is going out and they'll see who's wearing bathers and who's not," said Steve Byrom, former head of PE at Australia's Future Fund, who now runs institutional advisory firm Potentum Partners.

"The challenge is that LPs haven't needed to figure out what quality looks like. It's no longer enough if GPs have high performance – it's about what drove that performance and can that be sustained in this new environment. There's little consensus among LPs on what quality looks like."

Quality is an ethereal concept, with most attempts to flesh it out evoking important but difficult-to-validate virtues such as experience through cycles and deep operational toolkits. The first step is often to weed out the hallmarks of momentum investing, including implied strengths around timing trends and a reliance on leverage ►



"The challenge is that LPs haven't needed to figure out what quality looks like"

– Steve Byrom

in a low-interest rate environment.

Increasingly, this process also means demanding evidence of a repeatable formula for post-acquisition value creation, whether that involves in-house or third-party resources, with data-driven performance benchmarking backed up by qualitative interviewing on specific operational contributions.

The imperative to seek out value-add capacity in GPs has only intensified as the impact of its absence comes into focus. PwC demonstrated this in dramatic style with new research suggesting that, on average, doing a deal destroys value in terms of total annual shareholder returns.

The study found that 53% of buyers and 57% of sellers in M&A transactions globally underperformed their peers (owners that did not do a deal) during the 24-month period following the deal. Private equity historically represents a minority of this activity, but that's on track to change, with PE involvement in Asian M&A said to have tripled to 40% of all deals in the past 16 years.

A survey conducted by PwC and Mergermarket, AVCJ's sister title, found that corporate executives experienced significant buyer's remorse, much of it doubtlessly driven by private equity. Only 34% said value creation was a priority at the time of acquisition, although 66% said it should have been. In Asia, these figures were 29% and 66%.

"It's usually the mindset of investors that value creation happens post-deal, but that's probably too late in a lot of cases," said Jacky Lui, PwC's Asia Pacific deals strategy and operations partner.

"The capability lens needs to be considered upfront by investors, especially in PE, because the market has already factored in programmes such as management reshuffles and cost optimisation. Those are already expected in multiples, which is partially why valuations are higher."

Internal cohesion

Assessments of this kind invariably hinge on intangibles about the individuals involved and their capacity to work together. Team cohesiveness has arguably increased in importance with many GPs opting for longer holding periods. These concerns bleed into the mechanics of longer holds and how decisions are made around instruments such as single-asset and multi-asset continuation funds.

Continuation funds are among the more acute points of contention, with one industry participant estimating less than 10% represent the GP's best assets and full alignment. Most LPs interviewed for this story deferred to Institutional Limited Partners Association (ILPA) guidelines in this area.

Further team-related issues include the makeup of the investment committee, who's on, who's off, and why. Who are the designated key persons and how often have key-person provisions been applied? Motivation and ownership structure can be quantified to some extent in formal compensation, but culture remains the wildcard.

"We have GPs founded by investors who were very frustrated they didn't get the ownership and economic recognition they felt they deserved and moved on to form their own firms," said an investor at an Asia-based sovereign wealth fund.



"But there are some managers in our portfolio where some of the very best investors do not have any ownership stake in the management company, and that's fine by them. They happen to be good investors and were brought into that regime."

Even where compensation and culture appear harmonious, there is a sense that a more uncertain macro environment – coupled with high levels of dry powder – could exacerbate longstanding challenges around getting comfortable with the risk appetite among the best and brightest.

"They're under pressure to deploy and sometimes take a chance to get deals over the line. If it works, they'll do brilliantly. If it doesn't, they'll just pop off to join another GP," said one industry participant. "You have to make sure they aren't forcing deals past investment committee on the back of personal motivations."

Countering this issue means approaching PE as an industry that has become as much about operations as ownership, where sole practitioners can no longer flourish. In this light, specialisation has come into focus as a potential indicator of team alignment, motivation, and likely longevity.

Expansion of LP private equity capacity appears to be driving this aspect of GP selection. Institutional investors on this path are becoming ever more aware of their internal PE teams' strengths and weaknesses, and where a specific GP could help them fill a gap. This amplifies the onus on managers to clarify their sectoral sweet



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“We’ll add selectively, and if we’re adding, then we’re probably not re-upping in somebody else”

– *Chris Ailman*

spot and differentiated knowledge base.

“We favour sector expertise because we think the market is so competitive these days, you need that focus of skills and insights,” said Stephen Whatmore, head of private capital at QIC.

“For many GPs, having a particular sector focus – maybe two – really helps galvanise those teams, their discipline, mindshare, and investment processes. There is less turnover in those groups, and that speaks to team cohesion.”

At the same time, LPs’ broad desire to pursue more compact manager relationship portfolios suggests the team-level advantages of specialisation will dwindle in relevance.

A prevailing philosophy, at least among the largest players, finds that diversification is best achieved in the underlying company portfolios, not at the GP level. This has translated into the targeting fewer, larger, stabler, and more internally diversified managers. But it’s not making selection any easier.

Two trends are driving the phenomenon: the impetus among GPs to go multi-strategy and the blurring of the asset classes that define those strategies. The concern from the LP standpoint is that asset managers in this vein must be judged for a more varied set of returns and results.

Issues of alignment can also arise depending on how the teams are incentivised across a GP’s various revenue streams, how big the various business lines are compared to each other, and the extent to which there is overlap between their respective management teams.

There is also the notion that more complex GPs must demonstrate higher competence in terms of teamwork and flexibility. Most investors acknowledge the complementary benefits of

a multi-strategy approach but are unsure of managers’ ability to juggle talent across different risk and decision-making cultures.

“When you get to the big firms that have every kind of asset class in every jurisdiction at every level, it’s inevitable that not all of their teams are going to be of the same quality,” said one Australian superannuation fund investor.

“We have a relationship with a big one like that, and we often talk about expanding it, but it doesn’t often pay off. It’s pretty infrequent that we spread across asset classes with the same partner because we can’t get conviction with all the teams.”

Flight to quality

Suspicion of multi-asset strategies is not universal among large LPs, but it does appear at odds with almost universal expectations for a flight to quality.

For example, Chris Ailman, CIO of California State Teachers’ Retirement System (CalSTRS), raises alignment of interest as a significant concern when considering how large GPs have tended to expand beyond a pure private equity approach. But the desire to take bigger bites with fewer managers remains.

“We’ll add selectively, and if we’re adding, then we’re probably not re-upping in somebody else,” he said, noting that track records have become relatively weaker performance indicators versus cultural factors that are best understood by physically visiting a manager’s office.

“It’s terribly hard to make a decision to not re-up with a firm or reduce your re-up early. But in reality, you want to sell high, reduce it when they’re doing well, and not put a lot when they’re doing poorly.”

To a large degree, the consolidation of GP relationships is a function of limited bandwidth within LPs. But this has been compounded in the more recent term by pressure to mobilise cash, given its purchasing power is eroding by the day in an inflationary environment.

The overwhelming urge is to access proven managers as quickly as possible. This comes with greater capacity to scale co-investment programmes and fewer headaches in terms of ensuring professionalism. But it is not without risk.

“If you’re going to have a flight to quality, you need to be patient and wait for those high-



quality groups to turn up,” said Potentum’s Byrom.

“Secondaries would be the wrong way to get exposure at the moment because that’s going to give you too much beta, which is really unattractive in this market environment. You need to be able to pace getting that money to work. Don’t be in a rush to get it all out the door today.”

New Zealand Superannuation (NZ Super) offers an illustrative case study in the difficulties of achieving a compact roster of GPs.

As the sovereign wealth fund has scaled – currently around USD 40bn in assets under management – there has been an instinct to tighten up the alternatives programme and go large. Fund commitments of USD 100m, for example, are not on the cards unless it comes with at least USD 100m in co-investment rights and access to other vehicles down the track.

Still, nine new GP relationships have been added in the past two years alone: three under a sustainable transition theme, three in real estate, two in infrastructure, and a toehold in VC via a fund-of-funds commitment to StepStone Group.

NZ Super’s quality criteria largely revolve around transparency and alignment, but choppy deal markets in the recent term have also highlighted an appreciation for restraint.

“We have one manager that didn’t deploy our committed capital because they said they didn’t see the opportunity to invest at the price they were seeking,” says Del Hart, head of external investments and partnerships at NZ Super.

“We thought, next time they come to market, we will have an increased level of trust with them, and we’ll be in a more comfortable position to deploy more capital because they showed discipline.”

The ESG angle

The firm’s highest hurdles, however, are arguably in environmental, social, and governance (ESG), with Hart adding that it is no longer acceptable for GPs to lack a robust process around managing the relevant risks and opportunities in their portfolios. This includes how they assess climate risk.

“We’re spending more time understanding not just their capabilities but also their mindset, making sure they have the appetite and belief that this adds value to their portfolios over the long term,” she said. “We’re moving to thinking about

sustainable investment more holistically.”

CalSTRS has made ESG a priority as well, defining it as a basket of business risk compliance considerations that carries the same weight as megatrends the likes of energy transition and ageing populations. The takeaway is that while investors may debate the connotation of E, S, and G, much of which smacks of moral posturing, no GP should be without a plan for the megatrend.

First and foremost, GPs must measure their carbon footprint at the portfolio level. This includes attention to at least scope-one and scope-two emissions (direct emissions and emissions from purchased energy) but also plans to think about the complexity of scope three (indirect emissions through the supply chain).

Do strict ESG requirements narrow the field to the point where GP selection is becoming easier? “No, GP selection is harder, mostly because of the lack of persistency in returns,” Ailman said.

“Just because the GP’s been bottom quartile doesn’t automatically eliminate them. It’s still an uphill climb, but it’s somebody you want to think about. And just because a GP is not up to speed right now, these are terribly smart people, and it doesn’t mean they can’t get there. A GP may go from a climate denier to somebody embracing it.”

In Asia, the heaviest ESG compliance overheads come with commitments from Australian superannuation funds, which are seen as in line with European requirements. GPs’ shortcomings in this area fall more under the G than the E or the S.

Possibly the most common dealbreaker in this area is proactive event notification arrangements, whereby GPs are obliged to keep LPs abreast of meaningful disruptions to business as usual.

“What we really want is people to say, for example, ‘There’s was a cybersecurity event, and we’re dealing with it.’ But seven times out of 10, GPs are pushing back on that. I can’t be constantly asking if everything is okay,” said the superannuation investor.

“They’ll say, it’s not fair to tell us about fraud because the people might be falsely accused. They can’t tell us until it is proven and it has gone through a court, and they’ve been convicted and are in jail. They don’t want the responsibility for deciding what’s material. There are a lot of what-ifs. But to me, it’s a really reasonable ask.” ■

Taking PE in-house: Less limited partners

Institutional investors continue to pursue more active roles in private equity, even as a souring macro backdrop makes the game harder to play. Talent is always the key variable

What are the implications of a more difficult macro environment for the relationships between large LPs and their portfolio GPs? First and foremost, it means there will be fewer of them, which suggests deeper, longer-term engagements. But it also means LPs will seek greater flexibility in how they invest – the kind of flexibility more typically associated with GPs.

“Big institutional investors are hesitating and being more selective about new commitments to private equity funds in light of market uncertainty. But when it comes to direct opportunities, it’s a lot more fluid,” observed Alex Boulton, a Singapore-based partner at Bain & Company.

“If they find something they’re willing to put money to work in, they will. And there’s capital on the balance sheet to do that. Taking on a new five to 10-year LP commitment takes a lot more forward planning, especially when it comes to your cash flow and asset allocation.”

The effect here is a seeming contradiction in terms of how investors take on a more conservative posture. Even as they pull back on fund commitments, direct exposures are vigorously pursued, often in categories where valuations are difficult to nail down. And there are reasons to believe the phenomenon is intensifying as macro pressures mount.

The number of direct investments by sovereign wealth funds (SWFs) reached a record 429 in 2021, up 60% against the prior five-year average, according to the International Forum of Sovereign Wealth Funds. Deal value hit a five-year high of USD 71.6bn, doubling the 2019 total. Asia was the most aggressively pursued geography in consumer, followed by the Americas in tech. ▶



“It’s possible that heading into some choppy waters economically might make it easier to hire and retain people”

– Eric Lang

Singapore's GIC has been among the most active players in this trend, particularly in light of a string of hospital deals. Last year, it invested USD 180m in Malaysia's Sunway Healthcare and USD 204m in Vietnam's Vinmec among others.

Global pensions, foundations, and endowments have similarly mobilised, deploying USD 4bn in the second quarter of 2021, according to FactSet. That's more than the prior six quarters combined. Standout moves in Asia included Robert Bosch and Novo Holdings co-leading rounds of USD 500m and USD 200m, respectively, for Chinese autonomous driving supplier Momena and Singapore's Esco Lifesciences.

In August, Ontario Teachers' Pension Plan (OTPP) took a majority stake in Sahyadri Hospitals, which was its first control private equity buyout in India, and its fourth major investment in the country over the prior 12 months. The pension plan followed up with its debut co-control deal in Asia, picking up a stake in China-headquartered packaging manufacturing company GPA Global.

People power

The key challenge for LPs going direct is maintaining a programme over the long term by retaining and multiplying the relevant talent. But OTPP appears to be leveraging the current frenzy

in LP directs to achieve critical mass in Asia: it opened an India office in September and now has more than 65 employees in the region. Could a downturn send more PE talent in this direction?

