25 years of Asian private equity and venture capital

1988 – 2012

ASIAN VENTURE CAPITAL JOURNAL

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Jag Dhaliwall

+65 6329 9658

jag.dhaliwall@principle-partners.com

Will Tan

+65 6329 9659

will.tan@principle-partners.com

www.principle-partners.com

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SILVER JUBILEE

Allen Lee
Publisher
Asian Venture Capital Journal

Looking back at the development of private equity and venture capital in Asia is an interesting exercise. Having been fortunate enough to watch from ringside seats as the industry grew and grew, I would describe its progress as nothing short of spectacular.

What was then nothing more than preliminary venture capital had a relatively good start with a number of bright individuals coming together and capitalizing on the opportunity to provide value-added financing to Asia-focused companies. There were no control transactions but the investment rationale was different from the present – capture a piece of the growing Asian consumer market or help Western companies outsource to Asia. Structures were less complicated and there were plenty of blunders and mishaps along the way. (Anybody remember Siu Fung Ceramics?)

It wasn't until 1997 that the industry picked up speed when the Asian financial crisis delivered the first of three major catalysts that turned private equity into what it is today. Seeing early movers like TPG Capital-backed Newbridge Capital complete restructuring and turnaround deals for distressed companies, many major Western firms set up in the region to capitalize on this newfound buyout opportunity.

Catalyst two was the 1999-2000 the dot-com boom, which catapulted venture capital into a class of its own and Asian start-ups along with it. Virtually anything with an internet strategy – it didn't matter if it worked or not – enjoyed sky-high valuations. When the bubble eventually burst it signaled a nuclear winter for VCs everywhere.

The third catalyst was China's WTO accession in 2001, opening up the country to foreign investment and a clear signal for private equity firms to ramp up their exposure to the region even further.

The numbers racked up over the last 25 years are staggering – assets under management have grown 40-fold and that doesn't include capital from global funds – yet these stats pale in comparison to the one factor that made Asian private equity unique: the people. As we all know and preach, private equity is ultimately about people – savvy investors investing in companies with strong management teams, whether they are founders, entrepreneurs, new or old management, it doesn't really matter.

AVCJ has acted as the voice of the industry throughout this first quarter of a century. In the pages of this special publication, you will gain insights from some of the smartest and indeed most interesting people in the world, all of whom were on the ground witnessing different phases of the Asian private equity revolution.

The publication is structured around milestones in the development of private equity and venture capital in the region. Starting from the early years with pioneers Lewis Rutherfurd and Ta-Lin Hsu, we take in the Asian and global financial crises, the rise of China and India, and the reemergence of Indonesia on investors' radar screens. Representatives of global buyout firms and independent regional and national operators discuss the development of private equity in their respective markets.

And, for those of you who don't know Affinity Equity Partners' K.Y. Tang personally, there is more than meets the eye as he shares with AVCJ readers the best of his annual "top 10" lists – a sideways look at industry bugbears that is, to say the very least, spot on.

This collection of interviews will hopefully provide a snapshot of the individuals, funds and firms that have left their mark on private equity in Asia over the last 25 years. AVCJ is proud to be part of this industry and we will continue to do our best to provide the news, data and analysis it needs to reach new heights.

Contents

AVCJ ASIAN VENTURE CAPITAL JOURNAL

Managing Editor
Tim Burroughs (852) 3411 4909
Senior Editor
Brian McLeod (1) 604 215 1416
Staff Writer
Alvina Yuen (852) 3411 4907
Andrew Woodman (852) 3411 4852

Creative Director
Dicky Tang
Designers
Catherine Chau, Edith Leung,
Mansfield Hor, Tony Chow

Senior Research Manager
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Research Manager
Alfred Lam
Research Associates
Kaho Mak, Jason Chong

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Conference Administrator
Amelie Poon
Conference Coordinators
Fiona Keung, Jovial Chung

Publisher & General Manager
Allen Lee

Managing Director
Jonathon Whiteley

Chairman Emeritus
Dan Schwartz

Incisive Media
20th Floor,
Tower 2, Admiralty Centre
18 Harcourt Road,
Admiralty, Hong Kong
T. (852) 3411-4900
F. (852) 3411-4999
E. info@avcj.com
URL. avcj.com

Beijing Representative Office
Room 1805, Building 10,
Jianwai SOHO, 39 East 3rd-Ring Road,
Chaoyang District,
Beijing 100 022, China
T. (86) 10-5869-6205
F. (86) 10-5869-7461
E. beijing@avcj.com

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The industry leader

Henry R. Kravis, co-founder, co-chairman and co-CEO of KKR, first visited Asia in 1978. He argues that going long and going local is the key to building a successful PE franchise

It is often said in the US that there are three secrets to success in business: location, location and location. Nearly 35 years since my first visit to Asia, I have come to believe that the three secrets to success in this region are: localization, localization, localization. This belief has been a guiding force for KKR's growth in the region and, consequently, a major factor in our success and that of our partners.

I first started coming to Asia in 1978, and made my first trip to China in 1993. But it was only in the early 2000s that we started thinking about establishing KKR Asia. When George and I first discussed bringing KKR to Asia, we recognized the need to align the firm's worldwide capabilities with the unique needs of each market in the region.

In 2005, I came out with Joe Bae to see if this was the time to establish KKR Asia. I remember returning to the US after a three-week trip to Japan, Hong Kong, mainland China and Singapore that included more than 60 meetings, and saying to our partners, "If we're going to do it, we have to take a long view on this. And we are going to have to do it locally."

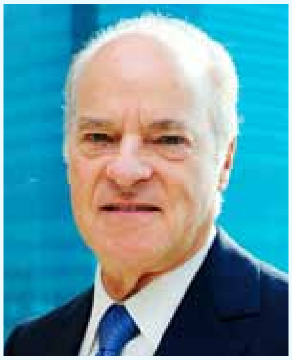
And that's what we have done. Taking the long view involves more than just raising capital. It means bringing people together in mutual understanding and trust, being committed to understanding local business environments, their unique challenges and opportunities, and the specific needs of its entrepreneurs, investors, workers and business leaders. Being good citizens makes us better investors.

In 2005, KKR opened in Hong Kong. Then, it was just Joe Bae, one of our youngest partners, and Justin Reizes, now head of KKR Australia. Their mission was to build Asia step-by-step, finding the right local team in each market.

We knew the more time we invested up front, the greater and more sustainable our returns would be. We decided to open one office per year, and only when we were certain we had the right local leadership to build upon.

Building up

What Joe has been able to do is build KKR Asia into very local franchises. The seven geographic teams we have built over the past seven years are comprised of people born, bred, educated, living and doing business in their home country, not people who fly in for a deal and then leave as soon as the closing occurs.



These teams are made up of an unparalleled global network of senior advisors who have deep relationships in the region as well as industry and operational expertise that is leveraged to assist our portfolio in both "going global" and integrating global best practices into local markets throughout Asia.

Foremost among these are our KKR Capstone executives. Working closely and collaboratively with our portfolio companies, Capstone executives bring extensive, hands-on international managerial and operational experience across a wide range of industries to enhance the operational value of our investments and to deliver sustainable change. We now have 16 members of the Capstone team in Asia, and we have the capability to work with our companies in their local language.

As impressive as Asia's economic growth has been, and as optimistic as the outlook is, the relative under-development of the region's capital markets poses a serious challenge to maintaining this trajectory over the long-term. Potentially hundreds of billions of dollars will be needed to finance future growth, and private capital is helping bridge the gap and underwrite tomorrow's.

In all, 28 of KKR's 79 portfolio

companies are based in Asia, representing an investment of almost $5 billion in equity. Our expertise and our flexible approach to investing in a dynamic global economy are reflected in the diversity of our portfolio companies in Asia, and in how these relationships are structured: KKR owns a minority stake of the Chinese start-up, China Modern Dairy, and is a majority owner of Oriental Brewery, a Korean beer-maker. We also have built strong partnerships with institutional investors such as the National Pension Service of Korea.

Looking forward

Three decades ago, our deliberative approach to developing our strategy for the region, with emphasis on cultivating strong relationships, seemed out of touch with the high-flying spirit of the era. Today, the evidence is strong that this approach was the right one. The Asia-Pacific region is the fastest growing segment of KKR's global PE business. Since opening Hong Kong in 2005 with two executives, we have added six more offices with close to 100 executives.

In seven years, we have achieved our goal of building local teams throughout the region to bring the best of KKR's values and network to Asia, while maintaining flexibility across multiple markets. KKR Asia today stands for global expertise delivered with local resources, marked by proven experience in operational value creation, capital markets, public affairs and stakeholder management.

Having achieved our initial goal, the task before us is clear: We will build upon our success and strengthen our company and the region, by continuing to build and strengthen relationships at the local level. And, most importantly, the "long view" will remain our guiding vision as we move forward together toward even greater prosperity in the years to come.

25 years of the AVCJ Forum

Over the past quarter of a century the AVCJ Private Equity & Venture Forum has emerged as the region's leading meeting place for institutional investors, fund managers and industry advisors from around the world. Here are some snapshots...

1999

Dan Schwartz (left) & Jean Eric Salata

2000

(From left to right) Hareb al Darmaki, Georges Sudarskis, Ta-Lin Hsu & William Perry

2002

(From left to right) Michelle Mak, Dandan Liu, Rebecca Xu, Anthea Au Yeung & Wendy Zhu

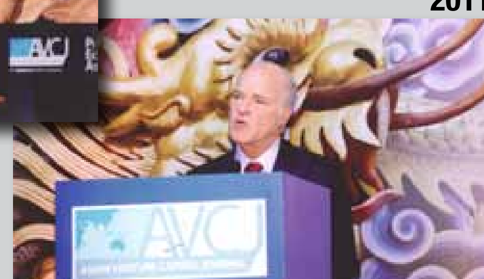
2004

K.Y. Tang

2009

David Bonderman

2011



Henry Kravis

The first editor

Richard Radez, now president of boutique investment bank Russell & Company, was the man responsible for Volume I, Issue 1 of Asian Venture Capital Journal

Clients sometimes ask you to do unexpected things – such as start a publication about Asian venture capital. Normally, Russell & Company provides consulting and capital-raising services for market entrants. Twenty-five years ago I had been advising Lewis Rutherfurd of Inter-Asia Venture Management about fund raising for an Asian "venture capital" fund. During the course of this assignment, we realized that many institutional investors, both outside and inside Asia, knew nothing about VC prospects in the region.

I still remember Lewis looking at me and saying that he wanted me to start the Asian Venture Capital Journal. Inter-Asia would put up a bit of money to get it started, but I would have to recruit staff, get out the first issues, and then raise capital to cover subsequent operating costs. I'd never started a publication before but suddenly I was chairman of the enterprise.

Volume I, Issue 1, was published in January 1988. Looking back at the inaugural editorial, I wrote: "In many ways, the venture capital industry in Asia is at a takeoff stage." So true. Inter-Asia was the first professionally managed venture capital firm to be set up in Southeast Asia. Japan had about 40 VC firms and China was in the process of setting up its first state-sponsored VC enterprise. I would be surprised if there was more than several hundred million dollars under management at that time.

Fast forward 25 years and there is more than $400 billion under management in Asia. And AVCJ has grown to encompass a larger and more sophisticated industry, with journals, directories and conferences covering everything from start-ups to buyouts. Yet its primary function is unchanged: bringing Asian private equity and venture capital to interested parties around the world. I congratulate Allen Lee and his team on what they have accomplished.

Looking forward

But what about the next 25 years? I think that the Asian PE and VC community faces three significant challenges: returns, competition and fundraising.

According to Cambridge Associates, at the 10-year mark, returns from Asian private equity funds are no better than the Morgan Stanley Emerging Markets Asia (MSEMA) Index. However, investors expect at least a 300-400 basis-point premium over a public equities index. The message is clear: Returns from Asian private equity funds have got to improve – significantly.

As for competition, it has arrived in a big way. The likes of The Carlyle Group, Bain Capital, KKR and The Blackstone Group have established regional operations. They have been joined by a host of indigenous players, ranging from pan-Asia buyout funds to niche country vehicles. With the influx of infrastructure and real estate vehicles as well as hedge funds, Asian private equity now finds itself as a subclass in an alternative asset class.

When it comes to fundraising, it's really a case of "haves" and "have nots." Global buyout firms are firmly in the former category, well equipped with in-house staff to comb through the LP community in search of that last $50 million commitment. As for the rest, they must get serious if they are to raise capital. This means devoting more resources to investor relations in order to keep existing and potential LPs informed on a continuous basis.

I will close on a serious note. While The Asian private equity and venture capital community faces challenges, the community itself is well established and also well serviced – by, among others, an industry journal that remains informative and authoritative after 25 years.

Chairman emeritus

Dan Schwartz, owner and publisher of Asian Venture Capital Journal between 1990 and 2006 and now the title's chairman emeritus, picks his highlights from a quarter of a century

Twenty-five years ago, Hong Kong was still a British colony; the Berlin Wall was still standing; investors were oblivious to China and India. For all intents and purposes, the industry didn't exist. Private equity and venture capital was exclusively a US and UK story.

Today, the statistics have all but reversed themselves. For the year to August, private equity investment in the US and Europe came to $106 billion and $25.3 billion, respectively. In Asia, it was $42.6 billion. What exactly has happened over this past quarter century? Several milestones stand out.

1992 – The $176 million Arral Pacific Equity Trust II collapsed, reflecting a feud between the fund's two partners. Pundits predicted that Asian PE was over. They were wrong.

1997 – In hindsight, the Asian financial crisis was a defining moment for fund managers. They no longer had to accept crumbs from family-owned businesses but could take majority stakes in companies.

2001 – The internet bubble burst. Asia came late and stumbled early, but for a while everyone wondered whether the internet would swallow traditional PE. Again, it never happened.

2003 – SARS sprung out of nowhere and emptied Hong Kong, Singapore, and Beijing. Three months later, it ended as quickly as it had started.

2004-2007 – The world awoke to the potential in China, India, Australia, and elsewhere. Resources poured in.

2004-2007 – The liquidity boom inflated deal and fund sizes around the world. Asian banks and funds were not quite as aggressive, though they suffered along with the others when fund raising and investment plunged.

2008 – Economic collapse in the West was an inevitable corollary to printing money that created supply for demand that didn't exist. Asian banks and fund managers took the heat, but their economies quickly rebounded.

It's now 2012… Looking back over the past 25 years, the clearest trend has been the rise of Asian economies and the stagnation of their US and European counterparts. Reasons abound, but the growth of America's national debt and the EU's political bureaucracy built at the expense of a unified financial policy are certainly among them. In the meantime, China's GDP has grown from $400 million in 1988 to $7.4 trillion today; and, the rest of the Asian economies have soared as well.

Among other trends, Asian countries have come into their own. Once unstable governments have developed their own personalities; the likes of Hong Kong, Singapore, Beijing, Shanghai, Mumbai and Tokyo have emerged as global cities; countries once dominated by wealthy families still honor them, but they are less and less the command economies of days past as entrepreneurial classes come to the fore.

The culture has changed as well. For better and worse, Western-style business practices have become the de facto standard in Asia. That is not to say that old customs have disappeared. But in virtually all regional financial centers, global franchises, modern buildings, and the English language are dominant. An ability to successfully close investments has been the result.

All of this has not been lost on Asian PE and VC. Progress has been astonishing – exit channels are a buzz of activity; Asian LPs and sovereign wealth funds are increasingly prominent investors; and PE firms are now raising their fourth and fifth funds

What will the landscape look like 25 years from now? There's no reason to believe these trends will disappear. As Asian nations become more confident in their own cultures and ways, the future will only look brighter for private equity and venture capital.

Inter-Asia Venture Management

co-founder of the AVCJ

is proud to announce

the celebration of its

40^{th} anniversary

of continuous operation through

its four venture capital funds

initially launched in August 1972

Lewis Rutherfurd	Cyril Fung
May Fung	Philip Kwok
James Man	Daniel Ng
Ronald Wan	David Cheng
	Anthony Chang

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The Early Years (Pre-1997)

Fundraising **$18.7b**

Funds **524**

Investment **$4.1b**

Deals **339**

FOUNDING FATHER

Lewis Rutherfurd, co-founder of Inter-Asia Venture Management, has been active in the industry for 40 years. During that time he brought McDonald's and Ikea to Hong Kong – and set up Asian Venture Capital Journal

Asian Venture Capital Journal was supposed to be a transfer investment. A venture capital firm approaches the owner of an established brand in the US or Europe; it pitches them on launching in Asia; a joint venture is set up with the brand owner putting in the name and relevant expertise and the VC firm contributing capital and local management. If all goes well, the brand owner assumes full control after a few years, facilitating the venture capital firm's exit.

In this case, the brand owner was Venture Economics, a US-based trade journal set up in the 1960s in parallel with the emergence of venture capital as an asset class. The company's database is now part of the Thomson Reuters private equity data offering.

However, when Inter-Asia Venture Management proposed a deal to Venture Economics in the mid-1980s, it met with a cold response. "We offered to put in some money and find people to run it," recalls Lewis Rutherfurd, co-founder and managing director of Inter-Asia. "They said, 'We're not coming to Asia, it's not interesting for venture capital. Chinese families are running the whole show, so the asset class will never work. They're won't be any subscribers, conferences or customers. And nothing to write about.'"

Big Mac incoming

Inter-Asia had already proved that the transfer model worked in Asia, albeit not for media businesses. The venture capital firm set up in Hong Kong in 1972, raised a $1 million debut fund and completed 15 investments. The first notable deal, which came two years later, was the transfer of McDonald's to Hong Kong. The fast food franchise was established in Japan and the marketing research that underpins judgments as to when new territories are ready for Big Macs was already looking further south and willing to listen to proposals from potential partners.

"It was easy to beat the likes of Swire and Jardine," Rutherfurd says. "Those guys were so incredibly arrogant and so impossibly British that no American company would even think about dealing with them. We also had a better strategy: we went in there and showed them the team they would work with."

McDonald's experienced a few teething troubles – the joint venture company had to leave its first premises when the landlord called a 300% rent hike – but the cuisine soon caught on and Inter-Asia exited its investment for a handsome return. Ikea was another transfer success story from Fund I and the VC firm continued with this approach, setting up Asia Renal Care, formed in part through a spin-off from Stanford Medical School's dialysis unit, and taking Australian sweet biscuit chain Cookie Man into China.

As for a regional venture capital publication, Inter-Asia had little option but to abandon the transfer concept and pursue the idea independently. Dick Radez was involved from the outset in an editorial capacity, and Rutherfurd approached three other Asia-focused VCs for help with funding: Victor Fung of Prudential Asia Investments, Ta-Lin Hsu of H&Q Asia Pacific, and Lip-Bu Tan of Walden International.

"The convincing argument was that we needed a trade journal, we needed a voice for the industry so we could all raise money and find out what everyone was doing," says Rutherfurd. "There were less than 20 players in the whole industry out here in Asia and we had no voice that could be construed to be independent, there were no conferences."

Asian Venture Capital Journal required about $500,000 in start-up capital plus further contributions to cover operating costs; Rutherfurd estimates the entire commitment was less than $1 million. The Journal pre-dated the first conference by no more than 12 months. They targeted 100 delegates and failed to reach that in the first two years, but within five years the 200 threshold was crossed. At the same time subscribers were signing up for the Journal and the Asian Venture Capital Directory was launched.

There were plenty of questions to answer across these platforms. Prospective institutional investors had little sense of the region, the opportunities and challenges for venture capital, the professional background of those engaged in venture investing and who was doing what. Among the early attendees were Betty Sheets of IBM Retirement Fund, Kevin Delbridge of Hancock Venture Partners [now known as HarbourVest Partners] and Betty Fagan of the Ford Foundation.

Deal flow was a key issue at the early conferences. The US LPs wanted to know how venture capital was structured in Asia, whether it followed the North American model, and how origination and negotiation were impacted by legal and regulatory considerations.

"I remember standing up and talking about transfers and people were taking notes," Rutherfurd recalls. "If you talked about transfers now, no one would come, but at the time it wasn't intrinsically obvious. Arral & Partners [co-founded by Anil Thadani] got a big hit investing in furniture. They found sourcing was a big theme in Asia – substituting manufacturing in High Point, North Carolina for Taiwan and Hong Kong. But how ridiculous is it just to be considering that now?"

Talking the talk

Having a communication channel was immensely valuable to Asia's venture pioneers, and Inter-Asia in particular. Fund I, which was raised from Chinese investors, had a relatively long life cycle – 12 years – and the carried interest was rolled back into the corpus for additional transactions. Asian Venture Capital Journal was among the first investments in Inter-Asia's second fund, a $10 million vehicle entirely backed by Royal Trust of Canada. The bank went under when its principal shareholders, the Reichmann family, overextended themselves in UK real estate and suddenly Inter-Asia was without an investor.

> **"We needed a voice for the industry so we could all raise money and find out what everyone was doing. There were less than 20 players out here in Asia and we had no voice that could be construed to be independent, there were no conferences"**

Rutherfurd maintains that Asian Venture Capital Journal helped him and others survive in a challenging fundraising environment. "People raised money from institutions in America and Europe maybe 3-4 years before they would have if there hadn't been a journal," he says. "It created knowledge of what people were doing out here, how they were doing it."

The exit point came around 1990. Inter-Asia and its co-investors made back their money, but the Journal was always more a service to the industry – and the investors' own fundraising needs – than a commercial exercise. None of Inter-Asia, Prudential, Walden or H&Q was particularly interested in print media as a business model.

The expectation was that Venture Economics, while wary of the Journal when it was merely an idea, would be more interested in acquiring the business once it was proven. The answer was still no. The investors were eventually introduced to Dan Schwartz, who already owned some financial titles and was interested in Asia, and he bought them out. Schwarz owned Asian Venture Capital Journal until 2006, when it was purchased by Incisive Media.

Inter-Asia is now in the process of raising its fifth fund,

> **"An LP called me and said, 'Your returns are number one but I will never invest in you again. I give you $5 million and get $15 million back over seven years. On an IRR basis, that's top quartile. But I can give Blackstone $50 million and they'll give me back $75 million in three years. You do the math'"**

which has a target corpus of up to $75 million, and remains focused on venture opportunities through the region. Rutherfurd notes that, from the outset, there were several fundamental differences between the US and Asian VC models – "there wasn't much technology to invest in back then, it was better to have a larger stake, and you certainly couldn't leave the entrepreneur alone" – and some still hold true.

Inter-Asia is keen on the food and beverage, healthcare and education sectors, but steers clear of technology unless working with a partner. The view is that transfer deals are most effective when the brand owner is investing alongside the venture capital firm, and this is largely because the model relies on the transfer of expertise as well as brand name.

For example, Inter-Asia set up Asia Foods, a China-focused catering company with Compass Group, a global specialist in the field. "Institutional catering is quite high-tech and we wouldn't have done it without someone like Compass to bring us the technology and best practices," says Rutherfurd.

