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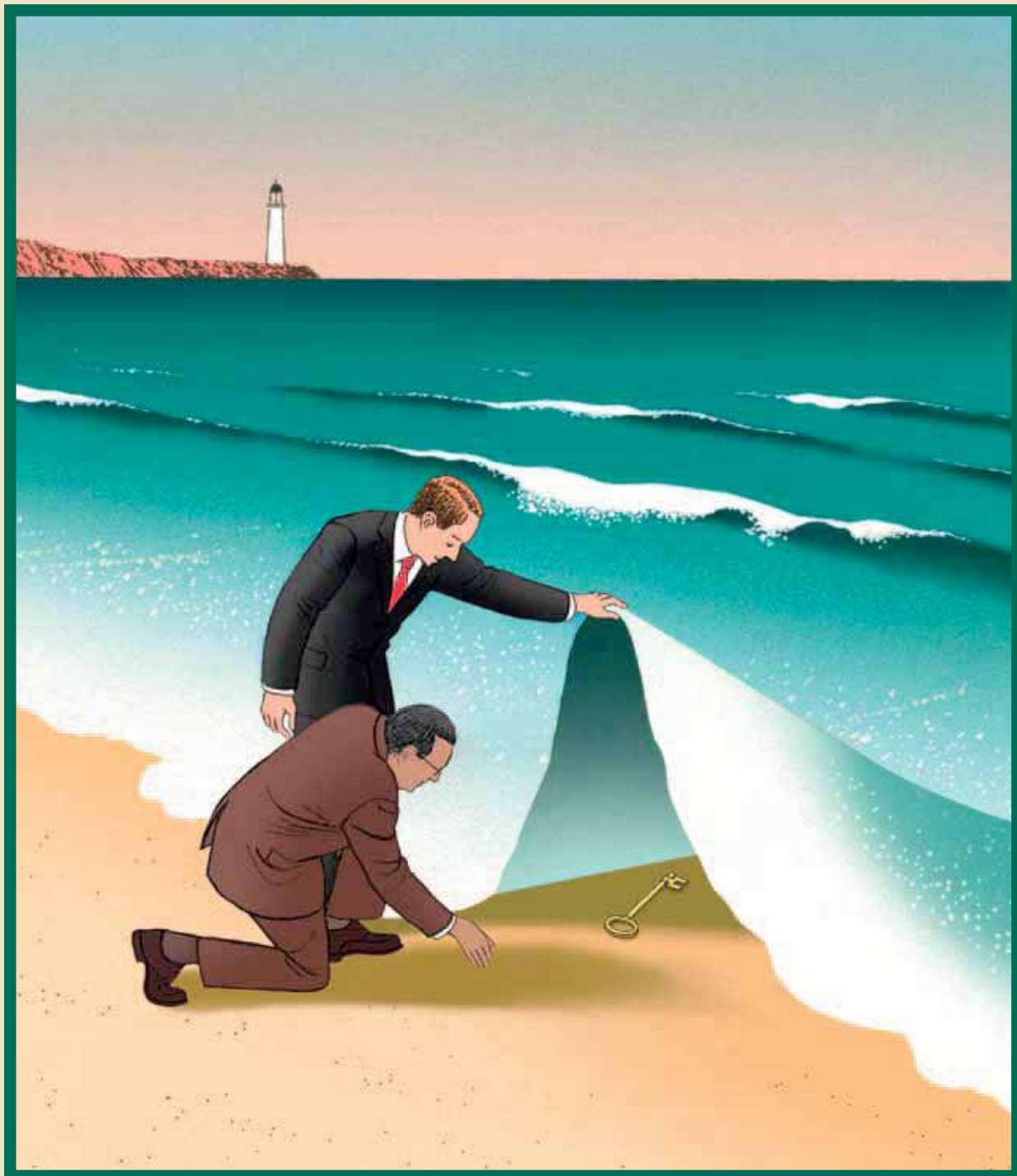
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Guarded optimism

TO MOST INDUSTRY PARTICIPANTS, 2015

feels like a relatively slow year for private equity in Asia. Perhaps it is the lack of drama-packed hostile takeovers or the comedown from the stellar exits of 2014 such as Alibaba Group IPO or the Oriental Brewery trade sale.

Certainly, the sluggish economies of many Asian countries, volatility in currency and equities markets, and lofty valuations have made many GPs less aggressive this year. According to AVCJ Research, deal volume is tracking down on last year, with just over 2,000 investments announced, compared to nearly 2,800 for 2014 as a whole.

That said, the amount of capital deployed is already on a par with last year (at \$92 billion), which means 2015 is all but certain to become the second most active 12-month period on record. The continued rise in total investment value can be attributed to a number of factors, which reflects some of the current trends in the Asian private equity and venture capital space. They include:

- 1) Big auctions are still happening. The \$6.4 billion acquisition of Homeplus – Tesco's South Korea operation – by an MBK Partners-led consortium and the \$6.3 billion purchase of GE Capital's Australia and New Zealand consumer lending business are the two largest private equity deals ever seen in Asia (and a major reason they the overall investment number is so high)
- 2) Sovereign wealth funds, pension funds and corporations are getting involved in private equity deals. Homeplus is once again a good example, with Canada Pension Plan

Investment Board (CPPIB), Temasek Holdings and the Public Sector Pension Investment Board all involved. CPPIB's contribution alone was worth \$534 million

- 3) The above comes in many different flavors, with a small but significant number of direct deals as well as co-investments
- 4) The rise of unicorns in Asia. Technology "start-ups" valued at over \$1 billion are a pretty common nowadays, with private equity firms, hedge funds and even mutual funds coming into increasingly large funding rounds. Didi Kuaidi, Flipkart and Coupang – representing China, India and South Korea, respectively – are just a few of the names able to attract large amounts of money.

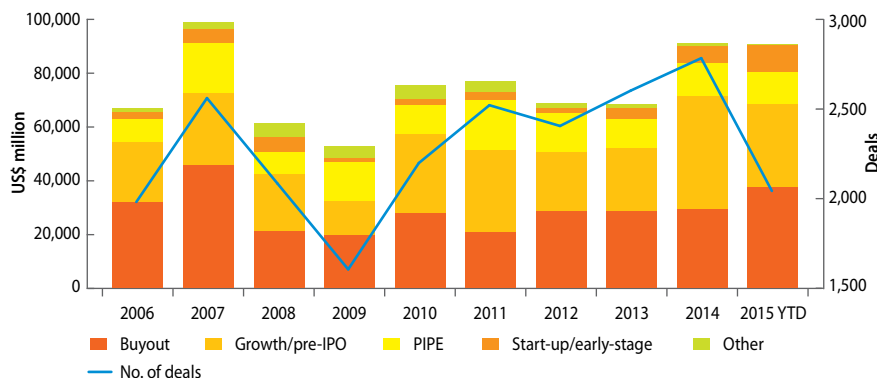
These are but a few reasons why the Asian private equity and venture capital industry is still active and playing a substantial role in the broader M&A market. Based on the amount of dry powder sitting on the sidelines, the potential for even greater involvement is huge.

However, it remains to be seen how quickly private equity investors that have held back choose to reengage. A continued decline in China's economic prospects, which would impact other markets as well, could create investment opportunities. But valuation remains largely a function of competition and the more groups pursuing a deal, the more it becomes a seller's market.

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Asia private equity investment by stage



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AUSTRALASIA

Apollo agrees partial exit from Nine

Apollo Global Management has agreed to sell a 13% stake in Australia's Nine Entertainment to regional broadcaster WIN Corp. A WIN subsidiary acquired approximately 119 million shares in Nine across several transactions, paying an aggregate A\$193 million (\$139 million).

Bridgeport Capital acquires Australia's UCS

Bridgeport Capital, the direct investment arm of Hawkesbridge Capital, has acquired Australia's Underground Cable Systems (UCS) in a deal worth approximately A\$100 million (\$73 million) alongside company management. UCS' businesses include the design, installation and cable jointing of underground electricity distribution networks.

GREATER CHINA

China travel sites Ctrip, Baidu, agree merger

China-based travel services companies Ctrip and Baidu-controlled Qunar have agreed an all-share merger that will create a single dominant player in the domestic hotel and air ticket booking market. The deal comes about four months after Qunar rejected an unsolicited buyout offer from Ctrip and then agreed a \$500 million strategic investment, of which \$330 million came from Silver Lake.

