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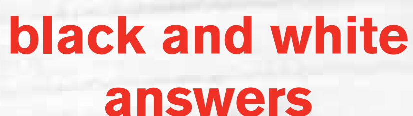

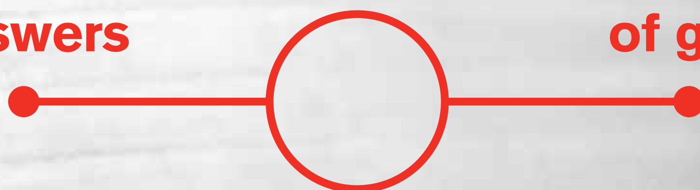

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The problem with Southeast Asian VC

AHEAD OF LAST WEEK'S AVCJ SINGAPORE Forum, this column was dedicated to the less-loved investment stories in Southeast Asia. VC made the list because, despite offering a similar fundamentals to China and India – rising disposable incomes and mobile internet usage – it has attracted nothing like as much money.

At the forum itself, participants offered more perspective and some insightful numbers.

According to Patrick Grove, chairman and CEO of Catcha Group, last month ASEAN overtook the US by internet users and at this month it will surpass the US in terms of total number of 3G connections. Fast forward three years and ASEAN will have twice as many 3G users as the US.

But there are only about 20 venture capital firms active in ASEAN compared to 1,000-plus in the US, 600 in China and 400 in India.

AVCJ Research data show that early-stage investment in Southeast Asia is already $278 million so far this year, only the fourth time in the last decade it has topped $200 million. In the bumper years, Singapore received the vast majority of capital and the key deals, while early-stage, don't fit the profile of your average VC.

The irony is that Southeast Asia first emerged as a venture capital market before China and India. So where has it all gone wrong?

Grove offered two reasons. First, too many VC firms are launched by the likes of bankers, consultants and mid-level managers from Yahoo who don't have direct experience building a business from the ground.

The same criticism could be leveled at some Chinese and Indian VCs, but those markets have still prospered. What they have that Southeast Asia does not are robust entrepreneur communities driven by a combination of returnees from the US and interaction with Silicon Valley. Many VC firms in these countries are either affiliates of or have strategic alliances with Silicon Valley investors.

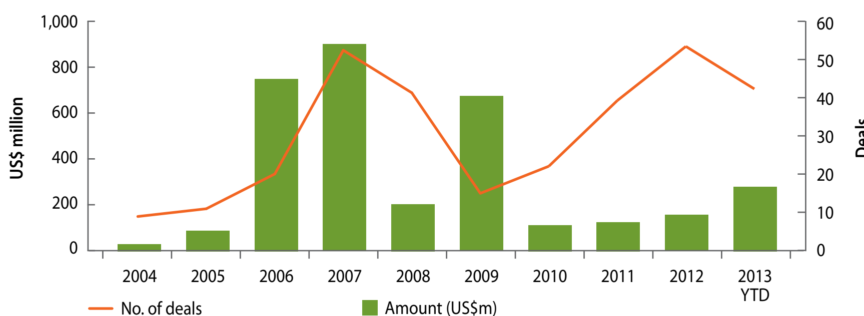
The second reason is scale. The thesis for the majority of VC investments in China and India has been the potential to rollout a service nationwide. In Southeast Asia, where social, economic, cultural and lingual barriers are longstanding, this is more challenging.

Several companies have succeeded in making the jump – each of the seven largest listed internet businesses in Southeast Asia have entered multiple markets – and it will be interesting to see how many others follow suit as ASEAN integration reaches new levels. Other participants at AVCJ Singapore noted that what started as a manufacturing-led phenomenon is now crossing into the services sector.

Is there an angle for venture capital?

Tim Burroughs
Managing Editor
Asian Venture Capital Journal

Early stage investment in Southeast Asia



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AUSTRALASIA

NZ's Rangatira takes 12% stake in Magritek

New Zealand PE firm Rangatira has acquired a 12% stake in Magritek, which manufactures nuclear magnetic resonance (NMR) and magnetic resonance imaging (MRI) devices, for an undisclosed sum. It has the option of increasing its holding to 18% in a year. The capital injection will strengthen Magritek's balance sheet and enable the company to increase its overseas sales and marketing efforts.

Australia's PushStart closes accelerator program

PushStart, an Australian firm that offers mentoring to early stage Australian tech startups, has shut down its accelerator program. PushStart founders, Kim Heras and Roger Kermode, told investors this week that the program had been halted earlier this month after almost 18 months in operation.

GREATER CHINA

Media entrepreneurs form China investment group

Chinese media entrepreneur Bruno Wu and Thomas Middelhoff, former CEO of German media group Bertelsmann and Arcandor, are to form a China-focused media and investment joint venture, pooling assets with revenues of $1-2 billion. The firm, known as BT Capital, will combine the partners' existing interests in education, music and news, as well as making PE investments in media in businesses in China and Western markets.

Google buys stake in VC-backed glass supplier

Google has taken a 6.3% stake in Himax Display, a subsidiary of Taiwanese company Himax Technologies, which manufactures liquid crystal silicon (LCOS) chips used in Google Glass and other products.

France approves Fosun ClubMed takeover

France's financial regulator has approved the takeover of vacation resort operator Club Méditerranée (Club Med) by Chinese conglomerate Fosun International and Axa Private Equity. Last month, the board of Club Med voted in favor of the friendly offer of EUR17.50 per share, which values the business at EUR557 million ($729 million).

Asian GPs under pressure to return capital

Asian fund managers are under pressure to return capital to investors as patience wears thin with promises of returns to come, despite the regional growth story being far from over, industry participants told the AVCJ Singapore Forum.

"The times when you could fundraise based on paper returns are coming to an end," said Bonnie Lo, a partner at NewQuest Capital Partners. "We talk to LPs and they say, 'We invested in Fund I and Fund II and we went with Fund II because there was a 3x return on Fund I, but it's been 6-7 years and we have not seen any distributions.'"

LPs aren't necessarily scaling back on their commitments to Asia, but they are becoming more sanguine in their expectations. "We would have expected by this point in Asia to see a much larger dispersion within the top quartile," said Doug Coulter, a partner at LGT Capital Partners. "That will still happen but right now a lot of firms are clustered around the median."

