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Anything is possible...

There are many barriers to liquidity in private equity: complexity, transaction size, deadlines, disparate assets, confidentiality, alignment, tax, shareholder sensitivities – the list goes on.

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Hunting the lion city

WHEN JOHN TSANG, HONG KONG'S financial secretary, extended the private equity industry a significant tax incentive in last week's budget, it was presented in the wider context of encouraging more funds to domicile in the territory. In some quarters, this was interpreted as a move by Hong Kong to challenge the Cayman Islands' hegemony over fund incorporations. Not so, or at least, not yet.

Given the upheaval in the regulation of offshore financial services in recent years, it is not beyond the realms of possibility that Cayman might one day be toppled. But a more immediate competitive threat to Hong Kong that must be reeled in is Singapore.

Allowing private equity investors to qualify for the profits tax exemption extended to offshore funds in Hong Kong is helpful in this respect. In practical terms, the change should offer greater certainty on tax treatment. Cayman-incorporated funds will no longer incur the costs of setting up complicated structures designed to avoid triggering permanent establishment in Hong Kong and thereby becoming liable for local tax.

It should, in theory, also make it easier for private equity firms to take full advantage of Hong Kong's tax treaty network – funds must meet certain local substance requirements to qualify for treaty benefits and this can now be done without risking local tax liability.

However, there are others areas in which Singapore still maintains an edge, perhaps because its regulators are willing to intervene in the market while their Hong Kong counterparts have traditionally operated on a less-is-more basis.

Firstly, tax uncertainty remains in certain areas. Neither Hong Kong nor Singapore taxes capital gains, but while the latter offers reasonably clear guidance on how the system works, the former has no legal definition of capital gains. Concerns have come to the fore in the last couple of years in response to the inland revenue department launching a crackdown on private equity and hedge fund managers. Firms are being audited and in some cases income that was previously classified as a capital gain has been reclassified as business income.

It is unlikely Hong Kong would torpedo the entire funds industry by taking a hard line on this issue, but investors are less likely to remain in a jurisdiction with inconsistent enforcement when a more transparent system is available elsewhere.

Secondly, Hong Kong offers no meaningful regulation to those who request it. The Securities & Futures Commission's (SFC) response to private equity firms registering with it has so far been passive. Public markets remain top priority and there is little interest in PE funds that are domiciled in Cayman with nothing more than an advisory presence in Hong Kong. Private equity firms managing these funds only fall within the regulatory remit if they are selling to local investors or if they offer certain other financial products. Many smaller players don't qualify.

This has become a pressing issue amidst uncertainty as to just how far the EU's Alternative Investment Fund Managers Directive (AIFMD) will go. Will Asia-focused managers that want to raise capital from LPs within the EU have to create costly onshore structures to do so? Or will offshore managers receive a passport to operate in the EU based on the credibility of their local regulators?

The worry is that European regulators might examine Hong Kong's setup and decide that it is insufficient and that mainland Chinese PE firms that want to raise US dollar-denominated capital might look to use Hong Kong as a fundraising hub and apply for local licenses, but ultimately opt for Singapore because the environment is more suitable.

Few people lie awake at night fretting about these issues and if Hong Kong fails to redress the balance with Singapore there wouldn't be a mass exodus. But it would chip away at funds' supporting infrastructure and, as people and functions are shifted out for strategic reasons, the broader financial services sector would suffer. And this sector employs 6% of Hong Kong's workforce and contributes 16% of its GDP.

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NEWS

ASIA PACIFIC

Washington State to invest $300m in Affinity Fund IV

Affinity Equity Partners has secured a $300 million commitment for its fourth pan-Asia fund from Washington State Investment Board. It is three times the size of the US pension system's investment in the GP's previous vehicle.

AUSTRALASIA

Australia's Pacific Road in Canadian resources deal

Australian private equity firm Pacific Road Capital Partners is investing A$10 million ($10.2 million) in coal mining firm CoalMont to fund its mining project in Canada. Pacific Road will take a 35% stake in the project at the Crowsnest Coal Field in British Columbia through its 100% owned subsidiary CanAus Coal.

NZVIF receives $49m government underwrite

New Zealand Venture Investment Fund (NZVIF), a venture capital fund-of-funds, will receive a NZ$60 million ($49 million) underwrite facility from the New Zealand government. While this is not a new allocation of capital, it will provide the fund with additional capacity to commit to two to three new venture capital funds.

Archer's Australian Aged Care buys Lend Lease unit

Australian Aged Care Partners, an Archer Capital portfolio company, has made an agreement with property group Lend Lease's to purchase its aged care unit for A$270 million ($276 million). The transaction is expected to be completed by the end of March 2013.

GREATER CHINA

KPCB, IDG-Accel invest $10m in China's EntreMed

KPCB China and IDG-Accel China have agreed to invest $10.7 million in EntreMed, a clinical-stage pharma company that develops drugs in the US and China for global release. EntreMed will sell a total of 4.5 million shares of common stock plus warrants to purchase a further 2.2 million shares to the two vebture caoital players.

HK extends offshore funds tax exemption to PE

Private equity investors will qualify for the profits tax exemption extended to offshore funds in Hong Kong as part of government efforts to encourage more vehicles to domicile in the territory.

Financial Secretary John Tsang announced the measures in his 2013-2014 budget statement, in which he also pledged to "provide relevant legal and regulatory frameworks, and a clear and competitive tax environment with a view to attracting more funds of various types to base in Hong Kong." The move on tax exemption will go some way to address local concerns that Hong Kong is losing ground to Singapore, which offers greater certainty on tax treatment and clearer regulation of PE. However, industry participants are wary of getting their hopes up before the government publishes full details of its plans.

In practical terms, it means that Cayman Islands-incorporated funds no longer have to set up complicated structures designed to avoid triggering permanent establishment in Hong Kong and thereby becoming liable for local tax. It should also make it easier for private equity firms to take full advantage of Hong Kong's tax treaty network - funds must meet certain local substance requirements to qualify for treaty benefits and this can now be done without risking local tax liability.

"It's a huge welcome for the industry and it is a little bit surprising that it has happened now," said Darren Bowdern, a tax partner at KPMG China. "We have been lobbying the government for a long time to do several things, including extend the current exemption to include private equity."

