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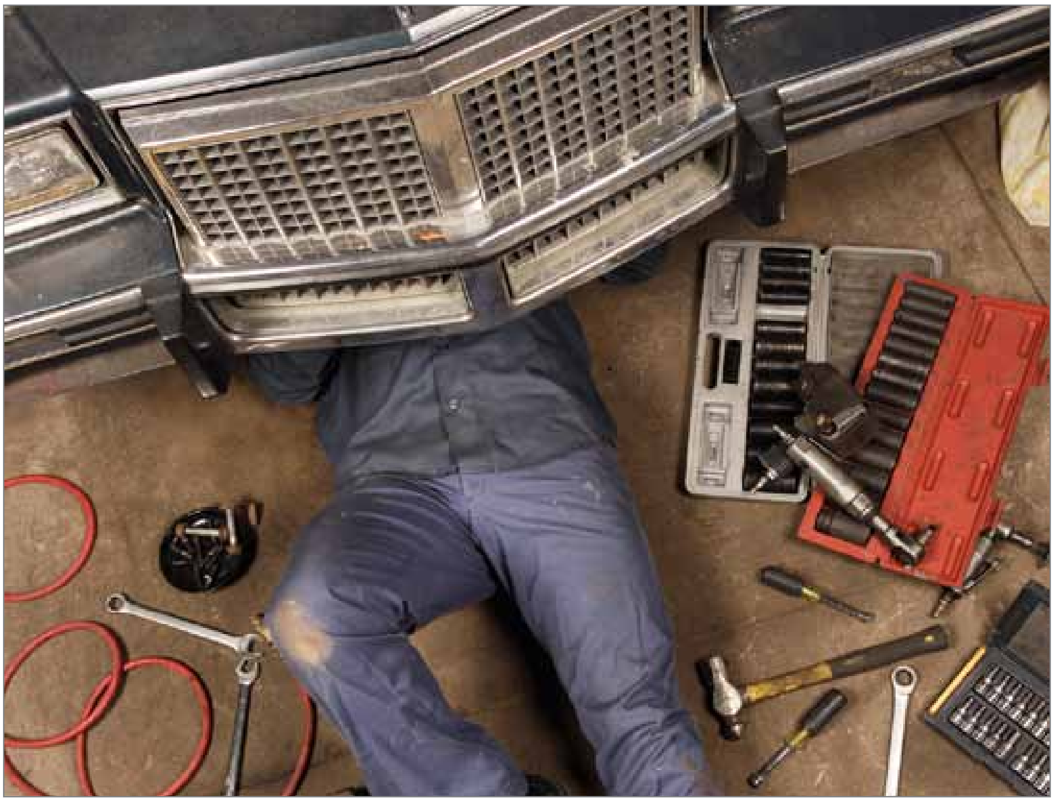

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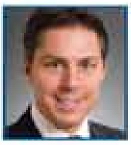

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EDITOR'S VIEWPOINT

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Beyond the hype

LAST WEEK *AVCJ* HELD ITS SIX-MONTHLY media briefing at which we – joined by several industry participants – reviewed private equity activity in 2012 and offered views as to what 2013 might have in store. The data made for sober reading: Fundraising was down by more than one third year-on-year to $46.8 billion, the lowest level since 2009; investment was also at a three-year low, falling 19% to $57.2 billion.

China was the primary influence. The region's largest private equity market saw deal value drop by more than one quarter to $21.8 billion, largely driven by a continued decline in growth capital activity as the pre-IPO market stagnated.

The fundraising situation was even more acute. China-focused funds attracted $23.4 billion for the year in full, down 51.3%, and just $6.7 billion in the final six months. Renminbi fundraising came to $19.9 billion, while US-dollar vehicles received commitments of $3.5 billion, a year-on-year fall of 35.7% and 79.6%, respectively. After reaching $15.7 billion in the first half of 2012, renminbi funds attracted $4.2 billion in the subsequent six months.

Yet the briefing still featured questions on spin-out managers and the nascent renminbi fundraising hub of Qianhai in Shenzhen. Are we to assume that one can't keep a good GP down?

Clearly the likes of Yawei Wang are playing a role. Known as one of China's top A-share stock pickers after a 14-year career as a manager with mutual fund provider China Asset Management (CAMC), Wang went solo late last year. The location of choice for his debut renminbi fund was Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone, China's latest mini-laboratory for financial innovation.

Qianhai promises a host of incentives for financial services operators, including corporate and personal tax breaks. For fund managers, there is also the option to raise capital for renminbi-denominated vehicles in Hong Kong. The initial PR exercise was rounded off with a few choice remarks from John Zhao, CEO of Hony Capital, who suggested that its company might raise its next local currency fund via Qianhai.

At stake is the $113 billion in renminbi deposits held in Hong Kong at the end of December, up tenfold on 2009. With mainland China's institutional investor base yet to emerge fully, the hope is that Hong Kong's more sophisticated investors can take the place of mainland high net worth individuals who have lost interest in the asset class. Hence the drop in renminbi fundraising might be remedied.

If this is indeed the presumption, then it is flawed. The fundraising spike seen in 2010 and 2011 was predicated on short-term lucrative exits derived from robust IPO market. In its absence, renminbi managers need to come up with a new investment thesis. Will Wang's be a string of PIPE deals? Who knows, perhaps this will snag a few Hong Kong investors but it's hardly a strategy that can be employed by all.

Another look at the fundraising data for 2012 offers a hint of the private equity market that China should aspire to become. The list of leading fund closes from the first half of the year is dominated by renminbi vehicles; they are understandably notable for their lesser representation in the subsequent six months.

Disregard the two substantial fundraises involving PAG and Bain Capital's Asia buyout vehicles, and the rankings exemplify specialization: three infrastructure funds, two energy funds and three distress-focused funds all feature.

It serves as a timely reminder that those most likely to draw favor from an increasingly picky global LP base are those that offer a strategy or skill set that can be obtained elsewhere. Perhaps investors that previously flung their money at any renminbi manager with a bucket to catch it will begin to think in the same way.

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NEWS

ASIA PACIFIC

IFC raises $280m for global climate change FoF

International Finance Corporation (IFC), the private investment arm of the World Bank, has received $280 million from the governments of Canada and the UK and Azerbaijan's sovereign wealth fund for its climate change fund-of-funds. IFC is contributing $75 million to the vehicle, which will invest in private equity and venture capital funds that provide growth capital to companies developing innovative ways to address climate change. A portion of the capital will be channeled through direct investments.