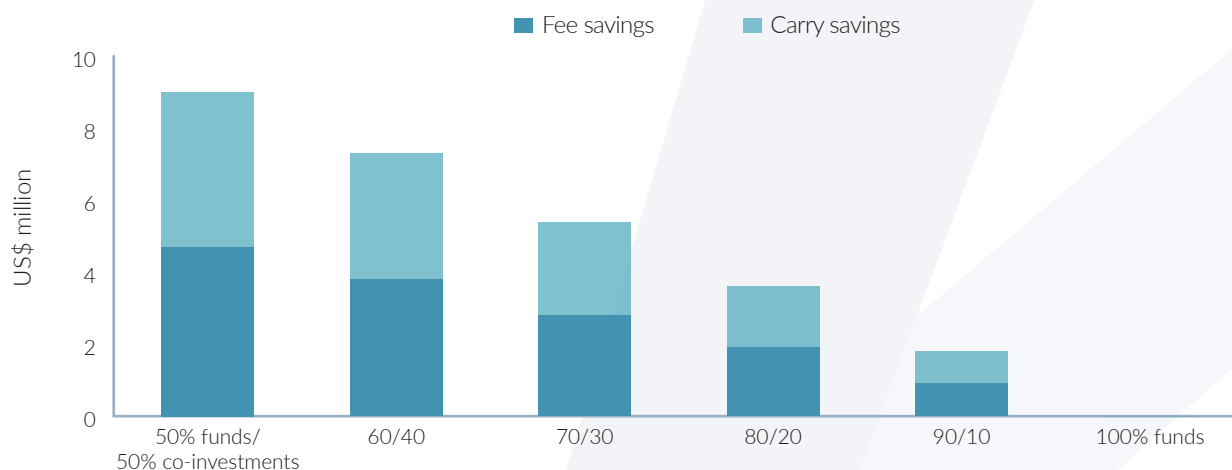
"For the past few years, the macro environment has been very good, everyone has struggled to hire PE talent, even our GPs. Now that that environment is changing, we don't know what's going to happen," said Eric Lang, senior managing director for private markets at Teacher Retirement System of Texas (TRS). "It's possible that heading into some choppy waters economically might make it easier to hire and retain people."

TRS, like many of its peers, has struggled to retain investment professionals in recent years. It has trained people up only to lose them mid-career, primarily for compensation reasons.

Still, there are murmurs that a slowdown in M&A is leading to staff cuts at investment banks, which could send more talent toward institutional investors. In a rockier macro backdrop with continued high competition and a lot of dry powder, operational abilities will be most in demand.

Whether or not they can be procured will decide much about GP-LP dynamics. LPs that can build out more internal PE capabilities will have different priorities in manager selection for fund commitments. In relative terms, it will be

Cost savings from 100% funds to a balanced funds/co-investment program based on a USD 100m commitment



Source: BlackRock

less about identifying the best performers in pure economic or impact terms and more about filling holes in an existing expertise set.

British Columbia Investment (BCI) is among the pensions tracking a rebound. In the past three years, its PE team has been trimmed from 52 to 42 people but rebounded to 50 in the past nine months. The goal was to reach 65, adding 10 as part of a New York rollout. The target for the expansion office has now doubled as M&A layoffs in the city fuel recruitment.

For BCI, the traction is confirmation that there is no talent shortage – it's just a matter of identifying the right style of talent for the LP universe. These are usually older people, who prioritise work-life balance. This talent pool is also attracted to variety in investment remit: large and small deals, a global geographic lens, and more opportunity to work across strategies.

BCI provides an apt example for the idea of LPs internalising PE activities as a secular expansion. As new divisions and strategies are added, headcount will undulate, perhaps especially in terms of the top talent. But rare is it to see an institutional investor consciously scale down its direct investment capacity after the strategy has been confirmed as a long-term ambition.

Denominator disruption

The pension plan is also in the relatively unique position of being able to accelerate its deployment pacing in private equity at a time when most of its peers are concerned about overallocation amidst more frequent capital calls class and drops in public market valuations.

The PE allocation is currently around 12.5% against a target of 15%, leaving significant room for increased investment across direct deals, co-investments, and funds. That is largely thanks to secondary sales, including some USD 4bn in fund positions in the past few years, and almost USD 5bn in direct deals last year alone.

"You don't want to be in a position where you have to sell in a down market. That's the worst time to do it. But there's an interesting dynamic in secondaries right now. For the past five years, there's been much more demand than supply, and today, there's much more supply than demand," said Jim Pittman, global head of PE at BCI.

"The public markets are down 20%, and GPs are between zero and minus 3%. So, to some degree, if you can sell funds today and get a 15% discount, you're probably net-net positive – if you believe where the public markets are."

Pittman estimates offhandedly that as much as 70% of pension funds are experiencing the denominator effect. They must now consider fundamental questions about their level of private equity exposure and whether they have the resources to play in that space long term.

With previously robust exit activity drying up rapidly around April, GPs are looking for near-term liquidity to alleviate the pain. Several LPs suggested to AVCJ that managers were looking to sell 30–40% stakes in companies to get distributions back on track. This could create an opening for LPs to re-allocate to PE over the next 6–12 months, but it remains a marginal trend and a theoretical fix.

Meanwhile, institutional investors could have fewer dollars to deploy in 2023. The wave of GPs coming back to market in shorter cycles in recent quarters has prompted many LPs – especially in North America – to begin chewing into their 2023 allocations as early as last April.

The more recent slowdown in fundraising has curbed this effect to some extent, but it is ongoing and raises the question of when 2024 budgets will be tapped. Allocation models have been under particular pressure in the venture and tech space, where access to the best managers is considered so competitive, re-ups are hard to deny.

Overlaying all these considerations is the idea that fund commitments must remain consistent because they are likely to be invested 3–4 years down the track and it is impossible to predict market undulations. Direct investments provide more options in terms of timing, but erratic valuations have proven a complicating factor.

Chris Ailman, CIO of California State Teachers' Retirement System (CalSTRS), observes that in the next six months, lower company valuations could create an enticing moment to put money to work in direct deals. But this would remain a difficult decision for LPs still overweight on private equity.

"Any pacing model is simply trying to predict the future, which is therefore flawed," Ailman said. "I've been adjusting and refining pacing models since 1996, and I can tell you for a fact that

it's all art, as much as it feels like science, simply because you're trying to make assumptions about the future and how people will react to it."

Timing a ramp-up in direct investments could be especially risky in large deals that will require currently difficult-to-access debt. Ailman noted that the largest co-investments in the run up to the global financial crisis turned out to be the worst. "It's no secret that when private equity does something big, it's usually not going to result in anything good," he added.

Co-investment conundrum

Nevertheless, larger LPs across geographies and organisation types appear unanimous in their desire to amplify their principal investment programmes in the years to come. The most fundamental impacts on GP-LP relations will revolve around demand for co-investment, which is likely to result in larger checks and smaller LP bases.

Fees remain the core motivator for internalising this capacity. The prevailing assumption is that the economic benefits of increasing co-invest versus fund commitments begin to become significant at a 75:25 ratio. Beyond that, the challenge of maintaining a significantly robust directs team suggests there could be long-term diminishing returns.

A study by BlackRock helps explain why an industry push toward a balanced PE programme (50:50 co-invest and funds) persists. Assuming a gross deal level return of 2x, fund management fees of 2%, co-invest fees of 0.75%, and 20% deal-by-deal carry, a balanced PE programme will deliver LPs USD 9m in fee and carry savings on a USD 100m deal versus USD 3.6m in fee and carry savings in a 80:20 split.

"It's not just about fees – it's about using our brand and capabilities to secure quality access"

– Stephen Whatmore

"Depending on the gross IRR, you're saving 500-700 basis points if you're not paying fees. But we also know that if you get your selection wrong, that can evaporate very quickly because the dispersion of returns in PE is the widest of any asset class," said Stephen Whatmore, head of private capital at QIC, an Australian SWF.

"So, it's not just about fees – it's about using our brand and capabilities to secure quality access. That looked easy for the last five years because everybody was making money, but now we're in a market where people are going to see that it's more challenging than they thought."

SWFs' ultimate motivations to internalise PE capacities often parallel pensions in terms of building and safeguarding public wealth. They are also similar in their ability to do direct investment more consistently through cycles without constraints around the size of cheques or stakes. For example, all GIC's hospital investments during the pandemic have been minority stakes.

Strategic agendas

Among the largest institutional investors, SWFs have historically displayed the clearest strategic agenda in terms of PE activity. But other types of institutions are taking on this profile as well.

Kimberly Kim, head of the financial institutions group for Asia Pacific at BlackRock, said her firm was tracking a significant uptick in demand among insurers for private market exposures for strategic reasons, especially around decarbonisation. This includes a greater appetite for co-investment.

In a survey covering 370 insurance companies – one-third of them based in Asia – representing USD 28trn in assets under management, respondents said they planned to increase their allocation to private markets by 3% on average over the next two years.

Private equity, typically a prohibitively expensive asset class for insurers for regulatory reasons, was the second most attractive area to increase allocations, with 48% of respondents expecting to lift their exposure in the next 12-24 months. Commodities was in first place at 55%.

Insurers will need to make various internal changes to accommodate this shift, which will have implications on their relations with managers. They will need to be nimbler and more tactical, ►



use more data analytics in-house, and enhance capabilities around leveraging external managers.

GPs, meanwhile, will increasingly need to consider the specific needs of insurers, including an understanding of asset and liability management requirements and an arguably greater climate focus versus other LPs. BlackRock, for its part, has coded local insurance regulation into its Aladdin portfolio management software to provide more customised service.

“In terms of GP-LP dynamics, we’re going to see a more partnership-based approach and deeper relationships between the two parties. And a lot of that will really depend on the strategic objectives of the insurance company,” Kim said.

“Based on our observations, increasing interest in exploring co-investment opportunities is not just about economic benefits – there’s a strategic motivation for getting into that space.”

From the GP perspective, these developments indicate that co-investment is no longer a perk limited to anchor LPs. The trend appears likely to create the most disruption in the middle market, where managers could be more susceptible to being pushed out of their comfort zones.

“It means either GPs have to punch above their weight into a new deal size – selectively where

they can put a lot of money to work – or they need to do more deals, which creates challenges,” said Bain’s Boulton.

“You don’t want your LPs to walk away with only the big, risky deals, where you lever them up with co-investment. You need to be thoughtful about how you’re going to offer co-investment and do it in a consistent way that delivers value.”

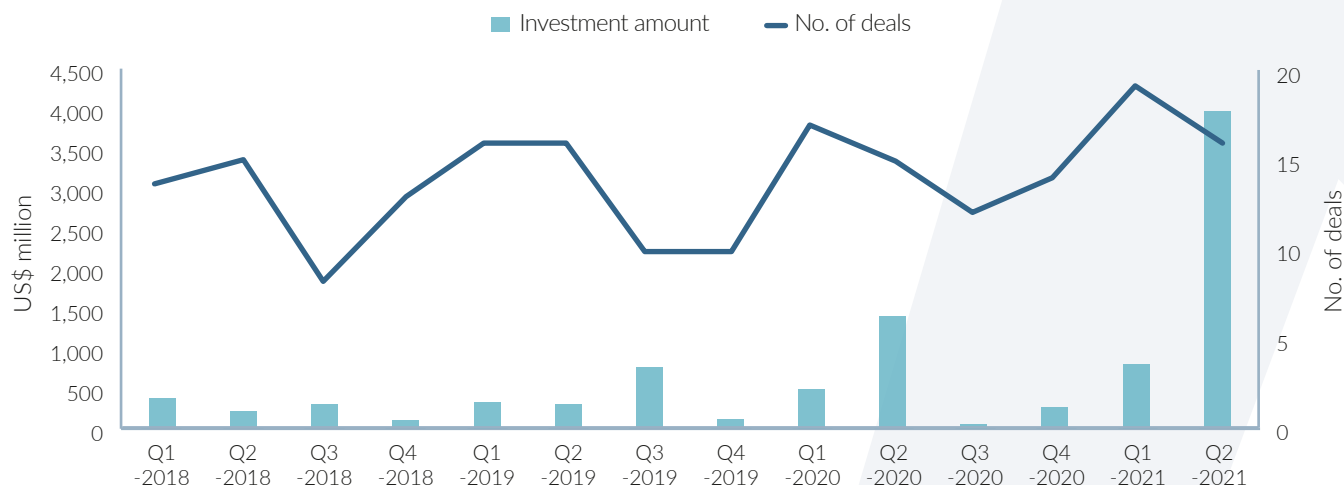
Sowing seeds

The smaller end of the market is another story, given there is much cross-over between the needs of boutique managers and LPs trying to internalise PE skillsets for the first time. This can lead to some creative approaches to PE internalisation and uncommonly intimate partnerships.

Sun Hung Kai & Co is the standout example in Asia. A stalwart of capital markets services since the 1960s, the Hong Kong-based investor began transitioning into alternatives around 2015. To a significant degree, onboarding knowhow has been a matter of seeding emerging managers.

The strategy appears to have given Sun Hung Kai an unlikely confidence in high-risk domains. For example, there have been direct investments in bleeding edge models such as a virtual real estate platform (Hong Kong’s Sandbox) and

Direct investments by pensions, foundations, and endowments



Source: FactSet

a digital assets bank active in web3 concepts (Singapore's Sygnum). It's worth noting that one of the managers Sun Hung Kai has seeded is a crypto specialist.

The group positions this GP portfolio as a one-stop alternatives platform for its clients, so helping its constituent investors grow is considered a clear win-win. As part of the effort, Marcella Lui was brought in earlier this year as head of funds distribution and investment solutions to help these managers with fundraising.

"That's not easy in today's market, which is pretty much in wait-and-see mode. But external investors appreciate the alignment of interest between Sun Hung Kai and these managers," Lui said. "The breadth and depth of this alternatives offering – and our ability to work with the managers – is also really compelling for investors who are looking for something bespoke."

The largest of these relationships is ActusRayPartners European Alpha Fund, a hedge fund manager that has grown from USD 20m to USD 300m in assets under management since Sun Hung Kai's investment. The only pure private equity player is E15 VC. It received USD 15m to anchor its second fund, which closed on USD 32m.

E15 VC is also based in Hong Kong and uses Sun Hung Kai's office space as headquarters. This has facilitated significant cross-pollination

between teams. Sometimes E15 goes to professionals covering other asset classes within Sun Hung Kai for support with a specific query. Sometimes, it's the other way around.

Not every seeded manager takes up residence in the office, and they do not all have close relationships with Sun Hung Kai. But the option is there; Lui notes that there is still available space although she emphasises such arrangements are offered on a selective basis.

