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EDITOR'S VIEWPOINT

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Compliance costs

CHINESE MOBILE GAME PUBLISHER iDreamSky Technology went public on NASDAQ in August 2014 after raising $116 million in its IPO. This windfall came with a price tag: the company paid $4.65 million in costs, most of it in accounting and legal expenses. A further $2.54 million was paid to PwC in 2014 for auditing its books and a further $30,622 for tax planning and compliance services.

IDreamSky claims to be the largest third-party mobile game publisher in China. Revenue ballooned to RMB984.1 million ($158.5 million) last year as the company strove to maximize scale ahead of its listing. These customer acquisition efforts weighed heavily on the bottom line: as a result of marketing and administrative costs, iDreamSky slipped from a RMB27.8 million net profit to a RMB16.7 million net loss.

The IPO represented a liquidity event for the company's VC backers, Legend Capital and Redpoint Ventures, although they had yet to start unwinding their positions. For Michael Chen, the company's chairman, CEO and single largest shareholder, in retrospect it might seem something of a damp squib.

IDreamSky sold it shares at $15.00 apiece and they closed at $15.94 on the first day of trading. A peak of $23.66 came last September but since then iDreamSky has trended downwards. It closed at $10.53 on June 9 before a small surge ahead of Chen submitting a take-private offer of $14.00 per share.

Clearly Chen, like many of his fellow founder-entrepreneurs of US-listed Chinese companies, feels he can getter a better valuation by listing the business back home. IDreamSky is essentially consumer-facing so it may get more traction with retail investors that know the company first-hand. And then, at least when the take-private bid was submitted, China's public markets were soaring.

Valuation arbitrage aside, the increasingly onerous reporting and transparency requirements for US-listed companies are a source of frustration for many smaller Chinese companies. Even though they may recognize the need to cover themselves they may question whether the time and money is worth it.

The US Securities and Exchange Commission estimates that the average cost of achieving initial regulatory compliance for an IPO is $2.5 million, followed by an ongoing annual compliance cost of $1.5 million. These expenses are described as generally higher than those in other markets.

A 2014 Heritage Foundation study looked at the impact of the annual compliance cost in greater depth. Say a company with $10 million in shareholders' equity and a 20% return on equity earns $2 million. Subtract $1.5 million and earnings and return on equity fall to $500,000 and 5%, respectively. Without scale it hardly seems worthwhile.

Other studies have questioned whether the one-off 2.5 million and ongoing $1.5 million figures are even accurate. Being publicly-listed means higher wage bills because CEOs, CFOs and other financial professionals cost more and new members added to the board of directors must be compensated. Compliance may also involve investment in better IT systems and the recruitment of investor relations executives.

The SEC might relax its requirements in time, but it is difficult to say where the line should be. Under a disclosure-based system, investors rely on companies providing sufficient information for them to make decisions. But excessive disclosure imposes heavy costs on smaller companies and there comes a point when investors are wallowing in so much information that it results in confusion rather than insight.

A US listing is not for every Chinese company, and it could be argued that compliance is the cost of entry: an exchange can't call itself gold standard if the protections offered are not top rate.

And as China alters the rules of its own bourses, transitioning from an approval-based to a registration-based system, similar issues will emerge. It is one thing for a company to say it would prefer to be listed domestically because the valuation will better reflect the qualities of its business. Moving for the sake of a cheaper and easier compliance protocols raises questions about the quality of those protocols.

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NEWS

ASIA PACIFIC

Formation 8 to raise Asia VC fund

US venture capital firm Formation 8 is looking to raise a $400 million Asia fund to connect start-ups in the region with Silicon Valley. The fund – called F8 Asia Growth – is expected to back 5-7 late-stage tech companies.

AUSTRALASIA

Investors commit $347m to Australian wind farm

Partners Group has led a A$450 million ($347 million) investment in Australia's Ararat Wind Farm project, alongside General Electric (GE), Renewable Energy Systems (RES), and Canadian pension fund OPTrust. The wind farm is expected to have a capacity of 240 megawatts.

Allegro closes Australia distress fund at $139m

Australian turnaround specialist Allegro Funds has closed its second vehicle at A$180 million ($139 million). The GP ended up with sufficient demand to exceed the original target of A$200 million but decided against seeking to increase the hard cap agreed at the first close.

CHAMP PE to invest in mining supplier Bradken

CHAMP Private Equity and Chile's Sigdo Koppers have agreed to invest A$70 million ($54 million) in struggling Australian mining industry supplier Bradken. A merger of Bradken and Sigdo-owned Magotteaux Group is also under consideration.

Crescent to buy Healthscope business

Crescent Capital Partners has agreed to acquire the Australian pathology operations of Healthscope for A$105 million ($80.8 million), comprising A$92.5 million in cash and a promissory note worth A$12.5 million.

GREATER CHINA

Alibaba, Ant Financial form JV to invest in O2O service

Alibaba Group and its financial affiliate Ant Financial plan to invest nearly $1 billion in a joint venture that will tap into China's local online-to-offline (O2O) services market, initially focusing on the food and beverage segment. The JV, called Koubei, will receive contributions of RMB3 billion ($483 million) from each of the companies and they will hold 50% apiece of the business.

MBO no longer a 'dirty word' in Japan

The term management buyout (MBO) is no longer considered a "dirty word" among Japanese company founders, according to local GPs who are eyeing more succession deals.

Speaking at the AVCJ Japan Forum in Tokyo, Jun Tsusaka, managing partner and co-founder of Nippon Sangyo Suishin Kiko (NSSK), said that the idea of turning to private equity as a succession solution is not only increasingly acceptable, but founders often feel an obligation to bring in professional management to protect their legacy. "If you look back 10 years, MBO was a dirty word, owners hated the idea," said Tsusaka. "Now owners are happy to speak about it and there is no negative sentiment, they understand GPs can help grow their company."

His comments reinforced sentiments expressed by Hideo Nagatsuyu, a senior partner with Advantage Partners. Nagatsuys also noted that the change in attitude towards outside investors was not driven by regulatory pressure; rather by companies' desire to be more competitive at home and overseas.

Tsusaka added that a lot of the potential deal flow came from succession deals involving small and medium-sized enterprises (SMEs) with ageing founders. "SMEs account for around 90% of the Japan's GDP," he added. "So what you have is a very large pool filled with a lot of small fish."