Ropes & Gray appoints HK special situations partner

Ropes & Gray has promoted Daniel Anderson as a partner in its special situations practice in Hong Kong. He was previously a counsel with the firm. Anderson will represent funds and other investors in special situations transactions in Asia, including acquisitions of distressed securities and loans, "loan-to-own" strategies, private financings, in-court and out-of-court restructurings, and real estate.

AUSTRALASIA

Summit Partners to invest $25m in The Iconic

Summit Partners is expected to invest $25 million into Australian fashion online retailer, The Iconic. This investment comes in addition to the $20 million The Iconic secured in September from J.P. Morgan Asset Management. The company also received start-up funding from Berlin-based Rocket Internet. Adam Jacobs, managing director of The Iconic, noted that the Australian investment community is very conservative towards online retail and e-commerce in general.

GREATER CHINA

China Media Capital forms Raine Group partnership

China Media Capital (CMC) has formed a strategic partnership with The Raine Group, a global merchant bank focused on entertainment, digital media and sports. Under the new partnership, the two firms will exchange investment strategies, co-invest with one another, and also pool resources and develop conferences for both Chinese and Western media participants.

Asia PE fundraising drops by one third in 2012

Private equity fundraising in Asia Pacific slumped by more than one third to $46.8 billion in 2012 from $72.9 billion a year ago as capital committed to China-focused vehicles dropped off markedly over the course of the year. It is the lowest annual total since 2009.

China funds attracted $23.4 billion for the year in full, down 51.3%, and just $6.7 billion in the final six months, according to preliminary data from AVCJ Research. Renminbi fundraising came to $19.9 billion, while US-dollar vehicles received commitments of $3.5 billion, a year-on-year fall of 35.7% and 79.6%, respectively. After reaching $15.7 billion in the first half of 2012, renminbi funds attracted $4.2 billion in the subsequent six months.

Investment in the Asia Pacific region reached $57.2 billion in 2012, also the lowest level since 2009, with just over 1,600 deals completed compared to more than 2,000 the previous year. Deal value in China specifically was down 27.5% year-on-year to $21.8 billion. For the region as a whole, growth capital deal value fell to $15.9 billion from $21.6 billion in 2011. Buyout transactions, meanwhile, staged a mini-revival, with total deal value reaching $21.9 billion in 2012, up from $18.6 billion the previous year.

TPG's Li Ning to issue $241m in securities

Li Ning, the Chinese sportswear retailer backed by Government of Singapore Investment Corporation (GIC) and TPG Capital announced plans to raise as much as HK$1.87 billion ($241 million) through a convertible securities offering. The proceeds will be used to execute its brand revival plan. As part of the transaction, the conversion price for the convertible bonds GIC and TPG bought last February has been adjusted downwards.

J&J buys PE-backed Chinese baby skincare brand

Private equity-backed Shanghai Elsker Mother & Baby, a Chinese manufacturer of natural baby skincare products, has been acquired by Johnson & Johnson. Terms of the transaction were not disclosed but the price is said to be around RMB650 million ($104 million). Exiting investors include Edmond de Rothschild Private Equity China Fund and Shenzhen Maison Capital, as well as Elsker founder Xiaokun Liu.

Orchid to cornerstone Time Watch's Hong Kong IPO

Orchid Asia will participate as a cornerstone investor in Chinese watchmaker Time Watch Investments' proposed Hong Kong IPO. The private equity investor will inject about HK$204 million ($26.3 million) for an 8.03% stake in the company. Time Watch was listed in Singapore before being privatized in 2011. The mid-price watchmaker is currently looking to raise as much as HK$810 million.

Infinity and affiliate secure 4.7% of Anxin-China

Infinity Group, the Israel-based private equity firm created by China Development Bank and Israeli conglomerate IDB Group, has joined an affiliate in purchasing a 4.7% stake in Anxin-China Holdings for $30 million. Anxin's subsidiaries provide hardware and application software and services used in intelligent surveillance, disaster alert and rescue coordination systems.

Bain-backed Sunac drops on share-sale plan

Sunac China Holdings, a Hong Kong-listed Chinese property developer backed by Bain Capital, suffered from the biggest drop since March after announcing plans to sell HK$2 billion ($248 million) worth of shares. The Chinese developer was looking to position 300 million shares at HK$6.7 apiece. The proceeds will be used for working and development capital.

Kirkland & Ellis adds China PE lawyer to HK office

Kirkland & Ellis has added private equity M&A specialist Frank Sun to its Hong Kong practice. Sun joins the firm as a partner from US rival Paul Weiss. He has a track record of working on private equity and corporate transactions in China and across Asia, with former clients including The Carlyle Group, CITIC Capital, KKR, Morgan Stanley

Private Equity Asia, Silver Lake and Temasek Holdings.

NORTH ASIA

Softbank Ventures Korea invests $1.4m in KnowRE

Softbank Ventures Korea (SBVK), the venture capital unit of Japan's Softbank Corporation, has invested $1.4 million in KnowRe, an education technology company specializing in adaptive online learning services. KnowRe, which was established by a group of math instructors, provides game-based software for learning mathematics that adapts the curriculum in real-time as it tracks students' progress.

Korean couples app raises $3m Series B funding

Korean social media application Between has raised a $3 million Series B funding round from new and existing venture capital players. The proceeds will be used to expand the company's presence outside its home market. Stonebridge Capital and KTB Network each committed $1 million, while Capstone Partners and existing investor Softbank Ventures contributed the remainder.

SOUTH ASIA

PE firms compete for Everstone's stake in VLCC

Several global and regional private equity firms are reportedly in the hunt for Everstone Capital's 16% interest in Indian health and beauty treatment specialist VLCC. Everstone is willing to offload its holding provided the valuation is acceptable, and L Capital - the independent private equity arm of luxury goods giant LVMH - and KKR are among those interested in buying. Indian GP ChrysCapital is also in contention. The stake is said to be worth $74.3 million.

GEF to invest $8.4m in India's IClean

Global Environment Fund (GEF) has invested INR450 million ($8.4 million) for a minority stake in Integrated Cleanroom Technologies (IClean), which manufactures prefabricated modular cleanrooms and related equipment. The investment comes from the GP's South Asia Clean Energy Fund, which reached a first close at $128 million in November 2010.

CDH to reach $1b first close on Fund V by February

CDH Investments is expected to reach a first close of $1 billion on its latest fund by Chinese New Year. The Chinese GP has an overall target of $2 billion for CDH Fund V, which launched in September 2012.

