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Forbes
PRIVATE CAPITAL GROUP

March 2013

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Japan's Indonesian ambitions

SUMITOMO MITSUI BANKING CORP. (SMBC) is paying a princely sum for a slice of Indonesia's financial services sector. The price-to-book (P/B) valuation of the $1.56 billion it has agreed to pay for a 40% stake in Bank Tabungan Pensiunan Nasional (BTPN) – pending regulatory approval – has been put at 4.5x. This makes it one of the most expensive bank deals ever seen in Asia.

It should come as no surprise that large cap deals in Indonesia are coming in at stellar valuations. It has been the way for at least the last two years as foreign investors cottoned on to the latest growth opportunity in emerging Asia.

Just within a private equity context, who could forget the 20x EBITDA The Carlyle Group was at one point apparently willing to pay for a minority stake in GarudaFood? Or the offers of 19-20x EBITDA private equity bidders were mulling for between 20% and 49% of hospital chain Siloam last year – while the seller, the Riady family-controlled Lippo Group, had 25x in mind?

Neither is it surprising that a Japanese strategic investor is writing the big check. Indonesia has seen $9.9 billion in financial services M&A across 84 deals since 2011; Japan accounts for 13 of these transactions, worth a collective $1.9 billion, according to Thomson Reuters. And then consider that $7.2 billion of the overall total was DBS' bid for Bank Danamon, which was facilitated by its part owner, Temasek Holdings.

Strip out that deal and the BTPN represents the largest investment in the sector, followed by Mitsui Sumitomo Insurance's purchase of a 50% stake in MS&AD Insurance Group Holdings for $819 million. Marubeni Corp, Tokio Marine Holdings, Hitachi Capital Corp, Mizuho Bank and SBI Securities have also struck smaller financial services deals in Indonesia since 2011.

There is a rationale behind these investments: Japanese financial services conglomerates want to increase their exposure to emerging markets in the region and a combination of a (until recently) strong yen and low borrowing costs has supported these efforts.

In BTPN, SMBC will have an interest in Indonesia's seventh-largest bank by market value. The lender claims to have grown assets, deposits and capital fivefold in the last five years, and there is room for further expansion given that only 40% of the country's 240 million population have bank accounts.

For the principal sellers, TPG Capital and Northstar Pacific Partners, the deal represents a significant windfall. Their investment vehicle, TPG Nusantara (TPGN), bought a 71.6% stake in BTPN in 2008 for around $200 million. The holding has since been diluted to 57.9%, but SMBC will take 16.9% of it for $659 million; once the Japanese group receives approval to buy the full 40%, it will buy another 15.7% from TPGN for $528 million. That implies a money multiple of at least 6x and 25% still to exit.

From SMBC's perspective, there is a benefit to buying from private equity investors. Quizzing those who have advised on foreign M&A in Indonesia's financial sector brings forth a litany of frustrations. Often putative local sellers are just testing the market, under no pressure to do a deal but interested in seeing how much they could get if they tried.

In one more extreme instance – nevertheless seen as a fair reflection of the whole – a Japanese firm entered into exclusive negotiations with a local player only to discover in short order that its target was continuing talks with other parties. The deal fell apart but within months the putative Japanese investor was back at the table, ignoring warnings that its local counterpart couldn't be trusted. Anything for a slice of the Indonesia story.

At least when acquiring from foreign private equity investors, there is more common ground and therefore greater certainty – even if the valuation is lofty.

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NEWS

GLOBAL

Warburg Pincus raises $11.2b for global fund

Warburg Pincus has reached a final close of $11.2 billion on its latest global fund, one of the largest private equity vehicles raised since the global financial crisis. The firm fell short of its $12 billion target – as well as the $15 billion amassed by its previous fund in 2007 – in a challenging fundraising environment.

Adams Street hits $1b on global secondary fund

Adams Street Partners has closed its Global Secondary Fund 5 at $1 billion, surpassing the $750 million target to raise the highest amount so far in its global secondary series of funds. It is the fourth global secondaries vehicle to reach a final close this year, after vehicles managed by StepStone, LGT Capital Partners and Deutsche Bank.

Ares Management buys AREA Property Partners

Global alternative asset manager Ares Management has acquired AREA Property Partners, a New York-headquartered real estate management firm investing across North America, Europe and India. The acquisition will see Ares Real Estate Group (AREG) boost its committed capital to $8 billion.

ASIA

Carlyle reaches $1.5b on fourth Asia buyout fund

The Carlyle Group has so far raised $1.5 billion for its fourth Asia buyout fund, which is expected to reach a final close of $3.5 billion by the end of this year. William E. Conway, the private equity firm's co-founder and co-CEO, said in the first quarter earnings call that the target was in sight and the fund would start to generate fees – and therefore make investments – from June.

Accion backs Asian financial services start-ups

Non-profit microfinance pioneer Accion will provide funding to three Asian start-ups through its $10 million seed initiative, Venture Lab. Singapore-based Coda Payments, Demyst Data and Indian education access provider Varthana are among the five businesses that will receive capital. Each company will get $100,000-500,000, invested as either convertible debt or equity.

3i to stop investing in Indian infrastructure

3i Infrastructure will make no further investments in India as the $1.2 billion India Infrastructure Fund has not delivered the capital growth expected. The firm said it faced more political, market and macroeconomic challenges than expected when the initial commitment to the fund was made in 2007.

In its annual financial report, 3i Infrastructure Chairman Peter Sedgwick explained that the company would re-balance its portfolio towards future investment activity in core infrastructure and public-private partnerships (PPP) in the UK and continental Europe. The decision follows the departure of Anil Ahuja, managing partner and head of Asia for 3i, who quit the private equity firm in February this year.

3i Infrastructure had committed $250 million to the India fund for early-stage infrastructure investments, expected to deliver gross returns of around 20% through the fund's life. Of the commitment, $37.5 million remains but it is unlikely to be drawn as the fund reached the end of its investment period in November 2012 and will complete no new deals. As proceeds from existing investments are realized, 3i will not redeploy the proceeds in India. Non-yielding investments will be sold and proceeds re-deployed in core infrastructure and PPP projects.