MSPEA to complete $147m China dairy take-private

Morgan Stanley Private Equity Asia (MSPEA) is on the cusp of completing a $147 million buyout of Chinese dairy producer Feihe International after the board accepted a bid from the PE firm in conjunction with the company's chairman and CEO. It is the sixth take-private of a US-listed Chinese company to win approval in the last five months.

No date set for resuming China IPO approvals – CSRC

The China Securities Regulatory Commission (CSRC) has yet to set a timetable for resuming IPO approvals, scotching rumors that it would start pushing through new candidates in April, an official from the securities watchdog told Xinhua news agency.

Gen2 Partners rebrands as Adamas Asset Management

Gen2 Partners, a Hong Kong-based asset management firm that targets mezzanine opportunities, has rebranded itself as Adamas Asset Management. The firm described the move as part of the development of its core business, focusing on private investments and customized funds.

Matrix, Sequoia in Beisen Series B round

Beisen, a Chinese supplier of HR evaluation and testing tools and services, has received $10 million in Series B funding from Matrix Partners and Sequoia Capital. The new funding will be used for product development, with Beisen having introduced a cloud-based platform that offers integrated recruitment, evaluation and talent management services.

Carlyle's China Fishery in $277m Peruvian deal

China Fishery, an industrial fishing company part-owned by The Carlyle Group, will pay $555.8 million for Peruvian counterpart Copeinca. The acquisition will make China Fishery the largest player in the world's largest market by volume for fishmeal and fish oil exports.

NORTH ASIA

KKR boosts teams in Japan

KKR has strengthened its Japan team with the appointment of Hiro Shimizu and Sakae Suzuki as directors. The private equity firm now has 12 people in its Tokyo office. Shimizu, who previously spent 14 years at Goldman Sachs, most recently as head of the Japan financial

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institutions group, will work with KKR Capital Markets.

JAFCO invests $5 million in HiringBoss

Japan's JAFCO has put $5 million into HR software provider HiringBoss in a Series A round of funding. Singapore-headquartered HiringBoss will use the investment for R&D, product development and to improve regional sales and support mechanisms. The company also plans to launch two new HR software products by June 2013. Launched in 2011, the company also has offices in Japan, Indonesia and Vietnam.

AmorePacific leads pharma firm's Series B round

AmorePacific Ventures, the VC arm of Korea's largest cosmetics group, has led a $7 million Series B round of investment in Miami-based Brickell Biotech, a pharma firm specializing in skin conditions.The proceeds will be used to support the development of novel compounds in Brickell's pipeline.

SOUTH ASIA

Avendus launches third India PIPE fund

Avendus Private Equity has launched its third PIPE fund. India Opportunities Fund III is targeting INR5 billion ($91 million) and will focus on investments in mid-cap companies. The fund will look to sectors that have benefited from India's rise in consumer spending, rapid urbanisation and increased rural wealth.

India's Hikal raises $8m debt from IFC

ndian chemical company Hikal, part of the Kalyani Group, will receive $8 million in debt financing from the International Financial Corporation (IFC). The funds will be used to help finance the Mumbai-headquartered company's $15.5 million program aimed at increasing resource efficiency and reducing greenhouse gases.

VC-backed Tree House to acquire Brainworks

Pre-school management company Tree House Education, backed by Aditya Birla Capital Advisors, is to acquire 100% of Brainworks Learning Systems, a national chain of pre-schools. Brainworks is part of Better Value Brands. The value if the transaction was not diclosed.

7 Days board agrees to PE-backed buyout

Chinese budget hotel chain 7 Days Group has accepted a take-private offer from its co-chairmen and three private equity investors that values the company at approximately $688 million. Two PE firms, The Carlyle Group and Sequoia Capital, were initially backing the deal but an affiliate of Actis Capital has decided to roll over its existing holding into the acquisition vehicle.

The buyer consortium, led by Boquan He and Nanyan Zheng, 7 Days' co-chairmen, will pay $13.80 per American Depository Share, a 30.6% premium to the last close prior to the submission of the offer on September 25. The initial bid was $21.70 per share.

The transaction will be financed through a combination of cash contributions from Carlyle, Sequoia, Actis and He and a $120 million loan facility provided by Cathay United Bank, Chinatrust Commercial Bank, Nomura International, Ta Chong Bank and Taipei Fubon Commercial Bank. In 2008, Actis and Warburg Pincus invested $65 million for an undisclosed stake in 7 Days. Warburg also put in $25 million in 2006 and 2007. As of April 2012, Actis and Warburg owned 11.6% and 16% in 7 Days, respectively, while co-chairmen He and Zheng together held 32.7%. Shareholders participating in the roll over collectively own 50.16% of the company. The transaction now proceeds to a shareholder vote, with approval required from at least two thirds of shareholders who choose to participate.

PE-backed ACB to raise $200m through IPO, OFS

ACB India, a coal preparation plant operator backed by Warburg Pincus, is planning to raise as much as INR11 billion ($200 million) through an IPO and offer for sale (OFS) later this month. Warburg Pincus is expected to sell an 8.8% stake in the company through an OFS. The firm currently has a 22% stake.

Apax Partners continues Apollo Hospitals exit

Apax Partners has continued its exit of Apollo Hospitals, selling a 3.8% stake for INR4.4 billion ($83 million).The stake was acquired by Oppenheimer Funds through an open market purchase of 4.9 million shares. This latest sale comes two weeks after Apax sold another 4.5% stake for INR5.3 million, also to Oppenheimer Funds.

India to tax buyback exits by foreign investors

India plans to impose a 20% withholding tax on foreign investors in private companies who exit their holdings through a buyback of shares. Investments routed through jurisdictions such as Mauritius and Singapore to take advantage of double tax treaty benefits have in some cases avoided tax payments because buybacks are classified as capital gains.

IAN, Sequoia swap Jigsee holding for Vuclip stake

Indian Angel Network (IAN) and Sequoia Capital have become shareholders in VC-backed XinLab, which operates under the brand Vuclip, following its acquisition of mobile video start-up Jigsee in an all-stock deal. Sequoia and IAN had been early investors in Jigsee in 2011 when the company raised just over $1million.

OrbiMed launches Asia healthcare fund

OrbiMed Advisors will launch its second Asian healthcare fund towards the end of 2013, with a target of $500 million. The vehicle could be more than double the size of its $188 million predecessor fund, launched in 2008..