"You see that in pitchbooks about why you should use [a certain investor platform], but I hadn't actually lived it and seen how it works in real life, where you don't force it. Everyone has their doors, but they're glass doors," said Ted Lee, CEO of E15 and formerly a managing director at both Canada Pension Plan Investment Board (CPPIB) and The Blackstone Group.

"I know that if there's something complicated that needs to be discussed, there's a guy a two-minute walk away, who I can talk to. No special agenda necessary – it's just peers. There's real value in that."

Despite the intimacy of this approach, Sun Hung Kai fashions itself as having light touch with GPs. To this end, it prefers a revenue-share model – rather than taking equity stakes – while offering support such as warehousing facilities to expedite deals while fund paperwork is still in process. ▶

"If you're an LP, a great way of boosting returns is simply having a good portfolio and being able to do co-investments. And what better way to do that than constantly interacting with your managers and having them on site?" said Philip Liang, E15's managing partner.

"You're going to have the first access to deals. You're going to know the most about them, the upside and downside. The benefits to co-investment are huge because we know we have a partner that will do a follow-on investment, and they get to pick some of our better companies and get higher exposure, increasing their returns."

Going too big?

The Australian superannuation space helps illustrate the difficulty of scaling this kind of approach. In private equity, internalisation generally means a smaller number of larger-size fund commitments plus co-investment alongside portfolio managers.

Seeking to go large has resulted in a tendency to prefer the blunt tools of direct investing with in-house teams and more aggressive co-invest terms. In certain situations, super funds are known to demand USD 3 of co-investment for every USD 1 of fund commitment. They have significant negotiating leverage over local managers.

"Some of the old-school PE guys in Australia really don't want to give up co-invest, but you have to either give us a very material fee rate or co-invest, or both. The reality is, we have no requirement to partner with anyone in Australia if we don't want to," said one super fund manager. "You can go off to the US, and they'll ask who your local anchors are. If you don't have any, that's bad."

Part of the super fund equation is the idea that the industry is further down the conservative end of the spectrum than much of the pension fund universe. For the most part, there is an acknowledgement that Australian superannuation is not ready to take on the level of complexity in commercial decision-making required to do PE alone. Most funds want more direct ownership, but they want to do it with partners.

There are numerous local challenges, not least currency depreciation against the US dollar, which can exacerbate the denominator effect for those with large international portfolios.

More important is the notion that super funds are at a disadvantage to their Canadian counterparts in terms of regulatory requirements around budgeting for staff, which keeps the talent hurdle high. Another super fund manager said it has been in talks with the likes of GIC and Canadian pension plans about adopting a more cooperative approach with GPs, but people remain the sticking point.

"We see the Canadians as 10 years ahead of us. They partner with GPs rather than do everything internally, and that's where we would like to be," said the second super fund manager, flagging a need to reduce manager fees.

"Until the board gets comfortable paying the levels that the Canadians pay, it will be difficult to attract and retain the right talent. AustralianSuper has lots of people, and it is doing more internalisation, but it's still mostly a hybrid model where they partner with managers."

The talent question is set to become even more critical as deep operational capabilities become indispensable. And there is concern that in fee-sensitive jurisdictions such as Australia, programmes are being launched without the appropriate skills in place. At some point, the drive to internalise private equity may backfire and bring the industry debate more into the open.

The strongest brand names will have a natural advantage in terms of recruitment, though only where there is an existing PE programme. Entrepreneurial inroads such as seeding emerging managers will not serve the bulk of large institutions with intentions to scale indefinitely. But there are few other options for going from zero to one.

"Those that do it have done it from the start. I haven't really seen anyone new doing it. They ask about it, and some say they do it, but they rarely do," said David Brown, Asia Pacific deals leader for PwC, referring to institutional investors setting up new PE programmes.

"If you're setting something up from scratch, you're going to need to headhunt from established GPs, and you're going to need that kind of expertise and operational capability because you can no longer just rely on things being more valuable in time. That's going to cost you a lot of money, and it can be difficult and risky for many of these institutional investors to justify that." ■

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The 21st AVCJ Private Equity & Venture Forum - China, returns this year on 21-22 February 2023, bringing together leading private equity fund managers, institutional investors and regional experts for two days of exclusive networking and high-level insights into the Chinese private equity and venture capital landscape.

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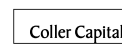
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Q&A:

CPPIB's Suyi Kim

Suyi Kim, global head of private equity at Canada Pension Plan Investment Board, on investing amid uncertainty, finding alignment with partners of all types, and the evolution of direct investment

Q: There is a lot of uncertainty around issues such as inflation, interest rates, and geopolitical risk. How is this impacting CPPIB's approach to private equity?

A: Investors are in the business of forecasting, and that has become much harder given all those uncertainties. If it's hard to predict an outcome, you apply a higher bar to it – and also focus on understanding the potential range of outcomes. In addition to wider operating assumptions, the interest rate hike changes entry and exit multiple assumptions. The higher the growth rate of a business, the larger the multiple adjustment. You also need to look at longer-term trading multiples. With inflation, you can make all kinds of assumptions as to how it might impact economies and businesses. The challenge is that most of us haven't seen this kind of inflationary environment in developed markets. It is quite an exercise to come up with a model and have confidence in it. That's why the bar gets higher and more diligence is needed when there is more uncertainty.

Q: What does this mean, in practical terms, for due diligence?

A: About half our global private equity portfolio is direct investment and half is funds. With fund investments, it is harder to time the market, but what I'm asking the team to do is to look at the longer-term track record of the manager, and its ability to handle crises. The most recent one is the global financial crisis. If a manager wasn't operational during this period, it is harder to predict that manager's ability to navigate a downturn. We also assess how a manager has



“The challenge is that most of us haven't seen this kind of inflationary environment in developed markets”

generated value. That comes from selecting an investment well, creating value during the ownership period, and exiting it well. We look at how revenue and EBITDA have grown, and the extent to which multiple expansion has contributed to returns. We are wary of managers that have been heavily reliant on multiple expansion.

Q: One industry response to the global financial crisis was the introduction of dedicated value creation teams. What might we see this time?

A: A key takeaway from the global financial crisis was that many investors globally didn't understand the macro factors that well. Private equity investing is bottom-up, so people would look at the companies, look at the industries, and not much outside of that. Coming out of the crisis, a lot of the large players set up their own macro teams or found a way to incorporate that perspective. We may see more of that going forward.

Q: Meanwhile, the pace of fundraising has slowed...

A: In the last couple of years, we have seen managers deploying capital very quickly and coming back within two years, which was unusual. We are going back to what we had before, which was four-year cycles. When there is uncertainty in the macro and business environment, buyers apply a higher bar, which creates a valuation gap between buyers and sellers, and in turn, leads to slower deployment and exits. We see that in our direct investment activity. Another reason for slower deployment is the leverage markets being closed. People were expecting the markets to reopen after Labour Day in the US, but that didn't happen because it coincided with higher-than-expected inflation numbers. As a result, the market for hung loans didn't get cleared. It probably won't happen until early next year. In the absence of debt, large deals are on hold.

Q: Have your views on specific geographies changed in the current environment?

A: Macro volatility is global; inflation is not global. When the Fed increases rates, it has a knock-on

effect on currencies, and on imports and exports, and no one is immune to that. When we think about what we might have done differently at this point, no one region or country stands out. That is why having a diversified portfolio is so important. We have a large private equity portfolio, which is well balanced and spread across North America, Europe, and Asia. The US is our largest market, and we are a bit overweight on the US going into this cycle. We are lighter in Europe. We have moved a portion of the European allocation to Asia over the last decade or so.

Q: How do you feel about China?

A: Investment has been slow for various reasons, not least because so much capital went into technology, and that sector has been in slow mode since Ant Group's failed IPO two years ago. But we will continue to invest in China and we continue to look for opportunities.

Q: How has the nature of CPPIB's engagement with GPs evolved?

A: We started a bit later in Asia and it's taking longer, given the overall maturity of the private equity market, but we have moved from passive co-investment to more active co-investment to co-sponsorship. A key part of our investment strategy is partnership. There are situations where we aren't working with private equity partners, but we still have partners – they could be other shareholders, management teams, or the founding families of companies. One of the lessons we've learned is it's great to have a partner, particularly in areas like value creation.

Q: Of the 50% of the private equity portfolio that is direct investment, how much of it comes through relationships with fund managers and how much through other partners?

A: We ask who is most aligned and who can create the most value. Oftentimes our private equity partners are most aligned. Most of our direct deals are investments alongside private equity partners, although in co-sponsorship situations where we play a more active role, they don't have to be ►

managers that we are invested with on the funds side. Different partners bring different kinds of expertise to deals.

Q: How does the sourcing process work for deals where you don't have private equity partners?

A: We have an active list of companies we would like to own; they could be private equity owned or not. We have 200 investment professionals in private equity globally. Our direct investment teams are organised by industry verticals. Last summer, when deal flow was very slow, people studied their industry verticals and identified companies they would like to own.

“Doing a solo deal is not in itself an objective. I tell our team all the time: the objective is to maximise our risk-adjusted return”

Q: What would it take for CPPIB to do a solo direct deal in Asia?

A: Doing a solo deal is not in itself an objective. I tell our team all the time: the objective is to maximise risk-adjusted return. What is the smartest way to do that? Buy well, create a lot of value, and sell well. Capable partners can help us in each of these areas, especially in value creation. We can't claim to add value across all industries and all countries. Apart from a small operation in India, our Asia team is based in Hong Kong and private equity is a local business. Having partners who are on the ground, day in and day out, is very important.

Q: Why is the PE team largely centralised in

Asia rather than distributed across the region?

A: I don't think it helps having people spread out too thinly. And even with local teams, we would still like to work with partners that bring deeper and broader resources. We like to have partners that can offer value creation capabilities we don't have internally.

Q: How do CPPIB's capabilities complement those of local partners?

A: We have experience and abilities in certain industries and areas. For example, we have a portfolio value creation team and one of the areas our team works with portfolio companies is in helping them with digitisation. We also have well-defined approaches to governance best practice, drawing on our expertise on the public markets side. We are an asset manager, with investments across different asset classes. A lot of our partners, focus only on private equity, so there is expertise we offer that they cannot. For example, we understand public markets and we have a long history in sustainable investing, which means we are called on to help companies preparing their IPOs.

Q: How often do you end up competing for assets with managers where there is a past relationship?

A: We partner with different private equity firms, based on the deal and the capabilities required. That is well understood. We pick our partners early on and work with them throughout the process for co-sponsorship deals. This incentivises partners to call us early if they want to work with us.

Q: To what extent is your long-dated investment horizon a competitive advantage?

A: It is a key differentiator. However, in the past few years a lot of private equity firms have raised core funds comprising longer duration capital or they are raising continuation vehicles and can hold assets for longer. We still offer a lot more flexibility because we don't have a 15 or 20-year fund life and we don't need to raise continuation funds, but the gap has closed a bit. ■

Sport investment: Into the value chain

Investors are increasingly drawn to the structural nuances, sticky customer bases, and long tail of ancillary opportunities that exist around professional sports. Asia's role is small but growing

Gujarat Titans won the Indian Premier League (IPL) at their first attempt in May as a commanding all-round display from captain Hardik Pandya helped thwart Rajasthan Royals in the final of cricket's most lucrative tournament. In addition to INR 200m (USD 2.4m) in prize money, they accrued significant brand equity – invaluable to an expansion team.

For CVC Capital Partners, which bought the Titans last year for INR 56.3bn (then USD 700m), the real payoff came a month after the final, when IPL announced the media contracts for 2023–2027. Disney Star and Viacom18 secured the television and streaming rights, respectively, for a combined USD 6.2bn. It was twice the size of the previous five-year contract.

"In IPL, like a couple of US sports, most of the revenues derive from a central pool comprising media rights that are auctioned off by the league," said a source close to the investment. "As a result, on-pitch performance doesn't drive outsize volatility in financial performance the following year. This means that owning a franchise is much closer to having a share in the league itself."

The private equity firm – which declined to comment publicly on IPL – has emerged as a prolific investor in the organisations that hold commercial rights to sports leagues, with exposure to rugby, football, and volleyball, chiefly in Europe.

IPL is the exception to the rule by virtue of its structural qualities, but CVC was also sold on the growth story.

This sporting property is unique in Asia for offering emerging markets fundamentals and Western-style commercial viability: IPL has more than 230m TV viewers, an estimated 10m-plus subscribing streamers, and its media rights are



"Barcelona love to say they have 800m fans globally, but they don't know who these people are, so they can't monetise them"

– Nikhil Bahel

worth more than those of the English Premier League (EPL).

Asia accounts for a tiny portion of global sports investment, which Pitchbook put at USD 50.9bn in 2021, up 56% year-on-year. An appreciation for the industry's resilience, as well as some pandemic-driven buying opportunities, have led global alternatives managers like Dyal Capital Partners and Ares Management to launch dedicated sports funds, while sector specialists grow in number and in assets.

"I can't think of a sport that isn't looking for capital right now. Wherever there is an opportunity to own a stake in the league will be very exciting to a private equity group," said Adam Sommerfeld, a managing partner at UK-based Certus Capital Partners, which advises on sports deals. Football takes up most of his time, but enquiries stretch from swimming to athletics to paddle tennis.

Lurking in the shadow cast by deals involving high-profile leagues and franchises, there is a long value chain extending from sport through media and entertainment. It is increasingly entwined with technology as franchises think about how to develop their fanbases and explore the full gamut of commercial opportunities. Investors of all types are getting involved.

"Barcelona love to say they have 800m fans globally, but they don't know who these people are and so they cannot monetise them," said Nikhil Bahel, a managing partner at Elysian Park Ventures.

"This is the evolution that is still to come – understanding your fan base, where they reside, the socioeconomic, age, and gender profiles. Maybe they aren't going to sell [Robert] Lewandowski shirts at USD 90 a pop to some of these, but they could start a small game for them."

Entry points

Elysian Park completes the loop that connects mainstream franchises, venture capital, and technology. It was originally the in-house accelerator of the LA Dodgers, a Major League Baseball (MLB) franchise controlled by a consortium with roots in finance and entertainment, and – together or separately – interests across basketball and football.