Carlyle to invest $120m in Shanghai ANE Logistics

The Carlyle Group has agreed to invest $120 million in Shanghai ANE Logistics, a Chinese logistics and courier services provider. Shanghai-headquartered ANE claims to be the largest less-than-truckload (LTL) operator in China working under a franchise model. It provides road transportation and delivery services for cargos between 15 kilograms and three tons.

Legend-owned payment platform raises $242m

Lakala, a Chinese offline third-party payment service provider owned by Legend Holdings, has raised RMB1.45 billion ($242 million) in its latest funding round, at a valuation of more than RMB10 billion. Investors include Taiping Life Insurance, China Reinsurance, China Continent Property & Casualty Insurance and the Civil Aviation Development Fund.

Chinese tutor app Changingedu raises $100m

TAL Education Group, a US-listed K-12 after-school tutoring service provider, has led a $100 million Series C round for Changingedu.com, a China-based platform that connects private teachers with students. IDG Capital Partners, Trustbridge Partners and Sequoia Capital also participated.

Focus Media's backdoor listing encounters hurdles

Private equity-backed Focus Media's planned $7 billion reverse merger with Shenzhen-listed Hongda New Material has encountered another setback following the resignation of Hongda's chairman in response to a probe by authorities. Dehong Zhu, who is also the controlling shareholder of the shell company, has vacated his positions in the firm due to personal reasons, the rubber manufacturer said.

KKR commits $70m to education player Tarena

KKR has invested $70 million in Tarena International, a provider of professional education and training in China, as IDG Capital Partners and Goldman Sachs trimmed their stakes in the company. KKR has acquired 6.8 million shares while Tarena founder and CEO Shaoyun Han picked up a further two million for $20.5 million.

VCs commit $20m to logistics solutions provider

IDG Capital Partners, Matrix Partners and Yunqi Ventures have provided $20 million in

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NEWS

Series A funding to Olymtech Corporation, a Chinese cloud solutions specialist that focuses on the logistics industry. Founded in 2002, Olymtech provides cloud-based IT solutions for international freight forwarders and logistics services providers.

Wenzhou Kangning Hospital files for HK IPO

Wenzhou Kangning Hospital, a China-based psychiatric specialty care service provider, has filed for an IPO in Hong Kong. Guangzhou GL Capital and CDH Investments hold stakes of 29.14% and 12.35%, respectively, in the firm.

NORTH ASIA

Japan pension funds have out-dated view on PE risk

Japan's pension fund industry needs to reevaluate its perception of private equity as a risky alternative asset, domestic LPs told the AVCJ Japan Forum. Hidekazu Ishida, an advisor with Osaka Gas Pension Fund, said that, while many pension funds shied away from private equity, investing in other assets such as listed equities is potentially riskier because the investor has far less control over the asset. He added that, issues over fees aside, PE should be seen as fundamentally the same as investing in public equities.

SOUTH ASIA

PE-backed Coffee Day targets $180m India IPO

Cafe Coffee Day, an Indian coffee shop and restaurant chain backed by KKR, New Silk Route Partners and Standard Chartered Private Equity, is seeking to raise up to INR11.5 billion ($180 million) through an India IPO. Over half of the proceeds of the offering will be used to repay debt, with the remainder going towards building new facilities and refurbishing existing ones.

India to create trading platform for tech start-ups

The Securities and Exchange Board of India (SEBI) has provided details on plans for a trading platform for technology start-ups as it seeks to make it easier for companies to go public domestically. The Institutional Trading Platform (ITP) will have lower disclosure requirements and shorter post-offering lock-up periods of than those set out for India's major bourses.

Carlyle commits $500m to South Asia energy platform

The Carlyle Group has committed $500 million to an upstream oil and gas start-up that will primarily focus on development and production opportunities in the Indian subcontinent. The company, Magna Energy, was set up in 2013 as a passive investment vehicle by Mike Watts and Jann Brown, who until last year served as deputy CEO and managing director of listed oil and gas exploration and production (E&P) specialist Cairn Energy. They have a combined 60 years' experience working in the oil industry, including 30 years in South Asia.

The objective is to create a full-cycle oil and gas company through acquisitions and local licensing rounds, combining the founders' expertise with Carlyle's capital and industry knowledge. The equity commitment comes from Carlyle International Energy Partners (CIEP), which focuses on E&P, production, midstream, and refining and marketing in Europe, Africa, Latin America and Asia.

PE investors set for exit as RBL Bank files for IPO

Indian private lender RBL Bank plans to raise up to INR11 billion ($173 million) through an IPO, providing a full exit for Beacon India Private Equity and a partial exit for Gaja Capital and Capvent. The company will offer an undisclosed amount of new shares, along with up to 17.6 million existing shares, including 9.5 million from Beacon and 3.5 million from Gaja.

CX set for part exit as Matrix Cellular files for IPO

Matrix Cellular, an Indian telecommunications company that caters to people traveling abroad, has filed for an IPO. This would allow a partial exit for private equity backer CX Partners. The company plans to sell 15.17 million shares, of which 12.36 million are held by CX.

Nokia Growth leads Series B for India's Indix

Nokia Growth Partners has led a $15 million Series B round for Indian cloud-based analytics start-up Indix. Existing investors Nexus Venture Partners and Avalon Ventures took part in the round as well.

IDG Ventures India founder Manik Arora to leave firm

Manik Arora, founder and managing director of IDG Ventures India, will leave the firm. Prior to setting up IDG Ventures India in 2007, he led the India practice at Battery Ventures.

SOUTHEAST ASIA

Warburg Pincus consortium re-ups in Vincom Retail

A consortium led by Warburg Pincus has made a follow-on investment of about $100 million in Vietnam shopping mall operator Vincom Retail. The new investment raises the consortium's total commitment to Vincom to $300 million.

Maxpower gets debt, equity package from SCPE

Standard Chartered Private Equity (SCPE) has re-upped in Indonesia-based distributed power specialist Maxpower Group, providing $60 million in equity and serving as joint lead arranger on a $222 million debt refinancing for the company.

Soetantyo family buys Icicle Holdings from PE

A company owned by Indonesia's Soetantyo family has agreed to buy North America-based Icicle Holdings from Paine & Partners. Convergence Holdings will buy Icicle's land-based wild seafood processing and farmed salmon activities, while Dominion Catchers will take ownership of the harvesting and processing vessels as well as the associated fishing rights.