AUSTRALASIA

PEP-owned Hoyts seeks US debt financing

Australian movie theater operator Hoyts Group, which is owned by Pacific Equity Partners (PEP), is looking to raise $450 million in the US high-yield debt market. It is the latest in a string of Australian corporates to take advantage of strong liquidity in the US leveraged lending market, where the terms are seen as better than those available domestically.

Carlyle pursues Rio Tinto's Australia mining asset

The Carlyle Group is said to have made an initial bid for Rio Tinto's 80% stake in an Australian copper-gold mine. KKR previously showed an interest in the Northparkes mine in New South Wales but didn't follow up with a bid. It is not known how much Carlyle has offered for the stake but the sale is expected to generate up to $1 billion for Rio Tinto.

GREATER CHINA

Baidu buys VC-backed PPS' online video platform

Baidu has agreed to pay $370 million for PPS' online video business, creating an exit opportunity for the company's venture capital backers. Ceyuan Ventures, Qiming Venture Partners and Vision Knight Capital have invested in PPStream in the last seven years, with Hong Kong telecom provider PCCW also committing capital.

IFC mulls $20m investment in Hosen's China agri fund

International Finance Corporation (IFC) plans to invest up to $20 million in Hosen Capital's New Hope Agriculture and Food Fund II, which launched last June and is targeting $180 million for investments in China's agriculture sector. Thefund will be managed by a 23-person team, most of whom were initially part of New Hope Capital.

Alibaba invests $294m in digital mapping firm

Alibaba Group has agreed to pay $294 million for a 28% stake in AutoNavi Holdings, a Chinese digital mapping company listed in the US previously backed by several VC firms. In addition to becoming AutoNavi's largest individual shareholder, Alibaba subsidiaries including Taobao Marketplace and Tmall will form a strategic alliance with the company to develop location-based e-commerce opportunities.

Khazanah to cornerstone Galaxy Securities IPO

Malaysian sovereign wealth fund Khazanah

Nasional will commit $100 million as a cornerstone investor in China Galaxy Securities' $1.37 billion Hong Kong IPO. It is one of seven cornerstones that have agreed cover $360 million of the offering. Based on the mid-price of HK$5.88 per share, Khazanah's investment will translate to a 1.76% holding in the brokerage.

Hony-invested Biosensors completes bolt-on

Biosensors International, a Singapore-listed medical device company backed by Hony Capital, has acquired Spectrum Dynamics, an Israel-based medical imaging and clinical applications company, for $51.13 million. Biosensors will assume ownership of Spectrum's intellectual property, equipment and technology, including its cardiac imaging system.

Sequoia's Shen remains top Asia VC in Midas List

Seven Asia-based investors have made it on to the 2013 Forbes Midas List of leading global venture capitalists. This compares to 10 last year, although an increasing number of US resident members are known for backing Chinese and Indian start-ups. Neil Shen of Sequoia Capital remains the highest placed Asia-based investor at 15, up from 24 in 2012.

IFC commits $10m to Chinese LED manufacturer

International Finance Corporation (IFC), the investment arm of World Bank, plans to commit at least $10 million Chinese LED manufacturer Qingdao Jason Electric through a co-investment. The capital will be used for expansion, marketing and sales, and continued R&D.

NORTH ASIA

New Horizon, Integral bullish on fundraising

New Horizon Capital is considering enlarging its second fund against a backdrop of improved investor sentiment in the country. The GP may leave its fund open for another three months from June, increasing the target to JPY20 billion ($198 million) from JPY15 billion.

CPPIB, GE Capital launch property co-invest program

Canada Pension Plan Investment Board (CPPIB) and General Electric Capital Real Estate (GECRE) have formed a joint venture targeting investments in mid-size Class A-B offices in key central business district sub-markets in Tokyo. Each group will invest JPY40 billion ($396 million) in the venture.

TPG, Northstar in partial exit from Indonesia's BTPN

TPG Capital and Northstar Pacific Partners have agreed to exit part of their stake in Indonesian lender Bank Tabungan Pensiunan Nasional (BTPN) to Japan's Sumitomo Mitsui Banking Corporation (SMBC). SMBC will buy 40% of BTPN once it wins regulatory approval, paying IDR15.2 trillion ($1.56 billion). The Japanese group will start by acquiring 24.26% through the purchase of 1.4 billion shares at IDR6,500 apiece for a total consideration of IDR9.12 trillion ($939 million).

The bulk of the shares - 16.87% - will be purchased from TPG Nusantara (TPGN), an investment vehicle set up by TPG and Northstar when they invested in BTPN in 2008. Government of Singapore Investment Corporation (GIC) and

Noonday were co-investors in the deal. TPGN will exit another 15.74% in the bank once SMBC receives clearance to raise its overall holding to 40%.

TPGN originally acquired a 71.61% stake in for approximately $200 million. The holding was later trimmed to 59.7% after a BTPN rights issue in December 2010, and then to 57.9& after International Finance Corporation (IFC) completed a debt-to-equity conversion.

BTPN now has a market value of $3.45 billion, with 1,140 branches across 250 cities. The bank claims to have grown assets, deposits and capital fivefold in the last five years.

SOUTH ASIA

TPG in $301m partial exit from Shriram Transport

TPG Capital has sold a 10% stake in Shriram Transport Finance (STF) to Piramal Enterprises for INR16.5 billion ($301.4 million). Piramal acquired 22.8 million shares for INR723 per share in an open market transaction. The exit, TPG's second sell down of a 10% holding in three months, means the private equity firm has almost fully exited its investment in the truck finance provider.