The firm divides its strategy into four categories – culture, health, technology, and commerce –

which encompass the likes of content, esports, data analytics for training, sports betting, and financial technology. It can take ideas directly to different levels of Dodgers management.

Opportunities in this value chain are increasingly evident in Asia, where appetite for direct investment in sport is often constrained by limited scale in developed markets and governance and access issues in emerging economies.

"When I started looking at these trends, India was so nascent in terms of sports. You couldn't invest in the same way as people were investing in the US and Europe," said Anand Krishnan, founder of FidelisWorld, who previously worked on sports franchise deals as CEO of Dubai International Capital.

"You had to go stage-by-stage, and the best target was the value chain – companies that were supporting these teams and leagues – because you could create value regardless of what happened to the sports. We thought the space would grow and that's exactly what happened. Now, we are seeing large private equity players have started investing in teams in Asia and India as well."

Krishnan questions the valuations paid for assets like IPL franchises, not because he doubts the upside being created by a rising middle class, but because he's uncertain how long it will take for expectations to meet reality. FidelisWorld invests in India-centric, digitally-enabled businesses. Of the six Fund I investments, three were directly related to sports; each was exited to a private equity buyer.

They include Sportz Interactive, a Mumbai-based sports data specialist picked up in 2016 after its US-based parent was acquired by Vista Equity Partners. The company provides data analytics and visualisations – and related social media products – to the likes of FIFA, Bundesliga, Facebook, and Fox Sports, leveraging local technical expertise and a lower delivery cost than in the US and Europe.

FidelisWorld is currently in the market, seeking up to USD 300m for its second fund. Australia-based XT Ventures, established last year by Craig Lambert, who previously ran local accelerator Slingshot, is raising AUD 50m (USD 32m) for its first. XT's strategy involves using the sports ecosystem as a proving ground for fitness and

wellness technologies that are then taken into the consumer realm.

“At Slingshot, we worked with corporates looking for innovation in product development. Sports franchises want to innovate in how they connect with fans and support athletes. We are looking for investments that are aligned to solving those problems and then we drag them out of sport and bring them to consumers,” said Lambert. “We look at sport as a laboratory, like the new NASA.”

Follow the money

The starting point for private equity investors in sports franchises remains media rights – and they echo the sentiment about drawing comfort in revenue streams that will not fluctuate wildly based on on-field performance. In this respect, US franchises are a good fit: popular across cycles, robust distributions from centralised media rights pools, and no threat of relegation.

Ian Charles, co-founder and managing partner of Arctos Sports Partners, which takes minority stakes in sports franchises across the major US sports leagues – basketball (NBA), baseball (MLB), American football (NFL), hockey (NHL) and football (MLS) – previously established secondaries advisory business Cogent Partners. He got into sports with a view to providing liquidity for franchise owners.

Charles describes sports franchises as a blend of core infrastructure, core real estate, and growth equity – so stable that he wouldn’t be surprised if some pension funds eventually make direct investments. For now, they use Arctos as a proxy. The firm closed its debut fund on USD 2.1bn last year (USD 3bn, including parallel vehicles) and is said to be targeting USD 2.5bn for its second.

“We help franchises make investments that are accretive to their businesses in areas like franchise acquisitions, real estate development, digital technology, fan engagement and media rights,” said Charles. “And we provide institutional investors with access to an asset class that has low leverage, is negatively correlated, provides historically attractive returns and has high barriers to entry.”

Unlike Europe, there are strict rules on leverage levels and ownership. It is only in the last three

years that NBA, MLB, NHL, and MLS have allowed private equity into franchises. Jeff Moorad, CEO of MSP Sports Capital, which invests in sports teams and leagues on a deal-by-deal basis, notes there is still a preference for individual ownership and NFL remains off limits to funds and institutional investors.

Investors link the regulatory shift in the US to a transition towards more sophisticated ownership – characterised by a surge in new owners from the technology and finance sectors – that has swelled asset value and a recognition of the need for growth capital and liquidity.

European football is viewed in a different context. Capital has poured into clubs, but not necessarily from private equity. AC Milan, which Elliott Management acquired from a distressed seller in 2018 and exited to RedBird Capital Partners in August, is an unusual case.

For many, high valuations despite loose spending controls and a consequent lack of profitability, plus the closer ties between on-field results and financial performance, most visibly demonstrated through relegation, are a turn-off. BC Partners, for example, entered the bidding for Inter Milan last year, but is now concentrating on sports leagues and media rights holders.

“A lot of clubs are cash flow negative, and I don’t think they are suited to the private equity model. Leagues are almost the complete opposite. You invest in them because you believe in the value of the broadcasting rights and those are much more predictable, profitable, and cash generative,” said Nikos Stathopoulos, a partner and chairman of Europe at BC Partners.

Since the start of this year, the Spanish and French leagues have closed deals with CVC, while their counterparts in Germany and Italy are said to have revived talks with private equity investors in recent months. This activity comes as many clubs are still struggling to repair the financial damage wrought by COVID-19 when stadiums were closed to spectators for months on end.

Systemic flaws?

There are ways to address the risks that come with investments in clubs. Sommerfeld of Certus Capital notes that when PE firms do participate, deals are highly structured. “There might be a



tiny slug of equity, but the rest is preferred equity or debt," he said. "Otherwise, they say it's too risky."

Second, investors can target multi-club platforms with diversified revenue streams. Fenway Sports Group, owner of MLB's Boston Red Sox, EPL's Liverpool, and NHL's Pittsburgh Penguins, and City Football Group, a series of football clubs built around the Manchester City brand, are among the best-known platforms. Their backers include Arctos and Silver Lake, respectively.

MSP Sports Capital is doing something similar in collaboration with David Blitzler, head of The Blackstone Group's tactical opportunities group and a minority owner of a string of US franchises. They have accumulated controlling stakes in four mid-size clubs in Germany, Spain, Portugal, and Belgium, with a view to realising sharing talent and resources.

"It's a Manchester City-like model but one we think makes extraordinary sense. We have already seen advantages through cost synergies. For example, instead of four sporting directors overseeing the clubs, we could have two," said MSP's Moorad.

This trend extends into Asia as well. Hiroyuki

Ono, a Singapore-based partner at ACA Investments, which is part of Japan's ACA Group, led the acquisition of Belgium's KMSK Deinze earlier this year with a view to creating a multi-club platform and cultivating a Southeast Asian fanbase. For reasons of cost, he is looking beyond the big five leagues of France, Italy, Germany, Spain, and England.

There are opportunities to buy into clubs and leagues within Asia, but challenges abound. An explosion of activity in China several years ago came to nothing as assets proved hard to monetise. Investors claim the domestic industry has since become so politicised it is virtually inaccessible.

Krishnan of FidelisWorld notes that "every league in India has come to my office at one stage," but business models are often flawed. He believes kabaddi has huge potential, but Disney Star has a majority interest in the local league, which would create conflicts around media rights. Other sports have been compromised by feuds between rival administrative bodies and multiple products.

Meanwhile, a tennis league went bankrupt



because the operator agreed to underwrite the risk for each of the four franchises, according to a source close to the situation. It was called upon to cover the shortfall when the franchises were unable to pay the players' appearance fees.

In Australia, questions about governance and transparency are few, but investment upside can be influenced by market size. Supercars Championship, which is responsible for a series of domestic touring car events around the country, spent 10 years in the Archer Capital portfolio before it was eventually sold to a strategic buyer late last year at a discount to the GP's entry valuation.

Supercars remained profitable throughout the ownership period, but Archer invested in the expectation that the media rights would continue to appreciate every time they came up for renewal. This didn't happen because of a shift in consumption habits, according to Tim Miles, a managing director at Miles Advisory Partners, who advised on both Archer's entry and exit.

"There was a move from free-to-air TV to streaming services, which meant the free-to-air package wasn't as valuable as before because there were fewer eyeballs and therefore less sponsorship," he explained. "There was still more value in free-to-air, so it didn't rebalance, and Archer couldn't move it to a service like Amazon

because the reduced profile would have been damaging to the sport."

Miles contrasts the Supercars situation with Dorna Sports-owned Moto GP, which is a global series of racing events. He contends that Dorna could transition to a low-price streaming model, given its audience is in the tens of millions; Supercars wouldn't have the critical mass to follow suit.

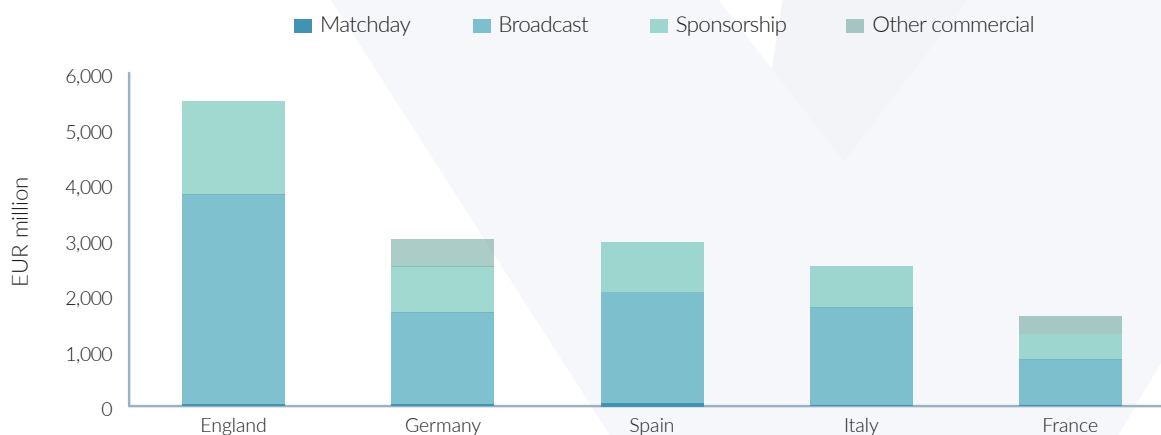
The issue has broader contemporary relevance following investments in New Zealand Rugby and Rugby Australia by Silver Lake and Ares Management, respectively. Silver Lake subscribed to a perpetual convertible security for NZD 200m (USD 117m), while Ares extended a AUD 40m (USD 26m) loan. Neither body is profitable, partly because they have relatively small domestic audiences.

"What they are buying is great global brands that generate enormous amounts of content valuable for consumption through multiple media channels," said Lambert of XT Ventures. "Media deals drive growth, but content is untapped in terms of the types of material you can monetise."

Modes of engagement

This is where franchises and sports technology meet. Building more touch points with consumers is an established theme, but COVID-19 is

Revenue sources for Europe's big five football leagues, 2020-2021



Source: Deloitte

thought to have pushed it up the agenda.

“The world is becoming increasingly digital, enabling more people to engage with sports, and growing the value and monetisation opportunities,” said Stathopoulos of BC Partners. “It used to be the only way you made money was by having people attend a match in a stadium. Now, you can engage with them 24 hours a day however you want.”

ACA's efforts to generate interest in KMSK Deinze among Southeast Asian football fans necessitate heavy use of different media channels. Last weekend, a documentary-style programme ran on national television in Vietnam – a key target market – that tracked the progress of some youth players recruited from a local academy to spend time in the KMSK Deinze academy system in Belgium.

ACA would like a portion of this intake to graduate to the first team, having noted the social media surge experienced by other European clubs that have signed Asian players. Capturing the “journey” is part of the story. The firm has also established its own short video platform that runs five-minute packages, in English, Vietnamese, Japanese, and Dutch, comprising highlights and other footage.

“We need new revenue streams and audiences,” explains Ono, who wants to reach 10m subscribers within five years. “We are installing web3 content as well because web3 and NFTs [non-fungible tokens] are everywhere in Southeast Asia. YouTube users can pay a subscription to remove advertising; clicking on ads on our platform gives you the chance to win some crypto.”

Danny Cortenraede, managing partner of the sports tech business at US-based early-stage investor Venturerock, advocates shorter-form content and centralised platforms as part of a digital media transformation strategy. This is based on a recognition that the younger generations targeted in most fan engagement initiatives would much rather watch highlights than an entire 90-minute match.

“Fan engagement and data are hot topics in the industry,” he said. “There are a lot of solutions around fan engagement, we’re looking into which ones really create value. Manchester United has 1bn fans across different channels, and they are leaning on Facebook and Instagram. How can they

build one channel for themselves? They want to own the content and the distribution platform.”

The 2022 edition of PwC’s North America sports outlook report, which tracks key industry trends, is littered with references to data analysis, differentiated content, NFTs and digital assets, sports betting, and virtual reality (VR). Each one is, to some extent, rooted in fan engagement, although some are so nascent it isn’t necessarily clear how they can be monetised on a stand-alone basis.

Various sports franchises have formed their own esports teams, ostensibly as a means of connecting with younger gamer communities that have a strong shared identity but don’t necessarily follow traditional sports. The world’s best-known esports team, FaZe Clan, is more valuable than most MLS franchises, but revenues are heavily skewed towards sponsorship, and it is still loss-making.

“Team dynamics and economics are difficult; in that sense, it’s no different to owning a Formula One team,” said Elysian Park’s Bahel. “You need to build a lifestyle ecosystem around it because the fan base is rabid, but your monetisation must be beyond the game itself. It’s about hoodies and t-shirts.”

Elysian Park has exposure to the space through Gamurs, an Australia-headquartered gaming and esports news publishing platform that has managed to achieve profitability on the back of advertisers wanting to reach its hard-to-access audience of 18–34-year-old males in English-speaking countries. CEO Riad Chikhani insists that no one has cracked the traditional sports-esports crossover.

“Anyone who tells you they have an answer to that is not being honest. The esports industry is still in its infancy,” he said. “One thing we do know is that under 13s and under 18s are not watching sports at anything like the level of 10–20 years ago. They follow influencers and gamers and streamers.”

Much to prove

Early-stage investors are interested in customised streaming services around which they can build communities comprising people with similar interests, from gamers to gamblers. These would ►

“We always talk about the lifetime value of the consumer – that will be the tip of the spear for future growth in sport”

– George Pyne

serve as natural platforms for highly targeted advertising campaigns.