SCPE commits $52m to L Capital-owned Crystal Jade

Standard Chartered Private Equity (SCPE) has committed $52 million to Crystal Jade Group Holdings, a food and beverage conglomerate owned by L Capital Asia. The company will use the funding to add more locations to its existing network of restaurants and stores. It will also expand to more international regions.

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Survival of the fittest

With US LPs refocusing their Asia exposure – reducing the number of commitments if not the aggregate size – smaller funds may be feeling the pinch. But this could benefit the long-term health of the market

THE CALIFORNIA PUBLIC EMPLOYEES' Retirement System (CalPERS) is every bit the heavyweight GP. It is the second-largest public pension fund in the US and the biggest contributor to PE. Of its $304.5 billion in assets, $28.8 billion is devoted to the asset class.

While CalPERS has no plans to dramatically reduce this allocation, it will be shared among a smaller number of managers – commitments to individual GPs will fall from 98 to 30 over the next five years. For CalPERS alone to engage in a major refocusing would be troubling enough. But the pension fund serves as a bellwether for LP attitudes, and its move has highlighted a problem that has been apparent some time now.

"A lot of people have distributed more of their attention and resources on a domestic basis," says Heidi Poon, senior vice president at advisory firm TorreyCove Capital Partners. "It doesn't mean that people completely ignore it, but there are definitely more questions along the lines of, 'Why do I need to fly over to China to look at this fund, when they haven't delivered the same returns?'"

As more investors join the so-called "CalPERS cull," the ensuing ripples are expected to hit emerging markets especially hard, with investors retreating from small, emerging funds and entrusting their money to larger players or even taking it home to domestic GPs. Unless they can find replacement capital, many less established firms may be swept away.

However, like all evolutionary thresholds, this trimming of GP relationships is not a universal negative. While some pain will come in the short term, the overall effect should be to strengthen the market and reinforce the best tendencies among those who are able to weather the storm.

Out of the comfort zone

Doing business in Asia can be frustrating for a US investor. It involves difficulties that are not present at home, including differences in time zones, language and culture. These additional challenges are factored into the risk-reward ratio, leading LPs to expect returns that funds don't always deliver.

An additional challenge to expectations is the relative novelty of private equity in Asia. While GPs in the region have made great strides in building their business savvy, they are still significantly behind their US counterparts. The latter have more experience and know more techniques for adding value to their portfolio companies – all in the context of conforming to the traditional buyout model. This gives LPs more confidence in these managers' ability to deliver strong returns.

"Where the US GPs are approaching 40 years old, in Asia they're just coming out of the first cycle," says Mounir Guen, CEO of MVision. "That's more the frontier type of exposure than it is the settlers, or a modern kind of environment. The US is in that urban, modern look. It's all slick, it's really clever, the guys really know what they're doing."

EMPEA's 2015 survey of global LPs supports these claims of skepticism. While the number of LPs expecting returns of 16% or more from their developed markets portfolios has risen slightly since 2012, expectations for similar returns from emerging markets, including Asia, have dropped from 72% in 2012 to just over half this year.

Moreover, the number of LPs planning to increase their allocations to emerging markets dropped from 64% in 2011 to 45% in 2015; the number planning to decrease allocations increased from 2% to 22%. While the survey did not track US LPs specifically, it is nonetheless useful for examining overall attitudes.

Not all funds are suffering from LPs' refocus on the US. In 2014, Asia private equity exits reached a record $65.3 billion, buoyed the $5.8 billion sale of Oriental Brewery and Alibaba Group's $25 billion IPO – respectively the largest trade sale and the largest public offering ever seen in the region.

The beneficiaries of Oriental Brewery, KKR and Affinity Equity Partners, are among those generalist, pan-regional GPs that continue to receive ample funding from investors. Silver Lake, one of the biggest winners on Alibaba, invests out of a well-supported global fund.

Smaller vehicles, with a country- or sector-specific focus, have a harder time attracting interest in this environment.

There are several reasons for this trend. Reputation plays a part; large, regional GPs tend to have a longer history than recently established specialist funds. Investors who have already seen Asian markets hit several speed bumps may also see bigger funds as a safer bet, capable of generating reliable returns with less risk attached, in part because they are not tied to the fortunes of single market.

Furthermore, consolidating investments into a few large funds helps LPs economize their GP relationships. Each fund, no matter the size, requires the same due diligence work. All else being equal, there is a clear advantage for investors to maximize the return that can be generated by the time spent.

> "I think the trend is definitely for emerging markets, and specifically the biggest markets, such as China, to take more of a place in private equity portfolios"
>
> – Javad Movsoumov

"For a pension fund in the US, with relatively little staff and a quite sizable portfolio, it's easier to evaluate a dozen or so funds in the $1 billion-plus space than to try to evaluate closer to 100 funds that operate in the $500 million to $1 billion fund space in Asia," says Javad Movsoumov, executive director of the Asia-Pacific private funds group at UBS.

AVCJ Research bears out these reports of consolidation. While the number of country-specific and regional funds receiving commitments has fallen from 2011 to 2014, the average size of each fund, of both types, actually increased from 2012 to 2014.

Tougher on terms

Another disadvantage for smaller funds has to do with some common restrictions imposed by LPs. Often an investor will be unable to account for more than 10% of the total fund size. However,

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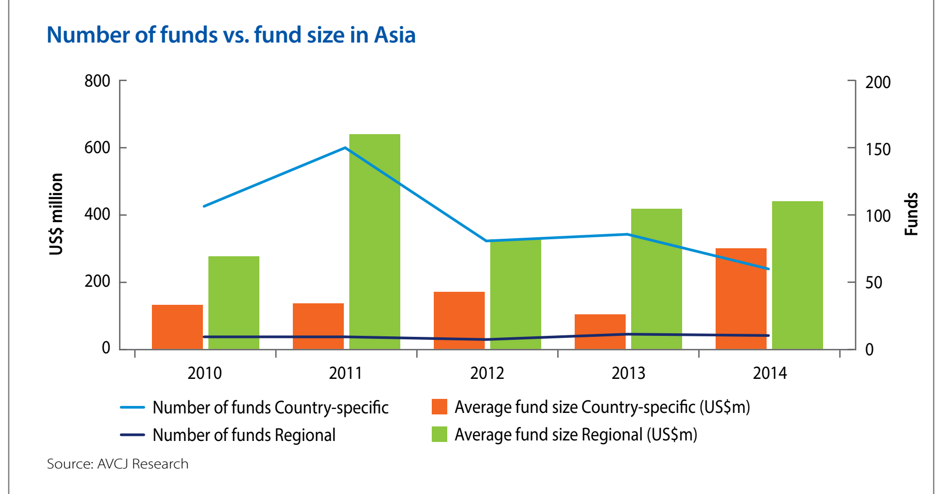
larger investors also are reluctant to commit small amounts, given the burden of due diligence and because the sheer size of their asset pools requires a substantial annual commitment to the asset class.