He added that average returns aren't compensating LPs for having their money tied up for 10 years. LGT views a 2-2.5x multiple as satisfactory for Asia.

MBK considers IPO for Taiwan's CNS

MBK Partners is reportedly considering an IPO for China Network Systems (CNS), Taiwan's largest cable TV and broadband provider, in place of a longstanding trade sale agreement that has yet to materialize amid regulatory concerns. The PE firm may opt to list CNS as a business trust. Earlier this year, two funds managed by Macquarie exited Taiwan Broadband, the third-largest domestic cable TV operator, through the $1.1 billion IPO of Asian Pay Television Trust in Singapore.

NORTH ASIA

J-Star reaches $205m final close in Fund II

Japanese mid-market buyout firm J-Star has reached at JPY20.4billion ($205 million) final close on its second buyout fund. Launched in April 2011, J-Star No. 2 is nearly twice the size of its predecessor, which launched in March 2006 and reached a final close of JPY12.25 billion in December the following year.

Globis, KDDI invest $2.6m in Japanese how-to site

Globis Capital Partners and the KDDI Open innovation fund have led a JPY270 million ($2.6 million) investment in Nanapi, a Japanese website offering everyday how-to advice. This is the second round of investment for Globis which previously backed the company in 2010.

Oak Capital invests $6.6m in Japan's K-Lab

Japan's Oak Capital Corp. has invested JPY650 million ($6.6 million) in online mobile game designer KLab. Set up in 2000, the company's flagship apps include social role playing game (RPG) Lord of Dragons and rhythm game Love Live! School Idol Festival - both of which are available on the Apple App Store and Google Play.

SOUTH ASIA

PE-backed Ramky Enviro in Australian acquisition

Ramky Enviro Engineers (REEL), an Indian waste management company backed by Standard Chartered and IL&FS Investment Managers, has agreed to acquire Australian environmental engineering and petrochemical services provider Enviropacific Services .

IndiaVenture eyes first close on healthcare fund

IndiaVenture Advisors (IVA), the PE arm of Indian healthcare company Piramal Enterprises, expects to reach a first close at around INR1.5 billion ($25 million) next month on IndiaVenture Trust Fund II, which has a full target of INR10 billion. The

NEWS

fund was registered in March 2013 and has so far received commitments of INR1.25 billion, mostly from banks and financial institutions invested in the first fund.

Blackstone to buy Agile Electric Works

The Blackstone Group will buy a majority stake in Indian auto parts maker Agile Electric Sub-assembly Limited (AESPL) and its listed subsidiary Igarashi Motors India (IMIL) for $110 million. It will acquire a 97.9% stake in AESPL from existing investors and subscribe to INR3.32 billion ($55 million) in new shares. This will give Blackstone a 62% stake in IMIL and it will make an open offer for another 26%.

Baring ups stake in India's Manappuram Finance

Baring Private Equity Partners India has upped its stake in Manappuram Finance, a listed non-bank financial company (NBFC) specializing in gold loans, to 11.56% from an earlier 9.48% via open market purchases. Sequoia Capital, India Equity Partners and Siguler Guff & Company are among other PE investors in the NBFC.

ASK eyes $100m first close for real estate fund

The ASK Group expects a $100 million first close of its first overseas real estate fund in September. The India-focused fund, which is has a final target of $200 million is called the ASK India Real Estate Special Opportunities Fund. It invest in foreign direct investment (FDI)-compliant residential properties in five cities - Mumbai, Bangalore, the National Capital Region around Delhi, Pune and Chennai.

Apollo's McGraw-Hill buys out India JV partner

McGraw-Hill Education, a US-based textbook publisher backed by Apollo Global Management, has bought Tata Group's minority stake in Indian publishing joint venture Tata McGraw-Hill Education. Financial details of the deal were not disclosed.

Pearson, Village Capital to fund education start-ups

Pearson - a UK education company which owns the Financial Times and publishers Penguin Random House - has teamed up with social investor Village Capital to set up a business incubator for Indian education start-ups. The incubator will select 16 start-ups through a peer review process, offering them a chance to receive up to INR4.5 million ($75,000) in funding.

Regulator refuses delay of Billabong deal

The Australian Government Takeover Panel has declined a request from Oaktree Capital Management and Centerbridge Partners to delay a A$395 million ($359 million) refinancing deal for surf-wear company Billabong International.

The two US hedge funds, whose own refinancing proposals were turned down by Billabong, asked the Panel to intervene in the deal with Altamont Capital Partners on anti-trust grounds. While stopping short of blocking the sale, the panel said it would investigate the deal. The two funds had requested the panel delay a $294 million bridge facility and the sale of Billabong's DaKine brand to Altamont pending the results of an investigation.

Under the terms of the deal, announced last week, Billabong will issue share options for 15% of the company to an Altamont-led consortium - which includes The Blackstone Group's credit arm GSO Capital Partners - along with the sale of the DaKine business. Billabong will also pay the consortium 12% interest on the bridge loan, and the five-year debt facility with which it will be replaced, from the end of the calendar year.

Should the consortium exercise the options, it will end up with a 36.3-40.5% stake in Billabong, diluting the equity of existing shareholders, whose approval is needed for the deal to go ahead.

SOUTHEAST ASIA

KKR seals debut Indonesia deal

KKR will become the second-largest shareholder in Indonesia's Tiga Pilar Sejahtera Food (TPSF) after agreeing to buy an approximately 9.5% stake for an undisclosed sum. This is the private equity firm's first investment in Indonesia. TPSF, which is controlled by TPS Group, is involved in food manufacturing, rice processing and distribution and palm oil and plantations.

KrisEnergy jumps 5% on Singapore debut

KrisEnergy, the Southeast Asia-focused oil and gas exploration and production (E&P) company which counts First Reserve among its investors, rose 5% on its trading debut in Singapore on Friday. The firm raised S$270.8 million ($213 million) through its IPO, selling 151.9 million shares at S$1.10 apiece, plus a further 94.1 million shares that were subscribed to by cornerstone investors.