VR also has significant potential across commercial and user applications. Sports franchises envisage a future in which they can sell seats at matches or access to training sessions hundreds of times over to fans around the world who, equipped with VR goggles, don't have to leave their homes.

“What I've seen in the last 6-12 months has been incredible, it's like you are in the game,” said Lambert of XT Ventures. Earlier in his career, one of the premium packages Lambert sold to rugby league sponsors in Australia was a seat in the coach's dugout during games. The coach didn't like it, but the club got AUD 50,000 a time. Using VR technology, this could be achieved with little intrusion.

The lack of unicorns in the sports tech space underscores how the developmental journey is still at an early stage. Sports betting is the exception, where US fantasy sports platform DraftKings made it all the way to a public listing. The legalisation of sports betting – in 36 states and counting – was a key move.

SeventySix Capital was convinced enough on the opportunity set to make sports betting central to its technology-oriented strategy. “It's fascinating how fast the industry has grown in the last four years,” said Wayne Kimmel, the firm's founder and managing partner, noting that some franchises now have betting partners as well as media partners, and direct partnerships with in-venue sports books.

Fantasy sports have taken hold in India as well, where RedBird followed up its minority investment in an IPL franchise last year by joining a funding round for Dream Sports. Like the US, critical mass was achieved on the back of a legal ruling, specifically that fantasy sports are games of skill and do not contravene bans on gambling.

Dream Sports and its direct rival, Mobile Premier League, raised capital aggressively during last year's boom and became unicorns. However, some investors are wary of renewed regulatory intervention.

It remains to be seen how aggressively sports franchises embrace technology as a means of driving fan engagement. Industry participants give mixed views on current progress. It is generally accepted that the US is ahead of Europe in terms of consumer tracking and data analytics.

Even in IPL where a generous media rights deal might invite complacency, there is a recognition that revenue sources will become more diversified as the sport – and India's economy – matures. The source close to CVC noted that the objective is to build the Titans not only as a force on the pitch but also as a consumer brand within Gujarat and nationally.

George Pyne, founder and CEO of Bruin Capital, which makes sports investments from a holding company structure and has exposure to Australia through marketing business TGI Sports, observes that new media will continue to grow even as old media players hold on as long as possible. Increasingly, the focus will be on depth and quality of engagement, not just the number of eyeballs.

“We always talk about the lifetime value of the consumer – that will be the tip of the spear for future growth in sport. You might have fewer people at the match, but the way you position products around them could generate a lot more value,” he said.

“Data, technology, and mode of access are converging. Today, the way fans engage and form communities around a team might be streaming a match. Tomorrow, it could be differentiated content, gambling, or other services. It's all wrapped around an understanding of the consumer, which means proper management of data is very important.” ■

Sport investment: China fading

Once a white-hot investment theme in China, and for Chinese investors looking overseas, sport has slipped into obscurity amid concerns about regulation and monetisation

I have been reading on a daily basis that the club's future is expected to be cleared up today. But, as I reiterated the other night, the reality is that the club's future has never been in question and our vision for Inter has been crystal clear since 2016," said Steven Zhang, chairman of Italian football club Inter Milan, addressing a shareholders' meeting following reports of a potential sale.

Inter has been controlled by Suning Holdings Group – owned by Jindong Zhang, Steven Zhang's father – since 2016, one of string of European football club acquisitions by Chinese investors around that time. A potential sale to BC Partners failed to materialise early last year, and a few months later, Suning's China-based electronics retail subsidiary required a USD 1.36bn bailout.

"This is a very complicated process," said a source close to the situation. "Everyone knows Suning is in deep financial trouble and that Inter is one of their most valuable international assets. Put those together and do the math."

Fosun Group, another previously free-spending Chinese company, is busy divesting assets as part of efforts to address a USD 36bn debt pile. However, Wolverhampton Wanderers, an English Premier League (EPL) club it acquired in 2016, is not for sale, according to Adam Sommerfeld, a managing partner at UK-based advisor Certus Capital Partners, who has worked on several sports deals for Fosun.

Wolves is one of five English football clubs known to be controlled by Chinese investors and there is a general expectation that any of them could be available for the right price, given how the Chinese government has soured



“There are lots of SPVs and when you investigate the cap stack you might find 10-15 people involved”

– Adam Sommerfeld

on extravagant overseas acquisitions. However, even with a willing seller, executing on these transactions could be complicated.

“We have a situation with a team in one of the English leagues where the local authorities cannot approve a sale because they are unable to determine that the individual in question owns the team and is able to sell it. This has made us reticent of China deals,” said Sommerfeld.

“There are lots of different SPVs [special purpose vehicles] and when you investigate the cap stack you might find 10-15 people involved, and they are all invested in one another’s funds. We’ve found Evergrande [a heavily indebted Chinese property developer] around a number of things.”

This represents a dramatic reversal of fortune that extends all the way from Europe to sports assets within China – and it runs contrary to the current global boom in sports investment.

Up then down

Private equity feasted on the periphery of China’s European football invasion. Hong Kong-based LionRock Capital retains a minority interest in Inter; it declined to comment on a potential sale. Trustar Capital and CMC Capital Partners both backed in City Football Group, the holding company for Manchester City and other related businesses; Trustar exited in 2019 and the status of CMC’s investment is unknown. IDG Capital has sold its minority stake in France’s Olympique Lyonnais.

However, a clutch of GPs rose to prominence in 2015-2018 through investments in other businesses situated in the sports and media value chain. They are now reluctant to talk about the experience.

CMC accumulated assets including the

broadcast rights to China’s domestic football league, sometimes through a long-dated investment platform. It declined to discuss these deals when asked by AVCJ earlier this year. Yao Capital, a private equity firm established by basketball star Yao Ming, is said to be inactive. Its website is inaccessible and Yao Ming’s co-founder didn’t respond to enquiries.

The China sports investment thesis in part originated in 2009 when Xi Jinping, the country’s newly installed president, shared his football dream – that China qualify for another world cup, host a world cup, and win a world cup.

A State Council blueprint published in 2014 designated sport a national strategic priority and envisioned the industry would be worth USD 750bn by 2025, 12 times the 2015 total. Football would spearhead this development, supported by a glut of new training centres and pitches.

Investors piled in, leading to the European football deals as well as a surge of capital into China’s domestic league that facilitated the hiring of high-profile international players. Much of the activity was driven by property developers and technology giants. Wanda Group, Fosun, Alibaba Group, and Tencent Holdings all set up sports units. So did Suning, as part of efforts to diversify from electronics into content.

The bid to monetise rising local interest in sport didn’t pay off. “Selling merchandise might be fine, but sports leagues haven’t been profitable in China,” said the source close to the Suning situation. “And if sport isn’t making money, then the value chain has no value.”

An investment professional with a China-focused private equity firm that has looked at sports assets, added that domestic football is a bad business. “There is no fan loyalty, tickets are dirt cheap. A lot of those investors tried to make back their money through real estate, but that didn’t work, so they turned to match-fixing,” he said.

Earlier this year, Chinese media reported that the Chinese Football Association summoned clubs to a meeting and warned them that it would work with the police to investigate and crackdown on match-fixing. This followed a series of investigations and prosecutions in the 2000s.

Investors still see upside in overseas sports assets that can command a following in China, ►

“It doesn’t make sense to buy something if there are not any market dynamics around it”

– Andy Mantel



notably live events. Wanda Sports Group acquired the Ironman brand in 2015 with a view to rolling out tournaments in China. It exited in early 2020 after pandemic-driven cancellations of events across its portfolio crippled business. Wanda Sports, which listed on NASDAQ in 2019, was delisted last year.

The China-focused investment professional lost out to Wanda on Ironman in 2015. He subsequently bid on endurance sports brand Spartan with a view to launching a TV series in China – as well as running events – to reach a wider audience.

Uncertain times

The overriding current challenge is uncertainty. A new five-year national fitness programme was unveiled in 2021, which positions sport in the context of health and wellness. There is an expectation that the industry will grow by two-thirds to USD 774bn by 2025, underpinned by investment in essential infrastructure like gyms, parks, and stadiums throughout the country.

Sommerfeld of Certus expects little in the way of outbound investment noting the emphasis is on domestic activity. Yet the source close to the

Suning situation questions whether social need will trump commercialisation in these deals.

This is playing out against what is described as a politicisation of sport. It came to a head in 2019 when the general manager of National Basketball Association (NBA) franchise Houston Rockets spoke out in support of protests in Hong Kong ahead of a preseason game in Shanghai between Los Angeles Lakers and Brooklyn Nets. Tencent cut the Rockets from its China streaming schedule.

It has contributed to a weakening in investor interest in China's domestic basketball league. Andy Mantel, CEO of Pacific Sun Advisors, launched Ten Events Ventures in 2020 to target China-related sports assets. He previously worked on potential investments in local basketball franchises but ambitions to take this further quickly faded.

"The league has been in a bubble for the past three years and they have started diluting the private ownership of basketball teams, some of which have been for sale," Mantel said. "It doesn't make sense to buy something if there are not market dynamics around it. At the same time, there's a risk the government could say, 'You can't do this.'" ■

Q&A:

BlackRock's Michael Dennis

Michael Dennis, managing director and head of alternatives strategy and capital markets for Asia Pacific at BlackRock, on co-investment, customisation, and what Asian investors want from alternatives

Q: What is the scale of BlackRock's private investment activity in Asia?

A: We taken a big step forward in terms of our investment footprint in Asia. Between 2018 and 2020, we were investing USD 1bn per year – equity and credit – from a private markets perspective. We are looking to grow to USD 3bn this year. We participate through global pools of capital and through Asia franchises in areas such as liquid credit, private credit, and real estate. We have USD 14bn in these solutions with dedicated Asia exposure, and most of that is liquid credit, where we are one of the market leaders. There has been a significant investment in talent in the last three years and our team has nearly doubled in size to around 180 alternatives professionals in the region. Within private equity, we have four areas of focus: direct investment, co-investment, secondaries, and primaries. We used to be heavy on primary fund-of-funds, but now it's much more about the other three. Our global private equity AUM is 45bn and co-investment forms the largest part, followed by direct and then secondaries.

Q: How is appetite for co-investment evolving?

A: We have the ability to deliver a far more diversified set of investments than any one manager, and a lot of clients are interested in having that conversation – more so than in the previous cycle. In 2018, it was very much about ramping up in Asia Pacific. Now, clients are asking how they can play across managers. And they want co-investment with expertise, someone to hold their hand through that journey. In addition to diversification, they get double the due diligence because our teams



“In 2018, it was very much about ramping up in Asia Pacific. Now, clients are asking how they can play across managers”

run diligence on transactions done by different managers and compare them.

Q: To what extent are co-investments sourced through relationships with GPs where there is a primary fund commitment?

A: We have relationships with more than 400 GPs and that doesn't necessarily mean we are LPs in their funds. Our co-investment business has evolved over the last 20 years, and we have expertise in different types of transaction. It's not about collecting LP rights around co-investment; the role we play is more like that of a partner and the GP brings us into the conversation because what we bring to the table has tangible benefits for underlying companies. We can follow a company through its lifecycle, providing capital in different forms, thanks to the growth of private debt and traditional bond businesses. Especially in this cycle, many issuers are looking for multifaceted relationships, so co-investment can be a steppingstone to broader conversations.

Q: How big a cheque can you write for a co-investment, and do you always look to co-underwrite transactions?

A: We are flexible on size. We have a healthcare specific co-investment business where we are doing USD 20m-USD 25m, and then we have a more TMT thematic where it's USD 200m-USD 300m. We do see situations where it is an auction process and the GP works to certain timetables and requirements, but we do more proprietary transactions, especially in the mid-cap space and in growth deals, where it can take time to build a consortium. We want to leverage our capabilities around different sectors and take a view on opportunities, rather than be a transaction taker.

Q: Would you avoid large buyouts?

A: We move between different deal types depending on the point in the cycle. Last year, we did less in growth investment and more with traditional buyout managers. We felt that valuations were getting extended in the growth space, especially for internet-based companies.

We pulled back from B2C and focused on B2B, working with GPs we thought would add value operationally, where we see a reasonably steady-state portfolio.

Q: BlackRock's name used to pop up in various growth-stage technology deals...

A: Those are often different pools of capital. We have a very large mutual fund business that makes long-only type investments, and sometimes it steps into pre-IPO rounds. There is a large technology-focused platform in our fundamental equities business, and it has certain products that take private risk alongside public risk.

Q: Have geopolitical and regulatory issues put you off investing in China?

A: Whatever the market, geopolitical and regulatory risks are top investment considerations. The main reason deal flow in China is slower is that there are still sellers and founders looking for valuations at 2021 levels. Public markets have taken significant drawdown across the board and private markets haven't done the same. That's not necessarily China-specific – we see the same in India and Southeast Asia. We need to be selective in growth-stage investments, but we continue to raise money across numerous vehicles that have Asia, including China, in their broader remit.

Q: How do direct investments differ from co-investments in terms of stage and sector?

A: We have a perpetual direct vehicle that partners with founders without the pressure of a 4-5-year exit. One of the best-known investments is probably Authentic Brands Group [the parent company of Sports Illustrated; BlackRock became the largest shareholder in 2019]. More recently, we launched Decarbonisation Partners with Temasek. That's an example of how we are trying to build portfolios around key themes that we think are on trend and where we can add value.

Q: What is behind the thematic approach?

A: We are tailoring to what we see as an

AFFINITY EQUITY PARTNERS

Affinity Equity Partners is an independently owned private equity fund manager and currently advises and manages over US\$14 billion of funds and assets, making it one of the largest independent financial sponsors in this region. Since 1998, the Affinity team has executed transactions with values aggregating US\$22 billion in 11 countries.