"It's tough for these guys to write checks much under $50 million. It's just not worth their effort and the diligence and everything they have to go through in order to get there," says Justin Dolling, a partner at Kirkland & Ellis. "It's difficult for a large institutional investor to justify going through all the necessary work and relationship building until a fund hits at least $500 million, because then they can write a $50 million check and still be below 10% of the fund."

say that Multiples' willingness to grant the requests of the LP in return for a re-up may have backfired.

"The deal that they have with CPPIB means that other larger investors want the same deal, which CPPIB doesn't want to give other investors, and therefore now people aren't really looking at it," says one executive familiar with the fundraising market.

Not everyone sees the well drying up for smaller funds in Asia. While some LPs are becoming more reluctant to commit to funds directly, there are alternative paths. Advisors and funds-of-funds, for instance, have long been seen as a way for foreign LPs to gain Asia exposure



Source: AVCJ Research

LP expectations are not limited to fund size. Over the last several years there has been a marked trend for investors to add increasingly strict conditions to a fund commitment. These demands, in the form of side letters, can encompass a range of issues, from governance or transparency issues to special fee arrangements.

Extra conditions have grown rapidly; while GPs were describing side letters as an unfair imposition as recently as three years ago, today industry veterans say they have become an accepted part of doing business in the Asia market.

One important note, however, is that LPs are less likely to require additional guarantees from managers with whom they have established relationships. This means that, once again, the burden falls on smaller, still-growing GPs to meet a standard that their larger or better-known colleagues do not have to face.

The difficulty that comes along with increased demands can be seen in the case of India's Multiples Alternative Asset Management, which is currently raising its second India-focused fund. Canada Pension Plan Investment Board (CPPIB) anchored the debut vehicle and industry sources

without taking on too much risk, since investors can commit to a single manager that then spreads its money around.

While this approach results in a double layer of fees, the peace of mind may be seen as worth the increased costs. Committing to a fund-of-funds also involves giving up some control, which means the money of a skeptical investor can still end up with a smaller GP in the end.

"If you look at some recent fundraises in China, they still get quite an amazing amount from the fund-of-funds community," says Conrad Yan, a partner at placement agent Campbell Lutyens. "There is obviously a time lag, because while a lot of investors have declining interest in China, they have already deployed the capital with the fund-of-funds. These fund-of-funds are probably less cynical about China than the direct capital owners."

However, this environment too is changing, and some of the old assumptions do not apply anymore. Funds-of-funds themselves are finding it harder to raise money, as outside LPs become more familiar with the local scene and more confident in their ability to deal with local funds themselves.

"It has become less complicated to evaluate funds in Asia over the last few years and that is what prompted us to expand our regional portfolio," Andy Hayes, private equity investor officer at Oregon State Treasury, told AVCJ last year. "The winners have begun to prove themselves, more GPs have started to return capital and we are seeing who can do this job in Asia."

It should be noted this does not apply to all LPs, many of which remain comfortable working through intermediaries that are familiar with the target markets. Neither does this trend necessarily mean less money is available for smaller players. "If the funds-of-funds are no longer doing the larger funds, they have to differentiate themselves, so they will have more time and attention to devote to the smaller funds," says TorreyCove's Poon.

Alternative sources

In addition to exploring fund-of-fund relationships, there are other LPs beyond the bigger-pocket public pension funds. One fund manager in Hong Kong sees family offices and endowments as willing to take bigger risks; a pension fund might not participate in a manager's fundraise until the third or fourth fund, but an endowment or a family office might come in as early as Fund II.

While risk-averse LPs such as pension funds may see Asia as too risky for their money, there are still plenty of opportunities around the region for those willing to take bigger leaps.

"Even though the Southeast Asian countries are smaller, and the funds are smaller as well, those funds are still very suitable for some adventurous LPs, like endowments," says Campbell Lutyens' Yan. "Vietnam would be a good example. Because Vietnam still has a lot of growth, it's a country that can be seen as a China-plus-one strategy, and there are some state-owned enterprise privatization plays that can still be seen as low-hanging fruits."

Asian managers may also be too devoted to certain types of investors from a prestige standpoint, passing over LPs who are more appropriate for them or more likely to commit. In the new environment, GPs that chase after pension funds because they have the biggest pockets could be outmaneuvered by those who are willing to accept money from other sources.

"Historically it's always been, 'I want US endowments and foundations.' That was the thing that everybody wanted, to have Harvard as an investor," says Niklas Amundsson, managing director at placement agent Monument Group. "Today it's more, 'I want US public pension money, because that's sticky capital, and it's always going to be there.' Just because

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something is trending at the moment, it doesn't mean it is right for you."

Positive forces

Perhaps the most troubling implication of the "CalPERS cull" is that of a general retreat from Asia for US investors. The headline numbers do not suggest this to be the case, or at least not yet. Private equity fundraising reached a record $68.3 billion last year, the highest level since 2011, which coincided with the height of the renminbi-denominated fundraising boom. What is unclear is where the money is coming from.

Even among the larger managers, while they may not have seen a retreat, the balance has shifted from the US and Europe to Asian and Middle East investors. In Affinity's fourth fund, which closed at $3.8 billion last year, LPs from these regions accounted for 39% of the total corpus, compared to 15% in the previous vintage. The North American share dropped from 50% to 38%. This is not unusual for Affinity's peer group.

However, UBS' Movsoumov argues that, if there has been a drop off in the US contribution, it is more of a realignment than a permanent withdrawal. "If you rewind back 8-10 years ago, there were a lot of LPs that had no emerging markets pocket at all," he says. "But I think the trend is definitely for emerging markets, and specifically the biggest markets, such as China, to take more of a place in private equity portfolios."

It is clear that the refocusing of larger LPs will create a harsher environment for smaller GPs, and one in which many managers could find themselves unable to cope. However, as industry professionals point out, a more challenging environment is exactly the circumstance that creates evolutionary pressure and forces adaptation.