A member of the LP community told AVCJ that CDH would likely exceed its target but restrict itself to less than the $2.5 billion hard cap. There is said to be strong demand among investors for a piece of the fund. "Once they get the first close done it should be relatively easy to reach a final close," the source added.

The private equity firm's target fund size represents a 37% increase on CDH Fund IV, which closed at $1.46 billion in April 2010. A corpus of $2 billion would give CDH the firepower to step beyond its average investment size of $100 million and deploy $200 million or more should opportunities arise.

China is expected to see a greater number of buyout transactions in the next few years and CDH's name has already been linked to two notable club deals: the $510 million acquisition of Luye Pharma, and the $3.7 billion management buyout of Focus Media, although it ultimately dropped out of the latter investment.

Kaizen, Bertelsmann back online education firm

Kaizen, an education-focused Indian private equity firm, has led a $4 million Series B round investment in Educomp Solution's subsidiary authorGen, which produces online education platform WizIQ. German global media company Bertelsmann has also participated in the round.

CX Partners' security deal hits regulatory hurdle

CX Partners' proposed INR5 billion ($89.5 million) investment in private security firm Security and Intelligent Services India (SIS India), one of the pioneers of the country's private security industry, has yet to clear regulatory hurdles six months of its announcement..

PE-backed Amtek sells 5% stake in subsidiary

Auto component maker Amtek Auto, which is backed by Warburg Pincus and ChrysCapital, has sold a 5% stake in its subsidiary Amtek Crankshafts (India) to an unnamed foreign investor for INR223 million ($4.1 million). The deal values the unit at INR4.4 billion with around 746 million shares being sold at INR300 apiece.

Fulcrum invests $1.5m in Congruent Solutions

Fulcrum Venture India has invested INR80 million ($1.5 million) for a 20% stake in Congruent Solutions, a specialist software service provider in the pension administration industry. Congruent will use the proceeds to expand its services business and commercialize COREDC, its proprietary record keeping system.

TA's Dhiraj Poddar promoted to principal

TA Associates has promoted Dhiraj Poddar to principal in its Mumbai Office. His job title was previously director. Poddar supports the firm's India operations and advised on investments in Tega industries and IndiaIdeas.

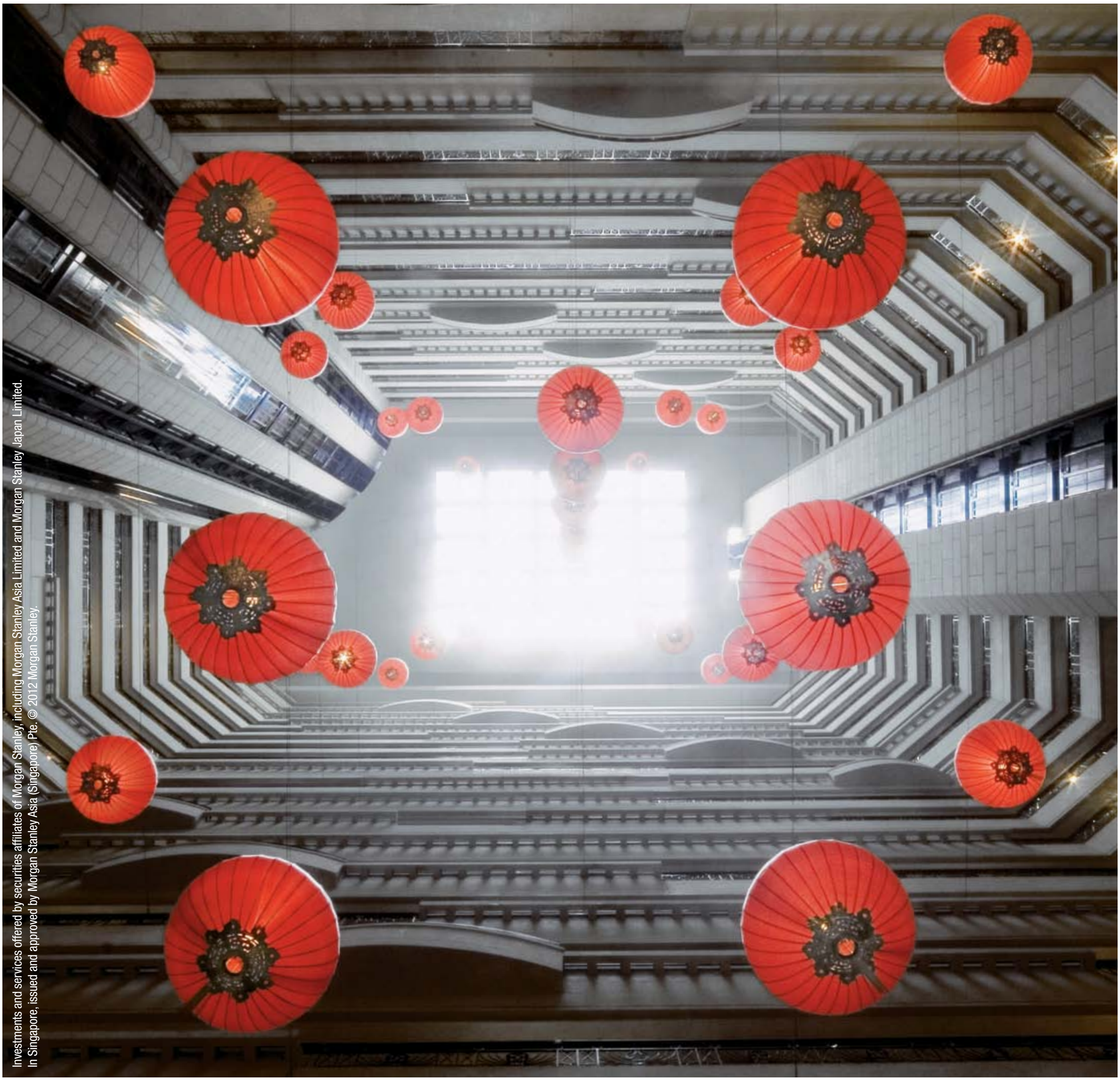
SOUTHEAST ASIA

Japan's Aeon eyes CVC's Matahari - report

Japan's Aeon Group and a unit of Thailand's Central Group are said to be eyeing CVC Capital Partners-owned Indonesian retail group Matahari Department Store. The private equity firm is seeking as much as $3.5 billion for the asset but also has the option of selling shares on the open market, with a private placement of roughly half its holding expected to raise up to $1.5 billion.