Infra fund to invest $85m in Philippines wind farm

The Philippine Investment Alliance for Infrastructure (PINAI) fund, a vehicle partly financed by the Asian Development Bank (ADB) and managed by Macquarie Infrastructure Management Asia, is investing up to $85 million in the country's first ever wind farm project.

McDonald's picks IDG man to bring brand to Vietnam

McDonald's has appointed Henry Nguyen, managing partner at IDG Ventures Vietnam, to assist the burger chain in taking its brand into the country for the first time ever. Nguyen, who will be the "developmental licensee" for McDonalds in Vietnam, set up IDG Ventures Vietnam in 2004.

Leopard Capital spins out public equities division

Frontier investor Leopard Capital's long-only PIPE deals fund, the Leopard Asia Frontier Fund (LAFF) and the rest of its public equities division has been bought out by the fund manager, Thomas Hugger. Hugger was previously a managing partner with Leopard Capital. Leopard Capital Management will be renamed Asia Frontier Capital.

Online grocer RedMart closes Series A round

Online grocery store RedMart has closed its Series A round of funding from Singapore-based Garena, which offers online gaming. The company did not disclose the exact amount raised in this round, only that the total amount of funding raised so far adds up to $4.6 million.

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Rich man's game

Asian GPs and fund lawyers are struggling with a demand-supply imbalance. LPs are negotiating more and conceding less - but for all that managers say fundraising costs are going up, lawyers say fees are going down

THE SORRY STATE OF PRIVATE EQUITY fundraising in Asia can be gauged by the amount of paperwork involved. Go back a couple of years and a PE firm could expect five or so meaningful side letters from investors asking for concessions on top of those in the limited partner agreement (LPA). These were anchor LPs who knew the size of their commitments to the fund meant they could push for special treatment. Other letters would run to no more than three pages.

Now GPs are receiving side letters of up to 40 pages from dozens of LPs, regardless of investment size, and it can be difficult to reject these demands out of hand. As LPs know full well, many of the less-established fund managers are scrambling for every dollar they can get.

"We are executing 20-page side letters on $5 million investors in a $75 million fund – these guys used to be satisfied with only the documents," says Philip Culhane, an investment funds partner at Simpson Thacher. "They never even really expected the courtesy of an email from GP counsel. It was, 'Where is your subscription agreement? Did you sign it? If not, you're not in the fund.'"

As recently as 2011, you could set your watch by an Asia private equity fundraising. A GP issued a private placement memorandum (PPM); the LPA and subscription documents followed one month later; and LPs submitted feedback a few weeks after that. Within two months of starting a first close would be in sight. The more popular a fund, the more a GP could dictate the schedule and therefore the amount of time spent on negotiation.

Asia PE fundraising peaked at $74.8 billion in 2011. The following year it sank to $50.9 billion and a paltry $17.3 billion was accumulated in the first half of 2013.

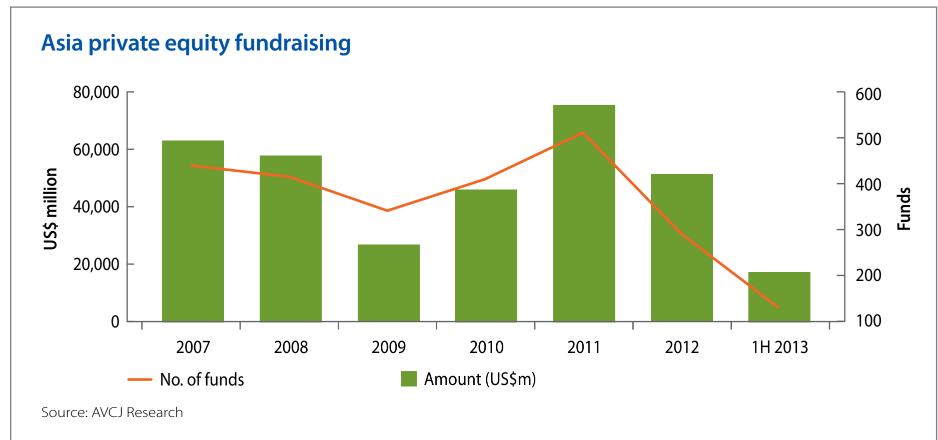
As such, the onus is no longer on LPs to seize the initiative and previous routines have been torn up. Rather than engaging five out of 30 investors in negotiations and then laying down terms for the rest, a GP might only reach a first close after one-on-one talks with all 30, resulting in a string of side letters. They no longer dictate the schedule and so costs are going up.

"Fundraising costs are certainly rising and that doesn't just mean legal fees," says Andrew Ostrognai, chair of Debevoise & Plimpton's Asia private equity practice. "You are travelling around, taking flights and paying for hotels."

More billable hours might appear to be a boon for lawyers, but they are caught up in a demand-supply dynamic of their own. Rising interest in Asia drew new players into the market – once home to about three established fund formation practices, Hong Kong now has at least 10 firms claiming competency in the field – but the drop in fundraising means there is more capacity than mandates to satisfy it. This has resulted in intense price competition.

It's unclear how long the imbalance can last, but ultimately this disconnect may be most damaging for GPs on their early funds. They have limited resources, there is less certainty of fundraising success, and so lower-cost options are attractive. However, the inherent danger of a market in which few are willing to pay a premium for quality is that industry best practice will be neglected and these fledgling GPs flounder, never able to generate sufficient LP interest.

> "We are executing 20-page side letters on $5 million investors in a $75 million fund - these guys used to be satisfied with only the documents" – Philip Culhane



Haves and have nots

Ostrognai describes a bifurcation in the market as larger funds continue to receive money while smaller funds come under pressure. But even the most successful GPs in Asia have found that the landscape is changing to some degree.

"We thought that, because it was Fund II, the due diligence might be a bit easier but in reality LPs' diligence standards are rising – they became more thorough," says Frank Tang, CEO of FountainVest Partners, a China-focused GP that closed its second fund at the $1.35 billion hard cap last year after about eight months in the market. "They also spent a lot of time on the LPAs. In between Fund I and Fund II, the ILPA guidelines came out, so we made a number of changes to be more compliant."