The perception game

What has changed is investor perceptions of early-stage investors, a by-product of Asia's obsession with pre-IPO deals and the arrival of larger private equity firms in the region. A start-up requires a relatively small amount of money and it might take eight years to arrive at a 6x return; backing a company just before it goes public may only generate a 3x return but the amount of capital deployed is larger and the period of deployment is much shorter.

As a result, Inter-Asia's LP base has migrated away from US institutions. "One of my LPs called me up and said, 'Your returns are number one but I will never invest in you again. I give you $5 million and get $15 million back over seven years. On an IRR basis, that's top quartile. But I can give Blackstone $50 million and they'll give me back $75 million in three years. You do the math,'" Rutherfurd recalls. "We now appear to be more interesting to family offices. They want to build relationships and find out who the entrepreneurs are and who the best person to do business with is in Hong Kong or Singapore."

And backing good entrepreneurs is still where it begins and ends for Inter-Asia. Rutherfurd recounts a conversation with a seasoned venture capitalist in Hong Kong. This investor went to China in the late 1970s and visited a battery factory staffed by young women. These workers would force zinc powder into the casings by hand, pass them on for the anode and cathode terminals and other components to be added, and then the batteries were sealed and shipped.

The investor took the company owner out for dinner that evening and tried to engage him in conversation about his family and personal background. But all the owner would talk about was batteries and production processes. The investor was transfixed and provisionally agreed to buy 50% of the company for about $500,000, but his investment committee wouldn't support a deal.

"It's now the third-largest battery company in the world," says Rutherfurd. "The investor asked the company owner what a 50% stake would be worth today and he was told '$300 million, maybe $500 million.' Picking entrepreneurs is very interesting. With some of them it really doesn't matter what they are doing – pens, batteries, chips, underwear – they are going to win."

TAIWAN'S TECH PIONEER

Ta-Lin Hsu, founder and chairman of H&Q Asia Pacific, brought venture capital to Taiwan as part of efforts to develop the tech sector. It was a launching pad for private equity across the region

Over the course of a 27-year career in Asian venture capital and private equity, Ta-Lin Hsu has seen plenty of nearly deals. One of his favorites came in 1994. H&Q Asia Pacific, which Hsu founded and where he now serves as chairman, identified Rongcheng Rubber & Tire Company, then China's second-largest tire and rubber producer, as a potential investment target.

As with many of the PE firm's deals, there was a technology angle. Most of China's tires were bias ply, comprising overlapping layers of rubber; the design allows plies to rub against one another as the tire flexes, which causes friction and overheating. H&Q wanted to bring in radial tires from developed markets; the plies are arranged at 90 degrees to the direction of travel, which means less friction, better power transfer to the ground and lower fuel consumption.

H&Q searched for a Western partner to work with Rongcheng and when Michelin and Goodyear passed up the opportunity, Continental stepped in. The Chinese and German parties made several visits to each other's production facilities and soon reached a joint venture agreement. Rongcheng would sell under the Continental brand in China, paying a royalty in return. However, the CEO never turned up to the signing ceremony.

"When I finally got in touch with him, he said, 'Thank you, Dr. Hsu, we have learned so much, we photographed everything, and we've hired some people who were working for Pirelli in Qingdao. We just can't afford to pay Continental a 3.5% royalty, that's our profit margin.' They didn't realize that if you used the Continental brand and technology you could treble the price."

Hsu walked away, not wanting to do business with a company unable to understand intellectual property rights.

Placed in the context of H&Q's evolution, this was arguably a minor setback. When the firm started in Taiwan in the mid-1980s, no one had any idea what venture capital was, and few were willing to embrace the tax efficient structures, clearly demarcated roles and other conventions that underpinned GP-LP relations in North America.

"LPs put in the money with the pre-agreed outline, but after signing the document they can't tell the GP what to do – this was difficult for Taiwanese to understand," recalls Hsu. "Management fees and carried interest was another problem. They said, 'Dr. Hsu, you must be kidding. You want us to pay you to play with our money but if you make a loss it's my responsibility and if you make a profit you get 20%? Come on.' I had to spend hours explaining it all."

Academic export

Hsu ended up in the industry by way of academia. Born and raised in Taiwan, he completed a PhD at the University of California Berkley and from there joined IBM's corporate research department in the late 1970s. His breakthrough came with the introduction of magneto resistance heads in mechanical hard-disk drives, effectively allowing larger amounts of data to be stored and retrieved efficiently from higher density devices.

> **"They said, 'Dr Hsu, you must be kidding. You want us to pay you to play with our money but if you make a loss it's my responsibility and if you make a profit you get 20%? Come on.' I had to spend hours explaining it all"**

At the same time, the Taiwan government was looking to make a breakthrough of its own. Policymakers had been tracking the development of Silicon Valley and they wanted to recreate it in Asia. Taiwan had universities, science parks and returnees from the US fresh out of Bell Labs and Intel contributing technological expertise, but no independent venture capital. There was an element of corporate venture, largely driven by the tax breaks companies could claim by participating in it.

In 1982, the government approached Hambrecht & Quist, an investment bank focused on the tech sector, and asked for help. Founder Bill Hambrecht wasn't optimistic, pointing out that no one on his staff could speak English and Chinese and serve as a bridge between Silicon Valley and Taipei. That changed three years later with the appointment of Hsu, who had the required skill set and was already actively promoting US-Taiwan technology ties on an informal basis.

H&Q Taiwan was set up in early 1986 with the launch of the H&Q Han Tech Fund. In order to work around the fact that limited partnerships were neither welcome nor legally recognized, investments were made by Han Tech, the fund company owned by local enterprises, government entities and Hambrecht & Quist, but it delegated decision-making powers to H&Q Taiwan, the management company. "The two-company approach with a hands-off contract simulated the GP-LP model," says Hsu.

The fund corpus was $20 million; 48% from the government via a development vehicle, and 52% from private sources, including food and beverage giant Uni-President and Mitac Synnex Group. Half the capital was under the management of Hambrecht & Quist, which invested heavily in US biotech to little effect, and Hsu was responsible for the rest. As it turned out, a sharp jump in the Taiwan dollar against the US dollar meant that the local currency equivalent of more than two thirds of the corpus remained Taiwan.

"Our first investment was Acer – it went public about one-and-a-half years later and was exited over a period of three years giving us a return of 4-5x," Hsu recalls. "Our approach was based on US venture capital, but unlike Silicon Valley, there wasn't a lot of innovation in Taiwan. IBM had brought out the PC in 1982 and that is when Taiwan's high-tech industry took off, but it was mainly semiconductors, PCs and related components."

In addition to backing Acer, a PC integrator and manufacturer, H&Q put capital into companies producing everything from graphics cards to motherboards and keyboards

> **"Twenty years ago we would articulate the Asia opportunity and Fortune 500 CEOs looked at us and thought that we were crazy, but now everyone has to be here"**

to mice. It rode a manufacturing wave that saw Taiwan supplying roughly half the key components for PCs globally by the early 1990s. The investments were for minority stakes, typically Series A and B rounds.

A regional platform

From Taiwan, H&Q branched out into Southeast Asia, establishing operations in the Philippines in 1986, Singapore in 1988, Malaysia in 1990, Thailand in 1991, China in 1993 and Indonesia in 1995. Technology was always the primary focus but the nature of opportunities brought more sectors into play, particularly consumer-oriented areas that benefit from rising domestic spending. In the Philippines, for example, H&Q invested in fast food chain Jollibee and banana ketchup brands. It subsequently took Starbucks into northern China and launched MTV in Japan.

A number of these funds were mandates from governments, companies and development organizations. The first ASEAN vehicle came about because Singapore wanted to raise a $150 million hybrid fund with $30 million for PE. DBS was heavily involved as custodian and organizer, and it was generally assumed that the bank's venture arm would receive some of the capital, so H&Q successfully pitched for half. A Malaysia fund arose from a partnership with Malaysian Technology Development Corporation (MTDC), which was set up by the country's government in 1992.

In China, H&Q ended up working with international insurer Aetna. The company had teamed up with Bank of China to create a $90 million development growth fund as part of a wider effort to gain a foothold in the local insurance market. When the bank said it wanted the vehicle to make venture investments, Aetna invited H&Q to run it.

A major game-changer in the early 1990s arose from the US Overseas Private Investment Corporation's (OPIC) decision to launch a fully guaranteed $120 million ASEAN fund. "It was difficult to raise money so this was a godsend – at first I thought my staff had faked the invitation," says Hsu. "There was a beauty contest with many bidders and we were the second fund sponsored by OPIC."

For the first decade of H&Q's existence it was restricted to minority investments, even though there was a clear desire to pursue control transactions.

"At the time most companies were held by government or overseas Chinese families and there was no way you could penetrate that," Hsu recalls. "You have a government, a strong bank and a conglomerate in a cozy triangular relationship and it's extremely difficult to compete with that. For 3-4 years, before the Asian financial crisis, we wanted to get into this market but there was no way in. We couldn't break the triangle."

When the Asian financial crisis hit, H&Q quickly moved into private equity. Using William Perry, chairman of its advisory board and previously US Secretary of Defense during the Clinton administration, to make introductions, H&Q started investing in bankrupt companies in South Korea. The standout deal was Ssangyong Investment & Securities in 1998 – the first investment by a foreign company in a domestic brokerage. A commitment of $30 million delivered proceeds of $200 million when the holding was exited to Shinhan Financial Group four years later.

Korea's credit crisis also took root in 1998 and International Finance Corporation (IFC) asked H&Q to manage a $100 million restructuring vehicle. The new opportunities warranted larger fund sizes across the board. H&Q's third regional growth vehicle closed at $750 million in 1999 – the internet bubble didn't help what was still a technology-heavy investment thesis – while two Korea-focused funds each raised $300 million or more in 2006 and 2008.

Local and global

Over the course of three decades, Hsu has racked up more than three million frequent flier miles and now devotes a large part of his time to philanthropic activities. Looking back at private equity now versus private equity then, he fascinated by the interplay between globalization, which has made the asset class more accessible, and local nuances, which mean investment remains a challenge.

"There is no such thing as one country or region any more. Twenty years ago we would articulate the Asia opportunity and Fortune 500 CEOs looked at us and thought we were crazy, but now everyone has to be here," Hsu says. "On the other hand, there are a lot of pitfalls doing business here. It might be intellectual property, scandals in Chinese politics where it emerges that the juicy assets are owned by princelings, or corruption in Southeast Asia and Korea. These factors are difficult to overcome."

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For more information contact:

Asia Pacific PE Group Leader
Honson To
+86 (10) 8508 7055
honson.to@kpmg.com

Australia
David Willis
+61(2) 9346 6220
davidwillis@kpmg.com.au

China
David Xu
+86 (10) 8508 7099
david.xu@kpmg.com

Hong Kong
Jon Parker
+852 2140 2816
jon.parker@kpmg.com

India
Vikram Utamsingh
+91 (22) 3983 5302
vutamsingh@kpmg.com

Indonesia
David East
+62 (21) 574 0877
deast@siddharta.co.id

Japan
Osamu Matsushita
+81 (3) 5218 8768
osamu.matsushita@jp.kpmg.com

Korea
Chris Shin
+82 (2) 2112 0788
scshin@kr.kpmg.com

Malaysia
Chan Siew Mei
+60 (3) 7721 7063
siewmeichan@kpmg.com.my

New Zealand
Ian Thursfield
+64 (9) 367 5858
ithursfield@kpmg.co.nz

Philippines
Henry D Antonio
+63 (2) 885 7000 ext. 387
hantonio@kpmg.com

Singapore
Diana Koh
+65 6213 2519
dianakoh@kpmg.com.sg

Taiwan
Jay Cheng
+886 (2) 8758 9981
jaycheng@kpmg.com.tw

Thailand
Bob Ellis
+66 (2) 677 2118
bellis1@kpmg.co.th

Vietnam
Warrick Cleine
+84 (8) 3821 9266 ext 8200
warrickcleine@kpmg.com.vn

kpmg.com

The Asian Financial Crisis (1997-2003)

Fundraising $71.8b

Funds 1,666

Investment $64b

Deals 3,640

INTO THE STORM

George Raffini spent 21 years with HSBC's Asia private equity unit before the team spun out to form Headland Capital Partners in 2010. He witnessed Asia reach new highs in the 1990s before brutally falling to earth

The recent wave of economic and political reform in Myanmar has prompted talk in private equity circles about a new addition to Asia's clutch of frontier markets. But this isn't the first time Myanmar has appeared on the agenda. For about two years in the mid-1990s the country became a destination for investors in timber and tourism before disappearing off the map.

"Many firms were beating a path to Myanmar but the window closed almost as soon as it opened," says George Raffini, chairman at Headland Capital Partners who at the time was heading up HSBC's private equity unit in Asia. "We had colleagues who went there but they said, 'Not in my lifetime.' It was the political situation but also the corporate mind-set. We all wanted to invest in businesses that weren't just a bunch of guys who felt the wind at their back, were raising a few dollars and then saying, 'See you later.'"

Other countries in the region were able to sustain interest for longer periods, but private equity's brief flirtation with Myanmar says much about the asset class in the years leading up to the Asian financial crisis.

The industry was less global and institutionalized and there was far less legal and regulatory certainty, whether it involved Indonesian underwear manufacturers or asset-light Hong Kong traders establishing factories in Shenzhen. Nevertheless, there was a sense of opportunism as Asia simultaneously became acquainted with private equity and enjoyed its "economic miracle."

From the mid-1980s, Hong Kong, Taiwan, Thailand, Malaysia, Indonesia, Singapore and South Korea saw annual GDP growth of at least 7%. Little attention was paid to the rising levels of foreign debt.

Plain vanilla

"Between 1989 and 1994, there were two primary geographic themes: first, Southeast Asia," says Raffini. "It was small companies, low-cost exporters of relatively low value-add goods, and trying to ride that horse into a pretty small IPO. Second, you had Hong Kong companies transitioning their manufacturing into China, predominantly Guangdong province. It was usually a bumpy transition but those that pulled it off were often attractive listing candidates for the Hong Kong Stock Exchange."

The companies would be considered un-investible by present day standards: manufacturers of everything from calculators and eyewear to furniture and fabrics. As the decade progressed, Taiwan became more prominent with the emergence of its electronics industry. HSBC invested in two

Acer Group companies – Acer Peripherals and Acer Sertek – securing returns of up to 10x.

But it was still small scale. According to AVCJ Research, between 1990 and 1997, Asia-focused private equity and venture capital firms raised 472 funds with a cumulative disclosed value of $2.5 billion. For purposes of comparison, that is equal to three quarters of what China alone raised over the three months to September 2012 – and by recent standards it was a poor quarter. As for investments, a total of $4.1 billion was committed across 329 transactions.

HSBC's first fund, raised about the time Raffini joined the firm in 1989, had a corpus of $35 million – its most recent vehicle came to $1.4 billion – with the parent committing around one-quarter of the initial fund and the remainder contributed largely by Japanese institutions, such as Dai-Ichi, Nomura and Nippon Life. It wasn't until 1994-1995 that fund sizes started stepping up to $250 million and more as the wider investment community started to catch on to the potential of the Asian Tigers.

Indonesia, with its scale and resources wealth, was also targeted, but Raffini estimates there were only 20-50 deals per year, each one $5-25 million in size.

Although there were frequent gatherings of Asia's nascent private equity community in its Hong Kong hub, and a lot of note-swapping, the relative paucity of investment opportunities meant that industry participants often ended up chasing the same assets.

"Yes, it was more familiar and had the trappings of a less crowded market, but this was superficial," recalls Raffini. "It was intensely competitive and limiting in terms of the nature of deals that could be done. There was no India, no real China investing. We didn't see ourselves as pioneers, it was just early days in the region. The industry already existed quite substantially in much of the rest of the world."

One deal that stood out in a sea of minority investments was the buyout of Singapore-based Britannia Holdings, which operated snack brands throughout Asia and was part of RJR Nabisco. Following KKR's acquisition of the company, Britannia was sold off; HSBC was one of several private equity firms that picked it up alongside a strategic investor, BSN Group. When the company began to struggle in the face of greater competition, corporate governance issues and macroeconomic headwinds, BSN moved aggressively to assume complete control over the asset.

"I learned a lot through that investment and it carries through to today," says Raffini. "Private equity was less established, more insecure in its skill set, and so there was a tendency to invest alongside corporates, but they can be difficult partners. Britannia turned out fine, with a 2x money multiple, but that's less than it might have been. Now we most often would rather bring in corporate talent than invest alongside a corporate."

With hindsight

However, the steepest learning curve was created by the Asian financial crisis of 1997. Hindsight is a wonderful thing. It was apparent that Thailand's finances were becoming stretched and that countries across the region had built up large capital and current account deficits as they embarked on massive spending programs to expand export-oriented manufacturing industries, arguably adding far more capacity than required.

Private equity investors also recognized, largely through the deals they were executing, the mismatch between local currency-denominated revenues and US dollar-based liabilities. Few companies had the ability or inclination to deploy hedging strategies given that their domestic currencies were pegged to the US dollar. The risks were there: Should Southeast Asian countries experience a decline in exports and a rapid exit of hot money – through devaluation in the renminbi and the yen plus an increase in US interest rates – they would no longer have the foreign ex-

"Private equity was less established, more insecure in its skill set, and so there was a tendency to invest alongside corporates, but they can be difficult partners. Britannia turned out fine, with a 2x money multiple, but that's less than it might have been"

change required to support a fixed exchange rate.

Investors weren't deterred due to a combination of optimism and pragmatism, as well as the fact that they tended to have minority positions and couldn't dictate policy to CEOs. With the Asian Tigers growing so rapidly and aggressively creating wealth, no one wanted to call time on the party. Then there was the need to be competitive. A portfolio company drawing down local debt at 20% per annum would have to charge customers a certain price to remain profitable; the guy across the street enjoying US dollar rates of 6-8% could get away with lower prices.

"We look at businesses with a strong bottom-up focus. It's hard to anticipate top-down pressures, which means everyone is going to be blindsided by macros at certain times," Raffini says. "We were rarely embarrassed by the rationale underpinning our investments prior to 1998. There were a handful of situations where we invested with bad partners, and of course I would revisit these. Like a lot of other investors, we usually did strong due diligence on deals but many firms were swamped by poor macros."

Although Thailand is blamed for starting the crisis when it was forced to float the baht, Raffini argues that Indonesia – which was far more opaque than its neighbor – took investors by surprise. The currency dropped from INR2,000 to the dollar to INR18,000, crippling companies that had racked up US dollar-denominated debt financing. Suddenly investments on course for a 2-3x return were wiped out.

> "There were a handful of situations where we invested with bad partners, and of course I would revisit these. Like a lot of other investors, we usually did strong due diligence on deals but many firms were swamped by poor macros"

Yet many of these companies exist to this day, in one form or another. HSBC backed Anwar Sierad, an Indonesian poultry firm, and got out before the crisis hit, securing a 3x return on its investment. After skirting bankruptcy, Anwar Sierad announced in 1999 that it was close to clearing $160 million in debt through a restructuring and equity swaps.

"This was a good company in a good industry, it managed its farms well and grew on the back of domestic consumption," Raffini says. "It's a shadow of the company it was because sorting out the finances took so long, but it's still there." HSBC was less fortunate with the likes of packaging company Impack Pratama and underwear manufacturer Ricky Putra Garmindo as they were hit by the crisis while the PE investor was preparing to exit. However, both remain in business.

Families first

There is a clear link between present day corporate health and the speed in dealing with the carnage created by the Asian financial crisis. "In the rubble of 1998, the big got bigger and it took small- and medium-size enterprises a longer time to recover," says Raffini. "They often had their lunch eaten by larger corporates that had greater management infrastructure and were better able to manage their relationships with bankers."

Even those that defaulted on their debts did so quickly, which meant they got a jump start on rivals when it came to reorganization and returning to growth mode.

It remains a familiar theme in Indonesian private equity. Large, family-owned conglomerates have considerable influence by virtue of commercial might and informal networks that traverse the power spectrum. Raffini has seen investments made at the right time in the right companies fail to perform as expected due to larger rivals exerting pressure on regulators. For private equity, these groups can be either competitors or partners, although a number of them have yet to fully reconstruct reputations damaged by defaults during the Asian financial crisis.

In the mid-1990s, Indonesia was one of few Asian markets that represented a viable domestic consumption play, although private equity firms weren't able to marshal the resources required to build distribution chains on par with those of local incumbents. In Raffini's view, this is now changing across Southeast Asia as both the PE community and the target companies mature.

"The businesses were so much smaller and management teams didn't have the benchmarking you see today as a result of globalization. Companies were less well equipped to handle PE capital and the PE firms were less well equipped because of the complexities of Asia," he says. "The expectation was there before but I don't think the value-add or depth of management was there yet. You were often backing one compelling individual, not a team. It is different now."

THE BANK DOCTOR

Weijian Shan, chairman and CEO of PAG, made his name in private equity turning around troubled companies for Newbridge Capital. Two bank deals helped open international investors' eyes to the Asia buyout opportunity

"We didn't spend much time thinking about how private equity would evolve, it was more about how the Asian economy would evolve," says Weijian Shan, chairman and CEO of PAG. "At that time China, India and Southeast Asia were all about the size of Korea. Japan was the largest economy in the region by far but we knew China would become more important. We also knew that if these countries fixed their banking systems, they would come out of the recession."

These considerations underpinned investment strategy at Newbridge Capital in the late 1990s. Formerly a senior China banker with J.P. Morgan, Shan joined Dan Carroll as head of Newbridge's Asia operations in 1998, four years after the private equity firm came into being as a joint venture between TPG Capital and Blum Capital.

While they may not have paid much attention to private equity's growth trajectory, the Newbridge team left an indelible mark upon it. They specialized in supporting companies undergoing transition across a variety of industries, but are mostly readily associated with financial services and the turnaround of Korea First Bank (KFB) and Shenzhen Development Bank (SDB). These deals, arguably more than any others, are responsible for putting Asian private equity in the spotlight. For the first time, global buyout firms recognized regional buyout opportunities and responded by deploying more resources in Asia and creating the industry as it is known today.

"We all knew it was significant because it was the first time that someone from outside Asia had taken over a major national bank in Asia," Shan says of KFB. "It was a failed bank and had been nationalized by the Korean government, so we negotiated to assume control."

Few others were willing to take a shot at reviving the lender. As Korea's credit crisis took hold and Moody's lowered the nation's credit rating, the IMF came in with a bailout package and also singled out two distressed banks that could be sold off: KFB and Seoul Bank. Months of negotiations ensued and Newbridge, the only private equity firm that participated in the auction, signed an exclusive memorandum of understanding for KFB in December 1998 and closed the transaction in early 2000. HSBC, meanwhile, was unable to reach an agreement with the government regarding Seoul Bank.