Creador completes Indonesia food carve-out

Creador has agreed to buy Indonesian cereals and snack foods producer Simba Indosnack Makmur from India's Godrej Consumer Products. Godrej, which focuses on home and personal care products, took over the business as part of its acquisition of Megasari Group in 2010. It decided to offload the company as a non-core asset, creating an opportunity for Creador.



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Talent tinkering: Operating partners in Asia

Operational value-add is becoming the new normal in Asia as private equity firms hire professionals with the skills to build portfolio companies. However, methods of recruitment and retention vary hugely

ADDING VALUE TO A PORTFOLIO company is far from an exact science. Ask any Asian GP to name their operating partners or even define the role these executives fulfill and you are unlikely to get a uniform response. The idea of getting someone in to help manage an investment portfolio is by no means new to private equity and yet, in recent years, terms like "operating partners" and "operational value-add" have become increasingly integral to the lexicon of anyone on the fundraising trail.

"Five years ago, few GPs even spoke about operating partners," says Doug Coulter, the partner responsible for LGT Capital Partners' Asian private equity investments. "Today it's what a lot of GPs are talking about it."

The buzz is not only heard within the ranks of the international buyout firms, but extends all the way down the food chain to smaller firms. Their definition of an operating partner follows a similar arc, ranging from industry experts hired on an ad-hoc basis to full-time partners.

The question for many Asian GPs – often asked by prospective LPs during due diligence – is where these operating partners fit into their structure. The more experienced the individual, the greater his impact on portfolio companies; the more powerful within the private equity firm, the more readily he is listened to by the deals team, pre- and post-investment; the higher his compensation, or how closely it is aligned with a portfolio company or the fund, the better the chances of retention and outperformance.

"The operating partner model is important and everyone checks it," says one Asia-based LP. "It has an impact on how effective they can be and how they are managed, and also on the turnover rate. Operating partners are part of the bells and whistles everyone thinks they must have, but some are just junior members of in-house teams, while others are very present and material."

An evolutionary process

The demise of multiples arbitrage, which characterized the most recent phase of Asian private equity, has forced private equity firms to reexamine how they can deliver returns. For many, this involves paying closer attention to who they hire and how they can add value.

However, the use of operating partners – and, indeed, the length of their history within a firm –varies greatly depending on resources, investment nature and portfolio management style. KKR, for example, established a definitive operating partner model in 2000 with the creation of Capstone, an internal operations division. The model was rolled out globally and, 12 years on, Capstone has 60 consultants on its payroll. It is the yardstick by which many now measure value creation teams.

"It really has always been set up as a model of doers, not advice givers," says Scott Bookmyer, head of KKR Capstone Asia. The private equity firm eschewed the established practice of hiring external advisors in favor building its own pool of operational expertise that could be drawn upon as and when required by portfolio companies.

Part of the motivation for developing in-house consultants has been a desire to ensure the interests of those who add value are in sync with the firm and its portfolio companies – i.e. these executives are not distracted by outside business interests. Most LPs in Asia recognize the value in this approach.

"Ultimately it is about getting the alignment right," says LGT's Coulter, "If they are in-house and they are incentivized properly to drive value that would generally be preferable to an external advisor who does his job and goes away."

With this in mind, KKR incentivizes Capstone staff in much the same way as the rest of the firm: a combination of cash compensation, performance bonus and carried interest. This approach has also been adopted by many other GPs in Asia.

KKR may have formalized its operating partner model but it is by no means alone among the global buyout firms in being a long-standing champion of building strong in-house expertise. TPG Capital has a reputation for turning around troubled businesses and Steven Schneider, a managing director with the firm in Asia, agrees that operating groups are more necessary in the region than they have been in the past.

> "It is important to the portfolio companies given that organic growth isn't there as much as it was in the mid 2000s. Operational processes are key to improving a company's performance for the sustainable long term" – Steven Schneider

"It is important to the portfolio companies given that organic growth isn't there as much as it was in the mid 2000s," he says. "Operational processes are key to improving a company's performance for the sustainable long term."

Partner to the rescue

TPG describes its operating team as "inside orientated" with around 70 professionals and senior advisors globally, 19 of whom are based in Asia, including three operating partners and 16 senior advisors. The private equity firm has filled its ranks with former executives from companies like General Electric, Dell, Microsoft and Pepsi.

Schneider claims that any one of his team is able to serve as a CEO, CFO, general manager or functional head should the need arise to temporarily replace a senior level executive.

A vivid example of this came last July when

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Headhunting: Asia's got talent?

While many GPs have a clear idea of what they want in an operating partner, the role can still prove to be extremely difficult to fill. This is only likely to be exacerbated by the growing demand for such individuals across Asia.

"Finding top talent is always a very challenging task but especially in Asia where skills are always in shortage," says Allen Han, a senior managing director with CVC Capital Partners. "However, it has not been unusual for us, because of CVC's reputation, to find candidates are attracted by the opportunity to work in one of our portfolio companies."

While the likes of CVC and other large private equity firms are able to leverage their prestige, this doesn't necessarily work for the wider middle market. Vanessa Moriel, executive vice president at executive search firm Aims International says there is huge demand from PE firms for portfolio company CEOs. And beneath that lies a niche that is even harder to fill: professionals who not only have operational experience but are also familiar with private equity.

Although talent is scarce in some parts, many seasoned professionals in Asia see private equity as a means of fast-tracking their careers. Richard Folsom, co-founder of Japan-focused Advantage Partners, says one the biggest headaches is the best and brightest local hires are drawn towards the established corporations, government ministries or large financial institutions. That said, there is a growing appreciation of private equity as a short-cut to a CEO role.

"Private equity is more willing to take someone on in their prime, when they are in their 40s or early 50s, it gives them that opportunity to be in that senior role plus have the opportunity to make a substantial equity return in the process," Folson says.

Aims' Moriel sees a similar trend in Asia as a whole as experienced corporate executives turn to operational positions with private equity firms due to the potentially large financial rewards.

Han of CVC laments that it is still "extremely rare" to find candidates that can offer the ideal combination of corporate and private equity experience. He contrasts the situation with Europe where CVC recently hired two new operating partners, both of whom had previously worked with other private equity funds.

Asia will eventually evolve along similar lines but it takes time. It is only through private equity firms in the region making greater use of operating partners that the talent and experience pool will deepen.

Jin-Goon Kim, a partner at TPG, was appointed executive vice chairman of struggling Chinese sportswear retailer Li Ning following the departure of the company's CEO. Li Ning's CFO left several months later. When TPG and Government of Singapore Investment Corporation (GIC) invested in the company earlier in 2012 through a convertible bond issue, its prospects already looked bleak. Comparisons were inevitably drawn with the turnaround job the private equity firm performed at women's shoe retailer Daphne from 2009, an effort that laws led by Kim.