Towngas Smart Energy

Lead Investor

Investment in China's leading city gas and smart energy operations

November 2021



M-DAQ

Lead Investor

Investment in leading Singapore-based FinTech platform with global reach

August 2021

JOBKOREA

JobKorea

Lead Investor

Leveraged buyout of the largest online job portal operator in Korea

April 2021

PLAZA PREMIUM GROUP

Plaza Premium Group

Lead Investor

Investment in the #1 independent operator of airport lounges globally

February 2021



HDBank

Lead Investor

Investment in the 5th largest privately owned bank in Vietnam (by market capitalization)

December 2020



Serveone

Lead Investor

Leveraged buyout of the largest MRO company in Korea

May 2019



Scottish Pacific

Lead Investor

Leveraged buyout of Australia and New Zealand's largest independent financing provider to small and medium enterprises

December 2018

TRIMCO GROUP

Trimco Group

Lead Investor

Leveraged buyout of #1 speciality trims and labels supplier to the apparel industry

February 2018



Burger King

Lead Investor

Leveraged buyout of the exclusive operator of the Burger King franchise in Korea and Japan

April 2016
September 2017



MedicalDirector

Lead Investor

Leveraged buyout of the largest clinical and practice management software provider in Australia

May 2016



TEG

Lead Investor

Leveraged buyout of Australia and New Zealand's largest ticketing and vertically-integrated live events company

July 2015



Velocity Frequent Flyer

Lead Investor

Investment in a leading Australian airline loyalty program

October 2014



Loen Entertainment

Lead Investor

Leveraged buyout of the largest vertically-integrated music company in Korea

September 2013



Primo Group

Lead Investor

Leveraged buyout of Australia's largest meat processor

October 2011



Beijing Leader & Harvest Electric Technologies

Lead Investor

Buyout of the leading manufacturer of energy-saving electrical equipment in China

October 2009



Oriental Brewery

Joint Lead Investor

Leveraged buyout of the second largest brewery in Korea

July 2009



Loscram

Lead Investor

Leveraged buyout of a leading returnable packaging hire company in Australia

August 2005



Himart

Lead Investor

Leveraged buyout of Korea's largest consumer electronics retailer

April 2005

evolving client appetite around private equity. We are focusing on long-term structural trends – decarbonisation, digitisation, decentralisation – and staying tight to them. In infrastructure, we launched the Climate Finance Partnership for emerging markets renewables. We have a large energy transition fund and a large climate fund. We are trying to take a different approach to alternatives within a broader portfolio: it's not about doing aggregate buyout funds and multiple vintages of those, but taking a more thematic-driven approach, which is what clients are now looking for. Go back 10 years, there would be traditional buyout funds and venture capital in most portfolios. Now, some of our clients have private equity allocations of up to 40% of their portfolios and they are looking for diversification of risk. In our offering, rather than have a single

by major funds. We see credit becoming more widely adopted, for the lack of volatility and diversification it brings. There is also demand for customised access and more thought about the role individual investors can play in that customisation. It is very different to where Japan is right now. The rest of Asia is somewhere in between. At one end, depending on the institution and level of sophistication, there is a desire for real partnerships. At the other, groups like insurers are adding private exposure as quickly as they can to bring diversification and reduce volatility in their overall portfolios. We work with clients on their multi-year views against a backdrop of massive volatility in currency and rates, which is being felt across Asia in different ways.

Q: Currency depreciation has been flagged as a concern by Japanese LPs. How often does it feature in your discussions with investors?

A: Issues like energy security and portfolio diversification come up in every client discussion; they appear to be more pressing than shorter-term considerations like currency. What have been traditionally conservative organisations are becoming more proactive in how they think about portfolio development. Maybe their exposure to alternatives is 5% and they are asking what 20% looks like in the long term. That is reflected in actual commitments, not just in teach-ins or educational discussions.

Q: What challenges do Asian investors face when ramping up exposure to alternatives?

A: One of the biggest challenges is how they can get the most capital to be invested as quickly as possible. We have significant fund-of-funds businesses in hedge funds and in infrastructure, and we see huge demand for those because there's faster deployment and portfolio-type approach with a level of customisation. We also offer multi-alternatives asset solutions, and we are having a lot of discussions around that in terms of overall portfolio construction. The natural draw of alternatives was higher returns. Now, people are talking about getting high single-digit or low double-digit returns at scale in their portfolios. ■

“Rather than have a single fund that captures everything, we have defined teams following defined themes at defined levels of the risk curve”

fund that captures everything, we have defined teams following defined themes at defined levels of the risk curve. That is an important lens on how we think about private equity generally.

Q: What trends are you seeing in demand for alternatives from investors in Asia?

A: Asian LPs contribute 15%–20% of our total global alternatives assets, and there are some interesting trends in the region. In Japan, investors are still fairly underinvested in alternatives, so we see continued demand. There has been a pickup in conversations, especially regarding private credit and infrastructure. In Australia, PE and infrastructure are already widely used

China fundraising: Onshore vs offshore

Raising capital for China strategies is difficult right now, regardless of currency, but are geopolitical forces enabling the rise of renminbi-denominated funds at the expense of the US dollar?

China's private equity industry is unique in having two separate fund ecosystems, underpinned by different currencies and different investors. The popularity of US dollar and renminbi-denominated funds varies, often in response to shifting regulation, but most mainstream managers with a local presence recognise the value of having exposure to both.

This unusual dynamic creates an alignment of interest dilemma. LPs, especially on the US dollar side, want assurances that one pool of capital won't be favoured over the other. The standard GP response is that US dollar and renminbi funds target distinct opportunity sets, largely driven by foreign investment restrictions and divergent – offshore IPO vs onshore IPO – exit paths.

But US-China geopolitical tensions, and the prospect of economic decoupling, are redrawing the investment map. There is lingering uncertainty around offshore exits, particularly US IPOs, and whether foreign capital is welcome in certain high-growth industries. Some local investors believe the investment universe has narrowed for US dollar funds, with renminbi vehicles in the ascendency.

"Internal and external circulation in China are now relatively independent. The US dollar and the renminbi funds are moving further apart in terms of what they can do," said Frankie Fang, founding managing partner of Starquest Capital, which manages fund-of-funds and also makes direct investments.

"It's got to the point where some US dollar investors have shifted their thesis from being 'long on China' to being 'long on Chinese entrepreneurs' launching start-ups in other emerging markets with similar characteristics."

It is generally acknowledged that raising US



"Some US dollar investors have shifted their thesis from being 'long on China' to being 'long on Chinese entrepreneurs'"

– Frankie Fang

dollar funds for China has become incredibly difficult. Doubts were sowed in the minds of LPs during 2021 as a regulatory blitz clipped the wings of platform internet companies, made online tuition un-investable, and threatened to complicate offshore IPOs. The ongoing flash lockdowns tied to China's "dynamic-zero" COVID-19 policy have done little to inspire confidence.

Commitments to US dollar funds amounted to USD 20.5bn as of mid-October, roughly on par with the 12-month total for 2021. However, more than half of that went to a couple of VC managers with strong enough brands to defy the odds: Sequoia Capital China and Qiming Venture Partners collected USD 8.8bn and USD 2.5bn, respectively, for their latest vintages.

It is worth noting that the number of fund closes for 2022 to date – 25, according to AVCJ Research – is the lowest in nine years. Evidence of managers struggling to raise capital abounds.

FountainVest Partners, having hit the hard cap on each of its three previous funds in a matter of months, took 20 months to close its fourth just above target on USD 2.9bn. Similarly, BAI Capital launched its debut China fund in 2020 with every expectation of hitting the USD 750m hard cap. The regulatory imbroglio led to fundraising being put on hold for six months and a final close of USD 700m came in July.

Genesis Capital went to market with its third US dollar fund last year, seeking USD 1.2bn, but progress has effectively ground to a halt, according to a source close to the situation. BA Capital raced to a first close of USD 100m – against a target of USD 150m – for its first US dollar vehicle in 2020. Now, the process has been suspended until next year, a second source close to the situation added.

LPs note that China-based managers are offering all kinds of incentives in return for fund commitments. "We've never seen so much co-investment and secondaries. It used to be Indian GPs that were proactive on this but now it's the Chinese GPs," said one fund-of-funds LP. "All those managers in the USD 2bn-plus category, for example, are being very nice to us."

Others are pre-empting challenges by tweaking strategies and curbing targets. Legend Capital sought to raise USD 500m for its latest

technology fund – the same as last time – and then decided to exclude consumer tech and cut the target to USD 400m. Joy Capital's USD 300m target for Fund IV is lower than for Fund III and there is no sign of the accompanying growth vehicle present in the previous vintage.

Domestic dynamics

While there is certainly interest in the renminbi space – KKR recently registered to raise a local currency fund – it is not translating into increased commitments. Fundraising for 2022 to date is USD 20.3bn and it seems unlikely to pass the USD 32.7bn raised in 2021.

The reality is that participation in PE by banks through wealth management products was severely restricted in 2018, prompting a 60% year-on-year drop in fundraising, and the market has yet to recover. Government agencies and state-owned enterprises (SOEs) account for over 70% of capital in renminbi funds. All funds of CNY 10bn (USD 1.4bn) or more are now run by GPs with state-owned backgrounds.

"The problems for China's VC industry are much more serious than in 2018. Market-oriented fundraising is in full retreat. Everyone, including many well-known groups, are having difficulty raising capital," said Yucai Jiang, a vice president of Shenzhen Venture Capital Group, told a conference in August. "The industry must endure 3–5 years of pain. We are just entering the night; we are far from dawn."

This is reflected in the language managers use to describe fundraising. Trustar Capital, previously known as CITIC Capital Partners, announced this month that it had signed contracts amounting to CNY 1.5bn with the first batch of investors in its fourth renminbi M&A fund. No reference was made to the target size or whether there had been a first close.

"Even after the contract is signed, LPs can pull out of a commitment at the last moment or reduce its size, saying that the quota has been exhausted and they must wait for a new one," one local GP explained. "This has a knock-on effect on commitments from other LPs. You never really know whether you can meet your target until the money is in."

Uncertainty over fund commitments from



“If you add a semiconductor investment, it’s probably going to be on the renminbi side”

– Yipin Ng

local government LPs has been exacerbated by dwindling land sales amid the property market correction and rising pandemic-related costs. Every major Chinese city saw revenue decline in the first six months of 2022, with Shanghai posting CNY 94bn compared to CNY 380bn in the first half of 2021.

It is also worth noting that 2012–2017 was the peak period for establishing government guidance funds. Many of these vehicles are now entering the exit phase but distributions have been slow to come, making it harder to justify new commitments.

LPs that can make allocations to private equity managers often prefer to back local managers rather than funds launched by international GPs. One local investor recalled being pitched by Morgan Stanley last year regarding a CNY 1bn renminbi fund. They declined and the fund never achieved traction.

“We felt that their strategy was similar to that of other renminbi funds, but they had a preference for star projects, and their localisation is not as deep as that of domestic managers,” the LP said.

Several private equity firms have tried in the past to operate US dollar and renminbi funds in tandem – investing in the same assets on a pro-rata basis. This was the plan when CDH’s rolled out its venture growth strategy in 2015, but it was rendered impractical by China tightening controls on capital outflows and failing to push ahead on smoother approvals process for foreign investment.

Similarly, Trustar’s efforts to deploy the US dollar and renminbi tranches of its third fund in synch were complicated by a flurry of offshore investment activity and uncertainty over regulatory approvals for renminbi participation. Deployment

from the US dollar tranche outpaced the renminbi tranche. There was no parallel local currency vehicle alongside Fund IV.

Some managers do draw capital from both pools for deals, but many industry participants see US dollar and renminbi strategies as fundamentally different. The former are internet platform backers that like to write large cheques for big stories, prioritising innovation and less sensitive to valuation; the latter have shorter investment cycles, which leads to an emphasis on mature companies, cash flow, and profitability.

These are highly generalised characterisations, but they feed perceptions that some small and medium-sized enterprises now favoured by China’s policymakers for their role in addressing critical bottlenecks – often under the domestic substitution theme – wouldn’t meet US dollar fund criteria in terms of addressable market or upside.

“After IPO, such projects could have market capitalisations of CNY 4bn–CNY 30bn, which might be too small for US dollar investors. But for us, entering at a valuation of CNY 200m–CNY 300m and exiting at CNY 7bn–CNY 8bn, that’s a good fit. It translates into a ticket size of several tens of millions of renminbi,” said Peter Yin, founding managing partner at Inspiration Capital.

Sensitive sectors

The impact of regulation on strategic divergence, meanwhile, is multi-faceted. Web3 and crypto start-ups have no option but to operate offshore, so they will take US dollar capital. Consumer-facing internet has faded, partly because of the regulatory upheaval last year, and so US dollar investors are looking at exporting these business models to other emerging markets.

Deep-tech plays like semiconductors are regarded as renminbi plays because offshore capital, while not excluded from this area, is less popular with founders. However, this is a point of contention, with some US dollar investors arguing that their access is uninhibited.

“As a dual currency GP, it’s easier to answer the question of alignment of interest today because the two sides have clearly different roles,” said Michael Yao, a partner at ZWC Partners.

Dual-currency GPs claim to use a single strategy for both currencies and break down

investments by sector. However, certain sector teams are more likely to deploy renminbi than US dollars. “If you add a semiconductor investment, it’s probably going to be on the renminbi side,” observed Yipin Ng, a managing partner at Yunqi Partners.

Eric Gao, founder of semiconductor-focused financial advisor Winsoul Capital, endorses the view that companies in this sector are wary of taking US dollar capital. The potential impact on IPO prospects and market expansion are key considerations. The more sensitive the technology, the more heightened the concerns. Anything with military-industrial applications or government customers is for local investors only.

One Shanghai-based technology investor that recently led a funding round for a semiconductor specialist focused on 55-nanometre lithography used to make chips for the automotive industry recalls discussing with the founder whether US dollar investors should be included. They concluded that the technology was not too sensitive, but put a plan in place to remove these investors should regulatory issues emerge.