Anatomy of a turnaround

There were two main components to the restructuring process. First, Newbridge had to put in place a functional board, organized in accordance with international best practice, and appoint a professional management team to operate beneath it. Second, they had to create a credit culture, a tougher proposition because it meant recalibrating long-standing characteristics of Korea's financial sector.

"Before the Asian financial crisis, banking wasn't based on the creditworthiness and cash flow of the borrower but on government policy and relationships, and they got into so much trouble because loans went bad," says Shan. "In order to do real lending there has to be a culture at the bank – and at every stage of the lending process – for checking customers' creditworthiness. When thousands of employees have to be trained up, it is an enormous task."

KFB's non-performing loan (NPL) ratio stood at 30% in 1998. The Korean government carved out a large portion prior to Newbridge's investment and agreed to a "put back" clause covering the rest. During the private equity firm's ownership period the ratio fell to less than 1%, while KFB's business model transformed from one driven purely by corporate lending to a predominantly retail banking approach. The latter was particularly important given that a failure to diversify subsequently saw other banks run into trouble. Newbridge exited its 51% stake in KFB in 2005 when Standard Chartered acquired the bank for $3.2 billion.

By this point, the private equity firm was already invested in SDB, which was in a similar state of distress but there was no government on hand to help soak up some of the bad loans. In 2004, the year before Newbridge acquired its controlling stake, the bank's NPL ratio was said to be 11.4%, although it later turned out to be twice as bad. SDB's capital adequacy ratio was also worse than the reported 2.3%, and well below the required 8%.

No less than 20 potential investors were approached concerning the asset, most of them strategic players, but Newbridge was the only party to express genuine interest.

While the gap between government-imposed interest rate spreads for loans and deposits ensure that Chinese banks virtually have a license to print money, this is meaningless in the absence of sustainable lending policies. "If you look at SDB it was much more broken than KFB but by then we had operated KFB for a number of years and were very experienced in risk management and credit culture," Shan says. "We were confident that as long as we could control the risk we could turn the bank around."

Other private equity firms invested in Korean and Japanese banks around the time of the KFB deal with varying degrees of success – Ripplewood, J.C. Flowers and Shinsei, Lone Star and Tokyo Star, Cerberus and Aozora, The Carlyle Group and Korea Exchange Bank – but Newbridge won plaudits for being the first to venture into the space. Such was the profile of the KFB and SDB transactions that Shan found people were, inaccurately, describing him as a banking specialist.

Transition management

Investments in other sectors may not have required such extreme turnaround efforts, but results came as a result of putting people on the ground and addressing business challenges. Newbridge and Blum Capital acquired Australian department store chain Myer for about $1 billion, half in equity, in 2006 and exited via a $2 billion IPO three years later. Speaking at the 2011 AVCJ Forum, Ben Gray, a managing partner at TPG who was part of the Newbridge team that worked on the deal, said the investment generated a 6x re-

> **"In order to do real lending there has to be a culture at the bank – and at every stage of the lending process – for checking customers' creditworthiness. When thousands of employees have to be trained up, it is an enormous task"**

turn – 4.5x from operational involvement, 0.5x from debt payouts and 1x from a property deal.

Shan also highlights a $350 commitment to Chinese PC manufacturer Lenovo Group in partnership with TPG and General Atlantic in 2005. The capital was used to support the $1.75 billion acquisition of IBM's PC division but Newbridge's familiarity with both parties meant its involvement went further. "TPG had been looking at IBM's PC business for a long time and Newbridge had a good relationship in China with Lenovo," Shan says. "All the stars were aligned and we did this deal because Lenovo wanted to work with us on integrating the IBM business."

Now installed at PAG and investing the firm's $2.5 billion debut private equity vehicle, Shan claims that after 14 years in the industry he has yet to emerge victorious from an auction situation because he's never participated in one. Moving from a global firm like TPG, which fully absorbed Newbridge in the early 2000s, to a regional outfit, the intention was always to carry over certain strategic tenets, including a focus on larger transformational- or operational-type opportunities that don't appeal to the mass market. Pre-IPO deals are generally off-limits.

"We rarely encounter competition for what we do, back when we were doing SDB or now," Shan says. "If you do pre-IPO there is a lot of competition because it's based on price. If you are doing transformational buyouts it is more about your ability to help the target achieve its objectives. You have to bring many more things than capital to the table, but you can also cut your own deal."

Picking winners

While PAG has an Asia-wide mandate, China remains the principal area of focus. This is driven by a combination of fundamental and cyclical factors. Private equity in China remains a fraction of the public markets and banking sector capital pools, as well as accounting for a smaller percentage of capital than in America or Europe, which suggests there is room for greater participation.

The challenge is picking the right company in the right industry. Shan notes that there is overcapacity in nearly every industrial sector, from steel to cement to aluminum, as well as in a number of downstream sectors such as auto manufacturing. Consumption, which makes up 35% of Chinese GDP compared to 70% in the US, is seen as a better bet, but understanding the structural nuances woven into the industrial fabric of the country is not easy.

"We are seeing a faster slowdown in electricity consumption than GDP growth because heavy industrial sectors are large consumers of electricity and they are slowing much faster than the rest of the economy," says Shan. "On the other hand, industries such as mobile handsets and pharmaceuticals are experiencing rapid growth. When deciding whether to invest in a firm, the first thing we look at is how it is differentiated from the competition."

The cyclical factor that favors the likes of PAG, meanwhile, is weaker economics. As the West continues to grapple with the effects of the global financial crisis, private equity in China has been buffeted by a decline in the pre-IPO market over the last 18 months and tighter bank lending policies. Valuation expectations, driven up across the board by lucrative public market exits, are now moderating; companies that embarked on ambitious capital expansion plans with a view to a quick IPO now find the window has closed and banks are less willing to be flexible on loan repayments.

"If you do pre-IPO there is a lot of competition because it's based on price. If you are doing transformational buyouts it is more about your ability to help the target achieve its objectives. You have to bring many more things than capital to the table, but you can also cut your own deal"

The global financial crisis didn't hit emerging Asia as hard as the regional apocalypse of 1997-1998 – and no one is expecting another spate of distressed bank deals – but opportunities are emerging for private equity.

"Money is tight, valuations have come down and you find that many firms are running into difficulty," says Shan. "History has proven that this is as good a time to invest as ever. It may last for a little while because the global economy is so interconnected it's hard to see how the market can go back without major problems being resolved."

PICKING UP THE PIECES

Roy Kuan, managing partner at CVC Capital Partners, witnessed a transformation in private equity in the wake of the Asian financial crisis. Suddenly he was in the buyout business, carving out assets from distressed conglomerates

One of the reasons for Asian Venture Capital Journal's creation was to serve as an independent voice for the nascent industry, communicating opportunities for the asset class in the region and, hopefully, making it easier for managers to raise money. The publication has also helped others enter the industry. Roy Kuan, managing partner at CVC Capital Partners, is a case in point.

"My advanced study project in the MBA program at Wharton Business School was Asian private equity. I received a 'distinction' on this project and much of the source information came from AVCJ," he says. "I wasn't really aware of what private equity was until I got to Wharton but I became fascinated by it, and Asia private equity in particular."

Within three years of Kuan joining CVC's regional operation – then part of the Citicorp private equity business – in 1995, the Asian financial crisis prompted a paradigm shift in private equity that would generate material for dozens more research papers. The restructuring opportunities that arose also vindicated CVC's early arrival in the region compared to most global buyout firms.

Kuan was part of the team focusing on in Southeast Asia, principally Indonesia and the Philippines, and South Korea. These were expansion capital deals of $10 million to $50 million, often featuring convertible bonds or new shares with a put option. The underlying legal structures and protections were immature and untested, and in some cases target companies were weak or poorly governed. These issues were brutally exposed by the financial crisis.

But those that remained active in the region – CVC's downside was limited thanks to bank-mandated foreign currency hedges – suddenly found doors opening. The scale of buyout and restructuring deals quickly exceeded the capacity of individual investors, with equity checks in the region of $100-150 million. "None of our funds were big enough to accommodate that so there were a lot of consortium deals, notably between UBS Capital [Now Affinity Equity Partners], J.P. Morgan Partners [now Unitas Capital], and ourselves," says Kuan. "That had a knock-on effect on subsequent fundraising."

The momentum created by this deal flow led to the creation of CVC Asia Pacific in 1999, a Hong Kong-headquartered joint venture with the private equity firm's original parent, Citigroup. CVC assumed majority control nine years later. A debut Asia fund of $750 million was raised in 2000, and there have since been two successor vehicles, most recently the 2008 vintage CVC Asia Pacific III, which attracted commitments of $4.2 billion.

There were two main strategies in Asian restructuring: financial services and non-financial services. While the likes of Newbridge Capital, The Carlyle Group and Ripplewood Holdings pursed the former to stunning effect, CVC opted for the latter. In both areas, South Korea, crippled by credit problems in the wake of the crisis, was the primary market.

Corporate carve-outs

According to AVCJ Research, private equity firms committed more than $4.1 billion across 22 buyout and restructuring transactions in South Korea between 1998 and 2001. Before that, the country had been almost exclusively the preserve of venture capital investors. CVC was involved in four of the 16 non-financial services deals, accounting for nearly half its buyout activity by volume in Asia Pacific as a whole during the period.

"Many of these groups were overleveraged, they had expanded into non-core areas such as real estate, and they were forced by creditors to sell off assets," Kuan says. "The operations themselves were usually fine – it was merely carving them out from a distressed group. The focus of these deals was to retain new management and work on new business plans and value creation initiatives."

In the case of Haitai Confectionery & Food, it was necessary to replace the existing management team in its entirety. Over the course of 30 years, the company had established itself as South Korea's second-largest producer of confectionery, ice cream and frozen foods, but also diversified into areas far removed from its core business such as electronics and construction, even running a baseball team. Haitai collapsed under $3 billion of debt and was declared bankrupt in 1999, leading to months of legal negotiations as creditors put off liquidation while they looked for alternatives.

That alternative arrived two years later as CVC, UBS and J.P. Morgan acquired the confectionery assets through a leveraged buyout worth $369 million. The firm was exited to domestic rival Crown Confectionery for $490 million in 2005. CVC went through a similar process for Mando Climate Control, the air conditioner unit of bankrupt Mando Group in 1999 and Daewoo Telecom's IT business in 2000.

"The peak period for these deals was 2001, it slowed gradually and evaporated within four years," says Kuan. "But it changed the complexion of private equity in Asia. It went from expansion capital, very much focused on Southeast Asia and China, to buyouts in Korea, Japan and Australia."

"Many of these groups were overleveraged, they had expanded into non-core areas such as real estate, and they were forced by creditors to sell off assets. The operations themselves were usually fine – it was merely carving them out from a distressed group"

A number of trends prevalent in Asian private equity are linear and can be tied to wider macroeconomic or industry-specific developments, such as the switch in focus from export-driven investments to domestic consumption, the emergence of country funds operating regional vehicles, and increasing emphasis placed on value creation and deploying operating partners. Other areas are more cyclical: markets perform strongly, liquidity levels rise and valuations go up, followed by an adjustment, pockets of distress and the emergence of buyouts in place of the growth capital norm.

"It was ironic that expansion capital became such a big part of the industry again after 2005 and strong performances from the early-vintage China funds, because during the mid-1990s these deals fared quite poorly," says Kuan. "But when we look at China now it is very much like Southeast Asia pre-1997, and so we expect more control deals."

If there is one aspect of the evolution of private equity in Asia that has surprised him, it is the sheer volume of funds competing for these transactions. When Kuan wrote his business school paper, the industry was dominated by a handful of names: Prudential Asia Investments, HSBC Private Equity, AIG and ChinaVest, with H&Q Asia Pacific and Walden International leading the venture space.

"It is shocking how it kept growing," he says. "When I started working in this industry, the AVCJ directory was so small you could fit it in your pocket."

The Tech Bubble (1999-2002)

sina 新浪

VC fundraising **$8.5b**

VC funds **478**

Tech investment **$16.4b**

Tech deals **1,551**

THE SINA MODEL

Lip-Bu Tan, founder and chairman of Walden International, plotted the route by which foreign venture capital entered China's internet sector, as well as guiding dozens of Asian companies from start-up to listing

Lip-Bu Tan has won his place in the annals of Chinese venture capital as father of the VIE. This structure goes by two names: formally, it is the variable interest entity; informally, it is the "Sina model," named after the internet portal for which it was originally devised. Though arguably overused and abused since its inception in 1999, the VIE opened the door for much of the $9.2 billion that has flowed into China's IT sector over the past 13 years.

"We came up with a structure that worked," Tan recalls. "It was a case of convincing the Chinese government that it was a viable. Fortunately, I'd already made several investments in China and had demonstrated to them that I have experience investing in China, so they were supportive. Then everyone started copying the model."

The VIE was necessary to work around a ban on direct ownership of internet assets by overseas investors. This dated back to efforts made by foreign telecom operators to enter China in the mid-1990s through indirect ownership of joint ventures with local players. Beijing cancelled the agreements, saying assets such as networks and carriers were completely off limits.

However, it stipulated that areas such as the internet and related services would be subject to less rigorous oversight, provided a suitable structure could be found. The VIE was acceptable because the onshore asset is owned by Chinese nationals and the foreign investor controls a parallel entity; legal agreements secure this entity's economic interest in the onshore asset.

In the case of Sina, Walden led a $7 million round of investment in Beijing Stone Rich Sight Information Technology, which was set up by Sina's former CEO. This was then merged with a US-based company called Sinanet under a VIE structure and the resulting entity was called Sina.com. Walden then brought in Goldman Sachs and others for Sina's first institutional round, worth $38 million, and the company listed on NASDAQ in May 2000.

The bubble bursts

Two months earlier, the NASDAQ Composite Index peaked above 5,000 points and by the time Sina went public the index had already slipped to 3,300 before staging a rally. The value destruction that followed over the next two years claimed some notable scalps and wiped out a number of fundraising efforts by Asia-focused VCs as investors backed out.

From the start of 1998 to the end of 2000, just over 300 Asia-focused venture funds raised $6.7 billion, with Japan, South Korea and Taiwan accounting for 23%, 16% and 20%, respectively, of the capital. In the following three years, 290 funds attracted commitments of $4.7 billion. Taiwan saw the most substantial decline: VC investment fell from $4.3 billion in the first three-year period to $1.9 billion in the second.

"Of course our portfolio was affected by the dotcom bubble bursting – growth slowed and it took longer for companies to become profitable and generate cash," says Tan. "But many continued to do well. For example, Mindtree, an Indian IT outsourcing company, remained profitable despite the bubble bursting."

He adds that the fallout was eased by two factors. First, there was a breadth to Walden's investments in terms of sector and geography, itself a reflection of the opportunities available in nascent economies.

In China, early deals included Wuxi Little Swan, now one of the country's largest consumer appliance manufacturers, and Shenzhen Mindray Bio-medical, a medical equipment maker, in 1995 and 1997, respectively. Walden entered Malaysia two years later by backing employment search site Jobstreet.com and helped take the company into Indonesia.

Inevitably, there was a plethora of Taiwan companies that together chart the progress of the domestic tech sector: electronic components manufacturer Umec, internet telephony company Mediaring, LCD display manufacturer Mytech and semiconductor producers like fourth-generation wireless specialist Beceem Communications.

"We have always been very focused on technology," says Tan. "Initially it was technology in terms of manufacturing and design and then it was software, mobile and internet. The one thing we have always done is semiconductors, especially on application-driven design."

Second, there was relatively little competition in the years running up to 2001, which helped in terms of valuations.

Walden was founded in 1987 and the initial LPs were development finance institutions, government and quasi-government agencies and local banks. It took seven years, around when the VC firm launched its third main fund and first China-dedicated fund, for North American investors to get interested. The LP roster for the China vehicle reads like a GP in transition: International Finance Corp. (IFC) and Tat Lee Bank, but also Commonfund Capital and the University of Minnesota Foundation.

North American venture capital firms, however, had yet to establish Asian affiliates. "There weren't too many guys from Silicon Valley at that point," Tan says. "They came in after the Silicon Valley Bank trip to China and India a few of years after the tech bubble."

> **"Our philosophy has always been to back good entrepreneurs, be disciplined with valuations and pick a 10-year horizon for the company"**

The arrival of these firms plus the emergence of domestic competition has brought critical mass, while the archetypal portfolio company has climbed the value chain from electronics-oriented original equipment manufacturer to a sophisticated brand owner carrying a lot of intellectual property. (It is worth noting that the VIE structure itself is evolving due to the changing competitive environment.)

However, there are negative connotations too, which to some extent challenge the Walden approach. "Our philosophy has always been to back good entrepreneurs, be disciplined with valuations and pick a 10-year horizon for the company, which is ideally what you need to build up from zero to $500 million in revenue," says Tan. "In the early days entrepreneurs valued long-term relationships but now they want to raise a lot of money very quickly at a high multiple."

Mindtree and Lashou are helpful case studies. The former was a Walden portfolio company more than 12 years, guided from Series A round to IPO and finally exited earlier this year for a 12x money multiple. The latter, one of many group buying sites set up in China from around 2010, accumulated $166 million through three rounds of funding in 12 months, but its plans for a swift IPO have yet to come to fruition.

"As long as the market continues to push up Chinese valuations, then good luck," Tan says, unconvinced by the prospects. His strategy for Walden is to add value through greater specialization, as evidenced by the firm's deepening involvement in the semiconductor supply chain.

It is a bet that Asia's venture capital community, still a shadow of the US market in terms of scale and sophistication, has a long way to run.

BAIDU AND THE REST

Finian Tan, founder and chairman of Vickers Capital Group, identified Baidu as a start-up and guided the search engine provider all the way to IPO. It was the first in a string of post-tech bubble investments in Chinese internet companies

In the early 2000s, Baidu nearly died. China's largest search engine is now valued at around $40 billion and has an estimated 80% market share, but as a two-year-old company backed by a spluttering of venture capital funding, life was anything but certain.

Baidu started out as a technology provider to the first generation of Chinese internet companies that went public in the US, Sina and Sohu. When users conducted web searches through these pioneering news portals, Baidu received a small on-screen credit and an even smaller fee. As internet traffic grew, the fees began to accumulate and the portals responded by renegotiating Baidu's contract. There was nothing the company could do: it had a world-class search algorithm but no independent channel through which to monetize the technology.

"We couldn't argue with these big gorillas and this meant our revenues would be capped forever," recalls Finian Tan, founder and chairman of Vickers Capital Group, who at the time was Baidu's principal VC investor through Draper Fisher Jurvetson ePlanet (DFJ). "We had three options: sell the company, remain a small-scale technology provider, or launch our own portal, which would mean losing our two biggest customers because Sina and Sohu would cut ties with us as a competitor."

Robin Li, who co-founded Baidu with Eric Xu and now serves as CEO, came up with a high-risk alternative strategy: launch a portal under a different brand and rely on it gaining traction before the incumbent gorillas realized what was happening.

The gamble paid off as Baidu's clean and simple homepage – a concept far removed from the cluttered web pages of the time – took off like wildfire. Within four years, the company listed on NASDAQ, generating more than 100x money multiples for its early investors.

What also paid off was Tan's early faith in Li. Then, as now, venture capital investing was as much about backing the entrepreneur as the idea. Baidu was the first DFJ deal in China completed under Tan's stewardship, after the investment committee rejected several earlier proposals. With only $780 million committed across 90 venture capital transactions in the seven years leading up the Baidu deal, China wasn't a proven market and US-based investors were apprehensive.

"Robin and Eric seemed like they had the right attitude and they were familiar with international business rules and etiquette," says Tan. "Robin could answer every question I threw him about search technology and how it would develop. He's the only guy I've ever met whose life revolved around search. You seldom find a world-class internet guy in China; most of the time it's China-class guys."

Anatomy of a start-up

When DFJ arrived on the scene in 2000, Baidu had been up and running in Beijing for one year with 15 employees and about $1 million in funding from two angel investors, Integrity Partners and Peninsula Capital Partners. The algorithm for search engine page ranking that underpins its success was devised four years earlier – around the same time as Google – while Li was working at IDD Information Services in the US. The initial objective was to displace a Taiwan company as technology provider to the portals.

"There was no revenue, they just had a code and it was better than anything else we'd seen in the market," Tan says. "By the time we signed the term sheet they had one customer and they were about to close a deal with Sohu. The market was so small then. We had to do B2B and corporate data technology as well as B2C search to create something that could potentially be worth $1 billion."

DFJ led a Series B round of funding worth $10 million, putting in $7.5 million itself while IDG Ventures contributed $1 million and Integrity and Peninsula covered the rest. As the second-largest shareholder with a 25% stake – rising to 30% by the time of the IPO following a $25 million Series C round in 2004 – Tan was responsible for two seats on the board and two seats on the four-person executive committee.

The investment closed after the dotcom bubble burst and Tan recalls valuations being low. "Robin and Eric were not too expensive and I didn't haggle too much," he says.

Although Baidu was Tan's first investment in China for DFJ, it wasn't his first exposure to the country's tech sector. An engineer by training who then forged a career in oil trading, in 1997 Tan was recruited as a deputy secretary in Singapore's Ministry of Trade and Industry, with the remit to turn the city-state into a Silicon Valley for the East. He recommended the creation of a $1 billion to foster innovation, the Technopreneurship Investment Fund (TIF), and became its chairman.

TIF helped jump-start many venture capital firms, such as Granite Global Ventures, and its direct investments included a small position in Sina. The fund was acquired by Kleiner Perkins Caufield & Byers (KPCB) and Tan moved on to DFJ as founding partner for Asia, where he appointed three young executives. One of them, Zhang Fan, subsequently leveraged his involvement in deals like Baidu to secure a managing partnership at Sequoia Capital China, working alongside Neil Shen, who made his name with VC-backed Ctrip and Home Inns.

> "Robin Li could answer every question I threw him about search technology and how it would develop. He's the only guy I've ever met whose life revolved around search. You seldom find a world-class internet guy in China; most of the time it's China-class guys"

Home runs, strike-outs

DFJ's first fund, Draper Fisher Jurvetson ePlanet Ventures, was a $650 million vehicle raised in 1999 that invested globally. Between 2000 and 2005, Tan was responsible for investments worth $41 million in Asia. Baidu was one of three significant home runs. The others were out-of-home advertising network Focus Media, where DFJ participated in a Series B round of funding about a year before the company went public on NASDAQ, and KongZhong, a mobile value-added services provider that also completed a US IPO.

DFJ invested about $800,000 in KongZhong in 2002, taking a 9% stake, and the company went public about 18 months later, generating a 36x money multiple for the VC firm. The IRR was even better than Baidu because the holding period was less than a quarter as long.