Last week Hong Kong-listed Li Ning saw its stock drop 13.8% after announcing it would raise up to $241 million through a convertible securities offering, with the proceeds earmarked for a brand revival plan. It appears the market – admittedly a short term-oriented creature – has little faith but should Kim manage to work his magic once again he is likely to be handsomely rewarded.

TPG's operating partner incentive program comprises a base salary, a regional performance-based bonus and an individual performance-based bonus. In addition, operating partners receive "vintage shares" in the portfolio companies they work with, which is essentially a means of awarding carried interest but on a more specific basis. There may also be opportunities to co-invest when sourcing deals – a vital component in aligning respective interests.

CVC Capital Partners also stresses the need for operating executives to be able to fulfill an interim management role, although the need has yet to arise in Asia. Allen Han, a senior managing director at the private equity firm, describes the ideal résumé as "five years management consultant experience and 10 years of operating experience."

The private equity firm has three full-time operating professionals in Asia, plus six in Europe and one in America. The Asian representatives are each responsible 3-4 portfolio companies, supported by a global network of industry advisors who offer sector-specific expertise and sometimes act as a source of deal flow.

"It usually will involve a typical directors' fee but if they help originate the deal we offer co-investment rights," says Han. "It has been quite effective in Europe and North America, and in Asia we have had a number of deals sourced through industry advisors".

In this way, global firms have naturally been ahead of curve as they react to prevailing trends in Europe and America and export and adapt them to Asia. However, several Asian players also claim early-mover advantage, Unitas Capital among them. The firm's senior leadership comprises eight partners, half on the deal side and half on the operating side. The latter include three former CEOs and one former division head at a multinational.

"There is a significantly higher degree of integration compared to what you would find in a lot of other PE firms," says John Lewis, Unitas' CEO. "The reason we do this is that we believe an ex-CEO has more to bring to the table than what is fully utilized by private equity firms." In keeping with this approach, operating partners receive the same level of compensation as deal partners, with carried interest shared out between them all. Lewis argues that an incentive model tied to the performance of the fund rather than individual companies is vital in forming a cohesive team.

The specialists

Although Unitas targets control deals it rarely seeks to take operational control, instead empowering and incentivizing existing or imported management teams to run businesses. This is in part a reflection of case-by-case needs in Asia and in part a product of specialization – the GP exclusively targets the industrial and consumer-retail spaces.

Other PE firms with a specialist investment thesis have also tailored their operating partner approach to suit their expertise. Silver Lake, for example, set up a value creation team (VCT), which numbers 20 operational professionals globally and is the fastest growing part of the firm in terms of head count. Five are based in Asia and spend a substantial amount of time working on opportunities in the region, particularly China.

The VCT includes full-time employees and special advisors who have other interests. As a technology specialist, Silver Lake's network is deep and many people within the sector have worked with the private equity firm before as investees, customers of investees or consultants. While special advisors are brought in when required as opposed to being held on retainer, there is preexisting familiarity on both sides.

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Compensation is described as running the gamut of cash, carry and retainer, depending on the situation.

"With technology, more than any other sector, you need industry expertise," says Ken Hao, head of Silver Lake Asia. "You can't put a hardware guy in an internet company and you can't put a software guy In a specialized Chinese communications company. The issue of fitting an operative executive into a portfolio company is the tricky part."

The idea of leveraging an extensive network of external advisors is also integral to EQT Partners. The private equity firm's approach, which was developed in Europe and has been carried over to its operations in Asia, is based on a global database of 650 experts who are divided into seven tiers based on how closely they work with the firm. About 50 are located in Asia, and a handful of them are "tier one" advisors.

"Tier one advisors are almost full time staff but they are not strictly employees," explains Martin Mok, a partner with EQT in Hong Kong. "They act as consultants and devote around 50-60% of their time to EQT, normally sitting on two or three boards."

Advisors in tier one and tier two account for around 15% of the global pool and they are kept on retainer. While the first tier is exclusive to EQT – and compensated to reflect this – tier two advisors are paid less and have the option to take on projects elsewhere. Neither group received carried interest from the fund but the real incentive lies in co-investment opportunities. As with TPG, this is seen as a means of aligning interest, but EQT adds a twist: co-investment is mandatory.

Mok claims the external advisor approach is particularly effective in China where owners are reluctant to give up control to outside investors and so PE firms try to add value by supporting the incumbents. "Going into a firm with 10 guys sitting on the board full time can be like having too many cooks in the kitchen," he says. "It takes away the accountability."

No consensus, but who cares?

In keeping with the amorphous definitions and modes of operating partner across the region, not everyone agrees with this approach, even within a China context. But as the operational partner philosophy filters down to Asian GPs that can't rely on global networks and resources, models will inevitably deviate, throwing up compromise solutions.

Lunar Capital is an interesting example. The private equity firm targets control deals involving mid-market consumer companies in China. Although it has a fraction of the resources of a global buyout firm, its operational partner model is not that far removed from a KKR or TPG, emphasizing the need for in-house expertise. The problem is that a GP of Lunar's size is unable to maintain a dedicated team in this area. The private equity firm's solution is to hire individuals with relevant expertise before making an investment, uses them during due diligence and then offers them a salary-plus-equity package as CEO of the portfolio company.

While firms like Lunar are still the exception in China, and indeed in Asia, the trend for operating partners taking centre stage is likely to gain more traction in the region. There may be no consensus as to which approach is most effective, but this misses the point. GPs have to convince both investees and LPs that the model they employ works for their particular fund size and strategy. There is no turning back.

"I think the emphasis on value add will be a sustainable trend," adds TPG's Schneider. "If the world continues to be a difficult place in which to invest, with no hyper growth, really smart business owners are going to want to be doing business with private equity firms that have the ability to help them. Not just by funding financial structuring but by rolling up their sleeves and helping the business grow."

Hole in the road

Still massively underserved, the Philippines infrastructure sector is finally on private equity investors' radar. Partnering with a credible local partner could be the first step to success

THE MAIDEN PRIVATE EQUITY investment made by the Philippines' largest pension fund, Government Service Insurance System (GSIS), is indeed ambitious. Last July, it agreed to put up nearly two thirds of the $625 million in capital raised by the country's first-ever infrastructure fund.