SOUTHEAST ASIA

Northstar buys stake in Hutchison's Indonesia unit

Northstar Pacific Partners is part of an investor group that has purchased a 35% stake in Hong Kong-based Hutchison Whampoa's Indonesian telecom business. The transaction facilitates the exit of Thai conglomerate Charoen Pokphand.

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When push comes to shove

China GPs are under pressure to return cash to investors but IPO exits are challenging. Secondary sales are emerging as an option. Who best placed to deliver on the US dollar and renminbi sides?

AT FIRST IT JUST SLOWED TO A TRICKLE. As of mid-2012, China's securities regulator was still willing to approve applications to list in Shanghai and Shenzhen, just not in the same volume as the boom years. Then in October the door closed and it has yet to be reopened.

The regulator went a step further earlier this year, asking the brokerages and accounting firms to review the listing applicants in their stables and remove those with suspect financial statements. The plan was to thin out the backlog of around 900 companies awaiting approval, but it will still take years to clear and no indication has been given as to when approvals might resume. Last week the regulator scotched rumors that it would happen as soon as April.

Many of these listing applicants are running out of time. Private equity backers are restless, keen to return capital to investors who were promised their money back – plus a handsome return – within three years. Unfortunately, such ambitions can only be realized in a market on steroids and China started to run out of juice as far back as 2011.

The subsequent drop in fundraising is indicative not only of how investor sentiment has turned against private equity but also of how a normalized asset class and the short-term outlook of the high net worth individuals who backed these funds were always hopelessly mismatched. Now they want out, and in many cases the fund managers who took their money are also contemplating a change of direction, driven by disillusionment or by an acceptance that they will never raise more capital.

"Funds have raised more than $70 billion over the past five years and the data show that there are more that 3,000 GPs," says Stephen Sloan, managing director with Cogent Partners in Shanghai. "Many of these managers will not be able to raise subsequent funds and there are concerns over the potential exit opportunities for portfolio investments given the slowdown in the IPO market. This will lead to an increase in secondary opportunities for both direct and fund investments."

This is the renminbi side of the China private equity story. For those with US dollar-denominated funds, the pressure is nothing like as extreme. Certainly compared to India, international LPs are prepared to be more patient with their China interests because they have made money there before. Nevertheless, the clock is ticking.

"If you look at the timeframe, the peak for China fundraising was 2006-2008 so most of these funds have yet to reach the end of their lives," says Lucian Wu, managing director at Paul Capital in Hong Kong. "We are getting close to the end of the investment period, which means we are approaching the point where GPs have exhausted the IPO options and pressure is building to look for alternative exit strategies. We are getting to a point where we should be seeing more secondaries out of China."

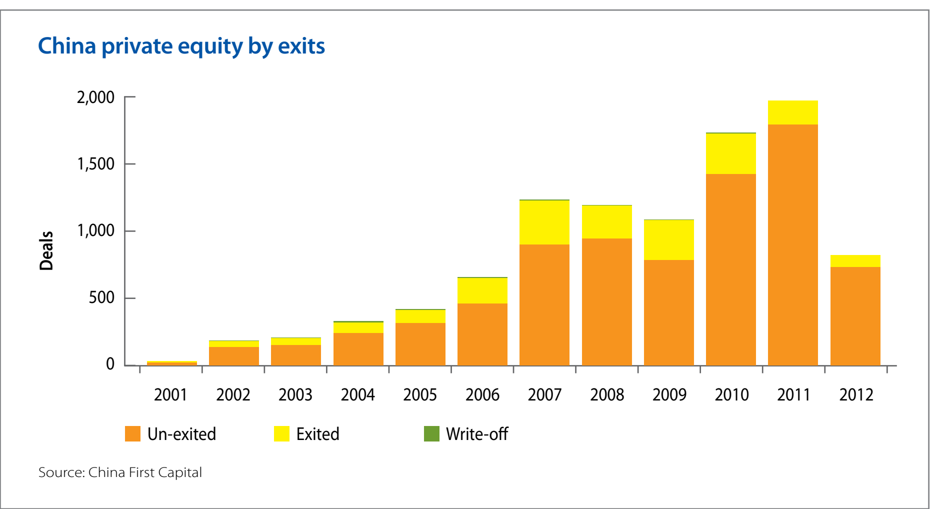
Cogent's Sloan and Tim Flower, a principal at HabourVest Partners, agree that it is still early days for China secondaries, noting that the country accounts for a small percentage of what they work on region-wide. China assets – either as LP interests in funds or direct stakes in companies held by GPs – do come onto the market but they tend to be pockets within larger portfolios.

Darren Massara, managing partner at NewQuest Capital Partners – a specialist direct secondaries GP created when Paul Capital, HarbourVest, LGT Capital Partners and Axiom Asia backed the spin-out of Bank of America Merrill Lynch's Asia PE unit – adds that the hunt for assets takes him far beyond traditional GPs. Hedge funds, investment banks, corporations and family offices are among those looking to monetize assets, and for a variety of reasons.

How big an opportunity?

In this sense, pinpointing the exact scale of the opportunity is difficult. According to a recent report by specialist investment bank China First Capital, 7,500 domestic companies lurk in the portfolios of PE firms. Of these, 200 were identified as "quality secondaries" likely to appeal to investors, and the number is expected to grow 15-25% per year as funds approach the end of their lives. However, Peter Fuhrman, China First Capital's chairman and founder, notes the calculations are based on deals that are either publicly disclosed or those of which his team has been made aware. The figure could represent a fraction of what is really out there.

And while there certainly are Chinese private equity portfolios in distress, this isn't necessarily the norm. Comparisons are readily drawn between the squeeze expected in China and the situation in Silicon Valley after the dotcom bubble burst. In both cases, a wave of euphoria gave birth to thousands of PE firms that were able to raise capital and didn't have the wherewithal to deploy it effectively. But the dotcom bust exposed unsustainable business models; in China, the crisis is at GP level, created by a lack of liquidity, and the underlying portfolio companies might be doing fine.



Source: China First Capital

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"Most of these companies have taken the VC money, spent it well and doubled in size," says Fuhrman. "They have made the difficult transition from non-compliance to tax and legal compliance. They are doing well because the economy is doing well. The majority are pretty well-established by the time of investment and they got where they are with zero capital."