However, KongZhong later came unstuck after failing to liberate itself from the gorilla that controlled the purse strings – in this case China Mobile, which operated the payment gateway for value-added services like ringtones and drove a lot of players out. There was no Baidu solution and KongZhong had to diversify its offering, looking at broader digital entertainment services such as online gaming. It is the nature of the internet business – for investors as well as entrepreneurs – that one must evolve to stay commercially relevant.

"Generally, we look at three things: space – it has to be fast growing and sexy; competitive edge – if you don't have this everyone will copy you and as a first mover you are dead; and the entrepreneur – even if the first approach is wrong, a gifted entrepreneur has the ability to re-invent himself and rise again," Tan says. "In China you have to reinvent yourself with every fund because what was hot in fund I has now all been done and it's finished. For example, you couldn't start a social network today."

> **"Generally, we look at three things: space - it has to be fast growing and sexy; competitive edge - if you don't have this everyone will copy you and as a first mover you are dead; and a good entrepreneur - even if the first approach is wrong, a gifted entrepreneur has the ability to re-invent himself and rise again"**

The industry dynamics have also evolved. Sina and Sohu, the original gorillas, are no longer such a threat; they have been replaced by Baidu, Alibaba Group and Tencent Holdings, China's preeminent search provider, e-commerce platform and entertainment portal, respectively, although each one is trying to broaden its product portfolio.

While the Sina and Sohu approach was to watch, copy and then kill off the competition, the new giants recognize that it is quicker and easier to buy their way into new markets. "It's creating a vibrant M&A environment that already exists in Silicon Valley," Tan observes. In 2011, Baidu made at least five lateral acquisitions, including the $306 million purchase of VC-backed travel booking site Qunar.

Widening the scope

Tan left DFJ to set up Vickers in 2005 and started investing more broadly, both in terms of sector and geography. In recent years the venture capital firm's portfolio has encompassed everything from the first independent real estate investment trust (REIT) to list in Singapore to a company that makes engines for electric hybrid cars to the Asia Food Channel.

Tan is particularly excited about US-based biotech firm Samumed, which he believes has the power to revolutionize approaches to oncology and degenerative conditions through drugs targeting the Wnt signaling pathway that regulates stem cell proliferation and differentiation. It has eight drugs entering clinical trials in the next 15 months.

"We have been reluctant to pull the trigger on life sciences because of the risk and the long-term nature of the investment, but all that changed with this biotech company," he says. "Everyone has been trying to develop drugs that target the Wnt pathway and they have done it. If they work as we hope, they will stop cancer, grow cartilage, bone, hair and cure many other diseases. This company is the most exciting company I've seen in my life and I have looked through something like 30,000 deals in my career."

Although life sciences tends to be more capital intensive than internet plays and requires larger ticket sizes, Vickers isn't about to leave its comfort zone. The previous fund was $60 million and the one currently being raised is targeting $150 million, with 60% of the corpus earmarked for China, 25% for Southeast Asia and 15% for the US and other regions.

Tan has no desire to upscale from venture capital to growth capital because the economics change: 90% of the companies in a VC portfolio can fail provided a couple deliver returns of 10x or more; the 3-4x returns that typically come from larger growth deals can't sustain this approach.

"Assets under management don't excite me," he says. "Can I be the largest asset manager in the world? No. Can I be the best performing fund? I have a chance. China is growing at 7% a year and they are seeing 100 years of opportunities compressed into 20 years. Indonesia is growing at 6%. It's a rising tide. If you are a smart team, follow the rules for creating a successful organization and treat the entrepreneurs as the real stars of the show, you should be among the best performers."

Regional Buyouts (2002-2005)

Buyout fundraising $22.8b

Buyout funds 152

Buyout investment $54.5b

Buyout deals 534

SPIN-OUT TREND SETTER

Michael B. Kim, founding partner of MBK Partners, left The Carlyle Group in 2005 to set up his own private equity firm. The time was right, the capital was available, and there was a desire to become more local

With an agreement to sell Taiwan's China Network Systems (CNS) pending final regulatory approval, MBK Partners remains, for now, the largest private owner of cable television assets in Asia.

CNS has 1.2 million subscribers; South Korea's C&M, another portfolio company, has more than 2 million. MBK is therefore indirectly responsible for sating viewer appetites for everything from CTV News Global Report and X-Factor equivalent One Million Star in Taiwan to reality show MBC Infinite Challenge and a dizzying array of TV dramas in Korea, not to mention the likes of CNN, ESPN and AXN. The companies also provide a range of telecom, broadband internet and related services.

What makes these businesses attractive is that viewer appetite is almost insatiable. "We love cable TV because you have a very stable customer which leads to strong recurring cash flow. Whether there is a recession or not, people pay their monthly subscriber fees," says Michael B. Kim, founding partner of MBK. "The story of North Asia is the story of domestic consumption. And it goes hand in glove with our concentration on telecom and media and financial services."

The private equity firm announced the acquisition of CNS for $1.5 billion – including $840 million in debt and equity participation from co-investors – from Koo's Group and Star TV in October 2006, three months after reaching a final close of $1.5 billion on its debut fund. The asset, Taiwan's second-largest cable TV operator, will be sold to Want Want China for $2.4 billion once the buyer agrees to certain conditions imposed by regulators.

C&M, Korea's third-largest but most profitable cable TV player, followed about one year later as MBK and Macquarie, with selected co-investors, acquired the asset in a $2.4 billion buyout, the largest in Korea to date. Korean lender HK Mutual Savings Bank was another early transaction that fell in the PE firm's consumption play sweet spot.

Leaving the comfort zone

Cable television and financial services in these markets were well known to the MBK team from its time with The Carlyle Group, which bought Taiwan Broadband Communications in 1999 and led the turnaround acquisition of KorAm Bank the following year. That they were willing and able to spin out in 2005 and pursue such deals independently speaks volumes for how far private equity had progressed over the preceding five years.

"I remember one of the slides from our marketing presentation for Fund I declared, 'The center of gravity of the global private equity market is shifting to Asia,'" recalls Kim, who had joined Carlyle in 1998 and eventually rose to the position of Asia president. "We certainly felt the center of gravity of the global economy was moving to Asia with the emergence of China and India."

The first vibrations came with the Asian financial crisis, which opened up a regional market previously defined by growth capital to distressed buyouts. Newbridge Capital took control of Korea First Bank and then Carlyle followed suit with KorAam, and suddenly the prospects for private equity in Asia were changing as others investors sought out restructuring and carve-out opportunities.

Kim, who led KorAm deal, describes the transactions as "a watershed for the industry." Global buyout firms started deploying more resources in Asia and, more importantly for the likes of MBK, international investors began to take the region more seriously. MBK Partners I, which remains Asia's largest first-time fund, is said to have received substantial support from Ontario Teachers' Pension Plan and Temasek Holdings.

It wasn't the only spin-out. Three years earlier, UBS Capital Asia Pacific broke away to form Affinity Equity Partners and launched its first fund raised from third-party sources in 2003, reaching a final close of $700 million. By the end of 2006 Affinity was already well on the way to a third fund worth $2.8 billion, its LP roster populated by North American pension funds.

The J.P. Morgan private equity team that set up in Asia in 1999 spun out the same year as MBK, forming CCMP Capital Partners, which was subsequently renamed Unitas Capital. The GP raised a $1.57 billion fund in 2005 and followed up with a $1.2 billion vehicle that closed in 2008. On both occasions the nature of the LP base was similar to Affinity.

However, the availability of capital alone wasn't enough; MBK and its counterparts had to convince prospective investors that their interests would be best served by backing a smaller, indigenous Asian GP.

"The private equity market in Asia was past its infancy stage, which I characterize as 2004-2005, and entering the adolescent stage," says Kim. "That's the period where you have a growth spurt but you also have some growing pains. The clear trend was you had to be local. We wanted to form an Asian firm operating in Asia owned and operated by Asians. We thought it was time for a local alternative to the global players."

The global players didn't take long to catch on to the benefits of localization, aggressively recruiting investment professionals native to the region, but building out local teams across Asia remains a challenge. As such, they tended to be much stronger in some geographies than in others. Kim cites Carlyle as an example. The firm hired a large team of Japanese and launched its debut country fund in 2001; progress in other parts of Asia was slower.

Strategic considerations

Two other, more strategic, issues also featured in MBK's pitch to LPs. First, there was a desire to find a middle ground between pan-regional platforms that might be too broad and shallow in coverage to identify certain deals and country

> **"The PE market in Asia was past its infancy stage and entering the adolescent stage. That's the period where you have a growth spurt but you also have some growing pains. The clear trend was you had to be local"**

funds where there is a concentration risk. MBK opted to focus on North Asia – China, Taiwan, Japan and Korea – and in this sense remains distinct from the likes of Affinity and Unitas, as well as from the global buyout firms' Asian entities.

"As a block they represent a larger GDP than the euro zone or the US and we thought that North Asia was really where all the buyouts were happening," says Kim. "We wanted to concentrate on this very fertile set of markets rather than do pan-Asia. You can't spread yourself too thin. We don't do venture, we don't do growth, we don't do distress. We do buyouts and we do them in North Asia."

Second, regulatory barriers make it difficult for private equity to operate in certain countries, which pushes firms towards geographic and even sector specialization. Korean

> "We wanted to concentrate on this very fertile set of markets rather than do pan-Asia. You can't spread yourself too thin. We don't do venture, we don't do growth, we don't do distress"

PE legislation promulgated in 2005 required GPs to register with the Financial Supervisory Commission. MBK and about 50 other firms now file disclosures with the regulator on a quarterly basis but in return they are classified as domestic entities and qualify for capital gains tax exemption.

The system also offers a competitive advantage in deal sourcing: once categorized as local, MBK was able to enter strategic sectors to which foreign investors are denied access. This made it easier to win regulatory approval for the C&M and HK Mutual Savings Bank transactions, both in highly regulated industries.

"Korea is an important market for us – it punches above its weight as a private equity market relative to its GDP – so it is important to be able to do business there," Kim says. "And it fits squarely into our investment thesis: to do local deals, where our localness would be an advantage, and focus on our two key sectors, telecom and media and financial services."

Too much money?

Seven years on from the spin-out, MBK is investing its second fund, which has a corpus of $1.6 billion, and is in the process of raising a third vehicle, with a target of $2.25 billion. The firm continues to target market leaders with strong cash flow, almost always seeking majority control because it's easier to implement operational value-add. TMT and financial services remain front and center of a portfolio that is 90% domestic consumption-oriented; export plays have never really come into it.

Kim argues that North Asia retains considerable investment potential, particularly Japan, which has been overlooked in recent years but still boasts a reliable legal system, a strong private equity infrastructure, including leveraged finance, and a lot of companies with compelling fundamentals. Comparing Japan with Korea, he notes that the government could do more to engage with the asset class and encourage cultural acceptance of private equity as an alternative form of capital.

On the flip side, too much money has entered the likes of China and India, leading to increased competition for deals and higher prices. "There was a huge flood of capital from the mid-2000s and it's turned into a high-class problem because there is just too much of it in Asia," Kim says.

As part of this trend, there has also been a proliferation of independent private equity players as investment teams follow the MBK route and break off from existing firms or emerge from other parts of the financial services and consulting industries. While the global buyout firms continue to operate across the whole region, spin-outs tend to have a more concentrated, country-focused agenda. As the fundraising environment deteriorates, it is becoming more difficult for these newly independent players to win over LPs and therefore imperative that they communicate a clear investment thesis.

However, Kim believes the value placed on the combination of local knowledge and international experience means seasoned executives will continue to generate a following in Asia. "They offer technology transfer – how to do a buyout, negotiate it, execute it – and create value post-investment," he says. "These people bring technology back to their home markets where they can marry Western knowhow with local norms, standards of business and customs. This is going to be a critical success factor in the next stage of private equity in Asia." 25

SETTING UP SHOP

Joe Bae, partner and head of Asia at KKR, set up the private equity firm's regional operation seven years ago with two principal goals: being as local as possible and building a franchise that is sustainable in the long term

Joe Bae's fact-finding missions began in late 2004. Over the course of several months in Asia he met with scores of private equity investors and service providers, head hunters, bankers, regulators and government officials. The objective was to return to New York and present KKR's co-founders, Henry Kravis and George Roberts, with an entry strategy for the region.

There was only one cast-iron requirement: the private equity firm's approach had to be differentiated from the competition.

"People had been looking at Asia since the late 1990s but we wanted to do it properly, rather than send three people to Hong Kong and tell them to generate deal flow," says Bae, who has been head of KKR Asia since 2005. "The growth dynamics were clear. Across our global portfolio companies, there were already about 40 manufacturing facilities on the ground here. The question was how do you take advantage of that opportunity as a PE investor and build a sustainable franchise?"

KKR's global expansion has been characterized by conservatism and considered movement. For the first 20 years of its existence, the firm focused solely on North America. A debut European investment came in 1996 with the acquisition of a UK newspaper company and a full regional operation came online in 1999. Around this time a foray into Asia was debated – the Asian financial crisis was offering rich pickings to a handful of global firms – but dismissed in favor Europe's bigger buyout potential.

On-the-ground assessment

When the issue came up again a few years later, Bae was sent to investigate. And what he found were perceived gaps in the market that could be exploited.

"We started our business in Asia with a clear recognition that this part of the world was very different from North America and Europe and that to succeed we would have to localize dramatically in terms of people," Bae says. "You couldn't be an American buyout shop and set up a presence in Asia and think you could succeed just because you had been successful in the US."

He concluded that few of the private equity firms operating in Asia at the time had credible region-wide franchises, rather different participants boasted pockets of expertise, such as strong teams in China or Korea. And none of these franchises were fully plugged into their parent firms' global operations; an observation that might be contested by some but in the case of others was broadly accurate. KKR wanted an integrated approach, with the Asian operations able to draw on expertise from private equity, operations and capital markets teams in the US and Europe.

The region was still divided up into six key markets – an acknowledgement of how different languages, cultures, regulatory systems and growth trajectories influence individual investment environments – but this was so KKR could address them one by one. China was the top priority, followed by Southeast Asia, India, Australia and New Zealand, Japan and Korea in no particular order.

"We had to be disciplined and sequentially build the platform market by market around the best people we could find, and when we found those people accelerate the entry strategy," says Bae. "A lot of the Western firms started out with a very Western approach, putting a lot of expatriates and US-trained investment bankers and consultants on the ground. We wanted a highly localized team in each market."

This approach is reflected in the makeup of KKR Asia today. With the addition of a Singapore office in October, Asia now accounts for seven of the private equity firm's offices globally with approximately 100 executives working out of them. Half are private equity professionals and only two – Bae is one of them – are expatriates. Private equity operations in Beijing are run by mainland Chinese natives, Indians in Mumbai, Australians in Sydney, Koreans in Seoul and Japanese in Tokyo. Singapore-based team members come from Southeast Asian countries.

Hiring policies

It has taken seven years to achieve this balance. KKR moved first in China, hiring current Head of China David Liu and three other senior executives from Morgan Stanley Private Equity Asia in 2006. This group had been investing in China for 12 years, building up a strong track record of domestic consumption-oriented deals that KKR saw as the basis for its own strategy in the country.

Growth capital investments have followed in the likes of clothing companies China Outfitters and Novo Retail, niche healthcare player China Cord Blood Corp, water treatment specialist China Envirotech and milk supplier China Modern Dairy. In 2010, four years after KKR launched its $4 billion debut Asia fund, a $ 1 billion China growth fund was created to accommodate investments of below $75 million that are seen as strong proxies for the domestic consumption story but are too small for the buyout-focused Asia vehicle.

"We want to hire world-class local people but they don't have to be private equity executives," says Bae. "The fifth senior person we hired in China, Xiang Li, came from Goldman Sachs but he spent most of his career at the National Development and Reform Commission (NDRC) so is close to policy executives. In India, we took Sanjay Nayar, formerly CEO of Citigroup South Asia, and paired him with Heramb Hajarnavis, who used to be country head at Goldman Sachs."

As head of KKR India, Nayar has been given license to pursue a local strategy in much the same way as the China team with their dedicated growth fund. Notably, the private equity firm set up a non-banking financial company (NBFC), a balance sheet vehicle that allows it to provide local currency debt products to entrepreneurs who don't want standard equity financing. The onus is on building ties with good companies that may ultimately require a variety of funding options as they expand.

KKR had been tracking Nayar for several years but it was only after the global financial crisis in 2008 that he was persuaded to leave Citigroup. Bae notes that the relationships his country head established with key local families, regulators and government officials during his time as a banker, plus an instinct for what will work in the local market, is more relevant in India than 10 years as a global PE investor.

The other major gap in the market Bae identified when

"A lot of the Western firms started out with a very Western approach, putting a lot of expatriates and US-trained investment bankers and consultants on the ground. We wanted a highly localized team in each market"

conducting his initial reconnaissance is perhaps best described as anti-opportunism. Private equity made its mark in the region through restructuring deals in the wake of the Asian financial crisis, which opened up a channel for larger-scale buyouts. By the time KKR arrived on the scene this window had closed, although arguably some of the spirit remained. The private equity firm felt the time was right for a longer-term, active involvement approach that it had already introduced in the US and Europe.

"In Capstone we have a large operations team on the ground," Bae says. "When you look at China and Southeast Asia, where you are participating predominantly as a minority investor, entrepreneurs want more than just capital. They are picking a partner and your ability to deliver dedicated high-impact operational executives to help drive growth is critical."

This input might concern sales and marketing, opening new stores, introducing manufacturing efficiencies or rolling out improved IT systems. Yet arguably the most vivid example of KKR value-add was China Modern Dairy, which saw the implementation of a whole new business model. The private equity firm teamed up with CDH Investments Management, a leading domestic GP, to acquire a 45% stake in Modern Dairy for $181 million in 2008.

The announcement came a matter of weeks after the melamine scandal when tainted milk products cost the lives of six infants and hospitalized hundreds more. One dairy company went out of business and it took the industry as a whole months to recover due to the massive drop in consumer confidence. The contamination arose from poor oversight of the fragmented supply chains through which Chinese dairy products manufacturers sourced their milk and KKR focused on this problem.

"A lot of people rushed in and invested in the milk processing companies because the stocks were down 30%," recalls Bae. "We stepped back and said the issue is there are no large-scale dairy farmers supplying milk in a safe way, there is an opportunity to create value for the industry by developing some. We brought in a lot of experts from the US and Australia to help set up this operation and ran it as a joint venture with Mengniu, China's leading dairy processer."

Where to deploy?

KKR has committed $5 billion across 28 deals in Asia over the last seven years. At least one major investment has been completed in each of the six key markets, with China accounting for more than one quarter of capital deployed, followed by Southeast Asia on 23%, India and Korea both on 17%, Australia on 10% and Japan trailing on 6%.

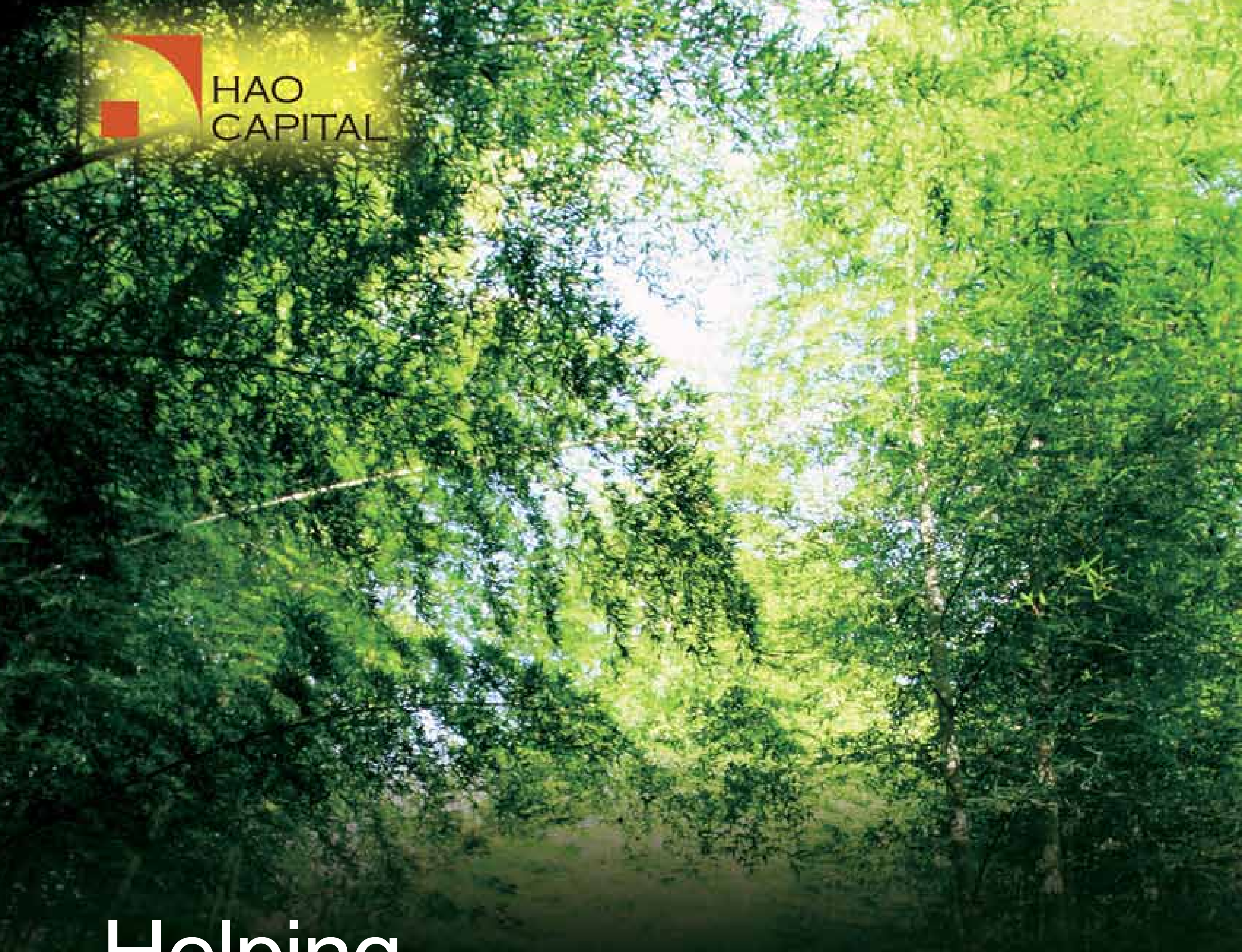
A pan-Asian fund has the luxury of investing in different markets as and when opportunities arise: KKR completed two large buyouts in Australia in 2006 and then sat on the sidelines until this year as valuations moderated; China is on schedule with more upside anticipated; India and Southeast Asia have seen more activity than expected.