For one thing, while Asian managers lack the experience of their US rivals, they also have the advantage of being able to learn from the history of the US market. With the global economy growing more interconnected, US and Asian GPs have increasingly similar backgrounds. In many cases, senior executives at indigenous Asian firms started out working in private equity firms in the US, before returning to their home countries.

This bank of knowledge and experience may allow the Asian private equity market to develop faster than others at a similar point in their cycles. GPs can build business models intended to avoid the pitfalls that those markets faced early on.

"Sector-specific is very hard to find in Europe. It's still very much regional, while in Asia, sector-specific is quite healthily growing. And the US is virtually all sector-specific now," says MVision's Guen. "They're all defined, and they're all differentiated. And you can see that coming already in Asia, in the way that GPs present themselves."

In the case of side letters, these too have a welcome herd-thinning effect. GPs that can meet the demands of skeptical LPs will quickly earn themselves a reputation for discipline and professionalism. Although established firms have an unfair advantage in this space – a well-known GP can always dictate its own terms – in the long run GPs that can meet these requirements may find themselves better-equipped for hostile conditions than those currently making it by on their reputations.

Industry watchers agree that small GPs have tough seas ahead, but they see this as a feature of any healthy market. Instead of bemoaning their bad luck, managers should get to work planning their course and making their plans for survival. The reward for a good approach will be to stay afloat after the storm recedes, and to be better prepared for the next one.

"Market crashes and market downturns are always good for filtering out the weak, and those who should not be raising money in the first place," says TorreyCove's Poon. "So then the strong get stronger, and eventually you'll be on a par with the global players that have, basically, international standards."

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From Beijing to the Bay Area

Chinese technology companies are becoming more interested in backing US start-ups, with some groups even building local teams in Silicon Valley. What does this mean for the start-up community?

RENREN, THE SO-CALLED FACEBOOK OF China, wants to end its tenure as a US-listed company and return to private ownership. The business has been struggling for years to grow its user base as China's younger generation prefers to conduct its social networking via smart-phone apps such as Tencent's WeChat and Sina's Weibo.

Revenue came to $83 million last year, a 43.9% drop from 2013, while net income fell from $64 million to $60 million, and then turned into a loss of $27.6 million in the first quarter of this year. Led by founder and CEO Joseph Chen, Renren is trying to revolutionize its business by investing in start-ups far removed from social networking and games. Most of the targets are in the US.

Earlier this year, Chen announced that Renren would invest $500 million in the financial sector, forging a new business model for the company. Mortgage marketplace LendingHome is one of these fintech bets, having received $70 million in April. Stock trading site Motif, real estate crowdfunding platform Fundraise and peer-to-peer lending site Social Finance are among the other US-based start-ups to receive backing.

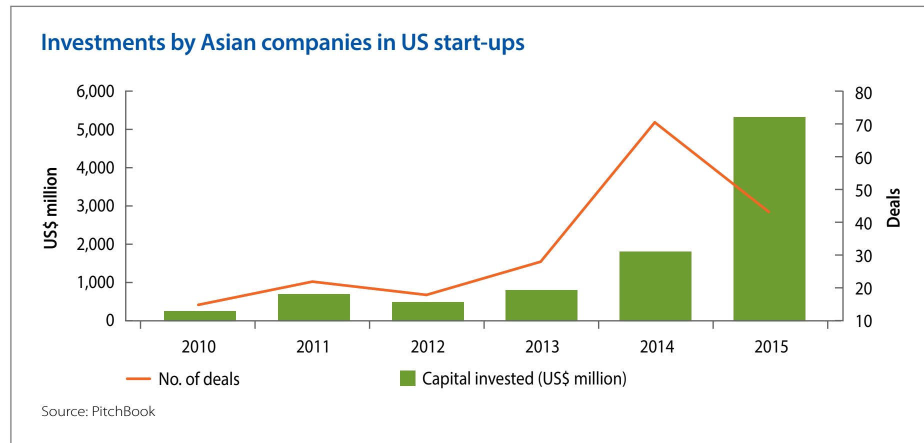
"We all understand that Renren has lost the advantage in its core operations. There is a joke that the company's future market valuation will equals its current cash flow, which is negative. However, Joseph is admittedly a talented financial investor," one US-based investor says.

Whether Renren can come up with a new idea through a string of start-ups and subsequently transform its business remains to seen. But certainly there is an increasing trend among Asian companies, especially Chinese technology firms, to look for investments in Silicon Valley. They are building corporate VC arms that provide capital with the promise of strategic support in Asia. But is the local start-up community buying into it?

First steps

Tencent Holdings was the first Chinese tech firm to establish a beachhead in Silicon Valley in 2005. The company, which rose to prominence with an instant-messaging app QQ, wanted exposure to new technologies coming out of the US. This was a key factor in the creation of WeChat. Even though competition was less competitive back then, it still took Tencent almost five years to train up its staff and fine tune its investment strategy.

Another two Chinese tech giants, Baidu and Alibaba Group, have also formed their US investment teams. Alibaba arrived last year after its record-breaking IPO, although it took a short-cut to become familiar with the start-up landscape: the company hired the likes of ex-Liberty Media executive Michael Zeisser and Mike Katz, formerly of Battery Ventures.



Source: PitchBook

They have now been joined by second-tier Chinese tech firms including antivirus software developer Qihoo360, online retailer JD.com, and game developers Changyou and Sohu. Participation isn't restricted to internet players. Electronics manufacturers Huawei and Gome, as well as Chinese conglomerate Fosun Group, are setting up investment units in the valley.

A few have their own VC funds or are making commitments to funds managed by local GPs. For example, Qihoo360's venture investment group is led by Edward Tsai, who previously worked at DCM in Silicon Valley.

The rest of Asia is represented by a handful of South Korean and Japanese conglomerates. Then, last month, Taiwan's National Development Fund and Ministry of Science & Technology agreed to form $120 million VC fund that will invest in venture funds targeting Taiwan and Silicon Valley start-ups. However, Chinese groups remain the most active players, partly because they have more to offer in terms of value-add.

"The bigger purpose for these Chinese companies is to try and find some innovative products or businesses and create cooperation that could make them look different to their competitors at home. They have ample cash and this money needs to go out. That's why a lot of VC funds have been set up here," says Xiao Wang, CEO of the InnoSpring Seed Fund, a Sino-US technology-focused incubator.