He cites a growth investment made by a large Chinese PE firm as an example. The target company is a leading specialty retailer and the capital was used to expand its store network, resulting in a 600% increase in profit over a three-year period. The plan was to file for an IPO in late 2012 but there was uncertainty about the length of time required to get approval. Given the private equity firm wanted to launch a new fund in 2013, it was keen to deliver some cash returns to investors and so completed a partial exit to another GP, getting back the original investment.

GP to GP

It is Fuhrman's view that China-focused GPs will be the principal beneficiaries of the emerging secondaries opportunity because they have the local knowledge, team and resources to carry out due diligence, as well as existing funds that can pick off and manage individual or groups of assets directly.

But when the assets in question are healthy as opposed to distressed, this has implications for pricing. If a private equity firm invested $15 million in a company four years ago and it has since grown at an annual rate of 25%, buying it at the same valuation multiple would require $50 million. While there may be a discount because the seller is getting liquidity immediately rather than at an unknown point in the future, it is unclear how many private equity firms could accommodate that size equity check.

Furthermore, as NewQuest's Massara observes, there aren't many of these GP-to-GP transactions currently taking place in China. General Atlantic's acquisition of hotpot restaurant chain Xiabu Xiabu from Actis last year is a high-profile exception to the rule. According to AVCJ Research, it was one of just five such deals in 2012 and the cumulative proceeds amounted to less than $600 million, which was actually a record high.

"Generally speaking, the primary guys have been reluctant to look at direct secondaries on a pure play basis," Massara explains. "There is a stigma to doing anything second hand. They ask, 'Where was it? What don't I know about it? What do these guys know about it that I don't?' Primary guys are a bit suspicious."

This suspicion manifests itself in challenging negotiations with little trust on either side. Indeed, the Chinese GP that made a partial exit from the specialty retailer would only consider two potential buyers, and one of them was runner-up in the bidding war for the primary deal four years previously so had a strong grasp of the business.

A GP that spends too much of its time on secondary deals might also end up having difficult conversations with its LPs. In Europe, for example, investors responded to a spate of post-global financial crisis secondary buyouts by questioning the balance between capital and opportunities.

"For the traditional GP in the growth equity space there is a disincentive to sell assets via secondary buyouts," says Jason Sambanju, managing director at Paul Capital. "The LPs ask why you are selling to another GP with a similar cost of capital. Are you leaving some value on the table? On the buy side, they ask why you are buying from another GP instead of sourcing deals yourself. There is a negative perception."

The general expectation is that other versions of NewQuest will emerge as the secondaries market matures in China. The LPs behind the NewQuest spin-out are approached by other groups – typically GPs that can't raise new funds and are looking for plan B or executives from the proprietary desks of investment banks who have identified orphan portfolios – looking for people to back them in direct secondary deals in Asia. India sees the most activity but there are also China-focused players.

The renminbi space is more complicated. LP positions in local funds are off-limits to foreign participants, with Vincent Huang, a partner at Pantheon, recalling how the Limited Partners Association of China broached the subject with regulators as part of efforts to address renminbi-US dollar conflicts through the Qualified Foreign Limited Partner (QFLP) program. "We were advised that under the current legal framework, investing into renminbi funds by foreign investors in any form would change the nature of the fund and therefore was not practical," he says.

Direct secondaries are seen as more feasible – it involves restructuring the portfolio companies offshore with a joint venture onshore – but industry participants warn of lengthy approvals processes.

Who's buying?

The government is trying to facilitate sales of LP interests in renminbi funds by setting up forums for exchange, although this doesn't solve the problem of where willing buyers will come from. One option is the local fund-of-funds. Magic Stone, which has a secondaries allocation within its existing comingled vehicle, is one of several participants examining opportunities in this space.

"A large number of high net worth individuals and companies, who are new and small investors, invested in the sector irrationally," a Magic Stone spokesperson tells *AVCJ*. "As time goes by, some of these LPs may find that VC and PE funds are not suitable investment assets for them. This is especially true since liquidity tightening began in the second half of 2011, and some LPs have sought to sell their shares in funds."

While foreign secondary investors don't dispute the logic, they question the ability of fund-of-funds to operate effectively, citing a lack of experience handling these kinds of transactions. According to Cogent's Sloan, there are a few renminbi-focused secondary funds currently being raised and he expects many of the large domestic fund-of-funds to play an active role on the secondary buy-side in this market. Industry participants suggest that the likes of Noah and China International Capital Corporation, which can rely on large distribution networks to raise funds, could feature prominently.

A more fundamental issue is who will provide the capital for these renminbi secondary vehicles. Unless these fund-of-funds can introduce credible long-term investors then the chronic short-termism that has plagued Chinese private equity can't be addressed. The problem is delayed, not solved, and all that is created is deal churn.

"The only long-term capital in China to date is the social security fund and insurance companies, and they need to see real returns from renminbi secondaries before getting involved on a large scale," says Pantheon's Huang. "Most of the LPs will therefore still be individuals, exactly the same type of investors who went into renminbi funds in the first place. It is a structural issue – using short-term capital replacing short-term capital."

Portfolio companies that have yet to join the queue for listing approval could take as long as seven years to go public, once the lockup period is taken into account. This means a long wait for LPs that are unable to find an alternative solution, but the risks don't stop there. Several industry participants suggest that zombie funds might not materialize in China as in the West. Renminbi managers entered the industry opportunistically and they might leave in the same way, leaving their investors high and dry.

"They will go to the LPs and say, 'The fund has a life of 7+3 years, we are in year seven and there are still assets to exit, so we need more management fees,'" Fuhrman explains. "If the LP doesn't agree they could say, 'We have no more money to manage the portfolio, won't do it for free, so we will distribute out to you your share in the un-exited companies and let you manage them.' It's the original Hobson's choice, that is where we are heading."

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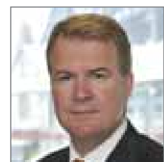
Consistency matters

Australia's private equity industry has seen robust deal flow in recent years and LPs remain committed to the asset class, albeit to a fewer number of GPs. Industry participants expect this to continue

The participants: Peter Wiggs, managing partner at Archer Capital; Anthony Kerwick, managing director of Pacific Equity Partners; and Andrew Major, general manager for investments at superannuation fund HESTA. Katherine Woodthorpe, CEO of the Australian Private Equity & Venture Capital Association (AVCAL) acted as moderator.