To some, ILPA – shorthand for the Institutional Limited Partners Association's (ILPA) set of principles intended to deliver alignment of interest, governance and transparency – is a real game changer. It represents the point at which investors' concerns were codified into a set of standards to which the private equity community could aspire to exist.

But most fund formation lawyers argue that ILPA itself isn't so much the issue; it is the hawkish environment from which the principles emanated. The cyclical push and pull between

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ILPA principles: A sticking point or not?

The publication of the Institutional Limited Partners Association's (ILPA) private equity principles has certainly changed the way GPs and LPs communicate. But what does it really mean for fund terms and conditions?

"If every GP agreed to be 100% compliant on ILPA then it's done, it's over," one Asia-focused fund manager tells AVCJ. "But ILPA's model LPA sets a perfect standard, offering a position from which LPs can negotiate with GPs and in the end there will be some kind of compromise."

This particular GP went as far as to switch out his US-style distribution waterfall for the European variety: rather than allow the GP to start accruing carried interest before an investment has been fully realized, it must wait until all drawn down capital has been repaid to LPs and an IRR hurdle rate has been met. The move is very much in line with the ILPA proposals on alignment of interest between GPs and LPs.

Fund formation lawyers have mixed views on dealing with ILPA. When the principles first came out a number of funds in the market at the time asked for ILPA audits – comparing every provision in their private placement memoranda (PPMs) to the LPA model and assessing what changes needed to be made. One lawyer recalls telling clients it wasn't worth the money or inconvenience to try and preempt demands because no LP walks away from a fund if the documentation isn't wholly in line with ILPA.

It is not so much a question of voluntary capitulation as knowing where to stand your ground. "Anyone who fights ILPA now is misguided," says Philip Culhane, a partner at Simpson Thacher. "If you want to fight ILPA and there are 22 points then you can pick two of them; give the rest away immediately. If a GP positions itself as the one fighting additional reporting requirements, it's like raising your hand and saying 'Don't pick me.'"

He draws a contrast between the transparency and conflict of interest provisions in the ILPA principles and the pure business terms. The former may not be ideal but they are not unreasonable, and to the neutral observer they can appear quite sensible given investors are allowing GPs enormous discretion over what to do with their money. The latter are fair game to fight over.

The European-style waterfall – an ideal provision from an LP's perspective but often a headache for first-time fund managers who worry about retaining junior staff if carried interest payments are pushed several years down the line – is a bone worth fighting over. However, Culhane notes that resistance on the part of smaller GPs in Asia has crumbled markedly in the last 12-18 months.

Certainly, there is a feeling among fund managers that ILPA has yet to deliver the egalitarian communication it promises.

"While we are not facing issues with our current, concentrated base LP base, the objective of ILPA shouldn't just be to impose minimum standards on GPs but also to try and impose some standardization among LPs so they aren't negotiating customization over and above that," says Paddy Sinha, managing partner of Tata Opportunities Fund.

GPs and LPs currently lies in favor of the LPs and they are making their leverage count.

As one industry participant puts it, many institutional investors "are engaged in a massive exercise of cover-their-ass." They saw the damage caused by the global financial crisis, are fearful of being made scapegoats for future poor performance, and so try to negotiate every point.

The investors might have a different take: a member of the PE division at a US public pension fund, for example, could be under pressure to justify the risk of committing capital to what is a comparatively expensive asset class.

Either way, this attitude appears to be percolating through into the small print. Several lawyers claim that LPs now want to see a lot of the information that goes before the investment committee. These demands are usually resisted because they can lead to recriminations – LP to GP: "You couldn't tell from there that the deal wasn't going to work?" – and maybe even legal proceedings.

In addition to excessive wariness there is also opportunism. One lawyer recalls a fund-of-funds offering to anchor an Asian GP's fund in return for a 50% discount on all management fees and carried interest. This was politely declined.

To be fair to the Asia-based fund-of-funds, they may be attentive on terms and conditions but their approach is at least guided by a familiarity with the region, which means they might equally act as arbiters for best practice.

"It was one of those classic conversations, where they said, 'We are a newish manager, we are expanding and want to open a new office, and we need the money to make it work,'" a fund-of-funds LP tells *AVCJ* of a recent negotiation. "We said, 'What you are asking for is just not market. No one gets this, not even first-time funds.'"

More annoying are the requests from US investors that fail to take into account the context of the fund. For example, a China-focused GP seeking to raise $300 million for Fund II doesn't have the in-house processing capacity of The Blackstone Group. If an LP insists on capping fundraising costs that can be passed down along to investors then launches into intensive one-on-one negotiations, the GP's economics will come under pressure.

"It used to be the case that I could work through the side letter and say, 'Rubbish, rubbish, rubbish, fine, tweak it,' tell the LP's counsel what we won't do, and then 70% of the time they would drop those points," says Simpson Thacher's Culhane. "Now they aren't dropping any of them."

Wheat and chaff

Many of the provisions raised in side letters are justifiable, such as requests for a particular type of reporting format, confidentiality clauses, and exemptions from certain investments.

"I once worked on an extremely successful fundraise with 100 investors and we had nearly 100 side letters," says Dean Collins, partner at O'Melveny & Myers. "If prepared properly, these letters are no problem at all. It's when they start to dictate issues of governance and what should be in the fund agreement that the dynamic changes."

Focal points stretch into conflicts of interest, tax and co-investment as LPs demand special treatment that goes above and beyond the main partnership agreement, specifying what will happen in particular circumstances.

A tax provision, previously seen as imperfect but acceptable, is now the subject of a dedicated three-page side letter, even though the provision might have come into play three times in 15 years in Asia. Some LPs also demand the GP commits to operating the fund in the most tax efficient manner possible. On one level, a manager is incentivized to do this so why is a pledge required? On another, how does one identify the most tax efficient manner when there are investors from 40 different jurisdictions?

This, essentially, is where formation lawyers

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add value. Working on a number of different funds, they have an innate sense of current thinking among LPs – which terms are potential deal-breakers and where there is room for compromise – and so can advise clients on how to pitch their products.