This boldness can ultimately be traced back to government policy – and GSIS is government-owned, government-controlled and run for the benefit of government employees. Known as the Philippine Investment Alliance for Infrastructure (PINAI), the fund is designed to facilitate investment in the Philippines' road, rail and energy projects. Other LPs include the Asian Development Bank (ADB), which put in $25 million, Dutch pension fund asset manager APG and Australia's Macquarie Infrastructure and Real Assets (MIRA). Macquarie will serve as manager.

Macquarie is certainly not the only private equity player targeting this sector – at least five PE houses bid for the PINAI mandate. Meanwhile, Capital Advisors Partners Asia (CapAsia), which held a first close for its $500 million Southeast Asia infrastructure fund in December, has earmarked at least one fifth of its corpus for deployment in the Philippines.

"We see a clear need for infrastructure investments in the Philippines combined with efforts by the government to create the right environment to mobilize investor capital into this sector," Brian Liu, an investment officer involved in ADB's commitment into PINAI, tells *AVCJ*. "As long as ADB can achieve the maximum developmental and financial returns, we would be interested in deploying more capital into private equity funds."

The PPP route

While the Philippines has long boasted strong growth potential and favorable demographics, investor interest only began to gather pace in the wake of the election of President Benigno Aquino and the launch of substantial efforts to curb corruption. Last October, Moody's raised the country's debt rating to one notch below investment grade. According to Thomson Reuters, foreign inflows to the Philippine Stock Exchange totaled $2.64 billion last year, more than double that of 2011.

However, the country's hardware has not kept pace with rising investment from overseas. Despite PHP339.3 billion ($8.3 billion) in government spending on infrastructure sector last year, investment in the sector is just 3% of GDP compared to a Southeast Asia average of 5%

"There is a significant infrastructure gap in the Philippines that needs to be met," says Frank Kwok, senior managing director of MIRA Asia. "In its Development Plan 2011-2016, the government highlighted the need for significant investment in infrastructure and has implemented policies that are supportive of such investment."

> "Even if you take the bottom-up approach, the risk-adjusted returns are still higher than many of the other markets"
>
> – Hans-Martin Aerts

The country is likely to spend more on infrastructure than ever before this year, with a budget of PHP400 billion, up 19.3% from 2012. At the same time, the government is looking to attract private capital into the sector through the Public-Private Partnership (PPP) Centre. Established in 2010, the PPP Centre already has 26 projects in the pipeline. PINAI, which aims to fund 5-10 projects costing $50-125 million each – is also exploring opportunities in the PPP space.

"The government of the Philippines is actively working to attract foreign investment to promote economic development," says David Stollard, Southeast Asia head of asset investment and finance at consultancy E.C. Harris. "The PPP Centre in particular has done a great job in providing visibility on its project pipeline. This increases potential investors' ability to evaluate the size of the market."

The hard work is paying off. When the Association of Mindanao Rural Electric Cooperatives Power Supply Aggregation Group (AMRECO PSAG) announced plans to construct a 300-megawatt coal-fired power plant in Mindanao last July, it had attracted at least six corporate bidders including the likes of AES Corporation, Aboitiz Group and Ayala Group. Meanwhile, four local groups are among the frontrunners for the $1.5 billion Light Rail Transit line 1 Cavite extension project, the biggest infrastructure project under the Aquino administration's PPP scheme.

Crowded market

Competition among strategic investors keep to expand their market share appears to be coming at the expense of private equity. According to AVCJ Research, KGL Investment Company's $30 million investment into Global Gateway Logistics City – an aviation-oriented logistics complex – is the only disclosed PE infrastructure investment in five years. Looking forward, Hans-Martin Aerts, head of infrastructure at APG Asset Management Asia, argues that one of the best PE approaches to tap into this market is to partner with a strong local partner.

"Domestic conglomerates including the likes of Ayala and Metro Pacific have all made substantial investments in the infrastructure sector and they will probably continue acquiring assets," he says. "You don't need to compete with them. What we want to do is to work alongside them. Even if you take the bottom-up approach, the risk-adjusted returns in the Philippines are still higher than many of the other markets."

Partnering with these firms, however, is easier said than done. While PINAI and APG's direct investment unit could leverage its close ties with ADB and GSIS to co-invest alongside some of the big conglomerates, independent private equity players must establish an on-the-ground presence in order to source the right partner. This takes time, given the country's regulatory, political and operational uncertainties.

CapAsia, for example, has spent five years exploring the country and is only now considering opening its fifth ASEAN office in Manila. Though happy to work with local companies, the PE firm targets mid-market deals in the region of $50-100 million so as to avoid direct competition with strategic investors.

"When more managers explore infrastructure opportunities in the Philippines, this will eventually create a larger market by itself – but in a pace slower than many may like," says Johan Bastin, CEO of CapAsia.

DEAL OF THE WEEK

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MGPA pays $111m for Perth office building

FOUR MONTHS REACHING A FIRST CLOSE of EUR85 million ($111 million), MGPA Asien Spezialfonds – an Asia-focused real estate fund structured to target German investors – has committed close to exactly that amount for its maiden investment in Australia.

The target property – Optima Centre – is a Grade A office building located in Herdsman Business Park in Perth and has a total net rentable area of 16,116 square meters over two buildings, including 500 car parking berths. MPGA purchased the asset through an off-market competitive process from a joint venture between the developer Alcock Brown Neaves Group and Macquarie-managed entities.

The deal souring process was not easy. As the EUR500 million property fund is regulated by the German Investment Act, it was designed to focus on high income yield from predominantly AAA- rated covenants and long weighted average lease expiry (WALE) – the average lease term remaining to expire across a portfolio weighted by rental income or square meters. The strategy is to buy into buildings that are already let and reposition them, generating rental and management income.

"The hardest thing is to find good quality deals. We had looked into 100 deals before finally finding the one that fits into our investment criteria," says John Saunders, Asia CEO for MGPA. "We have to be incredibly selective and patient. One may find a lot of transactions out there but only a handful of them are the ones that we want to do."


Perth: Robust commercial market

Herdsman Business Park in particular is attractive due to its proximity to the central business district. Besides, the two buildings were completed in 2009 and 2010 – still relatively new and immune from extra spending on capital expenditures. Both are fully let, with 83% leased to the Government of Western Australian, generating yield in excess of 8.6% and WALE of approximately 12 years.

"The fund is trying to achieve a distribution yield at the fund level at about 5% and it's very attractive especially to German insurance companies and pension funds," Saunders adds. "I think in Germany there is a desire to get exposure to Asian currencies and we are still seeing good interests in these high-yield products."