Fairbridge raises $34m via Thomas Cook offering

Fairbridge Capital, a subsidiary of Canada's Fairfax Financial Holdings, has reduced its stake in Thomas Cook India from 87.1% down to 75% via an institutional placement program (IPP), which closed on May 8. The firm raised INR1.85 billion ($34.4 million) from the oversubscribed issue of up to 34.3 million equity shares, priced at INR50.50-53.50 apiece.

IFC, Sabre to invest $40m in Global Hospitals

Ravindranath GE Medical Associates (RGE), which operates a chain of eight hospitals across India under the Global Hospitals brand, will receive $15 million from Sabre Partners and $25 million from the International Finance Corporation. The IFC investment will comprise $15 million in equity, and the remaining $10 million in an eight-year loan.

SOUTHEAST ASIA

JBIC to commit $25m to Mizuho ASEAN fund

The Japan Bank for International Cooperation (JBIC) will commit up to $25 million to Mizuho's new ASEAN-focused private equity fund. Mizuho Corporate Bank is to commit the remaining $125 million to the fund, which has a total corpus of $150 million. The fund will focus on supporting the overseas expansion of Japanese mid-tier and small- to medium-sized enterprises into the ASEAN region as well as joint ventures with local companies.

Temasek-invested US drug developer targets IPO

Portola Pharmaceuticals, a US-based drug developer whose largest shareholder is Temasek Holdings, plans to raise $127 million through a NASDAQ IPO. The other backers include MPM Capital, Prospect Venture Partners, Brookside Capital, Sutter Hill Ventures, Eastern Capital, Advanced Technology Ventures and Frazier Healthcare.

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Structured solutions

Mainstream GPs in Asia are becoming more open to investments based on debt rather than equity, addressing entrepreneurs' reluctance to give up stakes in their businesses. How significant is the opportunity?

IT IS A FAMILIAR SCENARIO: AN ASIAN entrepreneur has spent the best part of a decade building up his business and the next level is in sight – maybe expansion into a new market, adding a product line, or shifting to a more advanced production base. But the capital has run out; banks won't lend the entrepreneur the kind of money he needs to take this next step. Enter a private equity investor willing to bankroll the company in return for a stake in it. The entrepreneur hates the ideas of sacrificing even a minority position, but does he have any choice?

Increasingly, GPs are looking at how they can offer alternative solutions to companies that fall down the cracks between senior debt and traditional private equity.

Olympus Capital is one of them. In March the firm announced plans to enter the structured credit space by launching Olympus Capital Asia Credit (OCA Credit). Based in Singapore, the business will provide loans of $20-100 million with 2-3 year maturities, focusing on Southeast Asia, India and Australia. A dedicated credit team will operate independently of Olympus' core PE operation, not seeking to add value to companies but simply providing capital for expansion.

"In the past, once we realized that a deal wasn't well suited for private equity, we would throw those fish back in the sea, so to speak, but now we can refer companies who just require transition capital to OCA Credit," says Daniel Mintz, founding managing director of Olympus.

Others have already seen the potential for a more holistic approach to capital provision in India and Southeast Asia. KKR established a non-banking finance company (NBFC) to provide local currency structure credit solutions to Indian promoters, while Indonesia-focused Quvat Management has run a credit pocket alongside its corporate PE funds for several years.

Although credit funds are well established in other markets, few GPs have followed up thought with action in Asia and made the move down the capital structure, offering alternatives to companies they might otherwise have passed over. But is structured credit about to go main stream in private equity and, if it finds its feet, are traditional GPs best placed to take advantage of the opportunity?

Mintz is eager to make the distinction between what OCA Credit is doing and the kind of structured deals that already exist in the special situations and distress space. "We do not view this as a distressed debt opportunity," he says. "We believe this opportunity is about offering companies and owners an attractive trade-off between equity and debt."

As such, OCA Credit has positioned itself just below mezzanine on the capital scale, providing debt and taking collateral, but not exposed to as much risk. Continuity Capital, the Australian private markets asset manager, is looking at a similar niche. It recently announced plans to expand its Asia credit business from its new office in Hong Kong, with a particular focus on small- and medium-sized enterprises (SMEs).

"I think that private credit, lending to small to medium sized enterprises, is absolutely in the growth stages right now," says Scott Hancock, a partner with Continuity. "It is a very attractive space with terrific risk-adjusted returns and good downside protection."

The factors driving demand for structured credit solutions across Asia is seen both as cyclical and structural. In the short term, at least, regulatory pressure on banks to strengthen their balance sheets has starved the region of a once fulsome source of capital. The Volcker Rule and the Basel III standards have effectively double-teamed banks, the former restricting engagement in proprietary trading and alternative investments, and the latter imposing increased capital adequacy requirements.

Other potential lenders – ranging from hedge funds to family offices – have also withdrawn from the space in the wake of the global financial crisis.

At the same time, the significant expansion of in the number of medium-sized businesses in Asia has not been accompanied by similar growth in lending from traditional sources. "This is a long-term structural imbalance between demand and supply and we don't think that is going away in the near term," adds Hancock.

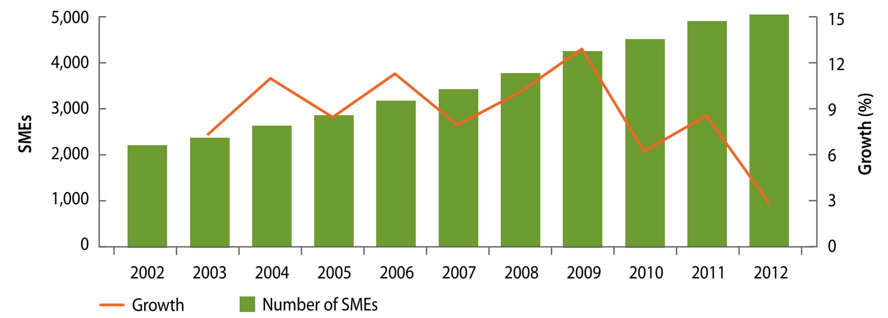
Regulatory conundrums

The scale of the opportunity appears to be greatest in China where demand for capital among SMEs is high. According to Adamas Asset Management, Chinese SMEs on rely on banks for just 4% of their financing needs – a world away from 80% in Europe and 30% in the US.