Taikang Life leads \$220m round for Womai

Taikang Life Insurance has led a \$220 million Series C round of funding for Womai.com, an online grocery shop under Chinese state-owned food conglomerate COFCO, valuing the company at approximately \$1 billion. Chinese search giant Baidu, Yunlong Capital and Yang Guang Ronghui Capital also participated.

Carlyle exits Natural Beauty via buyback

The Carlyle Group has exited in Natural Beauty Bio-Technology through a management buyback, prompting a group led by the founder and chairwoman to submit a takeover bid for the Hong Kong-listed business. The PE firm and the

GGV seeks \$1.1b for China, US venture deals

GGV Capital is planning to raise up to \$1.1 billion across three vehicles – a core venture fund, a top-up vehicle and an early-stage fund – that will target start-up and growth-stage technology deals in China and the US.

The GP has yet to release a private placement memorandum, but even in this soft marketing stage, LP interest is said to be very strong. The fundraising process is expected to be completed in the first quarter of 2016, although there is no



firm deadline, according to a source familiar with the situation.

GGV has set the hard cap for its sixth core fund at \$600 million, with a further \$200 million targeted for a parallel top-up vehicle, and \$300 million for the early-stage fund. This is broadly comparable to the approach to Fund V, although the core and top-up vehicles were raised separately.

Fund V closed in April 2014 at \$620 million, comprising an institutional tranche of \$600 million plus an entrepreneurs fund that included contributions from the GP and business associates. GGV Capital Select, a top-up fund of \$457 million dedicated exclusively to follow-on investments in portfolio companies from Funds IV and V, closed in May of this year.

family owner together paid HK\$819.8 million (\$105.8 million) for a 65.53% stake. The family has now acquired Carlyle's 50% interest for HK\$565.6 million.

LeTV buys control in VC-backed Yongche

Chinese media company LeTV Holdings has acquired 70% in Yongche.com, facilitating an exit for existing shareholders in the car rental and taxi-booking app. VC and PE investors in the company include Zhenfund, Morningside Technologies, Qualcomm Ventures, China Broadband Capital, DCM and GIC Private.

Philips uncertain over Lumileds sale to Go Scale

Philips has cast doubt on the sale of its LED unit to a Chinese PE consortium as it emerged that the Committee on Foreign Investment in the United States (CFIUS) has "expressed certain unforeseen concerns" about the deal. Go Scale Capital, which is sponsored by VC firms GSR Ventures and Oak Investment Partners, agreed to buy an 81.1% stake in the Lumileds unit in April.

CMC, Merlin Entertainment agree Legoland JV

CMC Capital Partners has agreed to form a joint venture with London-based Merlin Entertainments Group to develop a Legoland park in Shanghai. The Legoland Discovery Center is among three attractions that Merlin and CMC plan to open in the next 18 months. They also have built a Madame Tussauds and Sea Life aquarium in Chongqing.

Car servicing platform Tuhu raises further \$50m

Tuhu, a Chinese B2C auto services platform, has raised \$50 million in an extended Series C round of funding led by Hillhouse Capital. A fund managed by China International Capital Corp, Greenwood Asset Management, Hong Kong-listed leasing business Far East Horizon and Qiming Venture Partners also participated.

PE firms exit US oil assets to property developer

Chinese real estate developer Yantai Xinchao Industry has acquired two oil assets in West Texas backed by US-based private equity firms ArcLight Capital Partners and Denham Capital. The deal values the assets at RMB8.3 billion (\$1.3 billion).

Google invests in VC-backed start-up Mobvoi

Google has agreed to buy a significant minority stake in Mobvoi, a Chinese voice-activated mobile search services provider, as part of a \$75 million Series C round of funding. Mobvoi's best known product is Chumen Wenwen, which offers searches covering catering, group-buying, navigation, weather, tourism and public transport via WeChat and an Android app.

PE-backed drug developer files for US IPO

BeiGene, a Chinese company backed by the likes

of Hillhouse Capital and CITIC Private Equity that develops drugs to treat cancer, has filed for an IPO in the US. The company has four clinical-stage drug candidates.

NORTH ASIA

CITIC Capital buys Japan footwear brand

CITIC Capital Partners has acquired Japanese footwear company Akakura for an undisclosed sum. Akakura produces and sells women's footwear through a network of directly-owned stores nationwide. The PE firm is planning a revitalization of the company, which will involve operational improvements and supporting expansion.

Reorient sells stake in Korean GP EQ Partners

Korean Investment Holdings has agreed to buy Hong Kong-listed financial services Reorient Group's stake in Seoul-based private equity firm EQ Partners for \$6.6 million in cash. EQ spun out from Korea Investment Holdings in 2010 and Reorient bought a one third stake in the business two years ago for

SOUTH ASIA

General Atlantic buys stake in IIFL Wealth

General Atlantic has agreed to pay up to INR11.2 billion (\$173 million) for a minority interest in IIFL Wealth Management (IIFLW), a subsidiary of IIFL Holdings, the Indian financial services group formerly known as India Infoline. The investor is expected to end up with a 21.61% stake.

PE-backed Coffee Day to raise \$177m in IPO

Indian coffee shop and restaurant chain Cafe Coffee Day has fixed a price for its upcoming IPO that will put the offering on course to meet its target of INR11.5 billion (\$177 million). PE backers KKR, New Silk Route Partners (NSR) and Standard Chartered Private Equity (SCPE) set to retain their stakes.

GIC to buy renewable energy platform Greenko

Singapore's GIC Private has agreed to acquire Greenko, an India-focused renewable energy

PE investors set for part-exits from Viom

IDFC Alternatives and Macquarie SBI Infrastructure Management will make partial exits from India-based Viom Networks as American Tower Corporation (ATC) buys a 51% stake in the telecom tower business.

ATC will pay INR76 billion (\$1.17 billion) in cash for Viom, which was formed through a merger between Quippo and Tata Teleservices' telecom tower division in 2009. As part of the agreement, the US-listed company may acquire or be required to acquire the outstanding 49% in Viom.

Macquarie SBI and IDFC Private Equity Fund III will retain certain interests in the company,



as will Tata Teleservices and SREI Infrastructure Finance. SREI is a listed entity controlled by the Kanoria Foundation; Kanoria Group is the current managing shareholder of Viom. SREI and other Kanoria block shareholders will sell their entire stake to ATC for \$452 million, according to a separate filing.

Viom currently owns and operates approximately 42,200 wireless communication towers and 200 indoor distributed antenna systems across Asia. ATC's existing India portfolio of approximately 14,000 towers will be merged with that of Viom.

developer that has previously received funding from the likes of TPG Capital and EIG Global Energy Partners. It will pay approximately GBP162.8 million (\$252 million) for all of the assets held by AIM-listed Greenko.

OrbiMed leads \$50m round for Netmeds

Healthcare focused investment firm OrbiMed has led a \$50 million round of funding for Indian online drug marketplace Netmeds. Previous investor MAPE Advisory Group also participated in the round, along with the family investment fund of Netmeds CEO and founder Pradeep

Dadha. Netmeds offers both prescription drugs and over-the-counter products through its mobile app.

PE-backed SSIPL files for domestic listing

SSIPL Retail, a footwear manufacturer and retailer based in India, has filed for an IPO, providing an exit for PE investor Tano Capital. The company hopes to raise up to INR720 million (\$11 million) through the issue of an undisclosed number of shares plus Tano's entire stake.

I Squared buys asset from Madhucon

Cube Highways & Infrastructure, the India toll road and transportation investment platform of I Squared Capital, has bought an Indian toll road from developer Madhucon Infra. The firm will pay INR2.48 billion (\$37 million) for 100% of Madhucon Agra-Jaipur Expressways, which manages a 57-kilometer stretch of the NH-11 road connecting Mahua and Bharatpur in the state of Rajasthan.

PremjiInvest commits \$33m to India's HRI

PremjiInvest, the private investment firm for Wipro Enterprises Chairman Azim Premji, has invested INR2.16 billion (\$33 million) in cosmetics developer Hygienic Research Institute (HRI). The company will use the funds to invest in automation of its factories and upgrade its IT systems, in addition to R&D.