However, preconceived notions on North Asia, and Japan in particular, appear to have been misplaced. Even though existing investments are performing well, the portfolio hasn't grown due to a lack of quality assets coming to market. For Bae, the situation is an example of how KKR must play the long game and wait for cycles to turn. A second Asia fund, with a reported target of $5-6 billion, is in the pipeline and he expects to deploy a larger portion of the corpus in these countries.

"We stepped back and said the issue is there are no large-scale dairy farmers supplying milk in a safe way, there is an opportunity to create value for the industry by developing some. We brought in a lot of experts from the US and Australia to help set up this operation"

It is also reminder that, even though the private equity firm has been in Asia for seven years and the region is responsible for some of its best returns globally, local markets remain difficult to fathom.

"What's always challenging about Asia, especially in my regional management seat, is the complexity," he says. "What we thought would be hard, such as dealing with local entrepreneurs, has turned out to be hard. A lot of issues that you take for granted in the US – like return on capital – aren't looked at in Asia. The day-to-day execution is complicated and you need a lot of patience."


HAO
CAPITAL

The Rise of China (2004-2012)

China Fundraising (USD/RMB) $142.4b/$80.5b

Funds (USD/RMB) 949/705

China investment $147.8b

China deals 4,866

EARLY MOVER ADVANTAGE

X.D. Yang, managing director and co-head of Carlyle Asia Partners, joined the buyout firm as it sought to up its game in China. A hugely successful insurance investment remains the landmark deal, but he expects to see more

It is difficult and perhaps unfair to assess a private equity firm's experiences in China through the lens of just one or two transactions. For The Carlyle Group, however, the exercise is instructive, throwing light on the challenges and opportunities investors faced when the country first opened up to PE as well as offering a perspective on how the deal landscape might evolve.

This is the story of China Pacific Insurance and Xugong Construction Equipment. The former is reportedly on course to be Carlyle's largest-ever cash exit globally; the latter promised much but a proposed deal never came to fruition.

When Carlyle first came across China Pacific, the country's third-largest life insurer, it was every bit the classic distressed financial services asset: insolvent and losing money, its business – and 200,000 employees – kept afloat by accommodating government shareholders. The private equity firm injected $740 million into the company across two tranches, in 2005 and 2007, through its debut Asia buyout fund. Following a restructuring of China Pacific's subsidiaries, Carlyle ended up with a 19.9% stake in the parent company.

It was a groundbreaking transaction in terms of its size, sector, complexity and the fact that the private equity firm abandoned its typical buyout-only approach and agreed to take a minority stake. Investment professionals also had to put China Pacific's management through a crash course in private equity.

"We knew the company had great potential but a lot of work had to be done," says X.D. Yang, managing director and co-head of Carlyle Asia Partners. "We spent a fair amount of time explaining what Carlyle is. That was a good process for the two sides to get to know each other and I have to give credit to China Pacific's management for recognizing that a global firm like Carlyle could make a difference to their business. It's very different from today. Now everyone knows private equity and they know Carlyle."

China Pacific has also been turned on its head. Reorganized and recapitalized, the company listed in Shanghai in 2007 and in Hong Kong two years later. Based on public market disclosures, Carlyle held a 3.5% stake as of October 2012, having generated about $4.4 billion through a series of block trades.

Time to scale up

Carlyle has been investing in China since 1999, initially pursuing growth deals via its Asia venture funds, the first of which closed in 2000 on $159 million. Early victories included travel website Ctrip, now a NASDAQ-listed company with a market capitalization of around $2.5 billion.

Yang joined one year later from Goldman Sachs' China merchant banking division when Carlyle decided to step up its efforts and target more buyouts. The market wasn't conducive to realizing such opportunities. While the venture space was already well covered – and there was a degree of awareness of how it operated as a result of the tech bubble – the idea of investing in more mature companies was not understood.

"It wasn't a natural thing for an entrepreneur to say, 'I want some capital, I'm going to talk to a PE firm.' That concept didn't exist," says Yang. "We had to educate people on what private equity could do and it took quite a while. The education period was probably 2000-2004. We looked at some deals, but they were much smaller, nothing more than $100 million."

The standout transactions from that period were strictly minority deals completed by the likes of CDH Investments, Morgan Stanley Private Equity Asia, Goldman Sachs, Hony Capital and Newbridge Capital. This was the era of Mengniu Dairy, Yurun Food Group, Shanshui Cement and Shenzhen Development Bank.

In this context, Carlyle's $375 million bid for an 85% stake in state-owned Xugong, a leading construction equipment manufacturer, in 2005 was an extremely ambitious move. The private equity firm emerged victorious from a 12-month auction process run by Jiangsu provincial government, Xugong's ultimate owner. However, the Ministry of Commerce delayed on granting approval, while the president of Sany Heavy, a rival equipment maker, denounced the deal on nationalistic grounds and said his firm would pay a premium to keep the asset in Chinese hands.

Although Carlyle offered to make concessions, such as reducing its equity stake in Xugong, approval wasn't forthcoming and the investment agreement eventually lapsed in 2008.

From a 10-12 person team making selective investments in 2001, Carlyle now has at least 70 people dedicated to the country. In the Carlyle Asia Partners team alone, there are more than 20 investment professionals, up from 4-5 a decade ago. The firm's buyout, growth capital, real estate and renminbi-denominated funds have invested approximately US$4 billion in more than 60 deals in the country.

"That makes us one of the most active investors, multinationals included," says Yang. "How many companies in the world have invested $4 billion in cash in China?"

Post-Xugong, the PE firm has focused on minority investments in privately-held companies, partly because such enterprises have grown in size and sophistication. They now regard private equity as a viable funding channel, particularly given the capital markets slowdown and tighter bank-lending policies of the last two years.

"I have to give credit to China Pacific's management for recognizing that a global firm like Carlyle could make a difference to their business. It's very different from today. Now everyone knows private equity and they know Carlyle"

Yang, however, is unwilling to write off state-owned enterprise (SOE) opportunities. "In the mid-2000s there was a lot of consolidation, inefficient SOEs were shut down or taken private, and the survivors are mostly very large," he says. "On this basis, the opportunities for PE are likely to be minority stakes, but you can never be too sure. In the next few years SOEs will become more streamlined and divest non-core businesses. This should generate control deals."

The wider issues dictating the role of private equity in

> **"We've had minority deals, SOE deals, private company deals, pre-IPO deals, and more recently PIPE deals and take-privates. This trend of change will continue"**

China relate to the country's evolving development model. Reorienting policy with a view to boosting the consumption share of GDP and easing dependency on investment-led growth, strengthening social infrastructure, opening up the services sector and slimming down industries bloated by overcapacity; these fundamental changes will create openings for private equity in the next few years, especially if they take place in a slower growth environment.

"We thrive in these uncertain times and that's why there have been more deals recently," says Yang. "Private equity is also very hands-on and very good at managing change and value creation. There was a period dominated by pre-IPO investments and companies that just needed capital, but now PE firms have to be much more involved, helping companies in challenging operating environments."

In this regard, he expects to see just as much consolidation in the private sector as among SOEs, noting that there are numerous industries where major players have yet to emerge, domestically or internationally. Private equity in China is likely to experience a similar transition as marginal players exit and the larger, more successful firms – those with stable teams, strong skill sets and differentiated strategies – consume even more market share.

The upshot is bigger funds and bigger deals. Carlyle attracted commitments of $2.55 billion for its third regional buyout fund in 2010 and is reportedly targeting around $3.5 billion for the successor vehicle. The PE firm is also participating in the wave of take-private transactions that has sprung up recently, with approvals pending for buyouts of US-listed Focus Media and 7 Days Group Holdings, worth $3.5 billion and $635 million, respectively.

"China's GDP is $7 trillion and private equity as a percentage of companies' capital needs is still very small," Yang says. "A $1 billion transaction size isn't that big given the scale of the economy as a whole and investment themes are always evolving. We've had minority deals, SOE deals, private company deals, pre-IPO deals, and more recently PIPE deals and take-privates. This trend of change will continue. I don't think the Focus Media deal is a one-off because at some stage in the life of a company the public market isn't the best place to be."

Exceeds expectations

The situation is far removed from the days of China Pacific or even Xugong, but private equity, like many industries in China, has developed in a compressed timeframe. Indeed, its progress far exceeded Yang's expectations, particularly in terms of the competitive landscape.

He puts forward two explanations for this. First, when Carlyle set up shop, the country was still three years away from WTO membership. While economic growth was expected, the steepness of its trajectory was not – since joining the organization, China's GDP has gone from being about equal to Italy to more than three times the size of Italy. Private equity has ridden on a rising tide of multinational interest in the country. Second, the emergence of renminbi-denominated funds has been incredible, from zero in 2005 to many thousands today.

PE capital arrived en masse and somewhere along the way local companies began to accept the asset class and appreciate the role it plays. Government policy is more accommodating; entrepreneurs' eyes no longer glaze over at the mention of shareholder agreements, rights and warranties; there is a general acceptance that PE investors require access to financial records, board seats, veto rights, management engagement and exit rights. Executing deals remains a challenge, but it easier than 10 years ago.

"People always project the future based on the past," says Yang. "A decade ago you'd think there would be 5-10 private equity firms investing and the deals would be a bit bigger – $200-300 million rather than $100 million. And you'd expect there would be 20 people on each team and maybe 10 active funds, with the largest about $1 billion. Back then we never thought there would be local funds, but all these things have happened in 7-8 years. To have this mix so quickly is unprecedented."

LOCAL LEADER

John Zhao, founder and CEO of Hony Capital, teamed up with Legend Holdings to create China's first buyout fund in 2003. Nearly 10 years on, he is still restructuring state-owned enterprises but also looking to go overseas

John Zhao began his career in the movie business. Back in the 1980s, the founder and CEO of Hony Capital was a junior manager at Jiangsu Radio Factory, a state-owned enterprise (SOE) in Nanjing. The company was very much a creature of its era – a series of production lines gathered under one roof by local government planners, churning out a variety of goods. One division assembled first-generation PCs using imported parts; another was responsible for data transmission systems; and a third made audio systems for movie theaters. That is where Zhao started out.

"The company got twisted into a few smaller pieces and was eventually moved out of the city," he says. "Those pieces still exist but they aren't very good. It's a shame I was too late to restructure them. By the time I returned from the US in 2002 they were already in that shape."

Zhao spent nearly 12 years in the US, first as a post-graduate student and then in several managerial roles. If that period equipped him with the skills to run a private equity firm and interact with international investors, working at Jiangsu Radio Factory taught him all about what would become his target market. "I had no fear of SOEs," he recalls. "I thought most of them had very good assets, they just needed to make their system more market-driven."

Impressed by the economic and political progress China had made in his absence, Zhao concluded it was an opportune time to start an investment firm. The question was how to go about it.

Several foreign private equity firms had already made their first forays into China, with Goldman Sachs and Morgan Stanley Private Equity Asia backing Ping An Insurance as early as 1994. There was also one stand-out domestic player, the PE arm of China International Capital Corporation (CICC). It spun out in 2002 when the regulators banned securities houses from owning direct investment divisions and became known as CDH Investments Management.

CDH quickly carved out a niche for itself in the growth capital space, making profitable investments in the likes of China Mengniu Dairy, China Shanshui Cement and China Paradise Electronics. The first two were IPO exits in Hong Kong, laying a path that would be well trodden by private equity investors as the decade wore on.

Creating a partnership

Though a frequent investor in private companies, Zhao endorsed a different approach and ended up with a very different platform. Its origins lie with Chuanzhi Liu, founder and president of Legend Holdings, the parent company of Lenovo, China's largest PC maker. In 2001, Lenovo and Digital China, an IT services provider, were rolled out as subsidiaries and Liu identified investment management as an area worth targeting. He set up VC firm Legend Capital the same year but wanted to take a step further.

"China had just held the 16th Party Congress at which it was declared that SOE privatization would be encouraged, especially among those operating in competitive fields," says Zhao. "Mr. Liu sensed this would be a good opportunity for Legend; I wanted to start an investment firm but wasn't sure whether to do it myself or partner with somebody. We decided it would be best for both to work together."

Hony was founded in 2003 and Legend contributed all the capital for its $36 million debut fund, although the vehicle had a standard GP-LP structure. The firm's first transaction was unlike anything that has since followed. China's banks had been ordered to clean up their balance sheets ahead of the mid-2000s mega IPOs and so a wide range of assets – distressed and slightly less distressed – were put up for sale. Hony bought an asset management company from Bank of China complete with a portfolio of 28 equity investments.

"It was a one-of-a-kind deal," says Zhao. "It was done to demonstrate that Hony could quickly get into business with SOEs and make some money, and we did."

Several months later, the private equity firm secured its first proper restructuring deal with the acquisition of a majority share in mid-size flat glass manufacturer Jiangsu Glass Group for $9.7 million. The transaction was negotiated with the provincial State-owned Assets Supervision and Administration Commission (SASAC), which wanted rid of a loss-making enterprise on reasonable terms. Hony made improvements, including incentivizing management by giving executives stock, and took it public in Hong Kong two years later as China Glass. The company then embarked on an acquisition drive, consolidating its position as one of China's largest listed glass makers.

"People still talk about it because it was a classic buyout and restructuring, followed by a successful listing and aggressive rollout through organic and inorganic growth. And then the returns were very good," says Zhao. "We thought it was something we could latch onto and that these kinds of opportunities would continue to pop up. Ten years on, the majority of our assumptions have been proved true."

Heading overseas

Of the 70 or so deals Hony has completed to date, about half have been SOE restructuring of various kinds. They range from pure restructuring deals like Shijiazhuang Pharmaceutical, now a Hong Kong-listed firm that trades under the name China Pharma, to variations on the theme such as construction equipment manufacturer Zoomlion Heavy Industry, where the company was already an established leader in its industry but required assistance to achieve certain strategic goals.

While the association with Legend certainly helps when negotiating with SASAC and other regulatory authorities – Zhao says structuring Hony as a Legend-sponsored platform is "one of the best decisions I have ever made" – there is a broader theme of alignment of interest and value creation.

"Once we buyout a company from the state we can focus on running the company rather than pleasing the state, which has different priorities and interests," Zhao adds. "By realigning management's interest and the company's interest we make them more interested in improving operations, introducing new technology and boosting competitiveness."

Hony's investment approach evolved as the firm grew in size. The second fund closed in 2004 at $115 million, more than three times the size of its predecessor, with international investors such as Goldman Sachs and Temasek

> **"People still talk about China Glass because it was a classic buyout and restructuring, followed by a successful listing and aggressive rollout through organic and inorganic growth. And then the returns were very good"**

Holdings coming on board. Two years on, Fund III represented another large step up to $580 million, but it was really the fourth vehicle, Hony Capital Fund 2008, that saw the firm establish itself as a player of significant size.

At $1.4 billion, the fund was far larger than anything Hony had done before and saw the introduction of large institutional investors such as the California State Teachers' Retirement System (CalSTRS) and Canada Pension Plan Investment Board (CPPIB). But the private equity firm concurrently raised China's first-ever renminbi vehicle, which received commitments of RMB5 billion ($799 million).

With more firepower at its disposal, Hony began to support its portfolio companies in cross-border deals. Zoomlion was among the first, as the private equity firm participated in the $580 million acquisition of Compagnia Italiana Forme Acciaio SpA, an Italian construction equipment manufacturer, in 2008.

"Many of the companies we invested in earlier were considering international expansion," Zhao says. "It was a good opportunity for us to become a sponsor because we are close to the management teams and we also have a global LP network so there are many ways in which we could reach out. The deals also tend to be larger – exactly what we need as a larger fund – so everything fell in place naturally."

In another twist on the cross-border theme, Hony also invests in international companies that want to build up a presence in China but have neither the experience nor resources to address the market properly. Two years ago the private equity firm acquired a 29% stake in Singapore-based medical device manufacturer Biosensors International for $134 million and has since helped the company develop its distribution platform in China.

So far Hony has completed 5-6 cross-border transactions with more in the pipeline, particularly across luxury brands, high-end manufacturing and retail.

Scaling up

Over the course of 2011, the private equity firm boosted its assets under management by a further $4 billion as a fifth US dollar-denominated fund closed at $2.36 billion, while the second renminbi fund attracted RMB10 billion, twice as much as its predecessor. Hony now has about 180 people – including 65 investment professionals – in Beijing, Shanghai and Hong Kong and 30 more staff at its in-house consulting operation, which was set five years ago and is loosely modeled on KKR's Capstone division. The firm tends to hire people and train them up in expectation of each new fundraise.

"Our bottleneck has always been how quickly we could grow a quality team and I built the firm precisely with that as the limiting consideration," says Zhao. "Each time we raise a fund we make sure we have enough manpower to support however much capital we want to attract. And every time we hard cap the fund to make sure it doesn't get too big."

"Each time we raise a fund we make sure we have enough manpower to support however much capital we want to attract. And every time we hard cap the fund to make sure it doesn't get too big"

The rapid growth of the last 10 years has produced a well-known firm in what is an increasingly mainstream asset class in China. The explosion in renminbi funds – something no one in the industry predicted but Hony instinctively felt it should lead, as a strategic hedge if nothing else – is the principal actor in this. Zhao admits there have been some undesirable side effects as inexperienced managers who fall well short of global standards are carried along by the wave of private equity euphoria. But, equally, the slowdown seen in the past 12 months is expected to root out the underperformers.

"China is becoming a capital surplus country and it is better for these funds to be professionally managed rather than controlled by the old institutions," Zhao says. "Private equity has proved it can be a useful force and now we stand before a huge opportunity: China is entering a massive phase of restructuring and it also needs to improve management quality to become a strong global player."

While private equity and Hony in particular are expected to play an active role in this process, the firm's sheer size and name recognition is a benefit but also a burden because it implies closer scrutiny. On one side, Hony must fulfill the exacting compliance standards of large North American institutional investors; on the other, it is operating in a market that still has much in common with the Wild West.

"From day one, I was focused on building an institution that would last forever," Zhao says. "Strategy is important, focus is important. Reputation is everything. As we grow and have more impact, stepping on people's toes – unconsciously sometimes – we need to be more mindful about our public profile."

RETURN TO RATIONALITY

Yichen Zhang, CEO of CITIC Capital, watched as pre-IPO strategies took Chinese private equity to unthinkable highs in the mid- to late-2000s. As the market returns to more sustainabe levels, he sees control opportunities amid the chaos

"The speed at which PE has gone from obscurity to household name in China surprised everyone," observes Yichen Zhang, CEO of CITIC Capital. "The asset class is probably better known in China than in the US. And it's generally a positive view: you invest in companies, they go public, everyone makes a lot of money."

But is this view still accurate? Factor in the inevitable lag period and China fundraising follows investment, which follows the trajectory of capital markets. All have started to suffer over the past 18 months, calling into question the pre-IPO model that has defined Chinese private equity for much of its decade-long history. Mainland listings have slowed – with exit multiples a fraction of what they were 18 months ago – while Hong Kong's IPO market started to dry up towards the end of last year. Growth capital investment has stuttered and fundraising is declining, particularly among renminbi-denominated vehicles.

"We have never focused on pre-IPO deals, although if you look back to our first fund in 2006-2007 that's probably what we should have done," says Zhang. "Instead we chose the hard way, focusing on state-owned enterprise (SOE) restructuring, so we never followed the momentum in the market. In the early days you had funds trying to scrape together $100-200 million; it wasn't until 2006 that people realized the industry was going somewhere."

Zhang founded CITIC Capital in 2002 with Brian Doyle, having previously worked at parent company CITIC Group and before that as a banker with Merrill Lynch. Now jointly owned by CITIC Group and China Investment Corporation, it has $4.4 billion under management.

Back in 2006, however, there was only the $425 million debut vehicle. Its first investment came later the same year. Leading a group comprising Warburg Pincus and a local private equity firm, CITIC Capital took a majority stake in state-owned Harbin Pharmaceuticals. The transaction, which was almost two years in the making, is a typical example of what remains the firm's approach to this day. SOEs account for about half of its portfolio.

Harbin Pharmaceuticals was also typical of the kinds of issues faced post-investment: ushering out managers who are part of the fabric of the state system; eliminating overcapacity, corruption and ineffective spending; and replacing inefficient working practices.

Before CITIC Capital and Warburg Pincus invested, Harbin Pharmaceuticals was spending four times its annual net income on television commercials and investing in a portfolio of 100-plus products, many of which didn't make any money at all. Furthermore, each subsidiary maintained its own finances, which meant that profit-making businesses were receiving low interest returns on bank deposits while loss-making units paid heavy premiums to borrow money.

Action was necessary but it had to be incremental because it meant facing down resistance from managers desperate to hold on to power.

While CITIC Capital was implementing this turnaround the market was inflating. "In 2002-2003, Chinese stocks were trading at a discount; by 2006-2007 they were on a par with international equities; by 2007 a China premium emerged and it got even bigger after 2008 because growth was so strong," says Zhang. "The capital markets were clearly driving up primary market valuations and at the same time more was coming into private equity."

Valuation upheaval

The impact on valuations was felt by all China-focused managers, regardless of strategy and currency. In the early- to mid-2000s, private equity firms could invest at 5-6x forward price-to-earnings (P/E) ratios. Within three years, valuation expectations had more than doubled and by 2010 entrepreneurs were asking for as much as 15x. "Now it's sort of stuck, adjusting a bit but not fast enough," Zhang says. "Anything more than 10x and you still need to think about it carefully. By comparison, public-to-private deals can be done at 10x or less, if you take out the cash."

The full extent of the damage to portfolios caused by falling public market exit multiples has yet to be calculated. Success stories – a company lists within two years, generating an exorbitantly high IRR – are widely publicized but failures take longer to emerge. A portfolio judged on a mark-to-market basis in 2007 might have looked great because investments were recent and tended to be marked at cost. Four to five years down the line, the metrics are different.

"If you weren't able to cash out, you took a very nice ride, but now valuations have retreated and you can't mark up anymore," says Zhang. "At the height of the market the overall picture was distorted. LPs might have have had unrealistic views of PE given the early vintage funds were doing so well. However, the true stories will eventually come out."

GPs with reasonable track records, particularly those that manage US dollar funds and renminbi vehicles, are expected to emerge largely unscathed. The problem children are local currency funds raised on an overstated promise of strong returns within a 24-36 month timeframe.

Many are expected to go bust – and even if the multiples swing in their favor the IPO pipeline will not. It is estimated there are 4,000-6,000 of these renminbi funds. If they made 8,000 investments and the public markets were able to absorb 300 per year, it would take more than 20 years for the backlog to clear. CITIC Capital is already seeing situations in which existing shareholders are agitating for an exit and forcing management teams to find new investors capable of buying them out.

"The entrepreneurs don't want these guys in the company anymore," says Zhang. "When we negotiate with the entrepreneurs we offer to buy out the investors but ask for more equity on top of that. This creates change-of-control opportunities that would not otherwise be there. And these are good companies."