"This is massive driver for why SMEs in China are in need of credit," says Barry Lau, managing partner with Adamas in Hong Kong. "We believe there are around 50 million SMEs in China which contribute more than 65% of the country's GDP and are responsible for more than 80% of employment."

Yet few players in the private credit space are considering China because investing brings with it a host of regulatory hurdles. Though active in China through its private equity funds, Olympus, for example, hasn't made the country an area of focus for OCA Credit.

Growth of small- and medium-sized enterprises in China



Source: AVCJ Research

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Typically, those with China credit exposure have to construct deals though a network of holding companies and offshore entities to ensure they are in compliance with the law. One approach is to acquire a local lending license – of which there are several different types – so that assets can be collateralized for a loan with a piece of real estate or mortgage acting as security. Even then, it is extremely difficult for offshore money to secure collateral in China.

"We and other foreign dollar-denominated funds are not able to easily obtain security interests on hard assets," explains Joseph Ferrigno, managing partner at Asia Mezzanine Capital Group (AMCG). "You need to be a licensed lender or you need to work with a licensed lender."

AMCG and other cash flow lenders usually depend on the ability of the company to send dividends outside of China.

An offshore investor lends money to a Cayman Islands-incorporated company, which then invests the capital into a joint venture or a wholly foreign-owned enterprise (WFOE). This onshore entity must register with the State Administration of Foreign Exchange (SAFE) in order to send the proceeds of the investment all the way back along the chain in the form of dividends. In this way interest on the offshore loan can be serviced and the principal returned to the lender.

When investing in structured credit the level of risk involved should compare favorably with that of private equity, but success ultimately relies on a GP's ability to carry out effective due diligence.

"The big issue is what happens when things don't go well," says Hugh Dyus, head of Asia private equity at Macquarie. "Do the creditor rights put you in a position where you can seize collateral, liquidate the loan, or otherwise get your money back?" Dyus notes that most LPs are still observing these China strategies and will only back them once they are stress-tested, with a proven ability to recover value from difficult situations.

For investors looking to make structured credit play in Asian emerging economies – not only China, with its particular challenges in enforcing creditor rights onshore – the reality is that there are still dangers in dealing with potential target companies. Ferrigno speaks of AMCG discovering fraud in incidences when the Big Four accounting firms could not. "I would say it is very challenging to sift out the trustworthy management and companies," he remarks.

One of the advantages of the NBFC approach employed by KKR and others in India is that cross-border currency issues are not a concern – everything is done onshore. NBFCs differ from conventional lenders in that they are excluded from retail banking and foreign exchange, and are not subject to the same restrictions as conventional lenders. And as registered entities under the Reserve Bank of India (RBI), foreign-backed NBFCs are able to provide structured debt and mezzanine financing in locally currency.

KKR launched KKR India Financial Services in 2009 with a two-prong strategy. First, it wanted to facilitate the development of the country's still nascent debt markets, recognizing that corporate bonds and structured credit would become a significant asset class over time. Second, much like Olympus, there was a desire to desire to maintain a relationship with those quality companies who may not be an appropriate target for private equity investment.

"We have spent a lot of time getting to know their companies, getting to know the family members and these are groups we want to be partners with over time, but private equity was not what they needed or wanted at that point," explains Joe Bae, head of Asia for KKR.

As to how the debt solutions are structured, there is an emphasis on the bespoke approach, offering tenures that may be short, medium or long term, depending on what the business needs. "This is not plain vanilla corporate bonds or bank loans, these are highly structured pieces of credit that are tailored to what to the family needs or the collateral package they may have available," Bae adds.

Philosophical mismatch

While some GPs appear to be developing a taste for structured credit in Asia, they won't be able to realize these ambitions without support from LPs. It begs the question as to whether investors will be willing to back private equity firms that expand beyond their traditional competencies to provide such solutions. Is the risk/return profile on offer sufficiently attractive? Currently, those LPs with exposure to growth mezzanine and private credit space represent but a fraction of the whole private equity investor base.

"There is a philosophical mismatch," says Adamas' Lau, citing a common preconception that that credit can't deliver the 2-3x cash-on-cash multiples LPs investing in Asian private equity have come to expect. "However, our view is that if each deal we invest in can generate 1.5x over a 2-3 year holding period, post recycling of the principal/committed capital, we can get to the same multiples without taking on the same level of equity risk."

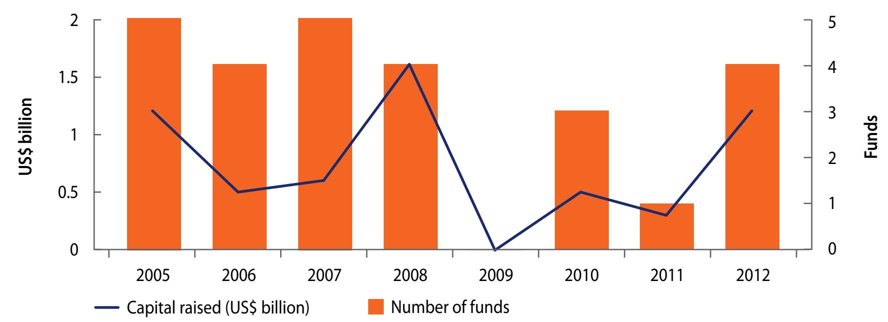
Indeed, this may appeal to LPs who have been disappointed by their portfolio GPs' performance in Asia. It is estimated that a properly administered credit play can deliver net returns in the mid to low teens, which in the current environment might be more palatable than a higher risk special situations strategy.