Tiger, Flipkart lead \$7.7m round for Cube26

Tiger Global and Flipkart have led a INR500 million (\$7.7 million) seed round for Cube26, an India-based developer of gesture control technology for smart phones. It is the first round of institutional funding for Cube26, which has been bootstrapped to this point.

SOUTHEAST ASIA

Formation 8 backs grocery delivery service

US-based VC firm Formation 8 has led a \$15 million Series A round for Singapore on-demand grocery delivery start-up Honestbee. The firm employs part-time shoppers at affiliated grocery stores to fulfill customers' online orders and drivers to deliver the purchased goods.



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Friends with benefits

Co-investment is becoming more sophisticated as managers sharpen fundraising strategies and respond to the needs of large investors. It points to an increasingly customized and complicated GP-LP relationship

THE PURSUIT OF CLEANING AND CATERING

contractor Spotless Group by Pacific Equity Partners (PEP) took upwards of six months. The Australian company's board resisted a series of approaches by the PE firm until, under pressure from major shareholders, in April 2012 it endorsed a bid that valued the business at around A\$1.1 billion (then \$1 billion).

PEP did not act alone. While the bulk of the equity came from the firm's fourth fund, there were further commitments from a parallel co-investment vehicle and additional co-investment from the market. Spotless swiftly introduced a value creation plan intended to improve earnings. Non-core assets were offloaded, overheads were reduced and productivity improved, and the business was repositioned to better engage with customers. By the time it re-listed in May 2014, EBITDA was up 78%.

Investors had already taken out some cash via a refinancing and further proceeds came through a partial exit at IPO and then three block trades, the last of which was completed in August 2015. The investment generated a multiple of 2.4x and an IRR of 55%. PEP is hoping for more of the same in its fifth fund, which closed earlier this year. However, the way in which co-investors participate will be different.

The PE firm's previous three funds were two thirds core equity and one third supplemental, with the latter used as top-up capital for deals above a certain size. Both tranches charged carried interest of 20%, but while the management fee for the main fund was 2%, the supplemental vehicle took a 1% fee on drawn down capital only. Every LP in the main fund had pro rata exposure to the supplemental vehicle.

For Fund V, the dual tranche approach has been modified, with a select subset of prequalified LPs now able to participate in co-investment on a discretionary basis with zero fees.

"The previous model worked well for us, but it became clear there was increasing segmentation in the market between investors who valued co-investment greatly and those that were not as able to participate in it," says Tim Sims, managing director at PEP. "The pricing had also changed for co-investment, with the more sophisticated investors wanting to participate at no or low fee level."

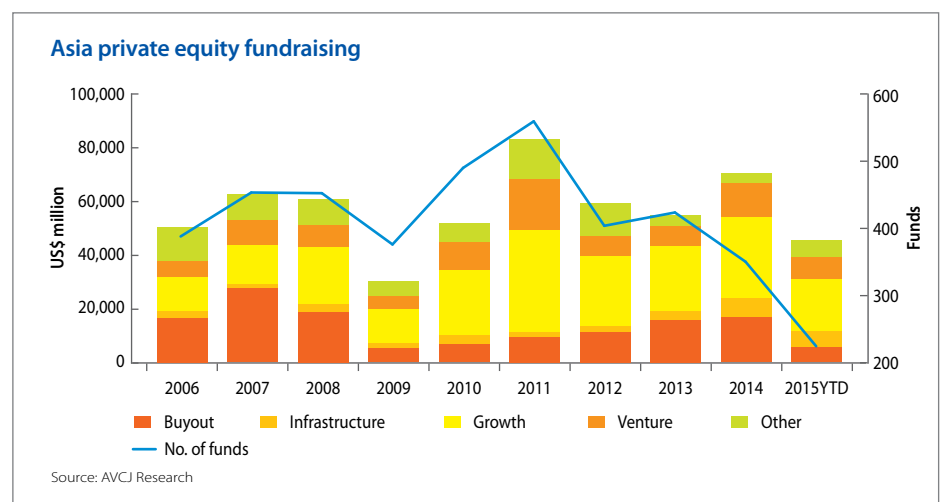
Under the new model, PEP is still able to flex

up from the classic Australian upper middle market deal to target businesses with enterprise values of A\$1 billion. But it functions most effectively with pre-qualified co-investors that have the experience and resources to respond to opportunities within a set timeframe.

This increasingly customized approach to co-investment is not unique to PEP. Various industry participants say they are seeing a shift away from dedicated vehicles to bespoke arrangements. It is not only a reflection of the differing levels of importance LPs attach to co-investment but also,

be closing in three months time, let us know what number you want and you may or may not get it, that is an entirely different dynamic."

This state of affairs also contributes to an ongoing bifurcation in fund size. A total of \$45.7 billion has been raised for Asia-focused private equity funds so far this year, tracking below the 2014 level but roughly on par with each of the two years before that. A consistent trend is that this capital is going to an ever smaller number of managers. A select few of these managers are raising ever larger funds.



on a broader level, an acknowledgement that not all investors are created equal. In a competitive fundraising environment, groups that are willing to come in big and come in early have increasing scope to dictate their own terms.

Haves and have-nots

Private equity fundraising in Asia follows the 80-20 rule: 20% of managers have no problem attracting capital, their vehicles come in oversubscribed, and LPs are term takers rather than term setters; the remaining 80% find the going tougher, and flexibility in terms and conditions becomes a means of attracting LP commitments.

"With funds that have a normal fundraising track you can play around with the LPA [limited partnership agreement] and negotiate," adds Wen Tan, a partner at Aberdeen Asset Management. "The ones that say, 'We are fundraising and we'll

"There has been a bit of a shakeout in the middle market," says Nicole Musicco, head of Asia Pacific at Ontario Teachers' Pension Plan (OTPP). "There are groups that hoped this time around they would be able to raise capital and they're having a tough time. And the bigger guys seem to be able to continue raising capital, assuming they have good track records."

Track record is generally the most important ingredient of a fundraise, but it is not the only one. Doug Coulter, partner at LGT Capital Partners, emphasizes the importance of a "narrative that hangs together" – a clear and compelling story that expresses the market opportunity and how a particular GP is positioned to capture it.

This corresponds to the experience of a manager who closed a fund earlier this year. The team's pitch was based on a differentiated story, a credible track record, and a strategy and skill sets that are relevant to the Asian PE landscape. For all

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the supporting documentation provided to aid due diligence, one LP had seven meetings but didn't commit, while another was happy enough to come in as the first investor after just one lunch, having got comfortable with the story and the dynamics of the team.

Comfort is key, particularly for US and European LPs with investment committees that do not necessarily have a strong grasp of Asia. Like many institutional investors, Andy Hayes, private equity investment officer at Oregon State Treasury, considers whether opportunities are additive to the portfolio in terms of diversification and returns, but there is also a somewhat holistic angle.

"It's a question of how they see us as partners," he explains. "Do we believe that if something goes wrong we can sit down with them and figure out how to go forward? That is something not all GPs in Asia understand but it is important to US LPs. It is all about trust and without that trust you don't even start."

Getting comfortable

In this context, negotiations over terms and conditions not only establish how an LP can hold a manager to account during the life of a fund, but also offer insights as to how the GP-LP relationship would function. Governance rights are a priority for many LPs, particularly what action can be taken – GP removal, key person events, no fault divorce clauses, and so on – should a manager fall short on its fiduciary responsibilities.

Fees are another consideration. While fund managers and advisors suggest the 2% management fee, 20% carried interest structure is not in imminent danger, discounts are available to those who commit a substantial sum to a fund or offer early support to a GP working towards a first close. Promises of co-investment perform a similar role.

"Some funds have a parallel non-discretionary co-investment vehicle that is there for fee reduction purposes," says Niklas Amundsson, managing director at Monument Group. "You put in \$100 million and \$50 million goes into the master fund at 2/20, and \$50 million in the co-investment vehicle, which is no fee and no carry. On a blended basis you get 1/10."

In its annual survey of fund terms in Asia, Aberdeen Asset Management found that approximately 40% of GPs have a tiered model, with LPs qualifying for preferential rights on co-investment if they commit over a certain amount or come in at the first close. A further 40% or so have a pro rata policy with co-investment shared out equally, and the rest have no specific guidelines.