“Deep-tech players like semiconductor start-ups often dare not take US dollar funding and they don’t need it. Many renminbi funds are willing to back them. When it comes to US sanctions

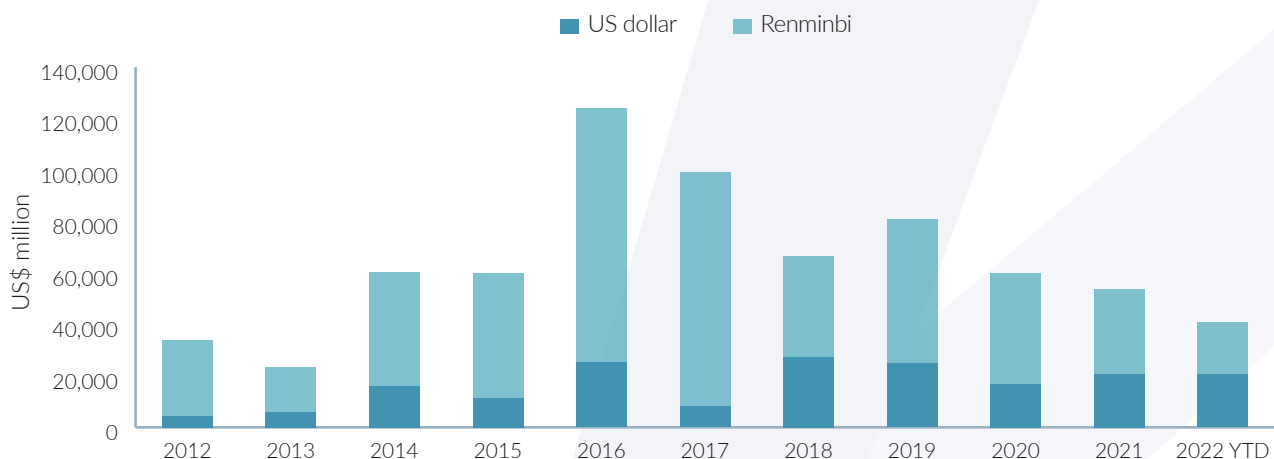
and the likelihood of an onshore IPO, it’s not only the company founder but also renminbi investors in the same round that will consider the various scenarios and share their views,” the investor explained.

A Beijing-based LP active in the US dollar space confirmed that for sensitive areas like semiconductors, GPs tend to invest through renminbi funds. “At least, they don’t need to force us out when US regulation tightens,” the LP noted.

Despite the regulatory issues for the semiconductor industry emanating from both China and the US, some of the best-funded start-ups – such as Biren, Enflame, Moore Threads, and Iluvatar CoreX – have received capital from US dollar funds managed by the likes of Sequoia Capital China, Primavera Capital, IDG Capital, GGV Capital, and Centurium Capital. However, the largest deals tend to be in renminbi.

There are two ways for US dollar funds to participate in renminbi-denominated rounds. First, the start-up is asked to switch designation from a pure domestic entity to a joint venture that can accept onshore and offshore capital. Second, the GP converts US dollars into renminbi through the Qualified Foreign Limited Partnership (QFLP) scheme. Entrepreneurs wouldn’t necessarily be able to tell the difference. ▶

China fundraising: US dollar vs renminbi



Source: AVCJ Research

“There are indeed more and more people looking to use the QFLP channel, but few have exited through it. Compared to the JV structure, QFLP is a pilot program that has more uncertainty,” said Mulong Gong, a Beijing-based managing partner at law firm King & Wood Mallesons. “Its accessibility can vary based on foreign exchange regulations in different cities.”

He added that QFLP operates at the fund level, not for single deals, and structures take over six months to implement, compared to 1-2 months for JV structures. At the same time, while QFLP uses renminbi to invest in deals, it cannot access sensitive sectors because regulators look through the structure to the ultimate beneficial owners.

The Beijing-based LP active in the US dollar space observed that the tax treatment for QFLP is not as clear as it is for JVs, which are subject to a 10% withholding tax upon exit.

In other areas, renminbi and US dollar investors may participate in different parts of the value chain. The supply chains for robotics and advanced manufacturing, for example, are largely in China but customers are often overseas. This means renminbi funds can invest in the technology and US dollar funds can target the outbound expansion phase.

Enduring the winter

Investment has slowed across the board in 2022; even industries such as semiconductor and artificial intelligence, which had received USD 11.8bn as of mid-October compared to USD 21.6bn for the full 12 months of 2021. Investors note that little happened in the second quarter when Shanghai was locked down. “Closing announcements were mostly from the first quarter or the end of last year,” said one GP.

At the same time, for all the talk of US dollars becoming less of a force in China, managers generally prefer that currency when fundraising. Offshore LPs are regarded as a more reliable source of capital that will re-up across several vintages, whereas their onshore counterparts are more like momentum investors. They follow the prevailing market theme and back a new round of GPs whenever it shifts.

“Local investors essentially rotate through the sectors. If a GP is not investing in the hot theme of

the day, how can it be expected to raise capital?” one local government LP observed.

In addition, US dollar investors are known for executing stricter due diligence, but also for respecting the autonomy of the GP and not interfering in daily operations. Moreover, unlike government guidance funds, there are requirements that investments must deliver value to certain cities or provinces – although there can be scope for negotiation in this area.

Regardless, Inspiration refused to accept some guidance funds in its latest renminbi vehicle, which closed recently on CNY 600m, because it wanted to focus on market-oriented opportunities and not be encumbered by investment-back requirements.

It is hoped that some best practices from the US dollar side will find their way into the renminbi ecosystem as local GPs and LPs become more sophisticated. However, politics and regulation appear to be the key forces in directing their trajectories and the extent to which these may converge and diverge.

Following the latest round of US sanctions on China’s semiconductor industry, the Beijing-based US dollar LP fully endorses the domestic substitution play, noting that backing the likes of Biren makes sense because the company’s strongest US competitor won’t be able to supply China. Exposure comes with risk, but this is manageable if these deals represent a small portion of the portfolio, the LP added.

Equally, others take the view that these shifts represent a temporary phenomenon and that, ultimately, US-China decoupling in high-end technology cannot be fully realised. Both sides emphasise opportunity rather than restriction, underscoring the fundamental optimism of investors.

“In 10 years, there may indeed be two systems and two markets, but that’s all. It doesn’t mean they won’t communicate or invest in each other,” said Jenny Zeng, a founding partner of MSA Capital.

“Chinese innovation has brought huge returns to LPs in the US and Europe, and most international investors make decisions independently rather than follow the will of government. I think that from the first quarter of next year, commitments to US dollar funds will start to recover.” ■

China semiconductor: Casualties of war

Private equity investment in China's semiconductor industry continues unabated despite intensifying US regulatory action. While start-ups are not explicitly targeted, many are feeling the heat

All is not well in China's semiconductor industry. Why else would a chip developer at the pre-Series A stage – that has yet to complete the tape-out process for its debut product ahead of manufacturing – be invited to acquire a rival of longer standing with accumulated revenue of CNY 20m (USD 3m)?

The Shenzhen-based company seeking a white knight is a consumer electronics chip designer. It has big-name customers like Vivo but its profit margin is less than CNY 1 per unit. In the second half of 2021, with consumer spending waning, revenue fell by 80%. This compares to a 25% retraction industry-wide, according to the founder of the pre-Series A start-up. Lower-end products were the most heavily hit.

Locked into fixed supply agreements with fabrication plants, inventory will continue to pile up on the Shenzhen company's factory floor. The founders knew they weren't in a strong bargaining position. They asked for CNY 2m in cash plus guarantees of continued roles for themselves under the new owner.

"We turned them down," said the founder of the pre-Series A start-up. "The only reason for us to consider the acquisition is to get access to their customer base, but their product type and price range are very different to ours. Given the market situation, we can't spend even one dollar unnecessarily."

It remains to be seen whether the Shenzhen-based company survives. Plenty of others have not. In the first eight months of the year, 3,470 semiconductor-related companies – defined as those with the Chinese character for "chip" in their registered names – have gone bust, according to Qichachai, a local business data provider. There ▶



“Domestic substitution is a very clear and certain theme. It creates opportunities for every segmented track”

– Alex Banh

were 3,420 closures across the whole of 2021 and 1,397 in 2020.

These challenges are playing out against a backdrop of an increasingly antagonistic China-US chip war and scandals linked to debt-laden Tsinghua Unigroup, the one-time pioneer of China's semiconductor self-sufficiency drive. But PE investment in the industry is not fading.

Indeed, the investment boom was triggered by an acceleration in the chip war in 2019, specifically US regulators placing Huawei Technologies and several other Chinese technology companies on a blacklist that prevents US companies from doing business with them. Suddenly, finding locally made replacements for imported components became a priority for all Chinese technology manufacturers.

By 2020, PE and VC players were looking for ways to leverage this trend. Investment in the semiconductor industry hit USD 7.16bn, up from USD 230m in 2019. It held steady at USD 6.7bn last year, although this doesn't include USD 9.4bn committed to the restructuring of Unigroup, and it has since kicked on. Nearly USD 9.5bn was put to work in the first eight months of 2022.

Investors aren't necessarily disheartened by the wave of bankruptcies. Rather, they believe consolidation could lead more rational industry development, with clear leaders emerging in each segment and greater emphasis on product quality.

"The semiconductor boom that started in 2019 attracted investors with no domain expertise, and this drove up valuations, but now that phase of high valuations has ended. This year and next year will be vintage years for semiconductor investment," said Raymond Yang, founding and managing partner of deep tech-focused WestSummit Capital.

He added that leading companies in the space are now raising capital at around half their targeted valuations; meanwhile, second-tier players are raising down rounds, if they can secure capital at all.

Sanctions to substitution

China's semiconductor demand dynamics are well-known. The country consumes more than 60% of global supply, and last year, imports of integrated circuits (IC) reached USD 432bn, up 23.6% year-on-year. They were responsible for 16% of national import value, according to customs statistics.

China's State Council wants the semiconductor self-sufficiency rate to rise from 30% in 2019 to 70% in 2025.

Industry research firm IC Insights believes those calculations of optimistic. It found that local suppliers addressed just 16.7% of local demand in 2021, up from 12.7% in 2011. It expects the self-sufficiency rate to reach 21.2% by 2026. However, if China-based manufacturing by foreign companies such as TSMC, SK Hynix, Samsung, Intel is excluded, the 2021 figure slumps to 6.6%.

"Domestic substitution is a very clear and certain investment theme. It creates opportunities for every segmented track. This is a space in which hundreds of start-ups can thrive, and it's not just for the next 3-5 years. Semiconductors will be a sunrise industry in China for the next two to three decades," said Alex Banh, a managing partner of specialist semiconductor investor IPV Capital.

Several LPs with US-dollar denominated assets, including family offices and fund-of-funds in Greater China, told AVCJ that semiconductor-focused managers are an essential component of their portfolios. But they are comfortable taking a "wait-and-see" approach.

On one hand, market conditions mean patience will not be penalised – there is no obvious advantage to committing early. On the other hand, it was reported earlier this month that the Biden administration is mulling restrictions on US investment in Chinese technology companies. It is deemed wise to put decisions on hold until the policy situation becomes clearer.

The investment restriction would be the latest in a string of measures targeting China's technology sector, especially the semiconductor space.

For example, the CHIPS & Science Act, which was signed into law last month, includes USD 52bn in subsidies for semiconductor manufacturers that set up factories in the US. In what amounts to an attack on China's longstanding manufacturing bottleneck, companies that receive funding must agree not to scale up their production of advanced chips in China.

Some industry participants challenge the economic rationale of the policy. Morris Chang, founder of TSMC, denounced the subsidies as "a very expensive exercise in futility" in an interview in April, noting it costs twice as much to operate a ►

semiconductor plant in the US than in East Asia.

While the US controls core technology and software, as well as key manufacturing tools, Taiwan-headquartered TSMC produces 92% of advanced semiconductor chips required for smart phones, laptops and ballistic missiles. US players like Nvidia, Qualcomm and Apple outsource almost all their manufacturing to Taiwan.

“This is the result of natural economic development. The US economy has developed to such a stage that chip manufacturing doesn’t really fit it,” said Jie Yuan, an associate professor at Hong Kong University of Science & Technology (HKUST), who leads the mixed-signal and sensory IC lab.

“It is still in charge of technology innovation for the chip industry, but manufacturing should take place somewhere that is more cost-effective. An artificial move against economic reality is not wise.”

Decoupling, still flourishing

The situation underscores how the chip war is more about politics than economics. China is often described domestically as the “country with no heart,” which plays on the fact that chip and heart are pronounced the same way in Chinese. This captures how keenly the paucity of semiconductor manufacturing capabilities is felt as well as the government’s resolve to address the issue.

At the same time, an emerging narrative in the US aligns the chip war with cross-Strait tensions and US national security concerns. Graham Allison, a professor of government at Harvard University, and Eric Schmidt, former CEO of Google, noted in a co-authored article that if Taiwan’s chipmakers went offline or came under mainland China’s control, the consequences for the US tech sector would be devastating.

“America is on the verge of losing the chip competition. Unless the US government mobilises a national effort similar to the one that created the technologies that won World War II, China could soon dominate semiconductors and the frontier technologies they will power,” they wrote.