"We are finding this opportunity is very interesting to LPs who want a stake in Asia's growth," says Continuity's Hancock. He sees the advantage of credit over traditional private equity as twofold: first, current demand-supply characteristics mean that moving down the capital structure to a more secure, less risky position can still yield high returns; and second, because these are loan funds, LPs receive an annual cash yield, with repayment of loans in 24-36 months.

Once again, though, Macquarie's Dyus asks whether industry participants can really deliver on what they are promising. A fund needs to go through a full cycle and return capital to investors in order to prove it is viable – no one in emerging Asia has done that yet. And for some, the strategy might not be viable at all, simply because they don't possess the appropriate resources.

"It is hard to do this without a separate pool of capital or a separate team of credit specialists who know how to structure a price," says KKR's Bae. "I think there is an opportunity there for a lot of other firms. Whether everyone's vision is along these lines, I don't know."

Asia-focused mezzanine funds reaching a final close



Source : Preqin

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Time to switch over

The digitization of the Indian TV industry should deliver a more transparent system and an effective subscription model. PE firms can help with the infrastructure investment required to get there

INDIA'S TELEVISION MARKET IS AT AN inflection point. The nationwide transition from analog to digital began this year it will have wide-ranging ramifications for the incumbents. They require capital expenditure in order to realize the windfall promised by digitization, and private equity firms appear happy to oblige.

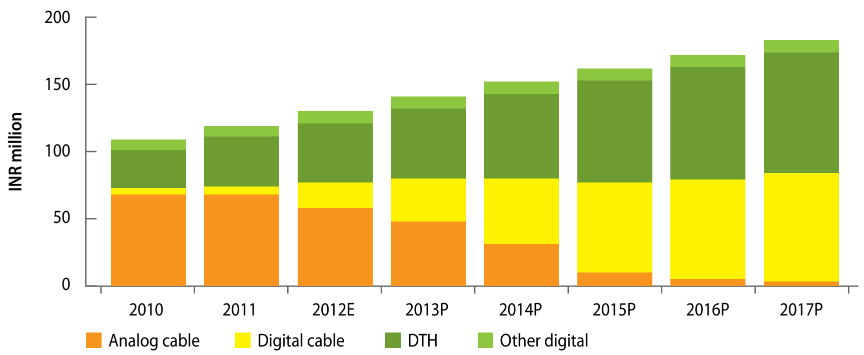
Last week Goldman Sachs completed a $110 million investment in cable TV distributor DEN Networks. Since 2009, the likes of Apollo Global Management, Macquarie, Providence Equity Partners, Softbank, India Capital and IL&FS Investment Managers have all entered the space. Their common thesis is predicated on the television industry ballooning to INR848 billion by 2017 on the back of five years of 18% compound annual growth, according to the Federation of Indian Chambers of Commerce and Industry (FICCI) and KPMG.

"This entire opportunity is a mirror of the great Indian consumption story," says Jagat Dave, director at Ambit Corporate Finance. "Earlier people took a leap of faith, saying 'We want to come in early and play out this consumption theme,' but the structure was not amenable. Now investors can take an informed view that regulations are headed this way. The roadmap is here and there is certainty."

The transition will see a largely unregulated analog cable industry transform into a more ordered government-mandated digital access system of set-top boxes. The TV multi-system operators (MSOs) and local cable operators (LCOs) that survive the move will need to spend billions upgrading their back-end infrastructure.

The pay-off is that the operators will actually start receiving the subscription payments they are due. The MSOs generate about INR58 million ($1 million) in subscriber revenues, with only a small percentage of households accounted for by local distributors. Money just disappears from the system. The stat that underpins the FICCI-KPMG projection is a jump in the number of paying households from 121 million to 173 million by 2017, covering 91% of actual subscribers.

India cable TV market by size



Source: KPMG India
Note: DTH figures are net of churn

"Digitization has been talked about for a number of years but it never happened for various reasons. We were evaluating it but we finally got comfortable in the beginning of 2012 after parliament passed the law mandating digitization" says Biswajit Subramanian, managing director at Providence. The PE firm bought a 9.9% stake in Hathway Cable for INR2.05 billion.

Goldman's new portfolio company DEN Networks is considered a real prize – and a likely consolidation play. It is one of the biggest MSOs, serving an estimated 11 million households in more than 150 cities. IL&FS Investment Managers invested INR234.7 million in DEN in 2011, three years after the company began to combine subscribers from smaller MSOs and LCOs.

"Besides a couple of large players there really wasn't anyone looking at all the small scattered unorganized players who controlled the last mile linkages and when the proposal came to us, DEN had already emulated the consolidation model to bring in 3 million subscribers, which was a huge number to being with," says Archana Hingorani, CEO at IL&FS. "That was the thesis as to why we invested at that point in time."

IL&FS' investment is currently valued at 1.3x, but it is what happens after the digital roll-out that the private equity firm has been waiting more than two years for.

Spanner in the works?

However, the analog cable players' passage to greater profitability might not as smooth as hoped. First of all, they face a challenge from the satellite direct-to-home (DTH) TV providers, who have typically done better in remote areas and difficult terrains where cable infrastructure is harder to lay.

"Right now there is a bit of a land grab," says Nikhil Raghavan, principal at Bain Capital. "Competition has become a little saner over the last few months but last year all the DTH guys were offering subsidized set top boxes and equipment. Customers were switching for a few months of free service and then switching again. When you have those dynamics, it's hard to know what your steady state level of customers and customer profitability will be."

Another risk is the changing nature of the business itself, where volatility in revenue profiles and economics. The industry view is that pricing will have to pick up for the companies to generate the cash and by extension the dividends that their investors are expecting. Raghavan notes that pricing could easily rise by 10% but the emergence of hyper-competitive situations could bring it all the way down again.

PE backers might be able to withstand the turmoil, provided they are comfortable with a 6-7 year investment horizon. As Varun Gupta, director of KPMG's strategy services group in India, puts it: after that, who knows?