Oregon State Treasury and OTPP both make

Fees: Marginal movement

Guy Hands, founder and chairman of Terra Firma, announced earlier this year that his next fund would not charge fees on uncommitted capital. "This means there will be no pressure from investors. We can take our time and deploy capital in an opportunistic way," he told AVCJ.

There are said to be GPs in Asia considering a similar approach, but the trend has yet to take hold. Indeed, while some LPs push for fee breaks in return for making early or substantial fund commitments, industry participants say the 2% management fee, 20% carried interest model is more or less intact.

"The downward pressure has largely been driven by LPs' view that managers shouldn't make profits on management fees," says Chris Churl-Min Lee, an associate at Cleary Gottlieb. "If a smaller manager goes out to raise a larger successor fund with essentially the same team, LPs might push for lower fee rates or one or more step-downs in the fee rate above certain fund size thresholds."

The 2/20 model is described many as "a good starting point" for negotiations. Anything over \$1 billion and it becomes difficult to defend 2%; below \$1 billion and there is less push back. Several LPs express discomfort at the notion of extracting discounts from smaller managers that might be struggling to get traction on a fundraise, although the practice is not unknown.

"We've done around 50 first-time institutional funds and there are situations where terms are untenable," says Chris Lerner, a partner with placement agent Eaton Partners. "If you are trying to build a business and you have an operating budget for that and you are being squeezed to take a discount it becomes difficult to run the business. The GP and advisor must have a good idea of what the operating budget is and then what fund size and fee string they need."

For some investors, the ideal scenario is using an operating budget, not 2%, as the starting point. "The GP presents a budget to the advisory board and then they back into a management fee based upon that," says Doug Coulter, a partner at LGT Capital Partners. "It's a transparent process, and in the cases I've seen, it tends to be less than 2%."

There is also variety in the hybrid structures that are emerging in Asia. If a GP wants to build up its track record and with a view to raising a traditional blind pool fund in the future, it might line up several deals and invite LPs to participate in a shorter-term structure. There are examples of fee breaks beyond the standard 25 basis points and even GPs charging no fees at all.

However, with zero-fee co-investment increasingly used to ease the financial burden on LPs, the focus is more on other charges. With the US Securities & Exchange Commission honing in on PE firms' approach to monitoring fees and board fees levied on portfolio companies, the real pressure is on management fee offsets.

"Some of that historically has gone straight into the GPs' pockets, but over the years it has shifted in favor of LPs," says Wen Tan, a partner at Aberdeen Asset Management. "The proportion of funds in Asia with a 100% management fee offset has increased from 48% in 2009 to 84% this year."

commitments of sufficient size to funds that they might be expected to receive some kind of special treatment. However, the importance they attach to co-investment differs hugely.

All of Oregon's co-investment activities are outsourced to a joint venture platform with Washington State Investment Board. In Hayes' view, this approach brings clarity to the decision-making process: there is no danger of backing "a B-minus GP that could deliver a lot of co-investment."

Musicco, meanwhile, describes co-investment as part of OTPP's DNA. The pension plan insists on participating as a co-underwriter in deals, working with the GP from day one and playing a role in the value-add process. It wants to write checks of \$150-250 million per fund and seeks co-investments of at least \$75 million.

This means that certain managers are too small for its remit, but the co-investment angle also imposes pressure at the upper end of the scale. There is a wariness of funds in Asia raising in excess of \$3 billion and the sweet spot is seen as \$1-2 billion, with the expectation of putting meaningful co-investment capital to work in a few larger deals. "If a GP needs to fill a \$200-300 million equity hole – which would be rare – our hope is they put in \$200 million and we put in \$100 million," Musicco says.

It is possible that a GP might up with an LP base comprising: large but passive US pension funds; Canadian pension plans and sovereign wealth funds that actively lobby for co-investment; fund-of-funds that write smaller checks but are looking to fuel their own co-investment programs; and any number of smaller

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players that might value the chance to increase their exposure to a particular deal.

Read the small print

Distributing these opportunities – and factoring in considerations such as size and timeliness of commitment, the longevity of the GP-LP relationship, and strategic objectives like rebalancing the LP base – is a complex process. PEP and others are jettisoning the pro rata model in favor of a zero-fee approach designed for a more select group of co-investors, but they may resist making specific promises.

“During a fundraise, a significant number of investors are likely to request co-investment rights in their side letters, and larger investors often push for priority co-investment rights” says Chris Churl-Min Lee, an associate at Cleary Gottlieb. “In general, GPs try to avoid making firm commitments to provide these rights. They prefer to retain flexibility over the allocation of co-investment opportunities for each deal.”

There are numerous reasons for this. For example, the GP has to take into account the individual capabilities of its LPs. If a deal is moving quickly and co-investors need to complete their due diligence within a limited timeframe, it is impractical to bring in LPs that are known for having very lengthy approval processes. PEP’s Sims notes that co-underwriters are particularly useful in public-to-private transactions where the GP must show it can provide funding.

In other situations, a certain LP might be targeted because it can add value to a deal. This is where a group like OTTP would want to involve its in-house sector specialists; indeed, the way in which these teams can complement a GP’s resources and strategy is included in the criteria for assessing fund commitments.

Second, concessions on co-investment may conflict with pre-existing “most favored nation” (MFN) agreements a GP has with other investors in the fund. Even if an LPA says that the GP has full discretion to distribute co-investment opportunities should they arise, larger LPs have been known to ask for side letters that give them preferential rights, in terms of first-look or percentage allocation. However, by entering into such an arrangement, the rights of other groups might be violated.

“You might see under-the-table deals between GPs and LPs along the lines of, ‘I am not going to put it in writing that I will give you preferential rights but we are business partners and we will take your needs into consideration,’” says Lorna Chen, a partner at Shearman & Sterling. “So rather than a side letter, there is an understanding between the GP and certain large LPs.”

However, there are still plenty of anecdotal

examples of LPs refusing to invest because they feel the terms granted to other groups are untenable, and GPs with unwieldy LPAs that require co-investments to be shown to every single fund investor. As with other terms and conditions, the level of flexibility comes back to how badly a private equity firm needs the money.

“If you are struggling to raise \$400 million and someone offers \$80 million but they want first-in-line co-invest, what do you say? That you have to keep it open?” asks Andrew Ostrognai, a partner at Debevoise & Plimpton. “So you give them first-in-line rights and that virtually assures you won’t get the second \$80 million check from an investor that likely wants to co-invest, because that investor won’t take second-in-line. But what is worse – not getting the second \$80 million or getting nothing? At a certain point you take the leap.”

Just as there is an element of cyclicity to private equity fundraising that influences

(CPPIB) \$534 million contribution to the MBK Partners-led \$6.4 billion acquisition of South Korean retailer Homeplus is extraordinarily large by regional standards. Indeed, CPPIB previously reduced its minimum check size for co-investments in Asia from \$50 million to \$35 million in order to capture more deal flow. But as economies mature, and more control deals become available in emerging markets, large-cap transactions should proliferate, albeit gradually.

The big get bigger

The more capital these investors want to deploy, the greater their demand for customized solutions from GP partners. Fund formation lawyers are already seeing a rise in separate accounts that exist alongside but independent of traditional co-mingled funds. For these vehicles, terms and conditions are subject to a completely open-ended negotiation. “There is no one-size-fits-all answer,” says Debevoise’s Ostrognai. “It is

“If you are struggling to raise \$400 million and someone offers \$80 million but they want first-in-line co-invest, what do you say? That you have to keep it open?”

– Andrew Ostrognai

how much GPs must concede on terms and conditions, some LPs are likely to reconsider their position on co-investment.

A number of groups led the way, building teams able to evaluate and execute transactions, and others have followed, regardless of the fact they aren’t properly set up to do co-investments. Those that rush into every single opportunity presented to them without conducting proper due diligence are likely to run into trouble. They may ultimately conclude that the risks outweigh the returns.

“It takes some time – you can’t just look at 1-2 years of results – but in the medium term your co-investment returns have to be better than your fund returns,” says LGT’s Coulter. “If a new CIO comes in, asks why the co-investment results are worse than the fund results, and the answer is because you’ve just been doing top-down box-checking work, he is likely to say, ‘We are either going to build up a proper co-investment team or we will stop doing it.’”

But even if only a small portion of those under-resourced LPs start taking co-investment seriously, there will likely still be increasing amounts of capital available from the big players. One reason for this is the expectation of more deal flow out of Asia.