Much like a placement agent whose job it is to know if a fund is suited to a particular LP, a formation lawyer can offer insight into concessions the LP made in its previous set of negotiations.

Success not only hinges on assessing whether or not a provision is unreasonable and ensuring it is vetoed, but also on limiting the number of side letters a GP agrees to overall. One of the worst case scenarios starts with the blanket acceptance of all requested provisions and ends with the GP not really appreciating what they have agreed to do and how much effort is required in fulfilling it.

"Every LP comes in with their own confidentiality provisions, which are slightly different from everyone else's," says Debevoise's Ostrognai. "What we try and do is get everyone to agree on a single provision. You look at where the changes are and what is really important and what is filler."

When it goes wrong

There are plenty of case studies of inexperienced formation lawyers getting it wrong. Perhaps pride of place should go to the provision that appeared in one agreement allowing for the removal of the manager if the GP ceased to have any employees – failing to appreciate that the advisory entity retains staff, not the fund itself. The PE firm contrived to trigger a default situation as soon as it started business and the LPs did subsequently get rid of management on this technicality.

Other frequently cited problems include poorly drafted agreements that open up potential tax liabilities or simply fall short of industry standard practice. If institutional investors are involved then LP counsel can usually pick up on these shortcomings.

In situations where first-time China funds, for example, hire local lawyers with little or no formation experience so as to minimize costs, LPs have been known to insist that an international-caliber player is brought in. Similarly, they might only agree to re-up if the manager uses a different law firm to last time around.

In this way, the value of using an experienced, and more expensive, formation lawyer is forced home, but it isn't happening uniformly across Asia. "Some people take a long-term view and are willing to pay for quality and value relationships with external advisors," says O'Melveny & Myers' Collins. "And some people don't."

The first category would include a recent fundraise in which the law firm agreed to a fixed fee for documentation plus a dollar amount per investor. One LP ended up coming in through several different entities, each of which required separate negotiation. When it came to calculating fees, the GP agreed to alter the original structure so payment was commensurate to the amount of work involved. It was a first-time fund and the manager was keen to build good will.

The second category, meanwhile, features several PE firms in the region that have used a different law firm for each fund raised.

This dynamic is in part driven by issues of culture and maturity: managers from emerging Asia often seem hardwired to go for the lowest-cost option and they haven't been hardened by the experiences of several fundraising cycles. But competition among law firms lurks in the background.

> **"We thought that, because it was Fund II, the due diligence might be a bit easier but in reality LPs' diligence standards are rising – they became more thorough"**
>
> – Frank Tang

The top-tier fund formation practices in Asia are the same as those globally: Debevoise, Simpson Thacher and Kirkland & Ellis. Several other firms have recognized formation practices in Asia and still more are seeking to establish themselves.

Price-cutting still extends all the way up from the aspiring leaders to the top tier. One lawyer tells *AVCJ* that he refuses to do discounts and most GPs are aware of his policy. Another started offering them 2-3 years ago in response to increased competition in the market. A third notes that the long-standing incumbents are able to double-down on existing clients while his younger firm "has really had to hit the market, build new relationships, and develop a geographically diverse play."

Reports abound of law firms offering to do formation for free in return for downstream M&A work, but the fee-generative models being proposed may turn out to be just as unsustainable. Fees vary depending on the nature of a fund, not necessarily its size – a $2 billion Fund V with plenty of re-ups is much easier than a $300 million first-time vehicle. But the critical factor is time.

A formation lawyer might quote an initial fee of $750,000 but leave it open-ended to accommodate unforeseen difficulties; a rival them trumps him by saying they will do it for a hard cap of $400,000. If the fundraise takes six months there is no problem. However, if momentum is slow to build and the manager has to stop and revise the PPM, the months and the billable hours begin to stack up.

Another important variable is the number of investors, which also impacts the length of time spent on negotiations. A $1 billion fund with five anchor investors who push hard on terms but come in early and set a precedent for those who follow is a very different proposition from a $500 million vehicle with 15 LPs committing $30 million apiece but in dribs and drabs.

Climate of uncertainty

The uncertain fundraising environment hardly helps matters. Lawyers talk of the need to receive a portion of the money up front to cover some of the initial negotiations but also because asking for a retainer is the only way to judge if the GP really believes it will raise a fund. However, the chances of getting what they want ultimately depend on how low others are willing to go on price and whether or not a GP is willing to pay a premium for quality.

It is a vicious circle. Just as the shakeout currently underway within Asia's GP community as PE players without track records struggle to raise money from increasingly discerning LPs, the imbalance between demand and supply on the formation side is expected to right itself.

The hope is that a leaner phalanx of law firms finds itself dealing with GPs who are no longer only interested in the lowest-cost option.

It is not so much a question for the larger, more institutionalized private equity firms that are better equipped to write off fees as a cost of doing business, but those in Fund I-III territory. They want to appeal to a broader LP base but are they willing to pay for the experience and market credibility that a more seasoned service provider brings?

"The proof of the pudding is will they use you next time around," says O'Melveny & Myers' Collins. "I was dealing with one fund where the CEO was complaining about our invoices. Then he joined in a call with some investors that covered some tax points and finally he realized how sometimes four clauses in a document can take hours to debate. Everyone moans about fees but this particular client was pretty good about it after that."

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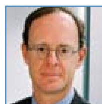

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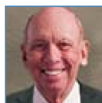

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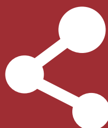

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A new alternative

India has opened up a channel for domestic start-ups to sell shares without going through a full IPO. The platform offers new fundraising and exit options, but regulators could help by removing more red tape

INDIA PRODUCED THE SECOND-LARGEST number of start-ups globally last year, after the US, according to Gust, a global platform for early-stage investing. Early-stage transactions accounted for 44% of total deal volume, up from 24% in 2011 and 16% in 2010.

The role played by angels in this movement received official recognition earlier this year, when Finance Minister Palaniappan Chidambaram announced that angel investor pools would become a subset of the venture capital category of Alternative Investment Funds (AIF), which means they can qualify for tax breaks. He also proposed that an exchange be set up to allow small- and medium-sized enterprises (SMEs) and start-ups to list.