"The longer term issue is the shelf life of the infrastructure as we know it is about 15 years, beyond which you won't know the difference between IPTV and satellite as it stands today," he says. "The question is how much you invest because everything that you put in has to deliver value over a 10 year period. Beyond that the investments are going to become worthless."

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KKR, CDH near end of dairy value-add story

AFTER MONTHS OF CONJECTURE, AND even a regulatory disclosure outlining its intent, China Mengniu Dairy has finally built up a commanding stake in its long-standing milk supplier China Modern Dairy. Mengniu already owned 1% of the company and has now added a further 26.9%, allowing private equity backers KKR and CDH Investments to make a partial exit for HK$3.18 billion ($410 million).

They have a generated a 2.9x gross return on their investment.

KKR's holding in Modern Dairy will fall from 24% to 3.5%, while CDH will be reduced from 8% to 1.5%. KKR originally paid $150.4 million for a 34.5 holding in the company with CDH investing $52 million for 10.5%. Both made partial exits when Modern Dairy went public in Hong Kong in 2010, raising HK$3.5 billion. KKR's total proceeds from the investment now stand at $310.6 million.

Neither Mengniu nor Modern Dairy expects the transaction to alter their relationship. Mengniu says it has no plan to acquire KKR and CDH's remaining holdings or appoint any executives to the Modern Dairy board. It will continue to buy all of the company's raw milk output.

For his part, Jiuqing Deng, chairman of Modern Dairy, stresses that closer ties with Mengniu will support business expansion but he has also previously cited KKR as a true partner that "works alongside us at every stage of … development."

Modern Dairy: Cow heaven?

The private equity investors' involvement with Modern Dairy is curious due to the circumstances in which it came about. Autumn 2008 saw the country hit by one of its worst food safety scandals as infant formula tainted with the chemical melamine cost lives of six children and hospitalized hundreds more. Consumers turned their backs on domestically processed dairy products.

The origins of the scandal lay in poor oversight of the fragmented supply chain through which Chinese dairy brands – led by the likes of Mengniu – sourced their milk. KKR saw an opportunity in creating a milk producing outfit that operated to global standards.

"A lot of people rushed in and invested in the milk processing companies because the stocks were down 30%," tells Joe Bae, head of Asia at KKR, told *AVCJ* last year. "We stepped back and said the issue is there are no large-scale dairy farmers supplying milk in a safe way, there is an opportunity to create value for the industry by developing some."

The private equity firm brought in experts from the US and Australia to work with Modern Dairy. KKR's Capstone unit spent 16 months on the ground, focusing on operational efficiencies and making improvements across feed purchasing, breeding, disease reduction and risk prevention. It even helped the company secure insurance cover for its cows.

According to a study by the Emerging Markets Private Equity Association (EMPEA), costs fell by 3%, contributing to an estimated 4% increase in EBITDA in 2010.

Phillip PE sees 7x return on biotech start-up

INVIRAGEN HAD INAUSPICIOUS beginnings. The firm came about through a marriage of convenience between two biotech start-ups that couldn't get funding: US-based Inviragen was working on dengue fever vaccine but had no capital for clinical trials; over in Asia, SingVax had attracted interest from Singapore's Economic Development Board (EDBI) in its hand, foot and mouth disease (HFMD) vaccine but no other investors would come on board.

Even as a joint proposition, the scaled up company was hardly what global drug developers' dreams are made of.

"It was not something very new," says Alex Koo, director of Singapore-based Phillip Private Equity, referring to DENVax, the dengue fever vaccine. "It was developed in Singapore in the 1970s by the government but there was never much interest from big pharma because dengue fever is known as a developing country disease so the project was frozen."

Mosquito: Dengue carrier

Nevertheless, Phillip agreed to back the combined company in early 2009 because it knew something of the project's history. Inviragen's founder located the research in the archives of the Centers for Disease Control & Prevention, the US national public health institute. The strain upon which DENVax was based had been tested on the Thai army before development efforts lapsed, so there was sufficient data to suggest the vaccine would work.

Bio*One Capital, part of EDBI, was the largest shareholder, followed by a Phillip-run venture fund with 21%. The numbers were made up by two US players, Charter Life Sciences and Venture Investors. They committed $27 million to Inviragen across two funding rounds.

Takeda Pharmaceutical of Japan last week agreed to pay $250 million for the company – $35 million up front and the rest once certain clinical development targets are reached – promising a money multiple of up to 7.5x.

Phase 2 clinical trials of DENVax are approaching completion while an HFMD vaccine has gone through Phase 1 testing. Based on Phase 3 investment in a dengue vaccine by Sanofi-Aventis, Takeda is expected to commit around $500 million to Inviragen. It is part of a wider effort to address a mosquito-borne viral illness that affects 400 million people each year, of which around 500,000 are hospitalized and 20,000 die, most of them children.

For Phillip's Koo, the investment was as much about the high chance of success as the clear demand for a dengue drug. Once the results of Phase 1 testing emerged and it became clear the vaccine worked, Inviragen's backers were confident a large buyer would come in for it. He also puts the relatively small amount of capital committed over a four-year period down to careful cost management.

"I don't think you would have this with big pharma where there are large overheads," Koo adds. "When people talk about biotech they think it's high risk but once you understand the process then risk can be managed."

Survival of the fittest

China's internet giants are on an acquisition spree as they seek to diversify their product platforms and carve out competitive positions in a battle that is likely to see valuations rise and rise

ALIBABA GROUP'S M&A BINGE of 2012 offers a distorted picture of acquisitions by Chinese internet companies. The e-commerce behemoth first completed a $2.5 billion take-private of B2B trading platform Alibaba.com in June, then bought back a 20% stake in itself from Yahoo for a further $7.6 billion in September. Public debt and private equity providers basked in a summer of plenty that is unlikely to be repeated.

Exclude these transactions and M&A activity by China's BATS – internet giants Baidu, Alibaba, Tencent Holdings and Sina – amounted to a more modest $631 million across 20 deals, according to AVCJ Research. It was down on the previous year's total of $1.5 billion but this isn't enough to shake an overriding trend: the BATS are spending more than ever before.