Differing agendas

Every company has a different purpose when investing. Tencent initially it hoped to acquire North American client-based game studios that could deliver high-quality games – and therefore revenue – to its platforms, but it didn't really take-off. This specific remit meant that Tencent America passed on opportunities to invest in YouTube and Twitter, which didn't fit with the company's China operations.

In recent years, it has expanded into other content-generating categories, such as social communications, online music and movies. Unlike other Chinese tech firms, which usually come in at later stages, Tencent invests early, either directly or through local VC funds. It has accumulated a portfolio of nearly 80 seed investments so as not to miss out on the next big thing among US start-ups.

Alibaba's strategy is more concentrated. Some investments related to its ecosystem, such as a delivery service provider ShopRunner. Others, including a $280 million commitment to voice and video mobile app Tango and $200 million investment in social network Snapchat, are denounced as "nonsense" by industry participants because there is no link to Alibaba's current business. However, Snapchat and Tango seem to

be a direct push against Tencent's stranglehold on chat and cross-platform services.

Baidu, meanwhile, is forging ahead quietly, mainly building R&D centers in the valley. For JD.com and Qihoo360, the focus appears to be the internet-of-things.

"Many Chinese companies have built investment units in Silicon Valley. But few of them operate independently by making investments from their own funds. Often times the money comes from the company's balance sheet, carries a strategic mission, and the parent companies have influence on the investments," says Brad Bao, managing partner at Fosun Kinzon Capital.

In this respect, Fosun Kinzon Capital is different, which is part of a wider effort to transform the group to be a global investment firm. The $320 million early-stage venture fund, in which Fosun is the sole LP, only wants financial returns. Over the past two years, it has backed over 30 start-ups in both China and Silicon Valley.

China expansion?

American companies are also keen to find strategic partners that can support their expansion into China. They are familiar with the likes of Baidu, Alibaba and Tencent, but less so with the second-tier players.

"Everyone is talking to US start-ups about the China story, but how many of them are really be able to offer what they have promised? Only a few. That's the same story when a lot of US venture funds said to the Chinese start-ups that they can help the Chinese companies expand in the State but actually not many of them walk the words," Fosun's Bao says.

Most US start-ups still prefer to receive capital from the US venture capital firms because they focus on their domestic market in the early stages. Even if they gain traction at home, entering China represents a challenge due to the intensity of competition.

"I tell the US start-ups, 'If you are considering taking money from Baidu, Tencent or Alibaba, you're going to have limitations in terms of who you can work with in the China on products distribution or business partnerships," says Chris Evdemon, a Silicon Valley-based partner at China's Innovation Works. "You might even have enemies before you come in."

US-based VC investors understand what strategic investors can bring to portfolio companies with the scope to enter new markets. But at the same time, they may not grasp the level of competition in China's technology space, or how the different leading players behave.

Evdemon notes that these companies cleaned up a lot of potential domestic rivals after going public. He sees little chance of a US company achieving fast growth in China. A recent example is the battle between the domestic taxi-booking platforms, Didi Dache and Kuaidi Dache, which have now merged and are trying to squeeze out Uber.

At the same time, it is difficult for Chinese strategic investors to enter the US. As such, it seems fanciful that a company might complete a spree of bolt-on acquisition over the next three years and succeed in driving up its valuation. The US is more a market for minority investments through which to keep tabs on technology development and build up a track record in order to source the best deals in the future.

Expansion is the primary objective in emerging markets such as Southeast Asia, India and Africa, given the demographic and developmental similarities with China.

"I don't anticipate a wave of M&A by Chinese strategic investors in the US. Most US companies would prefer to sell to US buyers such as Amazon or Google because they understand them better. Sometimes Chinese strategic investors have to overpay if they want to acquire an US company," says Hans Tung, managing partner at GGV Capital. "But it could change in the next few years as groups become more familiar with each other and more comfortable about cooperating."

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Hedging bets in India

Everyone is trying to get of the piece of tech story in India and US hedge funds are not different, but what will their entry into the early stage rounds mean for the broader venture capital industry

THE ACQUISITION OF TAXIFORSURE BY rival Ola in March all but ended the battle for supremacy among India ride-sharing apps. The $200 million cash-plus-equity deal combined TaxiForSure's 15,000 taxis across 47 cities with Ola's 70,000 taxis and 30,000 auto rickshaws across 85 cities to form the country's largest provider. Its footprint is said to be 10 times that of nearest rival Uber India.

A key factor behind Ola's success has been its ability to secure a large chunk of the market early on and expand rapidly. This – plus the recent acquisition – has seen the company burn through a lot of cash. The capital feeding the fire was not only sourced from VCs but also from a growing group of less traditional early-stage investors: hedge funds.

Ola has received capital from a least four hedge funds and one sovereign wealth fund. Its most recent round, which came a month after the TaxiForSure acquisition, saw the company raise $400 million in a round led by DST Global at a valuation of $2.4 billion. Other investors included hedge funds Steadview Capital and Falcon Edge Capital, Tiger Global Management (which runs a combination of PE and hedge funds), and VC firm Accel Partners and Singapore state-backed fund GIC Private.

Ola is part of a broader trend that has seen hedge funds from both the US and Asia target opportunities in tech companies across the region, with India a particular hub of activity. What does the increasing presence of hedge funds in late-stage rounds say about the current state of venture capital?

The next big thing

Some largest VC rounds in India over the past two years have included hedge funds. E-commerce player Flipkart, for example, counts Steadview, Tiger Global and Greenoaks Capital among its investors. Tiger Global has backed e-commerce platform Shopclues and property portal Commonfloor among others. To understand stand what is happening in India today it is worth looking at what has also been happening in China's tech space.

Aashish Bhinde, executive director as Mumbai-based Avendus, which has advised on many of these rounds, notes that the hedge fund activity comes in the wake of a number of successful IPOs involving VC-backed tech companies in China. The prime example is Alibaba Group, which raised $25 billion last year, generating blockbuster returns for the likes of Silver Lake, which invested $500 million in 2011 and 2012.

"For many of these funds that invested in the China opportunity – specifically around Alibaba and Tencent Holdings – it has been a rollicking success, but it has also been a huge missed opportunity for those that didn't," says Bhinde. "I think that is when the momentum built up, with people asking: where is the next Alibaba going to be built? Where is next frontier?"