The Securities and Exchange Board of India (SEBI) subsequently announced that these companies would be able to sell shares on an Institutional Trading platform (ITP) without having to do an IPO.

"The intent was two-fold: to help SMEs raise money through private placements, and also to offer exits to early stage VCs and angels," says Mahendra Swarup, managing director at Avigo Capital and president of the Indian Venture Capital and Private Equity Association (IVCA). He is on the panel SEBI tasked with suggesting guidelines for firms trading on the SME platform.

The ITP will exist in parallel to SME platforms launched last year by India's two main stock markets because the companies listed will only be accessible to informed investors such as angels, venture capital funds and PE. The minimum amount for trading or investment will be INR1 million ($16,787).

Flexibility in favor

Another move, to exempt companies from having to sell 25% equity in order to list on the ITP, has been welcomed by entrepreneurs.

"The hitch with the existing SME platforms is that you have to dilute 25% equity in the first go. Early stage companies usually don't know how much money they need," says Sanjay Vijayakumar, CEO of MobME Wireless Solutions. "For example, if I don't need $5 million, I can raise $1 million by diluting a small amount of equity unlike the 25% required now. Then at a later stage I might sell a larger stake at a much higher valuation as my model has been proved with the $1 million."

MobME is a mobile, media and entertainment company that provides value-added services for mobile phone users and network operators. It launched in 2006 and received equity investment of INR30.3 million between 2008 and 2012 from angel investors in the Middle East and Silicon Valley. The company generated a net profit of INR51.3 million for the 2012 fiscal year.

When it came to raising further capital, VC investment was not available and neither were bank loans because MobME was unable to offer collateral – a common problem for start-ups in India. In such cases, an SME listing could allow entrepreneurs to unlock value from their equity.

> "The hitch with the existing SME platforms is that you have to dilute 25% equity in the first go. Early stage firms usually don't know how much money they need" – Sanjay Vijayakumar

"I can take the equity to a bank and pledge it because there is a market value to it," Vijayakumar adds. "So I can raise debt with this equity as collateral."

Swarup endorses this use of the ITP but warns that the government must clarify that equity could be valid collateral.

On the exits side, the ITP is expected to offer existing investors a better chance to find alternate buyers, as both IPOs and corporate M&A of new companies are lacking in India. These exits might also be tax efficient as a sale over a listed platform attracts less capital gains tax – there's a 10% levy if the investment is less than a year old, and no tax if it is longer.

By bringing angel funds under the AIF umbrella, SEBI is trying to formalize the segment and encourage investment. Funds must have corpus of at least INR100 million, and minimum investment per investor of INR2.5 million – lower than the requirements for other AIFs.

"That's been one of the long-standing demands from angel investors. There were a lot of informal angel clubs which were investing individually and they could not do a pooling because the AIF regulations would have then meant that they would have to put in a minimum of INR10 million per person," says Siddharth Shah, a partner at law firm Khaitan & Co.

As a result, angel funds might be able to tap high net worth individuals (HNWIs) for capital. According to Gopal Srinivasan, chairman and managing director of TVS Capital Funds, there is roughly $2 trillion in rupee-denominated capital in India, the bulk of it with HNWIs. Take 10% of that – the typical alternate assets allocation by a global pension fund – and you have $200 billion.

Investment limitations

Angel funds are limited to investing in unlisted companies less than three years of age and with an annual turnover below INR250 million. Commitments must be INR5-50 million, with a minimum holding period of three years.

This stipulation has been criticized because funds often invest less than INR5 million to test the business viability of a venture. Also, incubators and accelerators put in as little as INR500,000 at the seed stage and exit within three years through the Series A or B rounds.

SEBI has created three categories of angel investor – funds, individuals and corporates – and each must have a certain net worth and experience with the asset class in order to participate. While angel fund investments are restricted to a certain size, individuals could step in to provide funding at the very early stages.

However, another problem is the "angel tax" introduced this year. If an unlisted company receives funds against the issue of shares in excess of the fair market value (FMV), the investee company can be taxed on the excess amount as "income from other sources."

This will not apply to investments from angel funds, but individual investors still face the issue.

"This results in 30% [above FMV arrived by the regulator] of an investor's money being indirectly subject to income tax, plus the cash flow of the company is impacted and growth impeded. It discourages investment in start-up companies," says Padmaja Ruparel, president of Indian Angel Network.

L Capital targets Chinese beauty

AS GROWTH SLOWS IN CHINA'S consumer sector, L Capital Asia has identified cosmetics as a segment with the qualities to withstand the broader trend. Put simply, as a woman's disposable incomes rise, so does her consumption of premium cosmetics, particularly anti-ageing and skin whitening products.

Between 2001 and 2011, China's skincare and cosmetics market expanded by 17%, while sales of luxury products alone increased by 22.35%, according to Mirae Asset Global Investments.

"We are seeing potential growth in this segment, particularly within the East Asian female segment. They are more willing to spend more on cosmetics, and not only for the functional purpose of avoiding dry skin," says Hanji Huang, managing director at the private equity firm.

He adds that the segment is also fragmented compared to Taiwan, Japan and South Korea, which means there are consolidation opportunities. L Capital hopes that Marubi Biological Technology Stock, can become a prime mover in this space and last week bought a minority stake in the Guangdong-based skincare manufacturer for an undisclosed sum.

L Capital focuses on mid to high-end companies, so the strategy differs from that of its luxury sponsor, LVMH Group. Even though, Marubi, known for eye care products, has a nationwide presence, its revenues mainly come from second- and third- tier cities. Last year, sales reached RMB3 billion ($490 million) and L Capital plans to support development through the acquisition of other brands.

Marubi: More than skin-deep

"When we say we will help Chinese companies on M&A deals, we don't mean helping them expand overseas – we don't think they are all ready," says Huang, "In the case of Marubi, the idea if to acquire foreign brands or R&D capabilities, bring them to China and develop new products for the local market."

Marubi can also expect to see its brands – Wanmei and Chunji – benefit from tie-ups with LVMH in China, sharing distribution channels with the likes of Christian Dior. China's largest cities have traditionally been the domain of multinational brands sold through department stores, while local players rely on cosmetics shops in second- and third-tier locations. But Huang believes the line is now blurring.