Peter Wiggs

Anthony Kerwick

Andrew Major

Katherine Woodthorpe

On the health of Australia's private equity market

WIGGS: I think the scene here in Australia has been remarkably stable for the last couple of years. Investment activity by value has been around the A$5-6 billion ($5-6 billion) mark for four years. That equates to A$2.5-3 billion in fund equity being invested each year. With the occasional larger deals being done by pan-Asian funds, the underlying activity has been pretty stable. On the other metrics like fundraising, it depends on who is coming to the market and how much they are looking to raise. There hasn't been much change in LP sentiment in the last 2-3 years and I don't expect too much change going forward. LPs are largely supportive of the managers they want to invest in and not supportive of the ones they don't want to invest in. Macros are not getting in the way of them making those decisions. On the financing side, it is tough to make any generalization on the markets here given how tightly they are controlled by a small number of players. It is a deal-by-deal market. We haven't seen the sea change that has taken place in North America with massive liquidity and high-yield debt. That doesn't happen here.

MAJOR: In 2011, there was a lot of liquidity in our investments. In 2012, there wasn't quite so much in terms of investments made and investments coming out. It was a consolidation year and 2013 will continue that trend. When I talk to other LPs in the market, there are those who continue to commit to the sector because they see overall value in the institutional portfolio. A second group has stopped investing and still hasn't come back to the market. Then there is a third group of LPs that are unsure and questioning their commitment to the asset class. One thing that we may see going forward is a little more activity on that front where LPs come to a decision of continuing to commit or withdrawing. In discussions with GPs I also see three broad groups. There are those that carry momentum into their fundraising and are able to raise capital in a relatively short period of time – I still see some managers raise in excess of their hard caps. Others have lowered their fund sizes to get back to their core business and away from the exuberance of the last 6-7 years. And then a third group of GPs is saying they will continue with their current strategies even though they could raise more. I think that is a positive perspective. When I put it all together, I am cautiously optimistic about private equity as an investment class in the next year or more.

> "When I look at the discussions on MySuper and Strong Super, it started with cost but the language has since turned to be more about net returns, which I see as positive"
>
> – Andrew Major

KERWICK: I'm more optimistic than cautious. The current environment is quite favorable, especially in terms of investment. You have a stable operating environment and a stable macro environment that means you can take the beat of future performance. The leveraged finance markets are still open for the right types of business, with loans available to support a growth investment thesis. There is competition for assets, as always, but you have a corporate sector that struggling to generate organic earnings to meet investor expectations and are not willing to put their balance sheets at risk for transformative acquisitions. As a result, competition for asset is on the low side and we see that reflected in the average multiples that have been paid in 2012. As we look forward to 2013, I don't see any seismic shift in these settings. It is probably the most favorable investment environment in the last 4-5 years. On the flip side, exits are not as easy. The ability to generate returns falls on value creation and the strategic repositioning investors can achieve with a business, and so we are likely going to see a differentiation in returns going forward. Given the nature of the asset class, it will be a while before this becomes apparent although it will more apparent with the current vintage of funds than before.

On what LPs want to see before making a fund commitment

WIGGS: The whole risk-return focus of LPs has moved. The over optimistic exuberance that led people to chase unrealistic returns based on unsustainable leverage is no longer attractive to LPs. Track records from 2005-2007 where there were a few deals where you hit it out of the park and a few deals where you lost all your capital are not so attractive. These days LPs want to see a tighter range of outcomes. There is an understanding that chasing spectacular success means taking on more risk and LPs prefer consistency – 1.5-3x rather than 0-6x. At the end of the day, LPs are looking performance through the cycles, which is why they invest in unlisted equities. The other thing LPs are really keen to get right this time is alignment. There is zero tolerance of anything that makes it seem as though GPs are putting their own interests in front of those of the LPs. This was not the case in

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the 2005-2007 era when pretty much all the LPs turned a blind eye to that stuff.

MAJOR: If I am looking at a new GP that I haven't invested before, first of all I have to understand their strategy and then I have to understand it relative to others who deploy a similar strategy, and with whom I may have or may not have a relationship. You are looking for consistency in strategy, fund size, terms and alignment between the manager and investor. The GP must also have the capacity to execute an investment strategy based on the amount of capital that has been raised and consistency with their track record.

On LP expectations in terms of returns

MAJOR: As a long-term institutional investor in private equity, our long-term return expectation shouldn't change in any way. We have to assess the class against listed equities and it should get a premium over listed equities over a 10-year period. You also need to look at private equity from an absolute returns perspective and then you focus on cost, which should be a discussion about net returns. You commit to GPs that give you returns at least in the high teens. Instead of just asking, "Should I invest in private equity or not?" it should be a decision based on which firms, strategies or regions are going to give you that target return. When I look at the discussions on MySuper and Strong Super, it started with cost but the language has since turned to be more about net returns, which I see as positive.

On private equity helping Australian companies expand overseas

WIGGS: That is more the role of my CEOs than me. Offshore expansion and growth could be a big part of the investment thesis and you have to make sure you get the right management in place and provide them with the capital. It is somewhat different to our pan-Asian competitors, who try to execute on the model that says look we have offices in seven Asian countries, we are networked with everyone, and we can grease the rails for you. Time will tell if they are successful.

KERWICK: One of the things private equity can bring as shareholders of predominantly medium-size companies is supporting calculated risk-taking where the payoff is likely in the medium term and in the short term there is likely to be added cost. One example of this is an international growth strategy. That whole mindset of agreeing with the management team what the strategic plan is over a multi-year horizon, being supportive of that strategy provided that the fundamentals suggest it was the right thing to do, and not shying away even when the going gets tough is fundamental to the value add of private equity. Of the deals we've done here in Australia, over half had some form of international expansion as a driver of the business. Sometimes you are surprised when it is better and easier than expected, but most o the time it is tougher and issues come out that need to be sorted. Other forms of ownership may not be as tolerant of these strategies.

On the activity in the Australian lower mid-market

WIGGS: There will always be more deal flow at that end of the market because there are more companies. The problem is there are some very poor managers in that space. It is endemic because that is where most of the new entrants start and some survive and some don't. But this part of the market will always be there. One of the advantages they have is banking support. In the mid-market we have to deal with institutional banks that are somewhat concentrated; the lower mid-market guys deal with business banks that have a branch in every suburb, so they will always have more debt options.