It points to a widening of CITIC Capital's target market. Previously it was easier to persuade local governments to give up control of companies than entrepreneurs: while the former had little vested interest in holding on to an underperforming assets, the latter wouldn't countenance giving up a majority stake because of what it might be worth to them personally post-IPO.

This is now changing, driven by weaker public markets but also by an evolving industrial environment and company owners recognizing the value of partners that offer additional managerial expertise and technology.

"Doing business in China is very hard," says Zhang. "Entrepreneurs never get off work – even after leaving the factory they are wining and dining government officials – and many now see the prospects are not as bright as before so they think about slowing down. The one-child policy also means there are limited succession options. That's why we see entrepreneurs becoming more receptive to buyouts." 25

"We have never focused on pre-IPO deals, although if you look back to our first fund in 2006-2007 that's probably what we should have done"

Emerging India (2005-2009)

India fundraising **$31b**

Funds **156**

India investment **$43.1b**

Deals **1,590**

MOTHER VENTURE

Renuka Ramnath, founder and CEO of Multiples Alternative Asset Management, helped kick-start India VC as ICICI Venture grew from a small-scale backer of internet start-ups into the country's leading private equity firm

Renuka Ramnath's departure from ICICI Venture Funds Management in 2009 represented not only India's most-high profile spin-out but also the end of an era. She had spent more than 20 years with ICICI Group, the last eight of them as CEO of its wholly-owned private equity business that had grown from nothing into the largest domestic investment organization of its kind.

"I had no choice but to leave – my ideology for ICICI Venture and ICICI's ideology were completely divergent," says Ramnath, who is now founder, managing director and CEO of Multiples Alternative Asset Management. "I firmly believe that a VC firm should be a stand-alone entity managing third-party capital and highly respective to the requirements of international LPs. ICICI believes that it is a big brand and they can run it just like they run their insurance or banking businesses."

She traces her ideology all the way back to a period spent at Harvard Business School in the 1990s participating in an advanced management program. The tech bubble was at its most inflated and anyone with a business degree and an internet connection had ambitions to create a tech start-up. Ramnath wanted to do the same in India.

"I had been bitten by the entrepreneurial bug," she says. "I wanted to develop something in e-commerce over and above what was already being done. I started to incubate e-commerce start-ups and make a few investments in other internet companies – online marketplaces, technology providers, software solutions companies. The general idea was to leverage internet penetration."

It was 1999 when Ramnath started creating an e-commerce network and ICICI Venture gave her the firepower to do it with the INR1 billion (then $18.5 million) EcoNet Fund. Within two years Compaq came on board as an LP and strategic partner. Among the first investments was BillJunction.com, a domestic payment service provider that was sold to a clutch of PE investors in 2007.

India's online population stood at about 2.8 million in 1999; one year later it had nearly doubled and by 2009 it was 61.8 million; in the last two years it has doubled in size again to 121 million. Ramnath's venture activities largely followed this trajectory – deal sizes got larger and there began to be some crossover between ICICI's EcoNet and venture vehicles as investment into technology and internet-related companies grew in popularity. She was appointed CEO of ICICI Venture in 2001.

"There was a position and they offered me the job because I was passionate about it," Ramnath says. "I was

"I had been bitten by the entrepreneurial bug. I started to incubate e-commerce start-ups and make a few investments in other companies. The general idea was to leverage internet penetration"

very excited to do it and they had confidence in me as an entrepreneur at heart."

ICICI Venture's investment horizons broadened, with minority commitments made to the likes of cinema chain PVR, GMR Infrastructure, Centurion Bank of Punjab, Reliance Petroleum and Metropolish Health Services. It also became the first Indian private equity firm to branch out into buyouts and corporate carve-outs.

ICICI Venture's debut carve-out was the acquisition of Ranbaxy Laboratories' diagnostics, fine chemicals and animal health divisions for INR1.25 billion in 2005. The animal healthcare business, Vetnex, was sold to Pfizer four years later for about INR3.75 billion while the remaining assets – operated as RFCL – were picked up by Advantor Performance Materials for approximately INR5 billion in 2010.

Ramnath also highlights ACC Refractories, bought from Associated Cement Companies for INR2.57 billion in 2005 and sold on to Calderys for INR5.5 billion within two years. "It was a case of taking practices from the West, modifying them for the local market, and then pursuing opportunities for a sufficient period of time," she says. "These were divisions of companies and the sellers were only interested in groups that could take 100% ownership and develop the business. It wasn't for minority investors."

Of all ICICI Venture's achievements during this period, arguably the most significant was exiting the legacy portfolio within an agreed timeframe – the EcoNet fund returned $150 million to ICICI, while Series I of the India Advantage Fund, an INR11 billion private equity vehicle launched in 2001, delivered an IRR in excess of 70%. As the likes of ICICI Ventures and ChrysCapital began to build up a stream of profitable exits, the international LP community became more interested.

Capital expansion

Ramnath identifies the turning point as 2005. ICICI Ventures launched the India Advantage Fund Series II and raised $1 billion, although $200 million was subsequently returned to investors due to concerns about fund size. Parallel real estate and mezzanine vehicles were also introduced. According to AVCJ Research, India fundraising jumped from $816 million in 2004 to $3.16 billion in 2005 followed by an even steeper ascent ending in a peak of $13.2 billion in 2008. It dropped off a cliff the next year and has yet to recover, with $2.2 billion raised between January and October 2012.

With the benefit of hindsight, what contributed to the build-up of capital? "They all believed India would generate sufficient opportunities," says Ramnath. "A larger M&A market was contemplated with more corporate high-ball. Even among smaller companies – those raising money to make acquisitions, for example – we expected significant expansion because India is a large country. The excess liquidity pushed up valuations and that is the main reason why funds have underperformed."

She argues that the valuation problem is still there, although in these more straightened times GPs are now less likely to compromise on terms and willing to walk away from deals. Eventually, entrepreneurs' expectations should moderate.

Multiples reached a final close of $450 million for its debut vehicle in November 2011, with commitments coming from CDC Group and Canada Pension Plan Investment Board and Indian Overseas Bank, among others. The smaller corpus means the typical deal size of around $50 million pursued in the latter days at ICICI Venture has fallen by half, but the underlying strategy remains the same.

"I didn't expect PE to bring more than $10 billion into the country in such a short space of time," Ramnath observes. "In 2003, I was struggling to raise $200 million, but by 2005 I could get $1 billion. We were fortunate that we exited our fund I portfolio on time. For Indian private equity as a whole, exits are not something we can be proud of. But if you haven't got a lot of experience and people keep telling you the price will go up further, it's difficult to sell."

STRONG FOUNDATIONS

Luis Miranda became CEO of a fledgling IDFC Private Equity in 2002, raised India's first infrastructure fund, and helped prove that the sector can make money. A flood of new capital arrived and the country is still adjusting to it

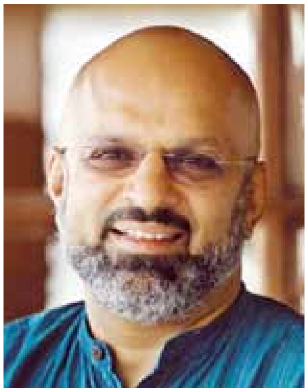
When Luis Miranda was first approached to run Infrastructure Development Finance Company's (IDFC) nascent private equity business, he had no idea what he was getting into. "All I knew was that infrastructure in India sucked," he recalls. "You had all these investors expecting 7-8% growth and the India story wouldn't work unless the infrastructure was fixed."

Most damning of all, no one thought it was possible to make money from infrastructure. As the newly installed CEO of IDFC Private Equity in 2002, Miranda faced an uphill task – he had to drum up interest in an unwanted part of a not widely understood asset class.

The concept of private capital investing in unlisted companies in India was first endorsed by government financial institutions in the 1970s and 1980s. A few specialist venture funds emerged, again with state backing, and it wasn't until the late 1990s that independent VC firms were set up, although the dotcom crash put some out of business.

As a banker at Housing Development Finance Corporation (HDFC), Miranda worked on deals with one of earliest movers, ChrysCapital Partners, and he ended up joining the firm in 2000, about six months after it was founded. The subsequent move to IDFC Private Equity arose because Miranda wanted a change of scene and IDFC needed an executive with a PE background.

The group was set up by the government in 1997 as a project finance lender intended to facilitate private sector involvement in infrastructure development. Five years later, the government asked why so little progress had been made and one of the reasons was limited availability of risk capital, which led to the launch of an infrastructure equity fund. "I met up with the chairman of IDFC, who had been one of my mentors, and I said I wanted to do something different on the development side," says Miranda. "He told me that IDFC had this infrastructure fund mandate from the government and asked me if I would like to set it up and run it."



The new vehicle, named India Development Fund, had a corpus of INR8.4 billion ($192 million). Its parent provided some seed capital, but contributions were also sourced from the likes of State Bank of India, Union Bank of India, Bank of Baroda and Life Insurance Corporation of India. The fund reached a final close in January 2004 and announced its first deal – the acquisition of a 15.1% stake in GMR Energy for $22 million – two months later.

Within 18 months, everyone was talking about India Development Fund, although not for the intended reasons.

"It stands out because it was an investment in the power sector, which at that time was in bad shape – even now the sector is in bad shape because it has gone through an entire cycle of boom and bust," Miranda says. "We invested because we thought the contracts they had were good and we liked the team. They were a small developer and had previously been involved in setting up a bank. Their partners had good things to say about them."

At the same time, GMR Group's infrastructure unit was nurturing big ambitions. It was keen to bid for the public-private partnership contract to develop Delhi International Airport (DIAL) and required financial support. The unit, already developing a greenfield airport in Hyderabad, was considered an outsider but IDFC PE thought the bid was impressive and agreed to participate. As part of the arrangement, its stake in GMR Energy would be swapped into another GMR unit that was planning an IPO.

GMR Infrastructure emerged victorious but the DIAL privatization process remains controversial seven years later. In August, the Comptroller and Auditor General of India published a report criticizing the government for awarding the GMR-led consortium a 60-year lease on the brownfield airport plus rights to surrounding land for well below market value. GMR and the Civil Aviation Ministry challenged this conclusion, noting that the process was cleared by the cabinet and the decision upheld by the Supreme Court.

"The entire legal process took about nine months and suddenly everyone knew about GMR," says Miranda. "We had a joke with the owner that this was the best pre-IPO free publicity one could get. With airports now a hot topic, rather than take one part of the business public, we decided to go with the holding company, GMR Infrastructure itself. We ended up with a 7x money multiple, which is pretty stunning for an infrastructure investment."

IDFC PE's second investment, a 20.5% stake in gas pipeline business Gujarat State Petronet bought for $19.9 million, was also exited via IPO with a 4.5x money multiple. One of the reasons for these impressive returns was minimal competition for deals. However, once others saw what IDFC PE was doing, they quickly jumped in. According to AVCJ Research, private equity investment in infrastructure and construction went from $105 million across five deals in 2004 to $774 million and $1.85 billion in 2006 and 2007, with nearly 30 transactions in each year.

"In 2002, infrastructure was in the dog house but by 2006-2007 it was the most exciting sector to be in. Valuations went through the roof. It was great for exits, but not for investments"

"In 2002, infrastructure was in the dog house but by 2006-2007 it was the most exciting sector to be in," says Miranda. "Valuations went through the roof. It was great for exits, but not for investments. With all this excitement, infrastructure became mainstream and a lot of issues came up regarding land acquisitions and environmental damage that plague the sector to this day."

After the excitement

After an understandably disappointing 2009, investment rebounded to above $1.5 billion in each of the following two years, but the $303 million transacted so far in 2012 doesn't bode well. Miranda doesn't necessarily see this retreat as a negative development: infrastructure is traditionally a low-risk, long-term yield play; in the mid-2000s it became a refinance-driven growth story; now it has returned to the norm.

IDFC PE's second fund closed at INR19.9 billion in 2006 and its third came in at INR29 billion two years later. In 2010, Miranda stepped back from business, moving into the role of non-executive chairman.

Although he believes that Indian infrastructure funds haven't delivered in recent years, Miranda says that IDFC PE served its purpose, proving that the sector can be a money-spinner. The likes of 3i Group, Macquarie, Actis, Morgan Stanley and Warburg Pincus have all since arrived and are committing capital to power, roads, ports and telecom towers. But he warns that investors must appreciate how the sector has evolved and modify their expectations accordingly.

"The kind of companies we backed in those days, if we hadn't given them the growth capital they wouldn't be where they are today," he says. "We had four IPOs – how many infrastructure funds can say that? Now is a good time to invest but it requires discipline. Money management is going to be important in terms of the next chapter in India's growth story."

Australasian LBOs (2005-2008)

AUSTAR

Australasia fundraising **$18.1b**

Funds **105**

Australasian investment **$49.9b**

Deals **916**

INDUSTRY CHAMPIONS

Bill Ferris and Joe Skrzynski set up Australian Mezzanine Investments in 1987. Now known as CHAMP Private Equity, the firm was responsible for some of Australia's first buyouts and then saw the market rise and rise during the 2000s

Buyouts require infrastructure: lawyers, accountants, consultants and bankers to identify targets and conduct due diligence, negotiate contracts, advise on audits, create debt structures and provide financing. Until 2000, no leading Australian banks had a dedicated PE team, but once they grasped the industry's potential, resources were put on the ground. Other service providers followed suit.

The missing piece of the infrastructure was skilled management teams that could be parachuted into portfolio companies post-acquisition. With time, suitable individuals emerged, increasingly mid-career refugees from public companies who had become disenchanted with heavy regulatory burdens and risk-adverse boards. In many cases, these executives ended up taking personal risks, leaving the safety of listed companies to run private firms for less money.

"The shortest commodity isn't the debt or equity, it is access to good management, but today we see serial executives working through" says Joe Skrzynski, founding partner at CHAMP Private Equity. "In the past, when we looked at a potential situation but there were doubts about existing management, we couldn't do a deal. Now we are fairly confident we can attract the management talent that might be missing into the deal at fairly short order."

He claims that more than 250 executives have earned in excess of A$1 million ($1 million) working for CHAMP portfolio companies. It is a statistic that shows just how far the private equity firm has traveled in its 25-year history. Originally known as Australian Mezzanine Investments (AMIL), the firm attracted commitments totaling A$30 million from four superannuation funds – one state and three corporate – for its debut fund. A staff of three proceeded to make investments of A$1.5-4 million.

Early starters

Skrzynski and co-founder Bill Ferris, who now serves as CHAMP's chairman, can trace their experience with the asset class back to 1970, when the former was making direct investments on behalf of a wealthy industrialist while the latter started Australia's first VC firm. "We were working parallel at that time and there wasn't a lot of activity," recalls Skrzynski. "It really got going in the 1980s when there was a bit of government support for early-stage investing through various schemes."

AMIL's early funds offered everything from early-stage to management buyouts – an acknowledgement of the fact that Australian LPs were getting their first taste of the asset class – but the industry began to mature rapidly. In the mid-

1990s, funds were typically A$50-150 million; when CHAMP I Trust reached a final close in 2000, it had a corpus of A$500 million.

The jump in fund size was partly a product of increased international interest. Indeed, CHAMP I Trust and its successors arose out of a joint venture with Castle Harlan, a US-based private equity firm. Castle Harlan's presence helped attract international capital from the likes of HarbourVest Partners and a few North American pension funds. These foreign players in turn encouraged Australian superannuation funds to support the asset class.


Bill Ferris & Joe Skrzynski (*right*)

"What also caught the eye was that the fund was dedicated to mid-market buyouts," says Ferris. "We had to convince ourselves and our investors that if we raised a fund of that size then demand for capital would follow. It was a pioneering phase during which we drummed up demand by encouraging intermediaries, consultants and bankers."

They ended up completing 10 management buyouts, including the purchase of mining and infrastructure materials manufacturer Bradken for A$48 million in equity in 2001, and pay-TV operator Austar, acquired out of bankruptcy for approximately A$67 million in equity one year later. Both companies were exited via IPO, generating money multiples for the PE firm of 3x and 6x, respectively.

CHAMP Buyout II Fund closed at A$950 million in 2005, nearly twice the size of its predecessor but still considerably oversubscribed. Around the same time, global buyout firms were arriving in Australia in force and over the ensuing two years, they tapped into the hyperactivity present in other developed markets. Suddenly Australia was the leading buyout location in Asia. "The debt side of the business became looser than it should have been," says Ferris. "Big or small, deals were overpriced and overleveraged."

As a mid-market firm, CHAMP was largely unscathed by the inevitable fallout. While foreign syndicates were willing to provide debt financing at 9-10x EBITDA, domestic banks didn't go beyond 6x. Now the entire transaction might be priced at 6x EBITDA and private equity firms ask the banks for a debt multiple of no more than 3x.

However, the global financial crisis was problematic for the third CHAMP fund. It launched in August 2009 with a target of A$1.5 billion and, even though a number of LPs wanted to invest, their ability to act was restricted by uncertainty within existing portfolios, which in turn impacted liquidity. The fundraising process took 15 months, about twice as long as the previous fund.

"Very few people were open for business, but the good news was that there was no one else in the waiting room," says Skrzynski. "We certainly got a lot of attention and, although not everyone was in a position to invest, two sovereign funds re-upped with us and we were the first commitment they had made to a GP in 12 months."

One factor that arguably worked in the firm's favor was a tendency among LPs to classify Australia as part of Asia when making geo-fund decisions. Allocations to the region are increasing, largely driven by a desire to boost emerging markets exposure, and Australia adds balance to the portfolio: As a leading commodities exporter, it benefits from growth in Asia, yet offers a rich vein of buyouts and a transparent market that isn't widely available elsewhere in the region.

These ties to Asia are something that CHAMP is keen to exploit as it nears its fourth decade. The private equity firm was the first – and is still the only – Australian GP to establish an office in Asia when opening up in Singapore four years ago, initially to support the expansion of existing portfolio companies. However, earlier this year, CHAMP completed two regional deals: a $1.05 billion joint investment with Castle Harlan and Lime Rock Partners in Shelf Drilling, a Dubai-based shallow water drilling services company that has exposure to Southeast Asia; and the A$199 million acquisition of a 33% stake in Singapore-based shipper Miclyn Express Offshore.

"These deals are only available to us because we have that cross-border capacity," says Ferris. "We have always been actively engaged in Southeast Asia – we did the first US dollar-denominated IPO in Asia when Datacraft went public in Singapore in 1997 – and in the decade ahead Australian private equity in general will become more engaged with Asian markets."

"We had to convince ourselves and our investors that if we raised a fund of that size then demand for capital would follow. It was a pioneering phase"

BIRTH OF THE LBO

Tim Sims, a founder and managing director at Pacific Equity Partners, was part of the team responsible for Australia's first-ever leveraged buyout in 1998. Fourteen years on, Australia is the regional hub for these deals

The massive leveraged buyouts of 2005 to 2007 saw a string of high-profile Australian and New Zealand brands fall into private equity hands – Coles Myer, Yellow Pages, PBL Media, Independent Liquor and Seven Network, to name but a few. Had shareholders not vetoed the proposal, Qantas, Australia's national carrier, would have gone the same way.

In the space of less than a decade leveraged deals went from zero to stratospheric and then, after the global financial crisis took hold, returned to a more subdued level just as quickly. Some prospered while others stumbled, but there is little doubt this period saw a market characterized by venture and growth-oriented transactions uprooted and emphatically transplanted into the world of global buyouts.

Its origins, though, were comparatively humble: the A$50 million acquisition of Frucor Beverages from the New Zealand Apple & Pear Marketing Board by a Pacific Equity Partners (PEP) and Bain Capital-led group in 1998. "If you are looking for when the big bang happened, it was probably Bain Capital and PEP with Frucor," says Tim Sims, a founder and managing director of PEP. "It was the first classic LBO done by international investors in this market place and a lot of the structures and documentation were imported from the US. It produced a 10x money return."

This was PEP's first deal but it took the Australian firm another five years to fully invest its A$150 million debut fund. As to why it took so long for the market to get moving and why it quickly became Asia's leading buyout market – Australia and New Zealand accounted for 44% of regional sponsor-backed M&A volume between 2006 and 2010 – when it finally did, one must explore the evolution of private equity and the nature of corporate Australia.

A frontier market

Initial domestic participation in the asset class was led by Australia Mezzanine Partners and a few captive funds. Their reach was limited by conservative institutional investors that were intent on small funds of less than A$100 million and limited fee scales. From a foreign perspective, meanwhile, the market was largely impenetrable.

"They faced two major challenges," Sims says. "First, it was unclear how you could participate from a tax point of view . Second, there wasn't experience on the ground that allowed foreign investors to replicate the behaviors that were successful in legacy markets such as the US and UK, but in an entirely new market."

There weren't enough law firms and accountants capable of dealing with leveraged buyouts, but the most interesting conundrum lay with the banks. Australia's banking industry was deregulated in the 1980s and this gave rise to an explosion in lending to a new generation of entrepreneurs – Robert Holmes à Court, for example – who engaged in corporate raiding, staging hostile takeovers of companies fueled by piles of debt. Inexperience counted against the banks and all had their fingers burnt, resulting in a wariness of leveraged deals. They also had little confidence in private equity as a serious contender for assets based on the small domestic funds present at the time.

The frustration for foreign private equity firms, in search of new buyout markets as competition intensified in the US, was that Australia offered rich potential. Though economically strong and boasting a legal system familiar to Western investors, the country was isolated and lacked buyout structures and support mechanisms.

Regulatory nuances also played a role: Australia's domestic tax policy didn't encourage outbound investment for local corporates because measures designed to eliminate double taxing of corporate dividends only applied to domestic profits while losses generated by overseas operations couldn't be consolidated in Australia for tax purposes.

"That resulted in a tendency to over-invest in seeking growth in the domestic economy, which created very large systems of loosely agglomerated corporations," says Sims. "In a contested capital market these entities probably wouldn't have existed." He cites Goodman Fielder as an example: a fully integrated food company producing everything from muesli bars to fats and oils to bread that had no meaningful operations outside of Australia, New Zealand and the Pacific Islands.

This combination of limited international exposure and large, unchallenged conglomerates represented an attractive target for private equity. Indeed, the realignment of ownership is still being felt: Australia is the world's 12th largest economy and its third-largest leveraged buyout market. Noting that it took the US about 50 years to work through its own disassembly of large, inefficient conglomerates, Sims believes that M&A in Australia will remain disproportionally active for at least the next 20 years.

But back in the late 1990s, these developments seemed a long way off. "It was an extraordinary situation on the demand side – a strong economy with some unusual characteristics due to regulatory limitations that made it ripe for contested ownership," Sims says. "We were mature in terms of capital markets and underlying infrastructure but lacked an asset class that had been active in the US for 20 years. I have described it as Tutankhamen's Tomb."