"We would like to see more local brands gaining more market share, at least within China," he explains. "One example is Herborist, which is owned by Shanghai Jiahua. It is a local skincare brand that is growing in China and in Europe. Marubi has the potential to do that."

L Capital Asia was set up in 2009 and the Marubi investment came from its debut fund, worth $650 million. The PE firm has four other portfolio companies in Hong Kong and mainland China: Emperor Watch & Jewelry and Ming Fung Jewelry, as well as fashion labels Trendy International Group and Xinhe Fashion.

"The Chinese retailers we invested in don't need money," says Huang. "They're mainly looking for partners to help them grow the business."

Jungle Ventures secures TravelMob exit

FOUR YEARS AGO, ASIA PACIFIC BECAME the world's largest aviation market, with 647 million travelers taking flights within the region compared to 638 million in North America. This growth shows no sign of slowing down – in the first four months of 2013, Asia Pacific travel rose 6% year-on-year, the highest rate of any market, according to the International Air Transport Association (IATA).

This was the rationale behind NASDAQ-listed vacation rental site HomeAway's acquisition of a 63% stake in Singapore-based start-up TravelMob last week. It facilitated an exit for VC backers Jungle Ventures, Accel Partners, New Zealand Venture Investment Fund and Sparkbox Ventures.

TravelMob: Room for investment

Increased travel within the region means increased demand for ancillary services. The TravelMob concept is simple – travelers looking for holiday accommodation are matched with property owners, or hosts, with space to offer. The format, arguably pioneered by US site Airbnb in 2008, has spawned a host of similar sites offering services ranging from casual room rentals (Couchsurfing) to arranging luxury retreats (HomeAway).

Jungle Ventures backed TravelMob last September, leading a $1 million seed round. "We had been looking at this space for while, since late 2011, but there were few companies around then," says Amit Anand, the VC firm's co-founder. "It was exactly this kind of growth, in the intra-Asia Pacific traveler segment, where we saw an opportunity."

Launched last year, TravelMob features over 14,000 short-term rental listings which run the whole gambit of accommodation offerings from luxury villas and urban apartments to houseboats and even some shared spaces. By the time Jungle Ventures invested, it already had operations in Singapore, Hong Kong and Indonesia.

"We focus on identifying and cultivating regional category leaders – and TravelMob was the right fit," says Anand. "What was also attractive about TravelMob was the experience of the team; they were pretty seasoned entrepreneurs and we liked the way they were thinking about scaling the business across the region."

The rapid growth of this segment, however, has also meant it has become very fragmented, setting the stage for larger players to seek inorganic growth opportunities and paving exits for early investors. By acquiring TravelMob – and investing an extra $2 million into the company – HomeAway plans to expand its presence in Asia and compete directly with Airbnb.

HomeAway also participated in two rounds of funding for Tujia.com, China's first online vacation homes rental service, alongside a group of venture capital firms.

"There will be some level of consolidation," says Anand. "Travel is a business where the margins are pretty thin but there is also phenomenal amount of volume. On the other hand I still see new models coming out for this type of business – we continue to be excited."

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Caffeinated returns

Private equity is already leveraging the growing popularity of coffee shops across Asia. But where is the next frontier – and is it all about the coffee?

CHINA HAS TURNED FROM A NATION OF tea-drinkers to the world's fifth biggest consumer of coffee. Private equity investors tapped the trend early with H&Q Asia Pacific providing $10 million in capital when Starbucks opened its first store in Beijing in 1999. Over a seven-year holding period 59 more outlets opened and today Starbucks has 851 nationwide.

According to Euromonitor International, China's market for chain coffee shops – coffee-themed enterprises with a minimum of 10 branded outlets – breached the $1 billion mark last year. In Asia Pacific, the market is worth $10 billion, nearly double the level five years ago.

There have been several notable PEP deals in the segment in recent years.

This month IMM Private Equity's bought South Korea's Hollys Coffee for up to $100 million; last year, Japan-based Advantage Partners saw a 7x return on its exit of Komeda Coffee to MBK Partners; and in 2011, Malaysian sovereign fund Ekuinas committed $5.5 million to San Francisco Coffee. In India, numerous PE investors have partnered with Coffee Day in the last seven years.

Explaining the context for the popularity of coffee in Korea, Joseph Lee, partner and senior managing director at IMM, looks back to the teahouse culture and the need for space in a densely populated country. Since then, there have been three main trends.

"First, people have more disposable income and second, consumer tastes have changed – so they are looking at coffee as more accessible and desirable," he adds. "As a result, in the last five years we have seen a significant increase in per capita consumption."

Korea is Asia's second-largest coffee shop market by value and it grew by 33% last year. In the past five years the market has expanded more than three-fold – from $508 million to $1.8 billion – and now has more coffee outlets than any other Asian nation, at 7,105.

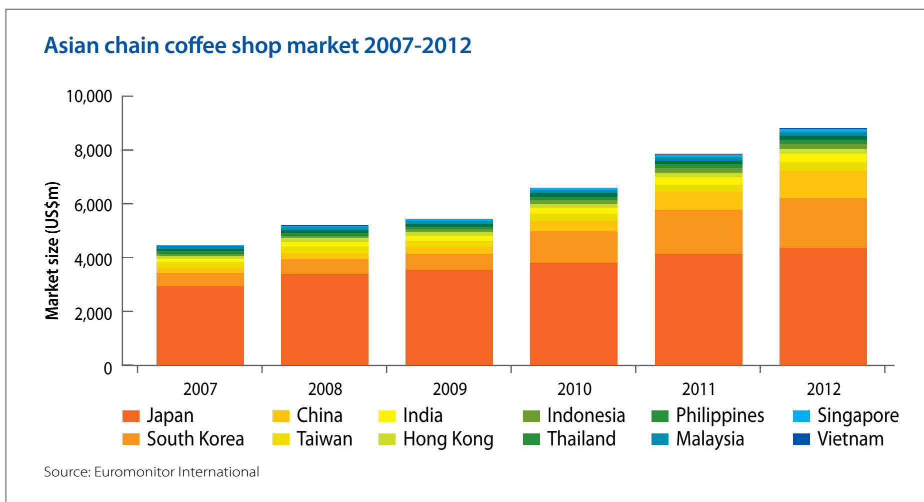
The third factor is the surge in number of Koreans looking to open their own coffee shops, mostly young people who want to start new businesses as franchisees. This approach fits in well with the Hollys strategy: real estate is expensive so the best way to expand is through franchises. The company is now the sixth-largest player in the market with a 6.2% share.