MAJOR: As people go through the fundraising cycles, they need one or two funds to prove themselves or otherwise. We are a lot more selective about who we back in the market and make sure that we don't cross strategies by putting two pools of competing capital against each other. We recognize this is an important part of the market but we want to make sure we are only backing managers who can help us achieve our overall objectives. There will be a process of Darwinian natural selection, if it hasn't started already. It is ultimately healthy for the investment market.

On exit options in the absence of IPOs

KERWICK: The consensus is that the market is currently receptive to IPOs but because it hasn't been too popular in the past two years, fewer people are thinking of that option. IPOs are an important means of delivering liquidity and returns to investors – not the only way but one of the more controllable exit routes. The other important route is sales to trade buyers. The trend that has emerged in the last three years is that – at least with the scale of company we get involved in – trade buyers find Australian businesses very attractive because they provide a platform for growth into Asia and emerging markets they don't currently have. The businesses are also attractive enough to fit into their own strategy in Australia. As a broad generalization, Australia is a country that multinationals want to be in and feel they need to be in. They don't want to spend time fixing a business that isn't performing as it should be, so the ability to deliver a meaningful-sized company on a safe trajectory is quite attractive to a lot of buyers.

WIGGS: Having a quiet IPO market is, net-net, a benefit for buyouts because IPOs are no longer an option for the vendor so they see you as better than a trade buyer. Sales from trade buyer to trade buyer can be tricky sometimes

"Having a quiet IPO market is, net-net, a benefit for buyouts because IPOs are no longer an option for the vendor so they see you as better than a trade buyer. Sales from trade buyer to trade buyer can be tricky sometimes" – Peter Wiggs

On the emergence of secondary exits in Australia

KERWICK: It has been underpenetrated historically, but the market is evolving and now we see a steady flow of those. One theme that has emerged is local players selling to global or regional private equity firms that can take a business pretty much like a trade player and use it as a platform for attacking other markets. We have at least one exit that has fallen under that category and the strategy has proven out for the buyer. However, they need to think about how they will manage what is an Australian business already operating at close to or full potential. That can be difficult without resources on the ground here.

WIGGS: We have been on both sides as a seller and as a buyer. The reason it has become more focused is due to the amount of companies private equity has brought in the last few years. It has provided a big inventory of businesses.

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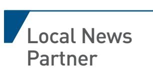

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AID Partners makes bet on HMV

THE RISE OF SERVICES LIKE ITUNES AND Spotify are enough to make any record store business shudder. Factor in the proliferation of file-sharing services and online piracy, and it is inevitable former giants like the UK's HMV seem to be going the way of the 8-track.

Yet this hasn't put off AID Partners, a consumer and entertainment-focused GP, which acquired HMV's Hong Kong and Singapore unit last week. Kelvin Wu, principal partner at AID, says not only is the business healthy but maintains that brick-and-mortar stores still have a place. "Distribution is not simply a means passing on the product it is also about providing an experience, it is about presentation, it is an art," he explains, adding that there are no plans to shut stores.

HMV Hong Kong and Singapore (HMV HK) comprises six stores in Hong Kong, two in Singapore and an e-commerce site run out of Hong Kong. Last year the Hong Kong businesses as a whole posted revenues of HK$300 million ($38 million), with Singapore contributing around HK$70 million. In Hong Kong, HMV accounts for 29% and 16%, respectively, of the music retail and visual media retail markets. In Singapore, the share is 25% and 10%.

Details were not disclosed but the transaction is said to be in the middle of AID's typical $10-100 million range. The purchase is one of a series of disposals by HMV Group since it went into administration last month. As part of the deal, HMV HK will receive a perpetual license to trade under the HMV brand, and it will also have rights to the brand in mainland China, Macau and Taiwan.

HMV Hong Kong: Still standing

In same way that TV technology is yet to see out the death of the cinema, Wu maintains there is still longevity in CDs and DVDs. Furthermore, he expects that technological developments like Blue-ray and 4K TV will ensure a consumer preference for purchasing high data capacity discs over the time-consuming practice of downloading movie files. HMV HK has already shown resilience in the face of Apple launching iTunes Asia with sales falling by less than 1%.

Despite this, HMV is still looking to move beyond just providing content. The company has already revamped its offering by selling peripheral goods such as headphones, consumer electronics, books, magazines and T-shirts. "We can say we are more of an entertainment retailer than a CD shop," says Emily Butt, managing director of HMV HK. "I think in HMV there is a reputation for being a bit edgy and bit different and we want to maintain the high-end and specialist shopping experience."

Wu adds that while the rise of digital content and piracy has attacked the company's top line, the Asia business has not suffered the same fate as its UK counterpart because the stores are exclusively in city locations. "The UK has a few metropolitan stores but the stores in big trouble are those in the small cities," he says. "In a metropolitan setting this model still can grow."

WestBridge renews commitment to Pathlabs

WESTBRIDGE CAPITAL'S INVOLVEMENT with India's Dr. Lal Pathlabs goes back to 2005, when the private equity firm invested around $10 million through its debut vehicle, WestBridge Venture Fund I. Back then, the Gurgoan-headquartered company, which provides diagnostics and pathology services, consisted of one central laboratory and 10 satellite laboratories. Annual revenue was around INR400 million ($7 million) and the company had been valued at INR1 billion.

India: Healthcare opportunity

Eight years on, Pathlabs is worth more than INR15 billion, with a network of 125 satellite laboratories nationwide. Last week, WestBridge renewed its commitment to the company through a joint $44 million investment with TA Associates. WestBridge was responsible for the lion's share of the equity, putting in $35 million from the WestBridge Crossover Fund.

The two investors committed a similar amount in 2010 and together the investment tranches bought up the remainder of the roughly one third share in Pathlabs held by the 2000-vintage WestBridge Venture Fund I.

Sandeep Singhal, co-founder and managing director at WestBridge, explains the firm had the option of selling its significant minority stake to TA or another investor, but decided to retain an interest by investing through the Crossover Fund. "This has been one of our largest commitments in the company so far," says Singhal. "We are very bullish about its prospects, both in the medium term and long term."

This investment also stands out as the Crossover Fund's first commitment to an unlisted company, having previously targeted PIPE deals. The vehicle, which reached a final close of $500 million in 2011, was established when WestBridge re-launched its independent operation after five years under the Sequoia banner. It had a broad remit from the outset..