"It's good and bad," says J.P. Gan, managing partner at Qiming Venture Partners. "The good thing is that we have another channel for exits, in addition to overseas listings. The bad thing is that some of our companies might not become multi-billion-dollar operations because someone comes in early and a few of the VCs or the entrepreneurs want to sell out."

Last week Qiming exited PPS when Baidu bought the company's online video business for $370 million. Ceyuan Ventures led the Series A round and Qiming came in for Series B, investing $8 million in total. It is looking at a 10x return.

Gaining momentum

Between 2001 and 2009, the BATS completed less than 30 deals worth $775 million. Since 2010, the deal count has soared to nearly 80, with $4.5 billion deployed, although the values for some of these transactions haven't been disclosed. Tencent is the most active investor with 38 deals during the period. This week Alibaba became the biggest spender, paying $294 million for a 28% stake in digital mapping company AutoNavi, taking its total commitments past $1.9 billion.

The driving force behind acquisitions is a combination of financial and strategic. "They are cash rich and under a lot of shareholder pressure to deploy capital," says Bob Partridge, managing partner for transaction advisory services at Ernst & Young. "They also want to diversify their portfolios and in certain cases leverage their existing customer bases."

By year-end 2012, Baidu had RMB34.7 billion ($5.6 billion) in current assets, of which RMB32.5 billion was in cash and short-form investments. Tencent's overall figure was a bit higher, although it had slightly less in easily accessible assets. Sina, meanwhile, had $885.3 million, with $713.6 million in cash and short-term investments.

"You just have to look at how their businesses have grown in scale in the last five years," adds Jon Parker, transaction services partner with KPMG China. "The motivation for them to do inorganic growth is because they have other revenue streams that help cover the costs. This allows them to focus on areas they think will be growth areas in the future."

The investments completed in the past week suggest as much. Baidu CEO Robin Li's comments in the first quarter earnings report offer a neat snapshot of where the company wants to go, and the acquisition of PPS' online video business ticks a few boxes. Li highlighted investment in mobile platforms – Baidu's search engine success has been built on PCs, but it is now responding to rising smart phone usage – and the need to integrate search with verticals such as e-commerce and location-based services.

The company already has an advertising-supported online television and movie portal – iQiyi – but incorporating PPS' business into this will create China's largest online video platform by number of mobile users and video viewing time. PPS has a much larger customer base than iQiyi, with 30 million active users each day. It also operates under a person-to-person client software model, which means the bandwidth costs are much lower than for web-based video streamed from server to user.

"PPS is the largest market participant in terms of user base and mobile devices," says Qiming's Gan. "Everyone is shifting from PC to mobile devices and Baidu has been criticized for not having a big enough presence in the mobile space. So has Alibaba."

The investment in AutoNavi, meanwhile, includes a partnership agreement with Alibaba subsidiaries Taobao and Tmall to develop location-based e-commerce opportunities. These enable advertisers to target customers individually, based on location and preferences.

Another recent Alibaba investment, the purchase of an 18% stake in Sina-owned Chinese Twitter clone Weibo for $586 million, offers

Potential obstacles

Alibaba Group is set to become the single largest shareholder in AutoNavi Holdings, a NASDAQ-listed Chinese digital mapping company, after agreeing to buy a 28% stake. But what are the chances of the deal triggering a review under the Anti-Monopoly Law (AML), perhaps even at the instigation of one of its rivals?

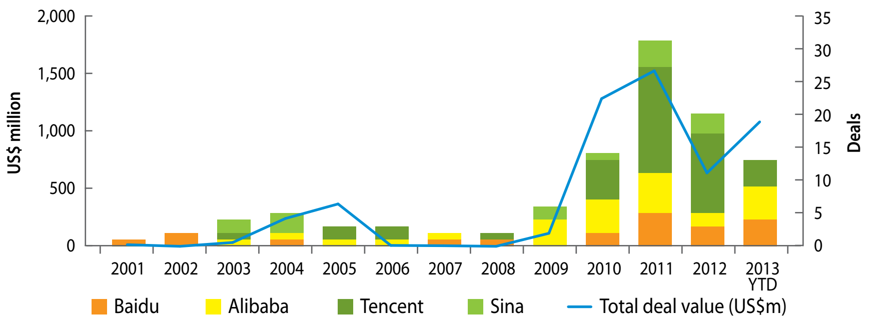
An AML filing is required if the two parties involved in the transaction have aggregate global sales revenues in excess of RMB10 billion ($1.4 billion) during the previous fiscal year, or aggregate China sales of at least RMB2 billion. Alibaba and AutoNavi appear to cross this threshold. It could be argued that this is a minority deal with no change of control but the Ministry of Commerce (MofCom) doesn't necessarily wave through such transactions.

At issue is the variable interest entity (VIE) structure used by many Chinese internet companies to work around the fact that offshore investors aren't allowed to have direct ownership of certain operating licenses in the sector. MofCom is generally unwilling to conduct AML reviews of deals that involve VIEs.

"This is an issue transaction parties are acutely aware of," says Miranda So, a partner at Davis Polk. "Each situation needs to be evaluated on its own facts to determine if AML review will be triggered and if there are alternative ways to structure a deal to achieve the parties' commercial objectives."

So advised on Baidu's recent acquisition of VC-backed PPS' online video business and is restricted from commenting on the specifics of the transaction. However, other industry participants suggest that Baidu only took the online video assets – and not the online gaming business through which PPS monetizes its video user base – due to concerns about a potential AML review.

M&A activity by Baidu, Alibaba, Tencent and Sina



Source: AVCJ Research

Note: Does not include take-private of Alibaba.com or Yahoo buyback

a foothold in mobile-enabled social media, treading on territory dominated by Tencent. At the same time, Tencent's recent M&A activity suggests intent to breach Alibaba's e-commerce hegemony. Of the last 10 Tencent deals for which AVCJ Research has records, five have involved mobile software and systems and four were focused on e-commerce.