The fund is expected to reach a significant second close by the end of the first quarter, if not sooner. A few more transactions in Australia and Tokyo are in the pipeline. The firm's sweet spot typically consists of investments of $80-100 million for key cities in Australia, and $25-50 million for Tokyo.

"The yields in Australia are interest rate-driven and anything we are looking at will be in excess of 8%. What's interesting is that while we start to see a series of successive rate-cuts, the yields haven't been driven down much from the high level, representing pricing opportunities," Saunders says. "Australia is very interesting at the moment and there's certainly an increase in buying opportunities over the last 6-9 months."

Australia's IFM enters UK airspace

AN INVESTOR IN AUSTRALIAN AIRPORTS for 15 years, Industry Funds Management (IFM) – which is owned by 30 domestic superannuation funds – has made its first foray into the global market with the acquisition of a 35.5% stake in Manchester Airports Group (MAG), one of the largest airport operators in the UK.

The investment is part of the MAG's GBP1.5 billion ($2.4 billion) purchase of London Stansted Airport, Britain's fourth-largest airport by passenger numbers. MAG had made no secret of its interest in Stansted ever since the asset was put up for auction by BAA. The seller, owned by Spain's Ferrovial, already runs five UK airports, including Heathrow, and had been ordered by regulators to divest some of its assets.


Airports: Predictable traffic

Other bidders for Stansted are said to have included Macquarie and Malaysia Airport Holdings.

Situated 50 kilometers from London and boasting a single runway, Stansted is predominantly a low-cost holiday airport. The acquisition price represents a multiple of 15.6x Stansted's 2012 EBITDA, which compares favorably with similar airport transactions in the country. IFM channeled the investment through its open-ended Global Infrastructure Fund after an 18-month discussion with MAG.

"Airport investments tend to have a slightly higher return than some of the more heavily regulated sectors as they are more linked to the up-and-downs of economic activities," Kyle Mangini, IFM global head infrastructure, tells *AVCJ*. "While there have been shocks such as SARS and 911, by and large airport traffic tends to increase predictability over time."

MAG owns East Midlands and Bournemouth airports in addition to Manchester. The group currently serves 24 million passengers and handles almost 500,000 tons freight every year. Passenger numbers and profit rose 6.7% and 26%, respectively, for the year ended March 2012.

"MAG has done a great job in managing its airports which are located at places with strong population and economic characteristics," Mangini adds. "For any airport investment, it's always a matter of understanding the nature of the GDP, population base and the nature of the regulation that we are working within."

The acquisition follows IFM's another bid for state-run airport operator ANA-Aeroportos de Portugal SA, which was part of a privatization program Portugal compromised to undertake in order to secure bailout package from the European Union and the International Monetary Fund. The asset manger was finally out bid by French construction company and highway operator Vinci SA in December.

"There has been reasonable deal flow in the airport investment space," Mangini adds. "Although airports are already funded by private money in many parts of the world, there is still a considerable amount of state-owned assets which may be privatized and we continue to be very active in this space and analyze every opportunity."

Secondaries in vogue in Korea

AMONG SOUTH KOREAN LPS THERE IS such a thing as the flavor of the month. We have seen global buyout and credit phases over the years, during which international private equity and credit houses mopped up more allocations than ever before. The last 12 months, though, have been all about secondaries.

"The Korean market is very large in terms of dollars but very small in terms of the number of institutions," an Asia-based gatekeeper tells *AVCJ*. "When they focus on a particular investment theme they tend to colonize the international market."

This is happening with greater frequency across different sub-sectors of private equity. Korea Investment Corporation (KIC) perhaps represents the extreme in terms of speed of alternatives investment program built-out: it went from virtually zero in 2009 to more than $10 billion in committed capital in the space of three years. Other LPs are unlikely to move at a similar pace, but they are certainly becoming more interested in international exposure.

As one industry participant puts it, "We now see more than just the usual suspects like KIC and National Pension Service (NPS). There are names like Korea Teachers Pension Fund (KTPF) and Government Employees Pension Service."

For a global GP, Korea is no longer just about the possibility of a $100 million commitment from KIC; other institutions, though they may have the capacity to invest no more than $10-50 million, are increasingly active. This clustering effect means that Korea is now well covered by placement agents and a regular stopping point for international private equity firms, if they don't already have a permanent presence in the country.

As to why secondaries are currently in vogue, one explanation is that these are young alternatives programs that want to ramp up their exposure without stepping too far outside the comfort zone. With secondaries, there is a bit more visibility in terms of what is on the block.

An even safer approach is intermediation, which is what KTPF opted for last week when it agreed to invest $30 million each in comingled funds operated by Hamilton Lane and Paul Capital. The former is in the process of raising its third secondary fund with a target of $650 million; the latter is seeking around $2 billion for what will be its 10th global secondaries vehicle.

There were nearly a dozen applicants for the mandate, including the likes of HarbourVest Partners and Partners Group. As with most Korean tenders, the process was reasonably transparent. Domestic regulations state that applicants must be registered in Korea and use a local securities house to act as a reporting entity to the institution in question. Third-party consultants also play a prominent role.

KTPF reportedly wants to increase its international private equity exposure to 15% of its overall PE portfolio within five years. Commitments to the asset class stood at $600 million at the end of 2012. Other public institutions such as Military Mutual Aid Association and Korea Post are also expected to edge from the fringes nearer to the center over the next few years. Expect more public tenders and more sub-sectors to enjoy their time as flavor of the month.

Reinvigoration project

When Lunar Capital invested in Sichuan Zhiqiang, the company's Joysun brand was well known but lacked relevance with younger consumers. It is now seeking to redress the balance with a revamped product range

AROUND 700 MILLION PEOPLE ARE expected to tune into China's Spring Festival Gala, which airs on state broadcaster CCTV on the evening of February 9. A 10-second advertising slot for this event is among the most expensive in the world at RMB215 million ($34.5 million), not including production costs.

Fourteen years ago the rates were less than one third current levels but the outlay proved almost fatal for Sichuan Zhiqiang. The state-owned walnut-based beverages producer was the biggest buyer of commercial airtime during the 1999 gala, projecting its Joysun brand nationwide and in the process racking up debts that couldn't be serviced. A local entrepreneur picked up the business as a distressed asset and from there it began to stagnate, not so much mismanaged as misdirected in a changing consumer environment.

"It's a well-known brand that has become a little old-fashioned – in much the same way you would think of Ovaltine in the West," says Derek Sulger, managing partner at Lunar Capital, the private equity firm that bought a 60% stake in Sichuan Zhiqiang in March 2012 for around $50 million. "We thought if we could buy a majority interest in the company and then reposition the brand, it would be a great opportunity."