Opening the tomb

PEP is partly responsible for the tomb being broken open. The founders were previously the regional leadership group for Bain & Company and, like many of their counterparts at the consulting firm, they wanted to enter private equity. Rather than follow the well trodden path from Bain & Company to Bain Capital, the group set up PEP, relying on Bain Capital as a joint venture partner for the first fund. This meant money came in from the US private equity firm's stable of global investors, allowing PEP to target deals that were at the time outside the comfort zone of Australian institutions.

> **"We were mature in terms of capital markets and underlying infrastructure but lacked an asset class that had been active in the US for 20 years. I have described it as Tutankhamen's Tomb"**

The alliance also fostered the development of local service providers. Bain Capital has a strong relationship with PricewaterhouseCoopers in Boston and the accounting firm transferred a team to Sydney to work with PEP. Efforts were also made to familiarize local banks and law firms with intercreditor agreements and other structures that underpinned private equity in the US.

Gradually, the world started to take notice. CVC Capital Partners was an early arrival but reconnaissance teams from the big buyout firms really started arriving in 2005. They brought with them strong international banking relationships, high leverage and covenant-light arrangements. Given the PE firms' broad goal of writing equity checks of $500 million, target companies needed to have an enterprise valuation in excess of $1 billion – around A$1.5 billion based on exchange rates and leverage available at the time. This was beyond the focus of local GPs like PEP.

Australia's unchallenged conglomerates were a natural target, but relatively few companies fell in the valuation range above A$1.5 billion. "These tend to be unusual businesses – banks, airlines, newspapers and television stations," Sims says. "They are very large asset systems often with significant operating leverage resulting from the returns to scale that helped to establish them in the first place. For example, a television station has attractive margins if you get good advertising support but if it contracts by a small amount the margins disappear."

> **"If you look at the track record, it's hard to apportion blame between the extraordinary economic circumstances and the disadvantages you face as an overseas itinerant investing in a remote market like Australia"**

This was the work of sophisticated deal-makers following investment models that had proved successful in the US and Europe. However, high levels of financial leverage in businesses that carry substantial operating leverage were vulnerable in the event of an unforeseen downturn. And the global financial crisis caused unprecedented and unpredicted havoc.

The irony is that Australia wasn't badly hit – its economy was strong and the fundamental drivers were unchanged. What undermined the country's position were the spillover effects of problems elsewhere.

Firstly, one third of publicly traded stocks were held by overseas investors and many promptly repatriated the capital in response to their home markets collapsing. As a result, the Australian equities index fell by 50% in 15 months. Secondly, domestic banks rely heavily on the overseas wholesale money markets and, although the government quickly moved in with funding guarantees, homeowners were worried about mortgage rates and so cut back on spending. Domestic savings shifted from from 2% of household income to 12% in two years. This compares with 4% to 6% in the US over the same period.

"For reasons that weren't endemic to Australia you had this whiplash effect," Sims says. "Some of the large legacy businesses suffered terribly. Media spend was cut dramatically by advertising companies that were no longer being fueled by consumer spend because consumers were worried about mortgages that were in some way connected to the global financial crisis."

Return to normal

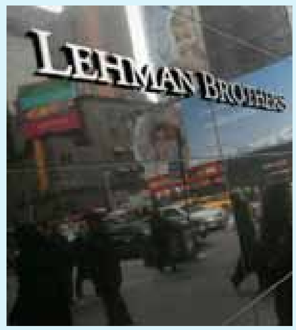
Buyouts have since returned but leverage levels are more modest and covenant-light structures have gone. PEP's fourth fund – a A$4 billion vehicle, including A$1.3 billion for co-investments, raised in 2008 – was designed to target companies with enterprise valuations of up to A$1 billion. It is consistent with a middle-market focus that has been part of the private equity firm's strategy since it raised its second fund in 2004.

Sims expects the larger deal space – investments worth $500 million or more – to remain active at the level of one to two transactions a year. This is partly because many of the investments made in this space in 2005-2007 simply haven't performed as the global buyout firms anticipated.

Of the $8 billion in equity that was invested in larger deals by international players during the period, he says that $5 billion is severely compromised and is carried at less than 1x of the original investment value. A further A$1.5 billion remains at book value and the remaining A$1.5 billion is above 1x but very few deals have been realized.

What may change is the fly in-fly out approach traditionally employed by international private equity firms in Australia. "If you look at the track record, it's hard to apportion blame between the extraordinary economic circumstances and the disadvantages you face as an overseas itinerant investing in a remote market like Australia," Sims says. "Establishing remote offices in this country brings with it a whole new suite of challenges."

The Global Financial Crisis (2008-2010)



Fundraising $132.7b

Funds 1,143

Investments $183b

Deals 5,283

COOL HEADS IN A CRISIS

David Gross-Loh and Jim Hildebrandt, managing directors at Bain Capital, guided the firm's Japan-heavy Asia portfolio through the global financial crisis. Acting fast without overreacting was central to their approach

As the financial crisis cut a swath through global markets, Bain Capital Asia's first instinct was to put people on the ground. The Japanese economy was the worst hit in the region – a mid-2000s recovery rapidly unwound as exports collapsed, sending the country into recession by the third quarter of 2008 – and it accounted for the private equity firm's three largest deals. It was logical that the work start there.

Asia portfolio executives, who are permanently embedded with companies to assist the management teams, were redeployed to trouble spots. There was also the option of re-tasking deal team members – given the economic uncertainty they were of course less busy – to supporting roles. A private equity executive that previously spent only 25% of his time improving companies suddenly saw that percentage rise to 50%, 75% or more.


David Gross-Loh

"We sent in a lot of people quickly to look at changes in direction and focus on cost opportunities, that was a huge advantage," says David Gross-Loh, the Bain Capital managing director who set up the firm's Japan office in 2006 and still runs it. "At one point with D&M we had 10-12 people on the ground, and not just in Japan because it's a global business."

D&M, a provider of premium audio and visual equipment, was acquired by Bain for about JPY47.6 billion (then $430 million) earlier in 2008, the transaction closing a matter of days before Lehman Brothers collapsed. Selling mostly into the US and Europe, the company inevitably struggled.

The initial challenge was realigning cost structures that had been drawn up on the basis of a growth strategy, which now clearly wasn't going to come to fruition in the short- to medium-term. D&M reduced costs by about $100 million over 12 months with one eye on consolidating a business that was put together through acquisitions – Denon was spun out from Nippon-Colombia in 2001 and merged with Marantz a year later – but had never been fully integrated.

"The whole goal was to manage costs and manage cash flow, so that we could ride the downturn and emerge as one of the players that had continued to participate in R&D and had good products for when the market came back, says Gross-Loh. "It pretty much played out the way we thought it would."

The crisis in perspective

The other Japanese portfolio companies didn't suffer as much. Payment systems provider MEI operated in business-to-business channels so was less affected by the drop in discretionary spending while communications equipment specialist Suntel required a small amount of surgery. Bain sold off the company's leasing business in order to pay down debt and introduce a more conservative capital structure, thereby de-risking the investment.

The remainder of the private equity firm's Asia portfolio was dominated by China and these companies also experienced relatively little hardship. Advertising player Sinomedia Holding and shopping mall operator Jinsheng Group were hit by a decline in media spending and real estate investment, respectively, but the impact was fairly mild.

Jim Hildebrandt, a Hong Kong-based managing director at Bain, notes that, while the Asian financial crisis "was clearly happening to us and, in the end, only to us, this one was happening somewhere else. It was coming from developed markets and affected emerging markets later."

In this sense, the risk factor was misjudging the severity of the crisis on individual markets and companies. It was difficult for managers to predict, for example, that China's downturn would last 1-2 quarters as opposed to a 5-10 year fallow period in the US. This uncertainty could potentially feed into restated top-line revenue profiles. "The danger was overreacting to the downturn and not continuing to invest in growth companies," Hildebrandt adds.

Much the same applied to getting back into the market. Would uncertainty over the macroeconomic climate cause private equity firms to restrain themselves and, as a result, miss out on attractive assets? Having announced D&M in June 2008, Bain waited about a year for its next deal, the acquisition of a minority stake in Chinese electronics retailer Gome for $234 million. There was an 18-month wait for another Japan transaction, the $1 billion buyout of e-commerce firm Bellsystem24 in late 2009.

Hildebrandt doesn't read much into the gap in China – pointing out that it takes 12-18 months to get a deal done there – but activity in Japan was muted because more time had to be spent working with portfolio companies and ensuring business stability.

A cautious attitude

What worked in the firm's favor was its relatively short history in Asia. Bain opened its first office in the region in 2005; its first investment – MEI – came in mid-2006; its $1 billion debut regional fund was launched later the same year. The portfolio wasn't that big, which arguably meant the firm was better positioned to see new deals.

Bain was also wary of getting involved in highly priced and highly leveraged transactions during the boom of 2006-2007 that preceded the financial crisis. Gross-Loh recalls passing on a number of deals due to concerns about valuation and structure, adding that private equity in Japan only really got started in 2000 and unsustainable exuberance is common in the early stages of a market.

> "We were cautious pre-downturn and then became very active. There was a notion that pricing was getting high, leverage levels were getting high on a global basis, so we were cautious. If you look at the capital we have deployed in Asia, it might be 13% was deployed pre-crisis and the rest post-crisis"

"The flip side of the economy being in a tough position is there are many interesting investment opportunities, Gross-Loh says. "We were cautious pre-downturn and then became very active. There was a notion that pricing was getting high, leverage levels were getting high on a global basis, so we were cautious. If you look at all the capital we have deployed in Asia, it might be 13% was deployed pre-crisis and the rest post-crisis."

Two years after Bellsystem24 became Bain's largest ever deal in Japan, the record was broken again with the acquisition of restaurant operator Skylark for $2 billion plus debt. The sellers were among those who got caught up in the euphoria of 2006-2007. Nomura Principal Finance and CVC Capital Partners bought the company for approximately JPY280 billion (then $3.19 billion) in 2006. Skylark was restructured in 2008, with Nomura putting in more equity, and then CVC exited its holding to Chuo Mitsui the following year in a debt-for-equity swap.


Jim Hildebrandt

Bain's acquisition structure featured a lower price and lower leverage, and the development plan for the company is rooted in a back-to-basics approach prior to targeting the growth that the market might be able to offer. The action points include in-store operational improvement and introducing marketing practices that proved effective in portfolio restaurant businesses elsewhere in the world.

"Strategically, it's more aligned with the things we are trying to do in Japan – taking good companies and helping them improve their fundamentals," says Gross-Loh. "It is a country of slow growth and undermanaged businesses. If you look at any metric of profitably, Japanese companies are way below their peers. We tend to be very value-oriented operationally-focused, so we see companies like Skylark as a big opportunity."

Geographies of interest

There were more than 20 transactions in Bain's first Asia fund, 10 of them in China and seven in Japan. The second fund closed earlier this year and, at $2.3 billion, it is more than twice the size of its predecessor. Southeast Asia is expected to feature more prominently while India and Australia – where investments so far have been made via Bain's global fund – are to be brought more under the regional umbrella. The private equity firm continued to recruit throughout the downturn in order to meet these broader demands.

China will remain the biggest part of the business – Hildebrandt sees China and India as well suited to Bain's operational focus – but there is a sense that capital will be deployed more broadly. "Investors went through a period of 5-10 years where China was everything in Asia and we are now moving past that to a more balanced view, he adds. "Each of these markets goes through cycles and they don't necessarily align, so you'll get more interesting opportunities in some markets than others in a given year."

Bain followed the Skylark deal with the acquisition of a 50% stake in Japanese television shopping platform Jupiter Shop Channel for $1 billion, forming a joint venture with the company's owner, Sumitomo Corporation. Gross-Loh expects more investments to follow, noting that the country strategy hasn't changed much since he first drafted it in 2005. He argues that if you look past the headlines declaring demographic gloom – based on the current trajectory, more than 40% of the population will be aged over 65 by 2060 – Japan's economic statistics are not so different from many European countries.

What private equity firms need to thrive, however, is staying power, and a willingness to ride out economic difficulties if and when they emerge.

"Japan is one of those markets where you have to build deep relationships," Gross-Loh says. "You can't really say 'I'm going to play in the market in 2006 and if it isn't interesting for a couple of years then I'll base my guys in Hong Kong and they'll fly in. The banks don't like it, management teams don't like it. In many ways, you are either viewed as a player who is committed to the market and who the institutions can trust, or you're not."

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KEEP CALM & CARRY ON

Nick Bloy, co-managing partner at Navis Capital Partners, saw Lehman Brothers collapse within days of a launching his sixth fund. LPs had to be reassured or replaced, and the strength of Navis' existing portfolio was pushed to the fore

When Lehman Brothers collapsed within days of Navis Capital Partners launching its sixth Asia fund in September 2008, there was a sense of déjà vu, but not despair. After all, the GP had been here before: it raised its debut vehicle during the Asian financial crisis.

"We thought we should absolutely continue with the fundraise because it was potentially an unusually good vintage," recalls Nick Bloy, co-managing partner at Navis. "Our sense that it was good to have cash overwhelmed our sense of 'Gosh, how many of our investors will be able to re-up because of what's going on in the world.' We were much more excited about the former and therefore less concerned about the latter."

The importance of having cash to deploy when others would find it hard to come by was emphasized repeatedly to LPs that were pushing for a delay. In many cases, the hesitancy was driven by the fact that institutions weren't in a position to commit. Their asset allocations had been thrown completely off balance by atrophying public markets and investment committees were unwilling to budge until there was sufficient portfolio transparency to decide when – and if – they had space for private equity.

In addition, allocation models based on pre-Lehman criteria had to be comprehensively revised. Portfolio company exits by funds would be delayed by months if not years, which meant distributions wouldn't be made to LPs as scheduled.

One point upon which Navis did compromise was fund size. The initial target was $1.75 billion, significantly larger than the previous fund, but suddenly this figure appeared neither realistic nor necessary. LPs won the day by arguing that, in a post-Lehman world of depressed valuations, $1.75 billion was too much of a step up in terms of company size and complexity. The target was revised down to $1.25 billion and the fund ended up closing $1.16 billion in August 2010.

Repackaging exercise

"Partly out of necessity and partly out of choice, we did reconstruct the LP base," adds Bloy. "It was painful but one of the

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biggest benefits was the fund-of-funds representation went from 35% to 11%. Although there are some very good fund-of-funds at the end of the day they are intermediating and putting a drag on returns. What we want are long-term relationships with pension plans and sovereign wealth funds."

LPs with limited exposure to private equity or relatively new alternatives programs were an obvious target – those already fully allocated to the asset class were scaling back their involvement due to the aforementioned risk concerns – but Navis still had to make a convincing pitch.

At its heart was the private equity firm's existing portfolio, which had performed strongly in spite of the macroeconomic headwinds. Bloy says there were two reasons for this. First, Navis focuses exclusively on control transactions. It is therefore much easier to take swift action in the event of a crisis, through cost cutting and cash management, compared to a minority investor who might have little influence over strategy.

Second, acquisition finance is used sparingly. Looking across all Navis' portfolios, on average each deal comprises 85% equity and 15% debt, and most of that debt is on companies' balance sheets at the time of acquisition. Many leveraged buyouts executed in Asia in the boom years of 2006-2007, featured debt portions of at least 50%, and rising as high as 75%.

"A feature of Navis historically has been to put in place the strongest possible capital structure," says Bloy. "We had no covenant breaches post-Lehman and we didn't have to go cap-in-hand to the banks because we didn't need to put new equity into companies. However, our 'over-equalization' approach isn't so much about managing the downside of a volatile global environment as making sure portfolio companies can make aggressive moves in Asia's emerging markets when a black swan event emerges – as they periodically but unpredictably do on a geographic, industry or company level."

A strong balance sheet also allows a portfolio company to take advantage of weak markets by acquiring a distressed competitor, building a new factory while others aren't in a position to expand capacity, or extending high levels of credit to customers in the knowledge that competitors can't follow suit. In this way, Navis' approach amounts to a bet that the drag on potential returns by using a small amount of debt will be offset by the likelihood of volatility hitting emerging markets at some point during the holding period.

Bloy admits that the strategy wouldn't work in a stable, mature environment where putting in the maximum amount of debt would be the best course of action, but in Asia that notion is turned on its head.

A king is crowned

The outstanding example of a Navis-backed company capitalizing on the post-Lehman chaos is King's Safetywear (KSW), which was exited to Honeywell International for an enterprise valuation of $338 million last November. The private equity firm secured an IRR of 63% and a 4x money multiple on an investment of $74 million made in late 2008.

KSW's value ramped up largely thanks to the relocation of production facilities to lower-cost jurisdictions as well as two follow-on acquisitions. The most significant of these was Oliver, the largest industrial shoe brand in Australia, bought for a low multiple in early 2010. It meant KSW, which already claimed a 50% share of the industrial safety footwear market in Singapore, Malaysia and Indonesia, could consolidate its position in Asia Pacific and improve its global distribution platform.

"It was a huge boost to the overall return profile," says Bloy. "Overall, between the global financial crisis and now, I would estimate that about three quarters of our portfolio companies have made some form of follow-on acquisition or investment. In other cases, we have put in money to build new plants, so it's organic rather than inorganic growth."

He adds that there is also a far greater willingness among entrepreneurs to work with private equity. The asset class is better understood compared to just five years ago and at present there is a disillusionment with public markets, which makes companies open to alternative sources of funding. Entrepreneurs need only look at orphan companies languishing on stock exchanges with no liquidity and owners that are unable to sell down their holdings to understand that expansion capital followed by a swift IPO isn't necessarily the best option.

Even so, the expected rapid deployment of Navis Asia Fund VI in a climate of depressed global financial crisis conditions has failed to come to fruition. Entry multiples were lower for a couple of deals but the portfolio average is on par or higher than for previous vehicles. Rather than experience a protracted U-shape, valuations for strong companies in Asia have followed a V-trajectory, which makes it harder to find economically viable deals.

This ran in complete contrast to the investment environment for Navis' first fund during the Asian financial crisis and the reason for the disparity is that Asia was far less damaged post-Lehman than it was by its own economic calamities a decade earlier. The real fallout was taking place in Europe and the US; no Asian conglomerates went to the wall because their domestic currencies had collapsed and they had US dollar-denominated liabilities.

"Distress wasn't really felt at the corporate level in Asia," says Bloy. "Even though public market valuations were down, entrepreneurs didn't think they had to accept those multiples; they just decided to wait another six months to one year. That's why it took us longer to deploy than expected. Three years since the first close in June 2009 we are about 50% drawn and we would normally expect to be more like 75-80% drawn."

Exits have been more prolific, with six companies sold in 2012 to trade or financial buyers. The same factors contributing to Navis' robust portfolio performance – control transactions, well-managed balance sheets and countercyclical expansion – make companies attractive targets for strategic investors. "We are former management consultants so we are very focused on the competitive position of a company when we buy it," Bloy says. "Trade buyers only want the number one, two or three in an industry or they might as well do a green field investment and outcompete the more marginal companies," Bloy says.

He admits feeling a hint of schadenfreude when the IPO environment turned, leaving private equity firms that entered minority transactions at high multiples in expectation of even higher public market valuations without a viable exit channel. Navis' 23 exits since inception have all been via trade or secondary sales.

The burden of compliance

While LPs look favorably on managers with a track record of returning money to investors, another characteristic of the post-Lehman world is that institutional players have become much harder to please. Navis may have bucked a trend by securing fund commitments at a time when few were forthcoming, but the price is higher levels of compliance and disclosure.

Gone are the days when a private equity firm could get away with the statutory minimum of quarterly portfolio reports and out-of-the-blue draw-down notices. Now Navis feels obliged to communicate with LPs more frequently. The firm routinely issues memos several weeks ahead of a draw-down that include a description of the target company and the industry in which it operates, an explanation of the deal structure, and a justification of the underlying investment rationale.

> **"Overall, between the global financial crisis and now, I would estimate that about three quarters of our portfolio companies have made some form of follow-on acquisition or investment. In other cases, we have put in money to build new plants, so it's organic rather than inorganic growth"**

"When Asia wasn't so important LPs deployed money to the region and expected to get it back in a few years; apart from a few milestones, there wasn't too much interest," Bloy says. "Fast forward to the present and institutional investors mark their portfolios to market much more rigorously. Interim movements in portfolio value have become much more important, whether it's basic compliance or assessing potential secondary market valuations. Those kinds of metrics have become the standard." 25

AFTER THE HYSTERIA

Michael Chae, head of international private equity at The Blackstone Group, arrived in Asia after the global financial crisis and as the pre-IPO fever was about to turn. Changing times require changing strategies

"When I arrived here, the unbridled optimism in the markets was probably peaking. Since then there has not only been a pull back in the public equity market but also, more tangibly, a significant pull back in the mood," says Michael Chae, senior managing director and head of international private equity at The Blackstone Group. "It has been fascinating to observe."

Already a senior partner with Blackstone in New York, Chae relocated to Hong Kong in 2010. His broad remit was continue building the Blackstone team, combining local hires with talent developed in the New York and London offices who bring a connection to the firm's global ethos.

At the same time, Chae is very much a post-global financial crisis appointment. The more sober investment environment has altered the nature of deal flow that confronted global buyout firm executives who arrived in either of the first two waves: the late 1990s, when turnaround opportunities thrown up by the Asian financial crisis were all the rage; and the mid-2000s, which saw the emergence of China as a fully fledged private equity location.

"Pre-2007 you had several eventually quite successful deals that involved restructuring Chinese state-owned enterprises because the market was short on liquidity and foreign capital was scarcer. These deals greatly colored impressions of the market, but in fact they were of a certain historical moment in time," Chae observes. "After the crisis, in 2009 and 2010, the tenor of the market was more about pre-IPO, growth-oriented investments but in the last 18 months it has slowed considerably. Combined with the tightening in monetary stimulus and general slowdown in growth, it makes for an increasingly more interesting investment environment."

Blackstone's method of addressing the Asian opportunity thus far differs markedly from that of its peers. The firm had a presence in Japan in the late 1980s and early 1990s but the business was exclusively advisory. A team was also sent to Hong Kong in the mid-1990s, focusing on advisory and private equity work. "From 1985-2005 we had a terrific brand and franchise in the region but weren't fully resourcing it from an investment standpoint," Chae says.

Since then, the firm has made more than 20 private equity investments in the region totaling over $2.5 billion.

It has a similar amount under management in real estate. Contrary to what one might expect, Blackstone's first office in the region opened in Mumbai in 2005, with Hong Kong, Beijing and Shanghai following two years later.

There was no conscious sequencing. India and China were always going to be key components to the business and it just so happened that the individual Blackstone wanted to lead its India efforts, Akhil Gupta, formerly of Reliance Industries, was available in 2005. Antony Leung, previously financial secretary of Hong Kong, joined in 2007 as senior managing director and chairman of China.