Darwinian theory

What this alludes to is that the BATS aren't just in acquisitive mode to develop broader platforms for themselves; they want to do it at the expense of one another. "There is an inherent level of competition amongst the largest players to expand the depth and breadth of their platforms," says Thomas Chou, partner and co-head of Morrison & Foerster's Asia private equity practice. "In some respects, it appears that an internet arms' race is underway.

This offers some context for the competitive tensions that exit between these companies. Qihoo 360, which shot to prominence by offering free-to-download antivirus software, has added itself to the mix in recent years and wants to move into search and social media. A dispute between Qihoo and Tencent ended up in an antitrust lawsuit while the government stepped in last year to mediate a search engine spat emanating from Baidu and Qihoo.

As long as these firms have firepower, they will pursue M&A opportunities, and there should be no shortage of targets. "When you look at the stagnant IPO markets there are a lot of different companies for whom a listing opportunity isn't coming as quickly as expected," says KPMG's Parker. "A number of these on the TMT side will be of interest to the big guys, particularly as the PE backers are looking to cash out."

If the relatively brief history of China's internet history has taught us anything, it is that the superpowers of today won't necessarily dominate tomorrow. But the incumbents are trying their best to build broader and more sustainable businesses. Transactions involving Sohu search engine Sogou (with interest from Qihoo, Tencent and Baidu) and mobile browser UCWeb (supposed to be a lock-up for Alibaba) are rumored to be next out of the pipeline.

In this hyper-competitive environment, check sizes are set to carry on rising. "We are already seeing companies valued in the hundreds of millions," says Qiming's Gan. "We will see more deals done closer to the $1 billion mark. And that's cash, which is very important for us VCs."

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Mobile evangelist

Sudheer Kuppam, managing director for India, Japan, Australasia and Southeast Asia at Intel Capital, outlines his plans to usher Asian consumers onto technology platforms by meeting local needs in local languages

Q: How has the Intel Capital portfolio been affected by the challenging exit market?

A: Irrespective of market conditions, we have done extremely well in Asia Pacific and the majority of our exits are IPOs. In 2012, we had two – Multi Commodity Exchange (MCX) in India and security chip developer Sinosun in China. This year ASPEED Technology went public on Taiwan's GreTai Securities Market. In addition, Olaworks in Korea was acquired by Intel last year.

Q: How does the strategy for investing in developed markets in Asia different from that for emerging?

A: In the mature markets of Asia Pacific – Japan, Taiwan and Korea – we are always looking to enable the next generation product. For example, our current emphasis is on enabling ultrabooks, smartphones and tablets, to enhance the user experience. We do invest in disruptive technologies but typically these are fewer than 10% of our total portfolio. We have a category called "eyes and ears" where we try to identify technologies that could potentially have a significant upside if they become financially and commercially viable. In emerging markets the motivation is to drive more users to get on the Internet and use technology. It's kind of evangelizing technology, to increase PC and broadband penetration rates.

Q: Could you give some examples of this?

A: If you look at the deal in Vietnam where we have invested in Vietnam Communications Corp (VCC), they are pretty much a local content as well as consumer internet business and services provider. In India, we have Yatra.com to enable online travel, PolicyBazaar for online insurance, including auto, home and life. And then we have investments in electronic program guides in the education vertical. We want to enable the usage of technology to deliver education, whether it is college prep or admission prep.

Q: What are the growth themes for Asia?

A: For emerging markets in general, we want to look for data center build-outs and enable cloud computing in the region. Most of the countries within Asia Pacific sooner or later will demand that all citizens' digital data should be within their territorial boundaries, which means that numerous data centers have to be built. That's an area of significant interest for us. At a high-level, we have very few themes: mobility, by which I mean Asia Pacific has a lot of languages so we want to build voice and speech recognition for local language and content on smart devices; consumer internet, enabling online education or deploying tech usage in delivering education; and software and services

Q: How large is the share of funds deployed in Asia?

A: Typically all of Asia Pacific, including China, is 25-33% of our global deployment. In 2012, China had a 7% share while 17% was invested in the rest of Asia Pacific. That's equal to the 17% spent in Western Europe and Israel. Historically, on an average we have deployed $300-500 million every year and one third of that is in Asia so we have $100-130 million available to be invested. China and India are the two significant markets Intel Capital is targeting, so if you look at our 20 investment professionals in the region, 12 of them are in these two countries.

"In emerging markets the motivation is to drive more users to get on the internet and use technology"

Q: Do you see more growth in Southeast Asia?

A: We are more opportunistic, at least in Southeast Asia, because in general we try to look for investments there that could target the entire region. Once you consider the entire region as your customer base, you have half a billion population and that would enable any business to scale. Most of the investment opportunities that we typically look for are of that nature. The exception is Vietnam where VCC is a conglomerate of several consumer internet businesses, which would also enable them to scale within Vietnam.

Q: Intel this year announced new products and efforts to accelerate its presence in mobile. What does that mean for Intel Capital's strategy?

A: Intel is now supplying Atom processors in the smart device space so we want to enhance the user experience for the average consumer using any of these devices. Our strategy will be trying to get better features for these devices, such as voice recognition, and speech recognition. For example, the majority of India does not speak English. For these 1.2 billion people, if you can get speech recognition in their local language you are now addressing a much larger market. Some of these features, whether it's gesture or speech, require a lot of processing power, which has traditionally been the forte for Intel architecture and processors.

Q: Do you expect Asian corporate venture capital units to play a bigger role in the region?

A: As long as a company is aligned with us on the mobile strategy that we are pursuing, we are willing to partner with it. We have co-invested with a lot of corporate venture units worldwide so in general we don't consider co-investors as competition because the venture industry works on a syndication basis. You always partner with other VCs or corporate VCs and try to foster entrepreneurship in the region.