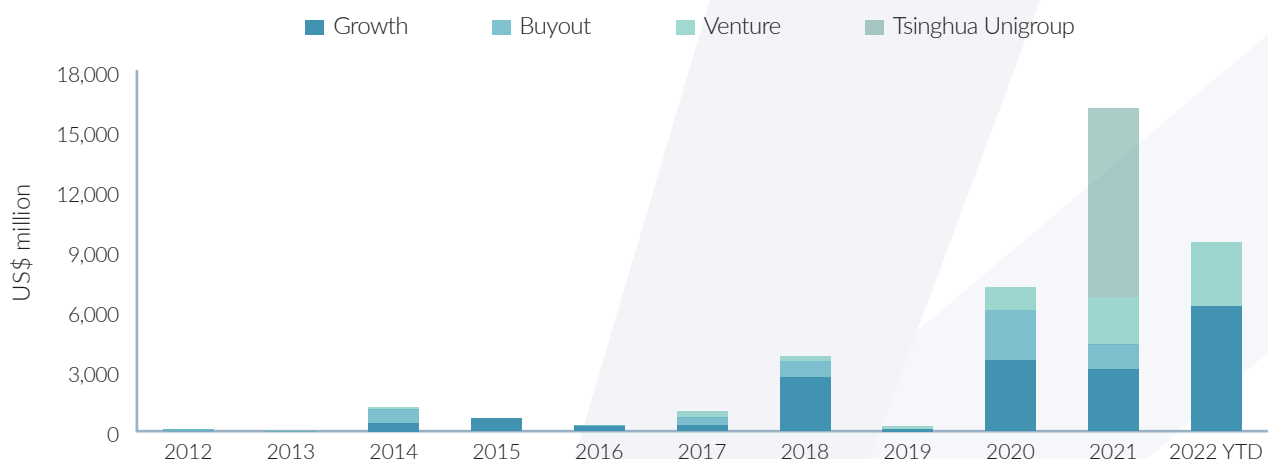
The polarising and politicised nature of the debate, on both sides, has already contributed to the destruction of global supply chains and may effectively split the world in two, Dylan Patel, chief analyst at SemiAnalysis, a boutique semiconductor research and consulting firm, told AVCJ.

“There will be more and more Chinese-only companies serving China and countries favourable to them and more companies that serve the US and its allies,” he said. “The world of technology may falter into two spheres of influence as the two countries escalate on actions against each other.”

Despite the moves to curtail chip



PE investment in China’s semiconductor industry



Source: AVCJ Research

development in China – with restrictions on exports of advanced chipmaking equipment and design software to the country among the most keenly felt – the domestic industry continues to grow steadily.

Authorities in Shanghai announced earlier this month that 14-nanometre chips are now being mass produced in the city. While global leader TSMC is still several generations ahead, having begun mass production of 3-nanometre chips, 14-nanometre chips are typically used in new energy vehicles, an emerging pillar industry in China and one in which the country is globally competitive.

Corporate performance is robust. Semiconductor Manufacturing International (SMIC), China's top fabricator, reported a 67% year-on-year surge in its most recent quarterly sales. Other listed industry participants, from video chip designer Shanghai Fullhan Microelectronics to smart card chipmaker Shanghai Fudan Microelectronics, are experiencing similar upswings.

According to Bloomberg, China is home to 19 of the world's 20 fastest-growing semiconductor industry companies, based on average performance over the past four quarters.

More importantly, the country's flash chips have rapidly achieved international recognition. Yangtze Memory Technologies (YMTC) has been shortlisted as a potential supplier of Nand flash memory chips used in Apple's iPhones. Facing widespread criticism in the US, Apple clarified that YMTC's chips would only feature in products sold in China.

YMTC recently unveiled its fourth-generation 3D Nand chip used in solid-state drives (SSD) – a top-of-value-chain product. In July, global leader Micron Technology released a chip with 232 layers of memory cells, up from 176, promising 50% faster data transfer speeds and 100% higher write bandwidth. YMTC skipped the 192-layer setup detailed in its original roadmap and went straight to 232, intent on matching Micron.

"YMTC is running ahead of other players in Nand with homegrown innovation. In a couple of years, we have no doubt that they will be cost competitive with even the best in the industry. They will structurally change the Nand industry,"

said Patel of SemiAnalysis. "Companies without a durable advantage in technology or large subsidies will face an apocalypse regarding their future business viability."

Trouble at home

The success of YMTC wouldn't have been possible without Unigroup, which established and seeded the company through the National Integrated Circuit Industry Investment Fund, also known as the IC Fund or Big Fund. The first of these vehicles – managed by Sino IC Capital – closed on CNY 138bn in 2014 and a second launched in 2019 with initial capital of CNY 200bn.

Unigroup and Sino IC achieved international prominence following attempts to buy assets overseas, including a bid for Micron in 2015. Most of these were either rejected or blocked by US regulators. They were prodigious investors domestically as well, and the weight of debt-fuelled acquisitions at home and overseas eventually pushed Unigroup into court-ordered bankruptcy restructuring last year.

Since then, the leadership of Unigroup and the Big Fund have been placed under investigation for suspected legal violations. Seven Big Fund executives have been implicated, including Jun Lu, the former head of Sino IC, Wenwu Ding, a general manager of the Big Fund, and Weiguo Zhao, who previously led Unigroup.

"[These investigations] suggest that the fund is deeply politicised in ways that are unlikely to produce effective investments," said Chris Miller, an associate professor at The Fletcher School at Tufts University.

"When the Big Fund was first created, some analysts saw this as adopting the best features of a private sector 'venture capital' model. The investigations at the top of the Big Fund are evidence not of a venture capital mentality, but of political intrigue. The more China's semiconductor investments are politicized, the less likely they are to produce viable companies."

An Alibaba Group-led consortium was poised to bail out Unigroup, but the bid reportedly faltered amid concerns about the e-commerce giant's US listing and heightened disclosure requirements tied to closer regulatory oversight of Chinese companies trading on US exchanges.

“The investigations at the top of the Big Fund are evidence not of venture capital mentality, but of political intrigue”

– *Chris Miller*

In the end, an investor group led by state-owned Jianguang Asset Management (JAC Capital) and Wise Road Capital – described as an international Asian growth capital investor – secured the restructuring mandate. Zhao immediately objected to the deal, arguing that it would contribute to losses of CNY 73.4bn, but the restructuring was completed in July.

The Big Fund was widely regarded as a “gold finger” investor: whatever it touched would see a spike in valuation. Holdings in the likes of SMIC and YMTC have delivered strong returns. However, compensation was structured like a state-owned enterprise rather than a VC firm – fixed salaries, no incentives – and there were reports of executives making personal investments on the side.

“What we lack is a proper repair system. We rectify an industry by rectifying individuals, and this means those in leading positions are no longer willing to take responsibility. They just play safe,” said a Beijing-based tech investor.

He added that investments by the second Big Fund overlap considerably with those of its predecessor. Moreover, the portfolio companies, including Shenzhen-listed Naura Technology Group and Advanced Micro-Fabrication Equipment (AMEC), don’t really need external liquidity.

Know your risks

As the politicisation of China’s semiconductor industry ramps up, private equity investors looking to back new domestic champions that benefit from domestic substitution face an array of risks. Chief among them is the widely held assumption that US dollar-denominated funds cannot back local chip start-ups.

Both WestSummit Capital and IPV Capital

stated that, to date, they have experienced no problems making investments in the industry through US dollar pools of capital. Exits are also smooth. While listing on Shanghai’s Star Market can be a protracted process because of the backlog of applicants, the criteria and credentials remain the same, WestSummit’s Yang noted.

In recent years, private capital has gravitated towards artificial intelligence (AI) chips, also known as GPU or CPU chips. The targets are often young start-ups with products years away from commercialisation yet helmed by founders or teams that previously worked for established technology companies.

Cix Technology, a CPU chip designer, is a case in point. The start-up has raised USD 100m since across three rounds since its establishment in October 2021, including a pre-Series A in July led by Nio Capital and Qiming Venture Partners. Led by a CEO who previously served as system-on-chip (SoC) director at AMD, Cix aims to create ARM-compatible CPU SoC designs.

Biren, which was founded by a former president of AI specialist SenseTime, is further along a similar path. It has raised CNY 4.7bn since 2019, most recently securing USD 410m in Series B funding in March 2021 from US dollar and renminbi funds. Ping An Insurance, Country Garden VC, and New World Development took the lead, with the likes of Source Code Capital and BAI also participating.

One investor in the round told AVCJ that Biren is now valued at around USD 2bn, up from USD 800m a year ago. The uptick partly reflects the company launching its first GPU chip, which surpasses Nvidia’s high-end A100 series on certain specifications. However, the investor noted that Biren cannot match Nvidia’s key asset – the Cuda platform, which serves as an ecosystem for gathering users.

Regardless, the company can count on plentiful support from domestic customers in need of alternatives to overseas products. But there are still risks – specifically, that only TSMC can produce these chips. The US has already blocked TSMC from supplying Huawei. A second investor suggests it may do the same to Biren, should the chip war escalate.

“This would be a sword always hanging over your head,” the investor added. ■

Q&A: Northwestern University's Tianhao Wu

Tianhao Wu, a managing director in the investment team at Northwestern University's endowment, on adding new GP relationships, addressing China risk, and pursuing geographic diversification in Asia

Q: What role does private equity play in Northwestern's overall investment programme?

A: Over half the portfolio is in private markets [the overall endowment has approximately USD 15bn, of which 23% is in venture capital, 15% in private equity, and 15% in real assets], and it has contributed to healthy returns. Now, though, we expect venture distributions to be slow for a period. We are constantly monitoring contribution pace and distributions, and running stress test scenarios. Our programme is mainly the US and Asia, and Asia is mostly China and India. About 9% of the entire endowment – split half-half between public and private – is invested in China. It has fallen from 14% two years ago, largely because there were strong distributions in 2020 and 2021, but since then, the markets have repriced a lot, especially on the public side for tech companies.

Q: What are the current priorities in portfolio management?

A: We have close to 110 active relationships – 60% of them in the private markets space – and we want to consolidate them, focusing on high conviction managers. This will happen step by step. We are open to secondaries; we sold some of our PE assets last year, raising a few hundred million dollars. However, pricing was very strong last year, and conditions have changed since then.

Q: How did you address the surge in re-ups last year and early this year?

A: It was crazy. We've never seen fundraising at that pace before. There were a lot of re-



“We have six GPs in China, and we could re-up in those, but adding a seventh in the near term would be difficult”

up decisions and because I joined recently [Wu followed Amy Falls, his CIO at Rockefeller University, to Northwestern last year], every re-up decision was a re-underwriting decision. This created a lot of work, but it was a good exercise, and we decided against re-upping with several GPs. The worst thing you can do is overcommit during a bull market, because when things go down, you don't want to be overallocated.

Q: Are you establishing new GP relationships?

A: The bar is higher for new relationships – there are liquidity constraints, and the cost of capital has risen, so our risk premium has gone up. However, we are still open to adding new relationships.

Q: Including in China?

A: It's harder. We want to maintain or increase our exposure to Asia because the region contributes 40% of global GDP, it is growing faster than the rest of the world, and it has strength in entrepreneurship and innovation. But we need more diversification by geography. We have six GPs in China, and we could re-up in those, but adding a seventh in the near term would be difficult. We must be mindful of the regulation situation. There are proposals in the US about restricting the role of US capital in certain sectors in China, including technology. For example, there is talk of a reverse CFIUS [Committee on Foreign Investment in the United States] process whereby US outbound investments would be screened. We need to figure out whether institutions like us are responsible for compliance and reporting or whether that falls to the GP. It's possible that a Chinese fund with US institutional investors would have to go through an additional regulatory process for some deals. If a highly restrictive regime is introduced, I could see GPs doing separate vehicles for US and non-US LPs.

Q: How are you navigating hard tech, given the surge in funding for this area?

A: There has been a shift from consumer internet to hard-tech and software-as-a-service (SaaS). It's debatable whether SaaS will continue to be

attractive. Part of the thesis was that comparable companies in the US were trading at 30x price-to-sales, but now valuations have collapsed. Within deep-tech, there are a lot of nuances. Robotics for factories and logistics are fine, and then some areas of semiconductor are too sensitive while others are not. Generally, we find that GPs tend to be more on the application side, targeting areas like automation where development is in line with what the government wants to achieve.

Q: To what extent are China managers turning their attention to markets like Southeast Asia?

A: We are seeing that a lot. As an LP, we support innovation and investing in areas with entrepreneurship and talent. There are lots of situations where Chinese business models have been taken into other markets, and we see Chinese entrepreneurs going to Singapore, Indonesia, and Vietnam to start companies, often with an engineering team in China and a local team for execution. The question is whether there are enough opportunities.

Q: What is attractive outside China?

A: Our India exposure is about half the size of our China exposure, mainly venture capital. In the last couple of years, India has done very well, helped in part by money that was earmarked for India being rerouted to China and by booming public markets. We don't have anything in Southeast Asia, but we are interested. We have discussed internally whether we need a dedicated Southeast Asian GP, or we are fine backing regional and global managers investing in Southeast Asia. We have one VC relationship in Korea, which is doing very well, and we are interested in Japan and Australia.

Q: How do you go about adding a geography?

A: We look at the size of the market and the opportunity set, and whether it reflects structural or temporary change. We don't want to jump in, see the tide turn, and get trapped. Assessment is harder than before because we are living in a world of greater deglobalisation, more government intervention, and heavier industrial policies. ■

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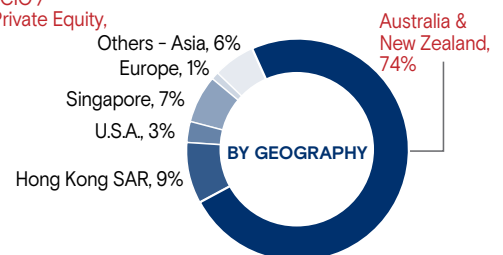
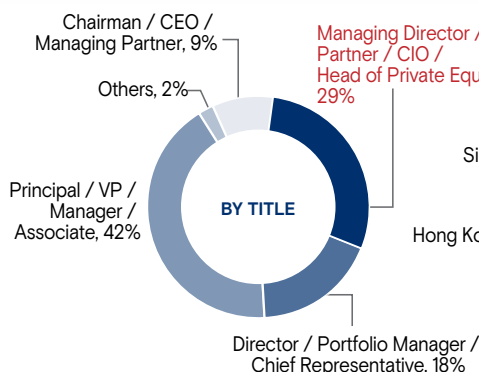
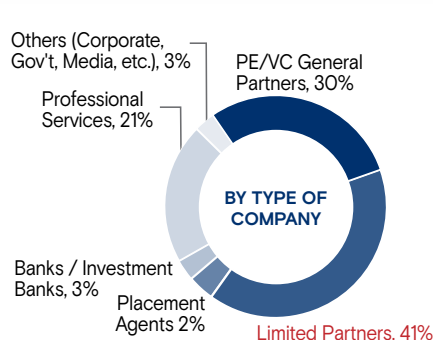


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