> "If you look at the money multiple around the success of these late private rounds, it has been much more satisfying than the money multiple on investments as they have gone public" – David York

The reason that hedge funds have started looking towards late-stage VC rounds is that tech start-ups in general are seeing far greater value accretion at the pre-IPO stage, while growth following listing has typically been modest by comparison. This phenomenon is often described in the context of US venture capital, though the same pattern is playing out globally.

"The public markets have become beta, while the private markets are becoming alpha," says David York, managing director and CEO of US venture capital-focused fund-of-funds Top Tier Capital Partners. "If you look at the money multiple around the success of these late private rounds, it has been much more satisfying than the money multiple on investments as they have gone public."

With the shift in emphasis from public market to private markets, many – including Top Tier's York – have compared many late stage VC rounds involving tech companies to a sort of "private IPO." Last month CB Insights, which tracks the early-stage venture capital globally, reported that so far this year private market fundraising as outstripped the public markets: US start-ups have raised $600 million though public offerings versus $20 billion through private offerings. In India the disparity is greater.

Ozi Amanat, founder of VC firm K2 Global, similarly describes a rise in larger private IPOs driven by hedge funds struggling to generate return in the public markets. "What they are doing is battling for turf space in the late-stage companies and it is a mixed bag as to who is getting access," says Amanat, whose firm focuses on pre-IPO rounds. "Traditionally, they are not the players who would be going into these companies. It's almost like you are having these mini-IPOs in the private market."

Cause for concern?

Inevitably some in the industry worry that these increasingly larger rounds are leading to unrealistic pricing. The concern is that hedge funds and other non-traditional private market investors have driven up valuations to unrealistic levels by piling into late stage rounds, as was seen in the dotcom era. Yet not everyone is convinced that the comparison is justified.

Top Tier's York, for example, notes that, especially in Asia, technology start-ups have far larger addressable markets than the companies of the dotcom era. "What is different this time round is that the businesses themselves are much bigger, much more profitable, and much more successful," he says.

Meanwhile, many observe that participation from hedge funds in later-stage deals is filling a gap in Indian venture capital. Vani Kola, managing director of Kalaari Capital, which counts furniture retail Urban Ladder – which raised $21 million from Steadview last year – among its portfolio companies, is of this view.

"Especially in India there is a gap in late-stage VC capital, and hedge funds can help bridge it," she says. "Secondly, I think they help bring maturity to start-ups as these kinds of investors have different expectations from the companies they back in terms of the information they must provide and reporting. As a kind of transitional venture capital, it is complementary."

Mind the gap

The fact that the US needs to improve much of its public infrastructure is undisputed. But the fragmented nature of the market and politicization of deals still leave private investors frustrated

US INFRASTRUCTURE INVESTMENT HAS a powerful advocate in Larry Fink, chairman and CEO of BlackRock. "Infrastructure in the US is dismal – whether it's crumbling roads, underfunded public transportation networks, or less visible things like power grids and sewer systems," he wrote last September before coming up with a shopping list of suggestions.

Fink wants cash-strapped local governments to partner with the private sector to get projects funded. He wants governments to aggregate assets in order to attract private investors. And he likes the idea of a federal infrastructure bank that would offer central leadership.

Despite the White House seeking to provide impetus with the Build America Investment Initiative, political risk – the fear that a tender issued by one administration will be withdrawn by the next – is the sector's most pressing problem. The US needs an infrastructure upgrade and investors, including Asian institutions building out their portfolios, like low-yield, long-term, cash-generative projects in developed markets. But they don't like uncertainty.

"Many investors want to diversify their holdings in North America and it is logical for them to be interested in US infrastructure, but the opportunity set is still quite skewed towards energy and utilities," says Kerry Ching, Asia managing director at AMP Capital. "Some telecom deals have come up in the last few years, and we think there will be more, but compared to a full-spectrum market like Australia, the US is still relatively confined to specific sectors."

Public problems

Energy appeals because public sector involvement is rare and it potentially offers higher returns than traditional core infrastructure. Global Infrastructure Partners' entire US portfolio comprises energy assets, while IFM Investors four out of five US projects are in energy and power. Nine of Brookfield Asset Management's 16 projects in the country are energy-related.

While praising the ethos behind the Build America program, one executive with a leading infrastructure player says that his objectives include developing partnerships with likeminded investors on deals. "Typically, those investments do not include governmental entities."

A US Department of Treasury report released last year emphasized the trying byproducts of underinvestment in public infrastructure: drivers annually spend 5.5 billion hours in traffic, resulting in $120 billion of losses in terms of fuel and time; businesses pay $27 billion in additional freight costs because of poor roads; and there as approximately 240,000 water main breaks per year due to deteriorating supply infrastructure.

At the same time, governments are directing less capital at these problems. Public spending on drinking and wastewater projects, for example, declined 23% between 2006 and 2013. The American Society of Civil Engineers estimates that the country's cumulative infrastructure needs will total $2.7 trillion by 2020, and public funding will cover only 60% of the cost.

> "The demand has always been there but dealing with political cycles and different levels of government is a problem"
>
> – Julio Garcia

Public-private partnerships (PPPs) have not achieved the same critical mass as in other developed markets, largely because local governments have been able to rely on the municipal bond market to finance infrastructure. With bond issuance declining in recent years and governments reducing commitments to infrastructure, there are calls for more innovative forms of funding. Adopting private market solutions, such as PPPs, is one option.

However, private investors have in the past struggled to secure privatizations of assets. The fragmentation of the market is one challenge – municipal and state authorities have the greatest say in how projects are allocated – and it exacerbates the other: political uncertainty. "There have been a couple of high-profile examples of bids going pretty late in the process and then cancelled. We see that less in some other jurisdictions," says Julio Garcia, head of North American infrastructure at IFM.

Andrew Garbutt, a principal at KPMG who advises on US infrastructure deals, points to the debacle over the $500 million Indianapolis city courthouse project that unfolded over the course of the last 18 months. He blames the decision by Mayor Greg Ballard not to seek a third term in office with removing impetus for the project.

"They took this deal right through to almost signing on the dotted line and it has basically died. Consortia have spent several million dollars in bid costs and an awful lot of time to get to that stage and it's just pure politics going against the project," Garbutt says. "It is buyer beware."

The courthouse was a greenfield project, but industry participants are united in the view that brownfield is the real problem. Although the private sector already accounts for a lot of US infrastructure, there is residual discomfort in privatizing assets and transactions can escalate into points of political contention. Privatizations therefore remain relatively rare and Garbutt says he often reminds sellers that it is not all about getting the highest price: money has to be left on the table for investors must sign off on certain pricing and service quality requirements in order to protect public users.