"This may be the first private investment but we have flexibility to invest in both private companies and early public companies – we invest either side of the line," says Singhal.

When WestBridge first invested in Pathlabs, the business had yet to capture the potential of India's nascent healthcare sector, but now the company wants to add another 35-40 laboratories by 2014 and is looking at acquisition opportunities in Bangalore, Chennai, Hyderabad and Kolkata. With a projected compound annual growth of 35%, it is expected to generate turnover of INR45 billion for the 2013 fiscal year.

WestBridge is not considering exit options given that Pathlabs still has compelling growth opportunities – both organic and inorganic – in a market that remains dramatically underserved.. "Pathlabs' rapid expansion is a testimony to the service the company provides and a testament to the opportunity in the Indian healthcare sector," Singhal adds. "The business prospects of the sector in a medical care-starved country like ours are very high."

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Seeking synergies

Alliance Cosmetics was already the dominant force in Malaysian make-up market when it was acquired by Navis Capital Partners in 2010. The next step was to use this experience to break into Indonesia

IN THE WORLD OF COLOR COSMETICS SKIN tone is important. A shade of eye shadow that is popular in Europe might be completely different to what Indian or North Asian consumers prefer. Local knowledge is therefore vital when taking a cosmetics company across borders and trying to open up new markets. Price is just one of many factors. Climate, diet and even religion can play a role in a woman's choice of make-up.

These considerations underpinned Alliance Cosmetics Group's bold decision to go toe-to-toe with the likes of Maybelline and L'Oreal in Southeast Asia. The Malaysian company recognized there was a niche for a local brand in a market previously dominated by foreign players.

SilkyGirl duly launched in 2005 as a range of affordable cosmetics that answered the needs of Malaysian women. Alliance already had the network it needed to get the brand to the market quickly, having been a distributor for brands including Revlon and Wet n' Wild in Malaysia, Singapore and Brunei. Within two years, SilkyGirl was the market leader in Malaysia's $96 million color cosmetics market by sales volume and only trailed Avon and Maybelline in terms of sales value.

The appeal was clear for Navis Capital. Following its successful $90 million exit from Malaysian diaper manufacturer Drypers in 2004, at an IRR in excess of 100%, the private equity firm was eager to find its next consumer success story. Alliance emerged as the standout contender following an internal search of local brands in 2010.

"There are not many areas where you see global brands alongside indigenous Southeast Asian brands and the local brand has a higher market share," says Rodney Muse, co-managing partner at Navis. "It makes for a pretty interesting story. In addition to that, it was a well-run business with a systematic approach to building out the product range and improving the consumer experience."

The timing was ideal as Alliance founder Thiam Hock Tan, who had built the company up from the ground and was looking for a way to de-risk the business, build a nest egg for his family and eventually step down as CEO. Navis agreed to acquire an 80% stake in Alliance for MYR40 million ($12 million) and set about forming a strategy for the company's expansion.

With a dominant position in Malaysia and a well-established foothold in Singapore and Brunei, SilkyGirl had made its first steps into Indonesia. However, Alliance had yet to make an aggressive play for a share of the country's $380 million color cosmetics market.

"Indonesia is a really large market and it jumped out straight away as a good strategy for the company," reflects Muse, noting that similarities in skin tone, culture and consumer tastes meant there were numerous synergies that could ease the SilkyGirl's passage into the market. "We thought that if we could succeed in Malaysia it was possible we could contemplate an entry into Indonesia."

The chosen man

With Tan looking to step down, the first challenge was to find a suitable replacement to guide the company through its Indonesia campaign. "Tan is a very charismatic, larger-than-life guy and there is always a danger when a guy like that steps away the business might falter," says Muse. "So we started to recruit for someone to take over before we even did the investment."

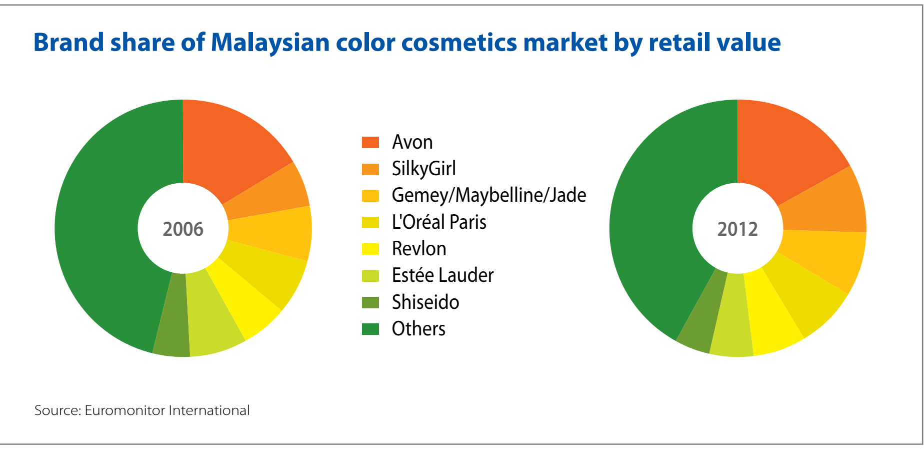
The man chosen to fill Tan's shoes was Chee Eng Ng. A native Malaysian, Ng had spent more than eight years with global cosmetics giant L'Oreal. His experience of the Asian market was broad, having worked as general manager of the company's consumer division in Taiwan from 2005 until 2008 before returning to Malaysia to serve as manager of the company's salon business.

Ng and Tan had known one another for many years and it was the Alliance founder who made the initial advance, explaining that he was bringing in financial investors and wanted to recruit a COO. It proved to be a good fit with Ng eventually assuming the CEO role in 2012 as Tan moved up to take a seat on the board.

The entry into Indonesia was not without its challenges. Muse describes the early days of as being something of a "two steps forward some step back" process. The brand registration process alone had been fraught with logistical complications and then came the issue of distributing in a country where the 238 million-strong population is spread over an archipelago of some 17,000 islands.

"As you can imagine, Indonesia is a place where things are distributed in very circuitous and funny ways," says Muse. "And finally you get to the bigger challenge of how you become relevant to many tens of millions of people in such a far flung country."

When a consumer brand goes overseas, the typical low-risk approach is to set up a local company to handle distribution nationwide. However, it is also low reward because the distributor gets a large slice of the revenues. Instead, Alliance decided to set up its own company in Indonesia to import the product and then enlisted regional distributors who would in turn utilize sub-distributors. In this way, they could ensure that SilkyGirl was spread as far and wide as possible.