Identify and acquire

Lunar looked at about 100 potential food and beverage targets before settling on Sichuan Zhiqiang. The brand's safe and healthy qualities – walnut-based products are well known in China for their nutritional value – were seen as well suited to current consumer priorities.

Convincing the entrepreneur to give up majority control after eight years of ownership presented another challenge. Lunar's approach was to build up trust and then present the case that capital alone wouldn't solve the company's problems: It was obvious that Sichuan Zhiqiang should expand its product line to incorporate ready-to-drink (RTD) as well as the existing powder-based beverages, but achieving this goal required new management and a new strategy.

Eventually they settled on a 60-40 split, with the entrepreneur retaining a seat on the board in addition to his equity holding.

The individual charged with executing the new strategy is Simon Liu, who was brought in as CEO. A veteran of consumer businesses in China, having previously worked for the likes of Sun-Rype, Coca Cola, Mentos and Vitasoy, Liu's initial role was to conduct due diligence for Lunar on potential investment targets in the sector. There was a general understanding that he would likely become CEO of any resulting portfolio company.`

Liu's brief is as follows: achieve stability in the business in 2012, expand the product portfolio in 2013, and become the category leader in walnut-based beverages within a few years.

Achieving stability first and foremost meant ensuring product quality and safety. "This is the number one concern in China," says Liu. "There are international standards we adhere to, but we also have our own internal standard: If you have a three-year-old kid, would you give our products to your kid? The plant and systems needed a major overhaul and that was the first decision on which the board reached a consensus."

Equipment was updated and the plant was partially reconfigured, but steps were also taken on the "soft side," improving systems and oversight all the way through the supply chain from farm to warehouse.

Located in Dazhou, a city in western Sichuan province, the company's plant is close to Dabashan, one of China's two major walnut-growing areas. Raw walnuts are sourced from farmers by a handful of specialist wholesalers who send people into the mountains to collect, crack and grade the product, before putting it into atmospheric storage for transfer to market.

Conscious of the supply chain weaknesses that have created food safety issues in other industries, Sichuan Zhiqiang limits the number of wholesalers it will work with and includes quality standards in contracts. "We need to make sure we aren't buying from wet markets or off-and-run suppliers," Liu explains. "We deal with specialists who know how to separate low grade from high grade at a significant scale of operations."

The ultimate objective of this quality drive was to secure Hazard Analysis & Critical Control Points (HACCP) accreditation, a globally recognized food safety management standard. Accreditation arrived in December of last year, but not before company's employees had been put through rigorous training and assessment processes on everything from personal hygiene to appropriate headwear. Sichuan Zhiqiang's shift manager was replaced due to concerns that he couldn't meet the required standards.

Senior management was also bolstered through the addition of department heads for operations, trade marketing, human resources and sales and marketing. Furthermore, Lunar introduced improved financial systems that allow proper budgetary disciplines as well as being used to carry out margin analysis on different product lines. This resulted in the culling of half the 50 product lines that existed when Lunar invested due to underperformance. At the same

Walnuts by numbers

Flavored milk beverages accounted for one quarter of China Mengniu Dairy's liquid milk sales in the first half of 2012, or RMB4 billion. Walnut is the most popular flavor and Sichuan Zhiqiang is the largest national supplier of walnut-based ingredients used to make the product.

Walnut consumption in China has grown 18.5% per annum for the past 12 years and total domestic net output ran to 1.3 million tons in 2011. Half of this was consumed raw: cracking the shells and eating the contents. The remainder was processed into walnut-based products.

According to Simon Liu, CEO of Sichuan Zhiqiang, the average wholesale value of one ton of nuts is RMB35,000, which implies total value for raw materials used in processing of over RMB20 billion. Factor in the retail mark-up and the value-add of food processing, and Liu estimates the processed walnut market is comparable in size to the RMB50 billion in annual China sales recorded by Coca Cola and Pepsi.

Of course, ingredients supplied to Mengniu and its industry counterparts are just one part of this market. In addition to powder-based and ready-to-drink walnut beverages, there is a huge food industry – ranging from biscuits to baked goods to ice cream – that derives from the nut.

time, six new products have been launched.

With RTD beverages not yet part of the product portfolio, Sichuan Zhiqiang's business is currently split evenly between powdered beverages and ingredients. The company is the largest walnut ingredients supplier in China, serving dairy firms such as China Mengniu Dairy and Yili Group, which sell walnut-flavored milk. On the powdered beverage side, Liu sees a handful of local competitors, but the company is already seeking to differentiate itself.

"In 16 years the packaging and formula didn't change much but consumer tastes and demographics in China have changed," says Liu. "The future of the brand will be determined by people born in the 1970s, 1980s and 1990s and plastic pouch packaging doesn't really appeal to them. When we took it over, the products only appealed to people aged 45-plus. While still an important consumer group, they are only a portion of the market we are seeking to serve."

Segmentation strategy

The fruits of these efforts will become apparent after Chinese New Year. Sichuan Zhiqiang's new product lines are entering the shops now, united by a common design to make Joysun synonymous to walnut nutrition but divided in terms of segment. Although there is a degree of geographical differentiation – gift packs sold in Beijing must be red in color and bulky, regardless of how much powder is inside, whereas in Shanghai there is a preference for understated quality – this segmentation is almost entirely driven by demographics.

> **"There are international standards we adhere to but we also have an internal standard: If you have a three-year-old kid, would you give our products to your kid? The plant and systems needed a major overhaul and that was the first decision on which the board reached a consensus"** – Simon Liu

At one end of the scale are products that emphasize nutritional quality for health-conscious adults; at the other are products packaged to appeal to the youth market, although the ultimate buyers might be parents looking to boost the nutritional value of their children's diet. Over the next year, Sichuan Zhiqiang's segmentation strategy will continue, with a particular focus on pregnant and breastfeeding young mothers. "We carried out consumer research on expecting mothers and the first thing that jumped out is 'walnut is good for you and for your baby,'" Liu says. "This is passed from generation to generation. You don't need public education on the nutritional value of walnut; it is all about making the brand relevant."

Should Sichuan Zhiqiang achieve the 2014 objective and consolidate its position as a category leader, Lunar sees three possible exit avenues: a stand-alone IPO, a merger with other assets in the portfolio, or a trade sale, most likely to a Chinese buyer. "What we see in the food and beverage sector is large companies are moving away from build-everything-yourself and becoming more acquisitive," says Sulger. "They are looking to buy other brands that are category leaders."