Hope in Indiana?

IFM's Garcia sees hope in the form of the Indiana Toll Road Concession Company. The asset was privatized in 2006 with more than 80% debt and went bankrupt last year. IFM acquired it in March for $5.7 billion – and with much lower leverage – bringing in a string of US pension funds as investors alongside other global institutions.

There is more investor interest in core infrastructure and US pension funds are no exception. Whether acting with fund managers or independently, these groups may be seen as more acceptable buyers and US infrastructure privatizations can deliver on their potential.

"That is where the industry is thinking things will go, it really depends on how quickly," says Garcia. "The demand has always been there but dealing with political cycles and different levels of government is a problem. Maybe it is easier to get comfortable about a bunch of local pension funds coming in and backing critical infrastructure than traditional private capital."

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The contrarian

Robert Petty, managing partner and co-founder at Clearwater Capital Partners, explains why a strong credit and special situations investment strategy in Asia often involves going against the grain

Q: What patterns have there been in your investment strategy in the last five years?

A: If you look at opportunity sets post-global financial crisis, we have consistently remained contrarian in Asia and the strategy continues to perform well for us. Two years ago I stood on stage at the AVCJ Forum and said India was an interesting market; that was a counter-cyclical, contrarian theme. We were doing well-underwritten, interesting deals at a time when no one wanted to do them in India and they have proved to be compelling investments, such as Jaiprakash Power and Suzlon. Volatility continues to be a dominant theme in Asia and that creates opportunities. Being contrarian across Asian economies, industry sectors and macro environments has generally allowed consistent, interesting valuation entry points, while creating steady portfolios and, equally interesting, exit opportunities into the volatile upswings of the markets.

Q: What has been the impact of slowing growth in China on investment opportunities?

A: While there is a slowdown in China, that has created greater opportunities for businesses that are still making money. A non-growth, stable business is actually a very good lending client and customer at a time when there are fewer lenders and banking institutions are more risk-adverse. In terms of amount of activity and dollars invested in China, our main focus has been on direct lending, with some offshore stressed situations. We participate in onshore direct lending investments, through our two China platforms and provide loans or structured investments that enable us to make investments offshore. For individual credit, we find both the onshore and offshore markets increasingly deep, diversified and growing.

> "Two years ago I stood on stage at the AVCJ Forum and said India was an interesting market; that was a counter-cyclical, contrarian theme"

Q: How much competition do you face from shadow banking?

A: What is shadow-banking? It's non-bank lending. If you are doing solid, well-underwritten transactions onshore then you are participating in non-bank lending, and it is useful for any economy. We are proudly doing this. A large percentage of the lending markets in the US and Europe – over 25% – is non-bank, which means getting capital to small and medium-sized enterprises and to parts of the economy the banks don't serve. The Chinese credit market is worth $20 trillion today and clearly direct lending will continue to develop as it has in the US and Europe.

Q: Do you invest in non-performing loans (NPLs)?

A: We can and do invest in NPLs but we've found it less opportunistic for us than investing in performing businesses generally. We find dealing with large businesses that are cash flow positive, can deliver a more stable and consistent return profile. Realizing 10 or 20 cents on the dollar through a legal court process is painful, and uncertain in terms of timeframe. We would much rather lend to the number five player in an industry that is having a weak quarter or year but still makes money.

Q: How does Clearwater's China strategy compare to India?

A: It is a very similar core underwriting thesis, there are similar structural enhancements, but very different cultural approaches. The two markets are 10 years different in scale and maturity. For example, property developers in China have a 10 million square meter development track record; whereas in India, you are large if you have executed 2 million sqm.

Q: You said that Clearwater has benefited from its contrarian approach to India. Can you give an example of this?

A: We are participating in the Suzlon Energy restructuring – it is one example of a market that has turned around, both the economy and the industry, during this period. Two years ago renewable energy businesses were in great difficulty. Under the Narendra Modi regime they received a reboot and these businesses are now profitable and fundamentally turned around. Suzlon has been fully restructured, sold a business in Europe for a $1 billion and its stock price has risen considerably.

Q: What sectors, throughout the region, are you most interested in at present?

A: We are looking at sectors that are facing cyclical challenges today, such as oil and oil services, and businesses in sectors that are facing difficulties, particularly those that are commodity-related. In Singapore we see opportunities in hard assets such as oil services and shipping related assets. It is more direct lending than stressed situations – real businesses with assets you can lend against that have gone through difficulties. In Australia we also like the opportunity set in mining services, and with the consolidation of core businesses we are focused on those companies who will be survivors. This cycle may or may not be different to the last one. Is the economic rebound globally going to be as fast as it was in 2009-2010 and is China going to be as strong a commodity swing factor as it was at that time? We are thoughtful that China may be a more steady-state consumer of coal than it was before.

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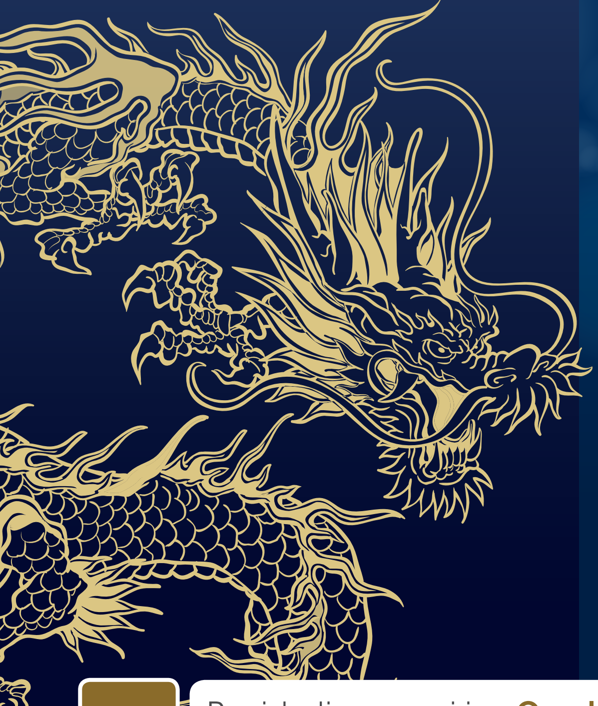

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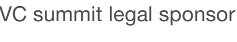

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