A matter of months after the rollout in China, the firm announced what remains one of its most significant investments in the country – the $600 million acquisition of a 20% stake in chemicals manufacturer China National Bluestar Group, a subsidiary of state-owned China National Chemical Corporation. At the time it was the largest private equity investment in China outside of financial services.

Blackstone has generated considerable deal flow in India, with logistics, IT outsourcing and manufacturing all featuring prominently. However, the largest commitments have come in the power and infrastructure sector, an area in which India has obvious needs. In the past two years, Blackstone has invested $300 million investment in Moser Baer Projects Private, $60 million in Monnet Power and a reported $111 million in Visa Power.

"Given the size of our capital base and the capital requirements for those projects, and our view of the infrastructure development opportunity in India, it makes a lot of sense," Chae says. He adds that these investments were a good fit for Blackstone's global power and energy practice. Earlier this year, the firm announced a final close of $2.5 billion on its first energy-focused global fund, which invests alongside the $16 billion Blackstone Capital Partners VI.

Differentiated approach

There are two vehicles specific to Asia: Blackstone assumed responsibility for $2 billion worth of property assets in 2010 when it replaced Bank of America Merrill Lynch as the GP for the Merrill Lynch Asian Real Estate Opportunity Fund; the firm announced its debut renminbi-denominated fund in 2009 with a target of RMB5 billion ($781 million).

However, Blackstone has no plans to launch a dedicated China or Asia US dollar-denominated fund. It raised the $22 billion Blackstone Capital Partners V – still the largest private equity vehicle ever seen – in 2005-2006, around the time its global counterparts were introducing Asian funds.

"We all made choices, and the global fund was raised with a view to serving as a platform for investing around the world," says Chae. "LPs liked this approach and they provided that size fund because they knew we would bring all our resources to bear investing in different regions. It's possible in the future we will look at other options, but for now we are happy with the global approach."

In the past year, efforts have been made to strengthen the China team, with Yi Luo joining from The Carlyle Group, Ed Huang from Morgan Stanley Private Equity Asia and Meng Gao from Oaktree Capital. Chae is also keen to expand the Blackstone footprint in Southeast Asia and is in the process of creating a regional hub in Singapore that will house teams focusing on PE real estate and other strategies.

"There are a number of different markets and it's hard to generalize, but the macros are really quite attractive long term," says Chae. "It is relatively early in the game in terms of the development of scale private equity but it's quite intriguing and we see attractive, sizeable opportunities coming over time."

"After the crisis, the tenor of the market was more about pre-IPO, growth-oriented investments but in the last 18 months it has slowed considerably. It makes for an interesting investment environment"

There is also likely to be deeper penetration on the fundraising side. Of the $190 billion Blackstone has under management across its private equity, real estate, hedge funds, credit and advisory businesses, it is estimated that more than $20 billion comes from investors located in Asia. Most of these LPs – typically sovereign wealth funds, pension plans, financial institutions and high net worth individuals – are still at an early stage in the development of their programs and have substantial growth ahead of them in terms of assets under management and allocations to alternatives.

"If you are talking to the largest institutional pools of capital, it's critical for them to have a consolidated set of relationships with some of the biggest managers, particularly those who bring exposure to different asset classes," says Chae. "That's a great opportunity for us."

Return to Indonesia (2010-2012)

adaro
PT Adaro Energy, Tbk.

Indonesia Fundraising **$1.7b**

Funds **5**

Indonesia Investment **$2.9b**

Deals **56**

INSTITUTIONAL UPGRADE

Sandiaga Uno and Kay Mock, founding partners of Saratoga Capital, transformed a family office into a private equity firm on the back of strong growth and sound investments in Indonesia

When Sandiaga Uno first invested in Adaro Energy coal was dirty, unloved and trading well below $40 per ton. It was 2001 and the dotcom revolution was in full swing while Indonesia was still picking up the pieces following the Asian financial crisis.


Sandiaga Uno

"Coal was not very much in vogue at the time, but we thought that an integrated play like Adaro would be very much in favor after the crisis," says Uno. "We were lucky that we got involved early on."

Uno invested through Saratoga Capital, the PE firm he set up with Edwin Soeryadjaya in 1998. Initial activity, including the first commitment to Adaro, was informal with Saratoga serving as a vehicle to manage the founders' capital as well as funds raised from associates. They paid about $50 million for a 51% stake in Adaro and set about helping improve output and profitability. Coal production grew from 17.7 million tons in 2001 to 47.7 million tons in 2011, while losses were transformed into net profit of $552 million.

There was a partial exit in 2005 as an investor group that included Farallon Capital Management, Quvat Management, Malaysian tycoon Robert Kuok, Government of Singapore Investment Corp. (GIC), Goldman Sachs and Citi put in $450 million. Three years later Adaro listed, achieving a market capitalization of $3 billion. It is now worth around $4.5 billion.

Adaro was the making of Saratoga, yet Uno sees the transaction as fairly typical of the firm's early activity. It was also quick off the mark with forestry player Sumalindo and telecom infrastructure provider Tower Bersama Group, both of which are now listed companies.

"Nothing sells better than a success story and once we started realizing those returns, local family offices that hadn't been investing private equity started to form investment firms," Uno says. "We spot the trend early and build an investment thesis around it and we maintained first-mover advantage by calling the right transitions in the mid-2000s. The next transition is consumer products and services and we are already involved in this space."

Success led to a transition within Saratoga itself. After about eight years of operating like a family office Saratoga began to manage third-party capital on a formal basis, which required the introduction of global standards and a more disciplined investment approach. Kay Mock, formerly of GIC, joined as a founding partner in 2006 to lead this effort and the firm's second fund – though its first properly institutional vehicle – achieved a final close of $152 million on Valentine's Day 2009.

"I'd spent about 17 years of my life at GIC and enjoyed it immensely but I felt it was time to leave the mother ship," Mock says. "Indonesia had been overlooked as the people who left after the Asian financial crisis focused on China and India. I felt it was just a matter of time before attention returned and, based on the last few years, I feel vindicated."

The crowning vindication came earlier this year as Saratoga Asia III closed at $600 million, one third above target. By comparison, the firm initially sought $300 million for Fund II but found itself third out of the gate behind Quvat and Northstar Pacific Partners at a time when LPs weren't nearly as interested in Indonesia.

The recent fundraise was all the more impressive given that none of the institutions that backed the previous vehicle were able to re-up due to internal restrictions. For example, CDC Group, the UK government's development finance arm, couldn't participate because Indonesia is no longer classified as a developing country. This underlines the rapid growth the country has seen in recent years and it has implications for private equity investors who until a few years ago faced relatively little competition for deals.

There are various contributing factors: Indonesia is enjoying a period of political stability; GDP growth remains above 6.5% per year, driven by rising domestic consumption by a youthful population; the country is rich in natural resources, and although the commodities boom has lost its edge of late, it can still rely on long-term demand from its Asian neighbors; and Fitch Ratings and Moody's now rank Indonesia's sovereign debt as investment grade, which is encouraging capital inflow.

"Everybody now sees Indonesia as a place to invest, which offers some new exit avenues, but competition is heating up and valuations are rising," says Uno. "We are worried about overheating and the ability to maintain the type of proprietary sourcing we've been able to generate in the past. It's good and bad, but overall good."

Target markets

Saratoga invests across three sectors – natural resources, consumer and infrastructure – and allocations to each one will inevitably change. Natural resources was the mainstay of the first two funds and, while the sector continues to be important, rising valuations in the past few years have complicated deal-making. Although prices have fallen recently and several Indonesian family conglomerates are overleveraged, which could

Kay Mock

> **"We maintained first-mover advantage by calling the right transitions in the mid-2000s. The next transition is consumer products and services"**

create opportunities for PE, Mock says it is unrealistic for investors to expect the 10x returns they got in the past.

"Everyone was caught off guard by the magnitude of the appreciation in natural resource prices – people were making multiples of their costs," he says. "On the back of that, domestic demand and the growth of the middle class has also surprised some investors. Tower Bersama, for example, feeds on phenomenal growth in mobile telephony. Telecom is still a sector that I feel optimistic about."

Of the other two sectors, consumer remains fundamentally attractive. It is rapidly expanding and fragmented, yet at the same time it is the sector that is most accessible to foreign investors and valuations remain a concern.

Infrastructure is to a certain extent the polar opposite. Earlier this year a Saratoga-led group acquired a majority stake in electricity producer Medco Power International for $112 million from parent group Medco Energy. Mock says this kind of opportunity doesn't come up very often, adding that it was only possible because of Uno and Soeryadjaya's relationship with Medco Energy's owners.

Saratoga targets control transactions and these can be difficult to secure in an economy populated by entrepreneurs who are loath to give up large amounts of equity when they anticipate further growth. Mock argues that opportunities are emerging in cases where company owners have reached a glass ceiling because they can't get access to banking financing or they face sizeable competitive threats. However, it doesn't foreshadow a wave of deals that meet the needs of larger foreign investors.

"It's good for Indonesia to attract more investment, but the reality is there aren't many deals of size," says Mock. "It doesn't have the same scale as China or India. The potential targets are already owned by the large families, most of them are doing well, and so there is no incentive to sell."

NORTHSTAR RISING

Patrick Walujo, co-founder and managing partner of Northstar Pacific Partners, leveraged local knowledge and relationships at TPG Capital to create Indonesia's largest domestic private equity platform

With an $820 million fund at its disposal, Northstar Pacific Partners has nearly three times as much capital to deploy as in the previous cycle, but its target deals are expected to remain more or less the same. Instead, the Indonesian GP hopes to a larger fund corpus will allow it to become a little more selfish when divvying up co-investment.

"If you look at our deals, they have not really changed," says Walujo. "We have invested nearly $2 billion together with our co-investors. About $700 million of that was from the funds we manage, meaning we have provided more than $1.3 billion of co-investment opportunities to our partners. Our strategy has evolved as our assets under management have grown and, going forward, Northstar-managed funds will represent a bigger share of our deals."

Delta Dunia, Northstar's largest transaction to date, is a classic example. Working in conjunction with the founder of Bukit Makmur Mandiri Utama (Buma), Indonesia's second-largest mining contractor, the private equity firm arranged a reverse takeover by listed investment holding company Delta Dunia in 2009. The deal reflects Indonesia's development over the past decade. Delta Dunia started out as a textiles manufacturer, exporting rayon, cotton and polyester threads to Europe and the US. As the economy evolved, so did the business model: the textiles operations were offloaded in 2008 and replaced by property investments; a year later, the strategy changed again to focus on coal mining services via the acquisition of Buma. The opportunity emerged because Buma needed assistance refinancing $600 million in debt.

A consortium of investors including a Northstar fund purchased a large minority stake in Delta Dunia. TPG, Government of Singapore Investment Corporation (GIC) and China Investment Corporation (CIC) subsequently came in as co-investors.

In addition to demonstrating Northstar's previous capacity for co-investment, Delta Dunia underlines two factors that have been crucial to the private equity firm's success: a long-standing relationship with TPG and proprietary deal access through ties to domestic conglomerates.

After the shake-out

Northstar was set up by Walujo and Glenn Sugita in 2003 in the wake of massive asset sales by the Indonesian government as it repaired an economy scarred by the Asian financial crisis. The Indonesian Bank Restructuring Agency (IBRA) played a significant role: its initial mandate was to restructure distressed banks and administer the government's blanket guarantee program but this was subsequently extended to managing state holdings in these lenders and complete asset disposals. Walujo estimates that IBRA, which was eventually wound down in 2004, directly or indirectly controlled 80% of the economy.

Notable corporate divestments included the sale of a 40% stake in Astra International, the country's largest automobile manufacturer and distributor, to a Jadine Matheson-led consortium for $506 million in 2000. The company is now worth more than $30 billion. Farallon Capital Management, the US hedge fund, also made a highly profitable investment in Bank Central Asia after heading a consortium that bought a majority stake in the lender from IBRA for $541 million in 2002.

"The groups that invested at that time – primarily hedge funds and distress funds – did very well," recalls Walujo. "We started at the tail-end of this period. The asset sales helped get the economy moving again because more businesses were back in private hands. It was an interesting time to do something on our own in Indonesia."

Walujo returned to Indonesia from Japan having spent three years engaged in M&A and business development for Pacific Century Group Ventures, a company owned by Hong Kong businessman Richard Li. Before that he was a banker at Goldman Sachs in London and New York, where he came under the wing of Tim Dattels, who subsequently moved to TPG as a senior partner in the private equity firm's Asian operations.

Gaining momentum

In the first three years of its existence Northstar invested on a project-by-project basis as well as doing corporate advisory work. "These were relatively small but high multiple investments," says Walujo. "It was opportunistic. At the time in Indonesia you could get hold of cheap assets no matter what the sector."

One of those assets was Adaro Energy, which has since gone on to become one of the country's largest coal producers by market value. Leveraging his relationship with Dattels, Walujo brought some TPG partners into the Adaro deal. The US firm was impressed with the execution and when Northstar decided to raise its first fund in 2006, TPG participated as an LP.

"When you look at our organization, we structure it much like TPG and our philosophies are quite similar in that we both pay a lot of attention to portfolio management and operations," says Walujo. "They only invested a small amount in the first fund. We teamed up not so much for the capital as for the expertise and endorsement from an international private equity firm. The fact that TPG selected Northstar lent significant credibility to what we were trying to build."

> **"TPG only invested a very small amount in the first fund. We teamed up not so much for the capital as the endorsement from an international private equity firm. The fact that TPG selected Northstar lent credibility to what we were trying to build**

Investors in the first fund, worth $110 million, were predominantly individuals and groups that had supported Northstar during the project-by-project days and knew the team very well. The second vehicle, which closed at $285 million in 2010, saw a broadening of the LP base as foreign institutional investors, including the University of Texas endowment, became more interested in Indonesia.

The standout deals in the first two funds include Alfamart and Bank Tabungan Pensiunan Nasional (BTPN). With the former, Northstar supported the original co-owner of the convenience store chain when he bought it from Philip Morris. The US tobacco giant had picked up the business as part of a wider acquisition and had no interest in retaining it. One of Northstar's funds led a consortium to take a significant minority stake in 2007, exiting three years later for a handsome return.

Northstar and TPG jointly acquired a majority stake in BTPN for $200 million in 2008. The bank's market capitalization has since more than doubled to $3.1 billion.

According to Walujo, it has only been in the last 18-24 months that Indonesian private equity has really gained momentum. During this period Northstar closed its third fund at $820 million and also formalized its relationship with TPG through a share swap agreement. The specifics of the arrangement are not public but the TPG is said to have a 10% stake in Northstar, which owns less than 0.5% of the US firm. Ashish Shastry, formerly a partner with TPG in Singapore, has joined Northstar as a managing partner, while Walujo and Sugita are now senior advisors to the US firm.

> **"We relate well to our counterparties because we have deep local knowledge in Southeast Asia. Working with a decision maker who understands your culture, and whom you can call at any time, makes you feel as though you are being treated fairly"**

"It is a very solid relationship. We have learnt a lot about private equity from TPG and they have learned a lot about Southeast Asia from us," says Walujo. "Interaction between Northstar and TPG is very strong and we expect that to continue."

A handful of investments have been completed out of Fund III, including listed tire producer Multistrada and a $200 million commitment to Triputa Agro Persada, a palm oil producer. Both are essentially a play on Indonesia's essential strengths: rising domestic consumption, low-cost production and natural resources.

Multistrada relies on exports for three-quarters of its revenue but domestic sales are rising 40% per annum on the back of strong demand for cars and motorcycles. Triputa, meanwhile, marks the culmination of a five-year search for palm oil opportunities that offer strong growth prospects, capable management and a reasonable entry valuation. Each company is a lowest cost producer, Walujo says, which means they can remain competitive regardless of price cycles.

Family ties

What makes Tiputra particularly interesting is its ownership and, by extension, the reach of Northstar's founders into the Indonesian business elite. The company is run by Theodore Rachmat – who is also Walujo's father-in-law – and Benny Subianto, two of the country's wealthiest individuals. Both men were formerly senior executives at Astra and the way in which their careers interlink with domestic business success stories speaks volumes for the value of relationships in deal-making.

Rachmat's uncle, William Soeryadjaya, founded Astra and Soeryadjaya's son Edwin also worked there and went on to set up Saratoga Capital with Sandiaga Uno. Alongside Subianto and Garibaldi Thohir, son of Mochamad Thohir, another Astra founder, they comprised the five-man team that created Adaro.

"Obviously it is a useful thing to have," Walujo says of his family connection to Rachmat. "He is a man of high reputation and he has a strong network in Indonesia. We have no direct economic ties – he has not invested a single dollar in our funds – but being associated with him definitely helps."

It does not, however, guarantee Northstar deal flow. The private equity firm almost always invests alongside partners – usually management teams, as was the case with Buma and Alfamart, and sometimes with other financial players. Walujo stresses that management teams do not look at Northstar as a generic private equity player offering an alternative to other forms of funding; rather, they study the individuals sitting across from them and decide if they would make good business partners.

"For many transactions there is some competitive dynamic with other firms, but in most situations we do not get the deal because we pay the highest price," he says. "We relate well to our counterparties because we have deep local knowledge in Southeast Asia. Working with a decision maker who understands your culture, and whom you can call at any time, makes you feel as though you are being treated fairly."

In a similar context, pre-existing relationships might open a few doors, but they do not necessarily result in an invitation to enter. "While they offer advantages, people are not going to bend over backwards and make an irrational deal just because of a strong relationship."

Afterword

THE ZEITGEIST

A fixture of the AVCJ Forum gala dinner in recent years, K.Y. Tang, chairman of Affinity Equity Partners, offers a sideways look at topical private equity issues. Here are some highlights

2011: Top 10 reasons why investment committees will never understand Asia

1. They keep worrying about the effect of a steep recession in the West on Asia
   Don't they know – Asia is decoupled from the West!
2. They berate you for not having invested enough in financial institutions in Asia. "Financial services is the best proxy for growth in emerging markets," they say
   So you send them proposals on: trust-banking in Wenzhou, China; microfinance in Uttar Pradesh, India; overseas employment bridge finance in the Philippines
3. You dare not tell them that the chairmen of large Chinese state-owned enterprises are not appointed by shareholders but by the organization department of the Communist Party
   Earlier you told them that you will use your board seat to enforce international best practices and good corporate governance
4. Some smart-alec on the investment committee analyzed your deal as follows: you make a decent return; the local promoters make out like bandits; the minority shareholders get @!#*?+
   You say, "Boss, that is the way business is done in Asia!"
5. They are not happy you want to invest $500 million into an Indonesian coal mine. The proceeds will be used to pay off the personal debts of the owner
   You say, "Hey, this guy is going to be the next president of Indonesia. When that happens, we will make out like bandits!"
6. They ask, "What do you mean?"
   Country X has the best legal system money can buy
7. They are not amused you want to put $200 million into a Chinese forestry company listed overseas with financial performance way above its industry peers
   You defended the seven-day, limited due diligence period by saying, "Hey, we can take comfort that it's audited by a Big Four accounting firm and the IPO is sponsored by a prestigious investment bank"
8. You have this 'sure-win' proposal to invest in shadow banking in China. The profit model is so simple – take deposits from the private clients of a major Chinese bank at 10% per annum and lend them to Wenzhou entrepreneurs at 10% per month
   You think it's a no-brainer; they think you have no brains
9. They asked why every deal from Asia comes with the same investment thesis: this is a play on the Asia growth story, the rise of Asia's middle class, and a play on the exponential growth of domestic consumption in Asia
   You can also replace the word 'Asia' with 'China' or 'India' or 'Indonesia'
10. After eight years, they still can't figure this out: China's economy is: socialism with Chinese characteristics, or capitalism with socialist characteristics, or socialism with capitalist characteristics

2010: Top 10 names private equity investors get called

1. Barbarians at the Gate (1990)
2. Vulture Capitalists (Japan, 2000)
3. Locusts (Franz Munterfering, senior German minister, 2006)
4. Casino capitalists and amoral asset strippers (UK trade union leader, 2007)
5. A bunch of unemployed actors with plenty of talent but no way to use it (Financial Times, 2010)
6. [Top-end] garbage collectors… picking up the dregs from the distressed financial services industry (Peter Briger, co-founder, Fortress Investment Group, 2010)
7. PE people are like buses… if you miss one, just hang out, and you'll get another one; you'll probably reach the same destination, but with a safer driver (Ashok Vasudevan, CEO of a food company that received private equity investment, 2010)
8. You have to kiss a couple of frogs before you get the right deal (Ramsay Goodrich, investment banker, 2010)
9. Desperate housewives… under pressure to deploy capita and easy prey for asset-touting M&A bankers (Philip Borel, editor, PE Online, 2010)
10. But not yet… the giant vampire squid wrapped around the face of humanity (Matt Tiabbi, describing Goldman Sachs, Rolling Stone Magazine, 2009)

2009: Top 10 reasons why this time it's different

1. For the first time in 10 years, it is better to be a PE fund with 10-year money than a hedge fund with quarterly redemptions
2. This time, GPs and LPs are running to their lawyers to ask, "How does this 'no-fault termination' clause work?"
3. GPs now understand why due diligence should not be done in less than two weeks and encompass only one management meeting
4. GPs have balls. They dare to tell LPs, "This fund will never pay out carry. We don't want to lose such a talented team. Therefore, Mr LP, it is in your interest to amend the waterfall distribution structure to start paying carry when the cash return reaches 0.5x cost
5. LPs have balls. They dare to publish a report with 74 one-sided recommendations on how fund terms and conditions should be structured
6. Sellers of businesses have balls. Ten years ago, at a time of financial distress, they sold for 4x EBITDA. At this time of great financial distress, they won't sell for less than 8x EBITDA
7. PE firms discover that loan covenants are real
8. A new standard has emerged in Asia for valuing for PE portfolios: it's called "higher of cost or DCF"
9. Last time, we invested 25% equity and 75% debt; this time, we invest 75% equity and 25% debt
10. Last time, "capitalism saved China;" this time, "China saved capitalism"

2008: Top 10 wishes for 2009

1. Public markets valuations to fall a further 20-30%; and stabilize thereafter, so I can price my deal
2. Private market valuations revert to the traditional discount to public market valuations, so I can close my deal
3. To all my banker friends… all you have to fear is fear itself! So please lend me what I need, impose no covenants and allow me to pay interest in kind, not in cash
4. Will somebody please switch the deal music from slow tango to fast rock 'n' roll
5. Regulators put a strict cap on all banking bonuses, so I can hire their best and their brightest
6. The industry standardizes all fund carry to be distributed on a deal-by-deal basis
7. Asian currencies rally, so I can count currency gains in my returns
8. Don't make me buy at the bottom of the market, and get the next bottom for free
9. Grant me my wish to be the "lucky investor," not the "smart investor"
10. May all my LPs be able to fund all my capital calls