Canada Pension Plan Investment Board’s

not a question of what other LPs are getting; there are no other LPs.”

Nevertheless, a separate account could have an impact on co-investment opportunities available to LPs in funds run by the same manager. It makes the web of agreements around preferential rights and fiduciary responsibility all the more complex.

This change may only be happening at the margins but it points to a fraying in the traditional GP-LP relationship and the terms that bind it. If the industry is to become increasingly customized, for sophisticated investors making large commitments or for groups that want special treatment in return for taking a risk on an emerging manager, the onus falls on the GP to manage the process. It is then a question of internal resources and what the leaderships and back office can accommodate.

“You want to keep it simply MFN, you want to keep straight,” says Mark Chiba, group chairman and partner of The Longreach Group, a Japan and North Asia-focused PE firm. “You don’t want 20 LPs with 15 different economic relationships because people choose different packages. At the end of the day, you are trying to take their capital and multiply it – that should be the basic objective. If you make terms too complex or heterogeneous they just become a distraction. ▀



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Co-investment is a key tenet of the private equity strategy at Ontario Teachers' Pension Plan. Nicole Musicco, managing director and head of Asia Pacific, explains how the group likes to participate

Q: What do you look for from potential portfolio GPs in Asia?

A: If you look at our developed markets portfolio, the funds tend to be \$1-3 billion size and sector-focused. We can take our internal team and be another smart set of eyes for the GP, and that has worked well. So in Asia Pacific a big piece of it is who the partner is, the types of deals they are going to do, and whether our expertise overlaps nicely with theirs. If all we are is just another LP with a big check book then we are unlikely to see co-investment. We look at who the other LPs are and whether we offer a differentiated solution because we have expertise in the sector or because the style of investing requires an LP that can be more agile and innovative. If the GP is looking to be a bit more creative about structure, maybe about how long they hold the asset for, we can play a larger role.

Q: What is the optimal fund size for you in Asia?

A: When we first came out here in a larger way in the early 2000s, we were either carving out teams from larger groups of setting people up in new shops. The funds tended to be under \$1 billion because that is what the market could handle. Fast forward to the next era and the funds were in the \$1-3 billion range, and we were comfortable with that. Now when we see funds raising above that it makes us nervous because we know there is lots of dry powder sitting on the sidelines – not only with traditional GPs but with sovereign wealth funds and groups like us. That tends to lead us in the direction of funds

raising \$1-2 billion where there average check size is going to be \$150-250 million and we think we can provide a co-investment solution that is meaningful enough in size. If a GP needs to fill a \$200-300 million equity hole – which would be rare – our hope is they put in \$200 million and we put in \$100 million.

Q: How small a check could you cut for a co-investment?

A: We have tried to stay at a minimum of \$75 million. In the context of a \$20 billion private equity portfolio and a very small team in this region we are cognizant of that return effort. In this market specifically, where there are probably more platform-play investments, we definitely see a scenario in which we write a smaller check today knowing that we would be adding more capital over time. Maybe you start with \$50 million and grow that to \$100 million or \$200 million.

Q: And OTPP has to be a co-underwriter in a deal, there is no interest in downstream syndication...

A: In 2006-2008 we participated in some syndicated deals and we weren't happy with the results. There was a pretty clear connection between returns and being at the table, using our own eyeballs and our own insights, versus just writing a check. One of the reasons we sent a team out here was to establish relationships with local partners – and those partners could be anything from an entrepreneur or family through to a very local GP or sovereign. Our strong preference is to work with GPs we have on hand. If we aren't

working with a GP we like to work with a local partner that we have got to know over time.

Q: What happens if you have co-investment opportunities with two different GPs that are bidding for the same asset?

A: We often get calls from one



If all we are is just another LP with a big check book then we are unlikely to see co-investment

or two groups so we are extremely diligent about not putting ourselves in an awkward position. When we get a call from one group we refrain from taking calls from others. We don't always win but it's more important to us to maintain that trust with our partner than to switch horses. If it's a large deal we like to know it's coming to market and so in most cases we have already done our homework so if and when the call comes we know who we think is best positioned to win,

who has the most expertise, and who would need us as a co-investor. When you go through that framework you would be surprised how quickly it makes our life easy.

Q: You said OTPP is interested in GPs that are looking to be a bit more creative about structure. To what extent do you see that creativity in Asia?

A: We are starting to see more variety. A lot of investments that were underwritten as 3-5 year deals haven't necessarily been exited and our message to our GPs is maintain discipline and make sure you are getting value creation done. Don't just look for a quick exit because we need the capital back. LPs are becoming more sophisticated in making sure we set our GPs up for success. There is dialogue at the LP advisory committee level as to whether there is value to be had if we are a bit more patient. In other instances we find a way to work with the GP, help them get a realization at a valuation that makes sense, and then together with other LPs that are interested, take the company to the next stage.

Q: Do you expect more LPs to build in-house teams in the region so they can do things like this?

A: If you have the right governance and compensation systems in place, it comes back to having the autonomy and agility to get deals done. Without a combination of those three things it's really hard to have the 20-year record we have in private equity. I think more groups will build in-house teams but it is not an overnight exercise. ■

The billion-dollar club

Asia accounts for one fifth of the global tech sector's unicorn population as companies raise larger rounds at ever higher valuations. But as investor sentiment weakens, some of these behemoths should be concerned

DON'T FANCY COOKING? SHAOFANFAN

will send a chef to your home who will serve up a meal for you. This was how the Chinese online-to-offline (O2O) start-up positioned itself when opening for business last year. Within a few months, the company claimed to have more than 200,000 users and over seven million chefs registered on its platform. IDG Capital Partners and Shunwei Capital Partners duly invested.

Last week Shaoanfan closed down. "After 11 months, regrettably we haven't figured out a sustainable business model," Zhijian Zhang, the company's founder, said in a WeChat message to users. "We tried to separate ourselves from all the craziness in the industry over internet-plus and O2O, and focus on what we really wanted to do. But the private chef model is just so inefficient."

One of several private chef platforms to receive VC backing, Shaoanfan failed to gain traction in a competitive market despite altering its strategy several times, one investor says.

A few weeks earlier, Meituan, a leading O2O services player with five years of history and millions in private funding behind it, experienced its own wobble. The company approached investors about raising more capital at a higher valuation but the response was lukewarm. This triggered a flurry of negotiations and Meituan announced a merger with rival platform Dianping, in the expectation that investors will look more favorably on an outright market leader.

Two companies of contrasting size and two very different outcomes, but a common driving factor: weaker sentiment in the tech space in China, and every chance that it will spread to India and Southeast Asia as well. For the unicorns in these markets – companies like Meituan that have valuations of \$1 billion or more – once solid

prospects now appear less certain. Investors are beginning to ask when, and how, they are going to get their money back.

"The VC market has cooled compared to earlier in the year. Some later-stage financing is taking longer and some companies are adjusting their valuations," says James Mi, co-founder at Lightspeed China. "Companies that are consuming a lot of money are under much more

services, e-commerce, financial technology and hardware. China has 21 unicorns and at least one representative in each category, while India has seven, mostly in e-commerce and O2O services. South Korea and Southeast Asia have two unicorns apiece.

The e-commerce space is packed with companies looking to emulate the success of China's Alibaba Group and JD.com, both of which

"There have been several 'private IPO' financing rounds by large mutual funds and hedge funds, but that does not necessarily solve the problem for venture capitalists"

– Jessica Archibald

pressure. Instead of burning cash, they need to figure out how to grow their businesses on a limited capital basis."

Myth to reality

The term of unicorn emerged in the US about three years ago. They were a rare species to begin with but have grown in number as companies in the past 18 months. According to CB Insights data, there are currently 140 unicorns globally with a total accumulative valuation of \$506 million, although given the nature of private markets this could be a low estimate.

Asia is home to 32 unicorns worth a combined \$132 billion, having raised more than \$18 billion. Chinese smart phone brand Xiaomi leads the way, occupying second place in the global rankings with a purported worth of \$46 billion, just behind Uber on \$51 billion. These companies are largely concentrated in O2O

went public in the US last year. India's Flipkart and Snapdeal and South Korea's Coupang sit near the top of the valuation rankings. Ride-hailing platforms are represented by Didi Kuaidi, Ola and GrabTaxi, from China, India and Southeast Asia, respectively, while China alone boasts several lifestyle-oriented local services unicorns, led by Meituan and Dianping (their merger is pending).