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With a distribution strategy in place, Alliance's next step was to carve out a place for SilkyGirl in Indonesia's crowded cosmetics space. Broadly speaking, the market is split between sophisticated global players and a multitude of tiny local brands, many of which are not particularly well run. "It creates a messy landscape," says Muse. "What Silky Girl was trying to do was position itself as part of that multinational set but with local flair – an aspirational purchase but also a value purchase."

> "We thought that if we could succeed in Malaysia it was possible we could contemplate an entry into Indonesia" – Rodney Muse

Carving a niche

With this in a mind, a two-pronged approach was devised, aimed at getting SilkyGirl into the flagship retailers while ensuring the brand was also sold in many smaller outlets to ensure greater market penetration.

Alliance formed a relationship with Indonesia department store chain Matahari, Indonesia's fourth-largest retailer. This gave SilkyGirl passage into 112 stores nationwide, but the real battle was fought in Jakarta, a crucial market if the brand was to establish itself a credible player in consumers' eyes. The company also engaged in what Ng describes as "second site activities" whereby SilkyGirl had a stall in the department store but also set up an additional promotional site for brand activities such as product sampling and offering beauty advice.

The second part of the strategy was to get SilkyGirl into local convenience store chain Indomaret. Much like a 7-Eleven, these stores are too small to provide the full range of products but instead sold pre-packed sets of Silky Girl's most popular products that could be put on display by the counter. "A department store like Matahari is very important for brand image, getting traction and running consumer trials," says Ng. "But we needed chains like Indomaret, which has around 5,000 stores, to gain that deep brand penetration."

To support this, Alliance also ran a national television campaign advertising Silky Girl's availability at Indomaret. It also used its distribution network to deliver products to small family-run general stores dotted around the archipelago. In the department stores at least, the strategy is gradually starting to pay off. Out of around 50 competing color cosmetic brands sold at Matahari stores, SilkyGirl currently ranks around 15th.

There were two other considerations that were vital in targeting the Indonesian market. First, SilkyGirl had to meet the requirements of the country's majority Muslim population. "It is really well suited to this market," explains Muse. "All our products are halal-certified, and don't include a pork base. You would be surprised how many cosmetics products around the world actually do include this." In addition to its make-up products, SilkyGirl also launched a halal-certified range of skincare products including moisturizers and skin creams.

Second, Alliance had to come up with a pricing model that worked. Given that Indonesian consumers have less disposable income than their Malaysian counterparts, Silky Girl had to adjust prices to maintain its value appeal. Despite this, Alliance was still able to get its products from the same factories and suppliers as the major cosmetics brands. Its eye-liners pencils, for example, are produced in Germany by Schwan- Stabilo, the same firm that supplies Estee Lauder and Lancome.

"People ask us why our prices are so attractive," says Ng. "Generally my response is that they should be asking why the other brands are so expensive. It is all about marketing."

SilkyGirl's success can also be traced back to a delivering a successful targeted marketing campaign within budget. In addition to building a profile in Indonesia through relationships with chains such as Matahari and Indomaret, there was a concerted effort to revitalize the brand image. "We did a study of consumers in Malaysia and Singapore, which is our core market, indentifying product gaps vis-à-vis what the consumers are after," says Ng. "At the same time we started repackaging our products and have spent the last 18 months building up new merchandise. We thought the brand needed a refresh."

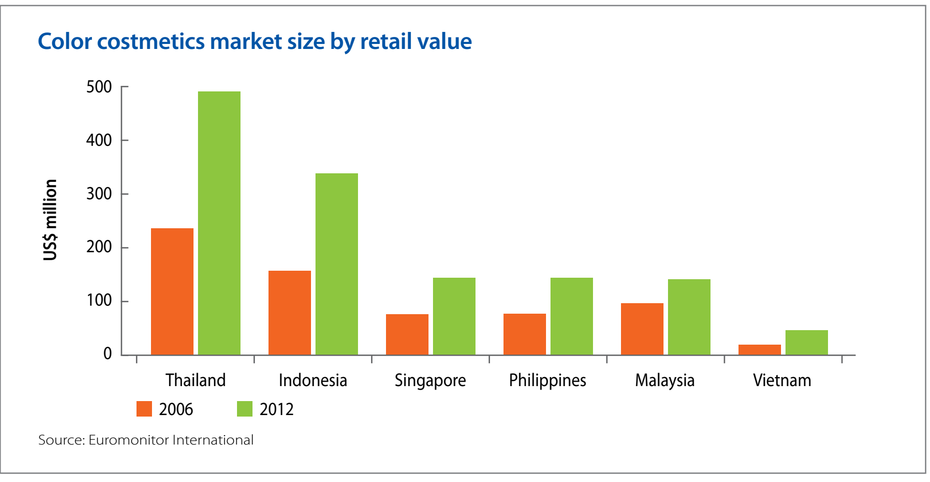
Well-known faces

Another important ingredient in the marketing strategy was brand ambassadors. Thanks to the synergies in Indo-Malay tastes with regards to fashion, entertainment and music, Alliance was able to bring together a small group of celebrity ambassadors that had appeal across all its target markets.

"Previously we had been more Malaysia and Singapore-centric, but now we are more sensitive to the needs of the other market," says Ng, who describes Silky Girl consumers as being part of the "Generation Y" group aged between 16 and 30. Alliance therefore sought out actresses and singers including Indonesian teen pop icon Gita Gutawa , Malaysian singer Stacey Angie and Singaporean actress Felicity Chin. All three appear feature on the SilkyGirl website as spokespersons for products, each offering their own beauty tips.

Over the last 18 months Alliance has seen its business in Indonesia grow organically, with a sales run rate of $2 million per annum now growing 15% month-on-month. Group EBITDA currently stands at around $15 million. Looking ahead Muse says Navis' likely exit will be through a sale to a strategic investor that values both Alliance's entrenched market position in Malaysia and Singapore, along with the growth potential of Indonesia.

Yet there is still plenty of scope to take the company elsewhere in Southeast Asia. "We have plans to move to the Philippines and Vietnam down the road," says Ng. "One of the core strengths we have with color cosmetics is that shades are important. Malay, Thai, Filipina – all these skin tones go well."



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