The franchise model is also found in Japan, Asia's largest coffee market but one in which growth has been relatively subdued compared to likes of China and South Korea. Last year it expanded by just 5.5%.

"Japan's coffee shop market is relatively stable, with most chains gaining market share from mom and pop shops," says one local GP. "Where elderly proprietors are retiring and closing their shops, there has been an opportunity for Komeda and others to expand – that is how the market is growing."

In addition, coffee chains need to work harder to differentiate themselves from competition in Japan to achieve the kind of growth PE investors require. Komeda, which was first invested by Advantage in 2008, is a good example. Unlike other chains, it shunned city-center locations, preferring instead to set up large out-of-town, roadside outlets with ample parking and encouraging customers to stay for longer.

Like Hollys, Komeda adopts the franchise model and saw business expand 15% last year.



Emerging markets

The two chains differ in that Komeda's growth strategy has been entirely domestic whereas Hollys wants to establish itself in emerging Asia, making inroads in China and Southeast Asia.

While the coffee market in Southeast Asia is still very small – worth just $774 million – annual growth has averaged nearly 16% since 2007.

"It is also not just about the coffee. It has almost become a socio-cultural evolution – the coffee culture is a 'social lubricant,' providing a convenient and comfortable environment for gatherings," says Amil Izham Hamzah, senior director of investment at Ekuinas.

He cites rising standards of living and a more global outlook as the main drivers in Malaysia's market as consumers explore a wider range of food and beverage offerings. San Francisco commands the number four spot in the market with a 6.2% share, but Starbucks holds a much larger chunk than elsewhere in the region with 54%. However, there is room for new entrants.

"International franchise-type brands are expanding aggressively to open new stores or to refurbish the older outlets with new concept and decor," says Hamzah. "We also see new independent brands being born. These are high-end cafes selling artisan-type coffee."

Although certain countries have become crowded, Asia's coffee story still has some way to go. Earlier this year Starbucks entered Vietnam – one of two Asian nations where it has yet to become market leader (the other is India) – to compete with local incumbent Highlands Coffee.

While Vietnam represents the smallest portion of Asia coffee chain market – worth a mere $39 million last year – it is still the fastest growing after China. Just as China represented consumer sector frontier territory back in 1999, maybe the less penetrated markets of today present the biggest opportunity for private equity.

PRIVATE EQUITY IN ASIA

Investment Breakdown by Country From 1 January to 31 June 2013

Investee Country	Amt. Invested US$m	No. of Deals	(Disc.)	No. of Investees
Australia	8,077.2	42	29	42
China (PRC)	7,993.2	233	170	232
India	4,792.7	164	118	163
South Korea	2,338.3	65	63	65
Japan	2,134.2	175	148	174
Singapore	581.1	38	31	37
Philippines	455.0	7	6	7
Vietnam	430.0	5	4	5
Indonesia	352.0	13	3	13
Malaysia	301.6	8	5	8
Hong Kong	216.8	8	5	8
New Zealand	115.9	6	2	5
Taiwan	23.4	10	6	10
Mongolia	7.5	1	1	1
Thailand	0.6	4	1	4
Maldives	-	2	-	2
Sri Lanka	-	1	-	1

FUND-RAISING MONITOR

CLOSED FUND

Location: Hong Kong
Fund Name: KKR Asian Fund II, L.P.
Closing Amount: US$6 billion (final close)
Launch Date: May 2012
Fund Manager/Advisor: Kohlberg Kravis Roberts & Co.
Stage Focus: Buy-outs (MBO/MBI/LBO), Expansion/ Growth Capital, Privatization, Turnaround/ Restructuring
Industry Focus: Agriculture/Fisheries, Computer related, Conglomerates, Construction, Consumer products/services, Ecology, Electronics, Financial services, Information technology, Infrastructure, Leisure/Entertainment, Manufacturing - Heavy, Manufacturing - Light, Media, Medical, Mining and metals, Retail/Wholesale, Services - Non-Financial, Telecommunications, Textiles and clothing, Transportation/ Distribution, Travel/Hospitality, Utilities
Geographical Focus: Australia, China (PRC), Hong Kong, Japan, New Zealand, Taiwan
Contact: Joseph Y. Bae
Phone: (852) 3602-7300
Email: baej@kkr.com
Website: www.kkr.com
Update: KKR has achieved the goal of raising US$6 billion for its second Asian buyout fund, KKR Asian Fund II, making it the largest fund focused on the region. The Fund attracted commitments of US$400 million from Washington State Investment Board, US$200 million from the Oregon Public Employee Retirement Fund (OPERF), and US$25 million from the Oregon Common School Fund. The fund plans to invest $1 billion in Southeast Asia.

NEW FUNDS

Location: New Zealand
Fund Name: Pioneer Capital Partners II LP
Target Amount: NZ$150 million
Launch Date: July 2013
Fund Manager/Advisor: Pioneer Capital Management Ltd.
Stage Focus: Expansion/ Growth Capital
Industry Focus: Computer related, Electronics, Information technology, Manufacturing - Light, Medical, Telecommunications, Transportation/ Distribution
Geographical Focus: New Zealand
Contact: Randal Barrett
Phone: (64) 9- 363-2966
Email: randal.barrett@pioneercapital.co.nz
Website: www.pioneercapital.co.nz
Update: Pioneer Capital is seeking to raise NZ$150 million for Pioneer Capital Partners II. The Fund will invest in privately-owned, small to medium-sized New Zealand businesses which are expanding in large international markets, with average investments of between NZ$10 million and NZ$30 million. The New Zealand Superannuation Fund has placed NZ$40 million to the fund.

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