Sectors such as healthcare and financial technology – rich unicorn territory in the US – are also getting traction in China. Ant Financial, Alibaba's online finance affiliate, is said to be valued at more than \$40 billion, although it is missing from the CB Insights rankings. There are places for peer-to-peer (P2P) lending platform Lufax and healthcare information portal Guahao.

These valuations are more about projection than reality: investors calculate an expected market size for a particular vertical and attribute valuations to companies based on their market



Asia's unicorns

There are 140 tech start-ups globally currently valued at \$1 billion or more, according to CB Insights. Here are Asia's 32 (although it's possible there are quite a few more)...

CHINA

Xiaomi

Consumer electronics

Valuation: **\$46b**

Funding: **\$1,540m**

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share, even though in most cases the capital being raised goes towards subsidies used to attract customers and maintain or increase market share. As such, several companies are not only valued in excess of \$1 billion, but have also raised more than \$1 billion in fresh capital. So what does it actually mean to be a unicorn?

"Unicorn status is less meaningful than a couple years ago. In the past when you had valuation of more than \$1 billion in theory this meant you were safe – no one could beat you. Now I don't think being a unicorn is enough to ensure a successful IPO. We will see unicorns die. Right now there are a lot of inflated unicorns because of the valuation bubble," says David Wei, co-founder of Vision Knight Capital.

Competitive spirit

The first generation of Chinese internet giants – Baidu, Alibaba and Tencent Holdings (the BAT) – has contributed to the current state of affairs. Keen to differentiate their business models or at least create traction for their ecosystems, these companies used capital to secure strategic alignments in each new vertical.

Prior to their merger earlier this year, Kuaidi Dache was backed by Alibaba while Didi Dache counted Tencent among its investors. Passengers could make payments through Alipay or Tenpay and enjoy free rides if they used Alipay or WeChat. Similar synergies were behind Alibaba and Tencent's decision to support Meituan and Dianping, respectively. The O2O services players were encouraged to broaden their scope and compete for business not only in group buying but in a host of other segments as well.

Other verticals such as mobile healthcare platforms that connect doctors and patients appear to be following suit. Tencent invested \$394 million in that Guahao and industry peers including Spring Rain and Xingren responded by raising large rounds from the likes of FountainVest Partners and Yunfeng Capital, which was co-founded by Jack Ma, executive chairman of Alibaba. The proceeds are being used to wage a marketing war.

"We are seeing unicorns in our space. A lot of people are putting in money to provide subsidies

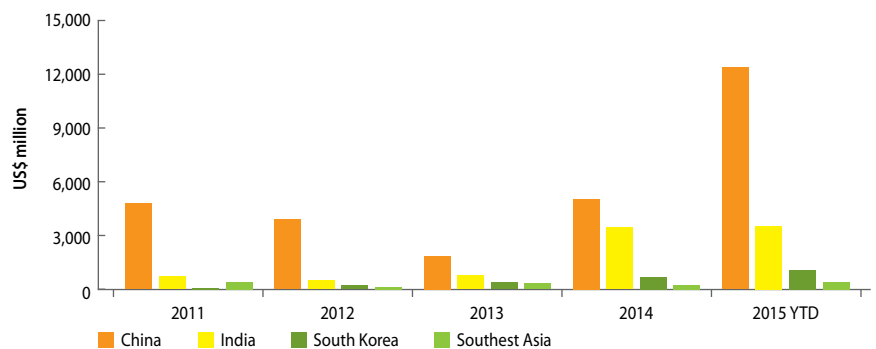
and accumulate market share. Some companies offer free consultations, even though they don't have enough doctors; and others are paying doctors RMB50-100 (\$8-15) a time to download apps. We're the only start-up not giving money away because it isn't going to work," says Martin Shen, founder and CEO of Xingren. "Patients will get better and stop using the platform."

This competitive dynamic is a product

maintain a low cost burn and have at least a 3-5 year horizon in terms of cash on hand to run with before doing another raise," says Ozi Amanat, founder of K2 Global, which makes pre-IPO investments in technology companies.

In the US, Top Tier Capital Partners currently has more than 50 unicorns in its portfolio and another 40 publicly-listed companies worth over \$1 billion in which its portfolio VC funds still hold

Asia later-stage VC investment



Source: AVCJ Research

relentless ambition. Every founder envisages becoming the dominant player in his space and potential long-term pay-off is so great they are willing to whatever it takes to maximize their chances of success. "A lot of these founders think several years ahead and ask 'What must I do to become a significant player?' They are willing to sacrifice profits today for a bigger market share and profitability in the future," says John Lindfors, managing partner at DST Global.

Subsidies are therefore seen as a necessary part of the expansion phase. The company builds market share, gets users comfortable with its service, and then weans them off the subsidies. It is hoped that customers will have developed sufficient loyalty to the platform that they are willing to pay a higher take rate.

Not all investors are happy with this approach. "We're hyper-aware of cash burn and any company that has an asymmetry in cash burn I walk away from. It is very important they

shares. The fund-of-funds only tracks the top 1% of these unicorns for which the average valuation is \$6.3 billion.

Top Tier's findings indicate that these companies are generating average revenue of around \$500 million and seeing year-on-year growth of 142%. These revenue numbers are a source of comfort: though valuations are high, the companies' performance suggests they are not inflated.

"Our biggest concern is the motivation for these unicorns to go public is small," says Jessica Archibald, managing director at Top Tier. "There have been several 'private IPO' financing rounds by large mutual funds and hedge funds, but that does not necessarily solve the problem for venture capitalists. These 'private IPOs' are more of an exit risk for VCs than an opportunity, but it is too early to call it a real concern."

The recent experiences of US-based document-sharing software provider Dropbox

INDIA

Flipkart

Online marketplace

Valuation: **\$15b**

Funding: **\$3,150m**

CHINA

Didi Kuaidi

Car-hailing apps

Valuation: **\$15b**

Funding: **\$4,420m**

CHINA

Lufax

Online P2P lending

Valuation: **\$10b**

Funding: **\$483m**

CHINA

DJI

Consumer drones

Valuation: **\$10b**

Funding: **\$105m**

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illustrate the difficulties that arise when private market valuations become unjustifiably high. Dropbox raised a \$350 million Series C round last year at a valuation of \$10 billion. However, industry peer Box then went public at a valuation \$1.6 billion, despite its revenues being no more than 50% lower than those of Dropbox. Investment bankers told the company it would struggle to hit a \$10 billion valuation on IPO.

BlackRock and other investors wrote down the value of the asset on their books, reportedly to around \$6-7 billion, and Dropbox shelved the IPO plan. According to PitchBook, US companies are now waiting a median of 7.7 years to go public, up from 5.8 years in 2011.

The classic example of a successful Asian unicorn IPO is JD.com – it went public at a valuation of \$26 billion and now trades at close to \$40 billion, representing significant upside for even the later-stage investors. But the private market valuations commanded by arguably less impressive companies, coupled with questions as to how many Chinese unicorns US markets can accommodate, is giving pause for thought.

Dianping was preparing for an A-share listing earlier this year before public markets crashed, the offering was postponed, and the Meituan merger was agreed. The combined entity is said to be looking to raise capital at a valuation of \$17 billion – more than the two companies were worth as independents – but would the public markets value it so highly?

“Dianping probably does over RMB2-5 billion a month in transaction value, while Meituan has about RMB 5-6 billion. That is more than RMB10 billion worth of transactions in one month,” says J.P. Gan, managing partner at Qiming Venture Partners and an investor in Dianping. “Commissions are 5-10% so the company is generating around \$500 million in annual income and growing 30-50% year-on-year. Why don’t you think they can’t be worth billions of dollars?”

The merger of Dianping and Meituan is a cost-saving exercise. They will no longer pump capital into subsidies intended to win market share off each other, and as the single dominant player in the market, there are no other rivals. The earlier merger of Didi Dache and Kuaidi Dache

served a similar purpose and the now-combined entity has ended subsidies and is looking to create a pricing system based on data generated before the relentless undercutting set in.

“They are making money from premium car services and there is still a lot they can do to improve service quality. It’s like Alibaba, which took 14 years to go IPO. The need for Didi Kuaidi to list isn’t as high as before, because there is a private market for them to raise money,” says

“Category leaders will always be able to raise funds at a certain valuation. If you aren’t one of the superstar companies, it is a lot more difficult”

– John Lindfors

Jixun Foo, a managing partner at GGV Capital. “Third, there is liquidity. If I wanted to sell my stake in Didi Kuaidi today, there will be people who want to buy in the private market.”

Winners and losers

The mergers also reflect an acceptance on the part of Alibaba and Tencent that the market opportunity is best addressed through collaboration rather than cutthroat competition. Investors may to participate for longer than originally envisaged – and perhaps invest more as the company continues to expand – but it is expected to deliver economic sustainability.

However, it is unlikely to work out well for everyone. Industry participants point to earlier developments in the e-commerce space. More than 1,000 companies have raised capital over the last 10 years but only a handful has achieved significant size – the hit ratio is said to be 5%.

“Everyone has to figure out how to build a sustainable business model. When the investing environment changes those that are slowest in finding an answer are the first go,” says James

Lu, a partner at law firm Cooley. “You have already seen a lot of the companies start to have operational issues, because their overhead is so big, and the competition is so fierce.”

One more recent development in the market is a growth in M&A activity and it is inevitable that larger players will pick of their weaker counterparts. These moves will also support continued expansion into new growth areas, as already evidenced in the strategies of Baidu, Alibaba and Tencent. Increasingly, this is likely to see Chinese companies establish footholds in other emerging markets.

Similar patterns are emerging in Southeast Asia and India. GrabTaxi and Ola have both launched delivery services, while Snapdeal and Flipkart are also making tech investments. These companies are not as acquisitive as their Chinese peers and reasons are given for this: the logistical and cultural challenges presented by Southeast Asia’s multiple markets are a hindrance to expansion; and in India the middle class is still comparatively small. At the same time, the unicorns in these markets are simply younger than the Chinese.

“In India, it may be too early to say, because none of the truly large internet companies in this cycle have gone through exits. My sense is, once some of the largest unicorns have gone through this, it will have an impact on downstream funding for the next batch. I think over the next 18-24 months there will be exits, at least for the largest companies,” says Gourav Bhattacharya, vice president at Matrix Partners India.

If valuations cool as many industry participants expect, there will be more casualties like Shaofanfan in China. Some unicorns may also run into difficulty, particularly if they have not been able to use their funding to establish leadership positions.

“Category leaders will always find it is possible to raise funds at a certain valuation. If you aren’t one of the superstar companies, it is a lot more difficult to raise money in a challenging market,” says DST’s Lindfors. “That’s what happens when a market is hot – a rising tide lifts all boats. When the markets face a tough time, investors will be more selective.” ▀

CHINA

Meituan

O2O services

Valuation: **\$7b**

Funding: **\$1,070m**

SOUTH KOREA

Coupang

Online marketplace

Valuation: **\$5b**

Funding: **\$1,420m**

CHINA

Dianping

O2O services

Valuation: **\$4.1b**

Funding: **\$1,440m**

INDIA

Paytm

Online payment

Valuation: **\$3.4b**

Funding: **\$1,270m**

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Leong Hup International

Sole Investor

Investment in a leading poultry producer in South East Asia

September 2014



Beijing Sunlon Livestock Development Co Ltd

Sole Investor

Investment in the largest dairy farming operation in Beijing

October 2013



TEG Pty Ltd

Sole Investor

Investment in Australia and New Zealand's largest ticketing and vertically-integrated live events company

July 2015



Velocity Frequent Flyer

Sole Investor

Investment in a leading Australian airline loyalty program

October 2014



Kyobo Life Insurance

Lead Investor

Investment in the third largest life insurer in Korea

September 2012



Loen Entertainment Inc

Sole Investor

Leveraged buyout of the largest vertically-integrated music company in Korea

September 2013

오비맥주(주) Oriental Brewery Company

Oriental Brewery Co Ltd

Joint Lead Investor

Leveraged buyout of the second largest brewery in South Korea

July 2009



Primo Group Holdings Pty Ltd

Lead Investor

Leveraged buyout of Australia's largest meat processor

October 2011



Tegel Foods Ltd

Lead Investor

Leveraged buyout of New Zealand's largest poultry producer

May 2011



Beijing Leader & Harvest Electric Technologies

Lead Investor

Buyout of the leading manufacturer of energy-saving electrical equipment in China

October 2009



United Test and Assembly Center Ltd

Joint Lead Investor

Leveraged buyout of a leading independent semi-conductor test and assembly service provider listed on the Singapore Exchange

November 2007

Korea Digital Satellite Broadcasting

Korea Digital Satellite Broadcasting

Sole Investor

Investment in Korea's only digital satellite TV broadcaster

August 2007



The FaceShop Korea

Sole Investor

Leveraged buyout of a leading cosmetics company in Korea

October 2005



Loscram Limited

Sole Investor

Leveraged buyout of a leading returnable packaging hire company in Australia

August 2005



Himart Co Ltd

Lead Investor

Leveraged buyout of Korea's largest consumer electronics retailer

April 2005



Haitai Confectionery & Foods Co Ltd, Korea

Joint Lead Investor

Leveraged buyout of the second largest confectionery company in Korea

September 2001



NS Electronics Bangkok Ltd

Sole Investor

Largest financial restructuring and recapitalisation buyout in Thailand by a financial sponsor

February 2000



Mando Climate Control Corp

Lead Investor

First leveraged buyout in Korea by financial sponsors

October 1999

In the fast lane

GrabTaxi started out as an entry in business plan contest at Harvard Business School in 2011, where it placed second. Co-founder and CEO Anthony Tan explains how it has since become Southeast Asia's leading ride-hailing company

Q: To what extent has the pace or nature of GrabTaxi's growth surprised you?

A: We started out with a vision to solve local taxi problems by addressing safety and traffic congestion. Today we work with over 141,000 drivers and our app has been downloaded on almost eight million mobile devices across 26 cities in six Southeast Asian countries. I've focused on taking it one step at a time; expanding into a new city when we have understood the local needs, offering a new transportation option when we ascertain there is a gap in the market. In the past 6-12 months, we have diversified our portfolio – with GrabCar and GrabBike – to give consumers more options, depending on their needs and preferences.

Q: You have raised about \$700 million in funding. How is it being used?

A: We are making strategic investments to extend our market leadership in Southeast Asia. We will continue to invest in important pillars of our business, including increasing our offerings and growing our network to include services such as GrabCar, GrabBike and beta testing a courier service, GrabExpress, in Bangkok and

Manila. We also want to improve our technology back-end and expanding our engineering offices, and implement more driver-centric programs to support recruitment and retention.

Q: What are the most challenging aspects of scaling the business?

A: The diversity of the Southeast Asian region, such as language, cultural differences and infrastructure challenges, can make scaling a business difficult. However, it is also our greatest advantage: We grew up here, we understand the nuances of local communities and our engineering and operational resources are focused on solving them. It is no coincidence that the leading ride-hailing companies in Southeast Asia, China and India are all local companies. Our hyper-local strategy means we understand the local issues and are able to leverage this local knowledge to build a viable business model that suits each community.

Q: How do you strike a balance between offering new services and ensuring existing ones meet expansion targets?

A: Our priority is to ensure that passengers have access



to their preferred mode of transportation, whether it is GrabTaxi, GrabCar or GrabBike. We are the only app in this region that offers a diversified portfolio of services under the GrabTaxi platform, allowing users to choose the vehicle type that best suits the current traffic conditions, weather and other factors that may affect how they travel. By segmenting our verticals, it ensures that each vertical is able to grow consistently. There are also dedicated teams for each vertical, so they can dive into the nuances of how customers use services and develop programs that cater to these specific preferences.

Q: When you are approached by new investors interested in participating future funding rounds, what are the key

considerations when deciding whether or not to work with?

A: As a start-up, we are always keen to partner with investors that can help us scale our brand quickly and efficiently. This would allow us to continue our pace of growth, provide more transportation options and expand to even more cities in Southeast Asia. We also look for potential investors who are aligned with our hyper-local approach.

Q: How do you feel about GrabTaxi being labeled a unicorn? Does it add to the pressure or is it just a number?

A: The labels are part of the business, as we are the largest player, with the largest land transport fleet, with the most options, in Southeast Asia. Personally my focus is very much on building a great business that provides a much-needed service to the local communities in Southeast Asia. The numbers that matter to me are the number of drivers who can improve their livelihoods using the GrabTaxi app, and the number of passengers who can easily book safe rides every day. Regardless of the size of GrabTaxi, my goal remains the same – to make public transport safe, affordable and reliable to all in Southeast Asia. ▀

AUSTRALIA

Atlassian

Security software

Valuation: **\$3.3b**

Funding: **\$210m**

CHINA

Ele.me

O2O services

Valuation: **\$3b**

Funding: **\$1,090m**

INDIA

Snapdeal

Online marketplace

Valuation: **\$2.5b**

Funding: **\$1,540m**

INDIA

Olacabs

Car-hailing apps

Valuation: **\$2.4b**

Funding: **\$905m**

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The long tail

From taxi journeys to pedicures, online-to-offline services are changing consumption channels in Asia's emerging markets. Some leaders have emerged, but much of the sector is still up for grabs

WHEN INDONESIA-BASED MOTORCYCLE

taxi firm Go-Jek wanted to recruit more riders, it moved from one recruitment center to a larger one and then a yet larger one. Eventually the company resorted to hiring out sports stadia as its army of riders – local people looking for additional income who connect with customers via a mobile app – ballooned from 300 to over 100,000.

Go-Jek, which takes its name from the ojek motorcycle taxis that are part of urban life in Indonesia, has been in existence for about three years. It was built on a call center model, although by the time NSI Ventures invested in the business in late 2014, the service was about to be re-launched with a location-based application.

"Timing is important because if you launch these things too early – before people have the right connectivity, the right phones – you need to be sufficiently confident that it can scale up," says Shane Chesson, co-founder of NSI.

As the green-jacketed riders proliferated, the company grew in scope as well as scale. Go-Jek's core services involved transporting people and packages on the back of a bike. They were soon joined by dedicated grocery and food delivery services.

The company has since branched out into online-to-offline (O2O) local services, whereby the app locates the cleaner, masseuse or beautician closest to the customer's home and a Go-jek driver ferries them over. Go-Box, meanwhile, targets the same user base but involves transporting larger consignments by truck. Sequoia Capital invested in the business earlier this year as NSI re-upped.

Chesson claims Go-Jek is a rare example of an

app-based ride-hailing platform getting traction in new verticals. That the company has been able to achieve this confirms the founders' initial notion that Indonesia's ojek resources were being underutilized – from standing on street corners waiting for rush hour, they have become multi-taskers and are better compensated as a result.

But it was also the right business model at

to run, easier to park, and quicker to mount and dismount than anything on four wheels. This efficiency is essential in traffic-laden cities like Jakarta.

China and beyond

Local nuance is the lifeblood of O2O in the sense that technology uses resources at a city or even

community level to address imbalances between demand and supply in the services sector. But follow the wealth creation patterns in Asia's leading emerging markets and – as has proved to be the case with e-commerce – the areas of activity in China are likely to be replicated in India and Southeast Asia, although there is no perfect imprint.

"These markets will follow China one way or another, but the question is how and when," says John Lindors, managing partner at DST Global. "The enormous middle class and fixed broadband as well as the proliferation of smart phones have driven a lot of growth in China, but in Southeast Asia and India the middle classes are proportionally smaller and fixed broadband will never be built out to the same extent as in China. These markets will really be driven by smart phone usage."

The sophistication of communications infrastructure, the nature of competition and local logistical challenges shaped the emergence of Go-Jek in Indonesia.

However, if China is a rough blueprint for how O2O services will evolve in Asia, the future will be one of consolidation around three key verticals: transportation, food delivery and local services.

Over the last two years, capital has poured into these verticals, often supporting the

Largest O2O funding rounds in China, India and Southeast Asia, 2014-2015

	Date	Amount (US\$m)	Investee	Business
CHINA				
	Aug-15	3,000	Didi Kuaidi	Ride-hailing apps
	Apr-15	850	Dianping	O2O services
	Jan-15	700	Meituan	O2O services
	Dec-14	700	Didi Dache	Ride-hailing apps
	Aug-15	630	Ele.me	Food delivery
	Jan-15	600	Kuaidi Dache	Ride-hailing apps
	Jan-15	350	Ele.me	Food delivery
	Oct-15	300	58 Daojia	O2O services
INDIA				
	Apr-15	400	Ola	Ride-hailing apps
	Sep-15	225	Ola	Ride-hailing apps
	Oct-14	210	Ola	Ride-hailing apps
	Mar-15	110	Foodpanda	Food delivery
	May-15	100	Foodpanda	Food delivery
SOUTHEAST ASIA				
	Aug-15	350	GrabTaxi	Ride-hailing apps
	Jul-15	250	GrabTaxi	Ride-hailing apps

Source: AVCJ Research

the right time. While Go-Jek faces increased competition from the likes of GrabTaxi's GrabBike, grocery delivery service Happy Fresh and the ubiquitous Food Panda platform, for now it is less intense than in other emerging markets. There is also a practical element: a motorbike is cheaper

SOUTHEAST ASIA

GrabTaxi

Car-hailing apps

Valuation: \$1.8b

Funding: \$690m

CHINA

Ucar

Car-hailing servicet

Valuation: \$1.8b

Funding: \$800m

CHINA

Beijing Lakala

Online payment & services

Valuation: \$1.6b

Funding: \$274m

INDIA

Mu Sigma

Data analytics

Valuation: \$1.5b

Funding: \$178m

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subsidies required to get consumers and merchants interested, and build market share. The \$3 billion round closed by ride-hailing app operator Didi Kuaidi in September, valuing the business at \$16 billion, is said to be the largest ever fundraise by a private internet start-up. As of July, the company – created earlier in the year through the merger of two rivals – was processing three million taxi rides and three million private car rides per day through its platform. However, the arrival of Uber has since shaken up the market.

Companies in the food delivery and local services spaces do not yet command such high valuations but the likes of Ele.me, Dianping, Meituan, 58 Daojia and Baidu Delivery have received plenty of capital from private investors. Indeed, Dianping and Meituan recently announced a merger and are believed to be working on a \$3 billion round at a valuation of \$17 billion.

Excitement about the potential of these two verticals is underpinned by the numbers. One investor justifies his decision to back Baidu Delivery as follows: the out-of-home dining market in China is worth RMB5 trillion while the penetration of takeout delivery is below 10% compared to 30% in developed markets; doubling the China figure could create a RMB1 trillion market. Speaking after KKR joined a consortium that invested \$300 million in O2O local services platform 58 Daojia, Lane Zhao, a director at the firm, described a market worth \$180 billion nationwide, again with relatively low penetration.

The business models that exist around these verticals share two particular characteristics. First, there must be an imbalance between demand and supply in traditional markets that is bridgeable using technology: a consumer demand that is not being met, workers who are underutilized, and an app-based platform that brings them together.

“As the middle class grows in China we are seeing big demand growth. But the home services market is also very fragmented – dominated by over one million small mom and pop shops or small agents that provide very low

CASE STUDY

Southeast Asia: aCommerce

The still-developing world of online retail provides many niches where a company can start to grow. For Thailand's aCommerce, the opportunity lay in the realization that many brands are eager to sell their products online, but lack the interest or the resources to set up an online portal themselves.

“Normally for a brand, your main focus is to manufacture or develop great products. And everything that is normally non-core, you actually outsource to other providers,” says Peter Kopitz, group COO of aCommerce. “Even overseas, the majority of the top brands actually outsource their own e-commerce, and they outsource it to similar providers to us.”

Since launching in 2013 with backing from Ardent Labs, aCommerce has set itself up as a provider of e-commerce expertise in Southeast Asia for international as well as domestic brands. The company offers end-to-end service, from setting up an online front-end to warehousing and last-mile delivery, in Thailand, Indonesia, the Philippines and Singapore.

aCommerce also engages with dedicated online retail providers such as Lazada and Tarad, which are capable of handling most of the front and back end themselves, but may find it more convenient to outsource certain functions. Last-mile delivery, which aCommerce provides for Lazada, is a common case, since the company has connections with most of the major third-party logistics providers in the areas where it operates.

Kopitz describes the ability to separate out its services for clients as an asset to help the company scale its operations. “That’s why we have a huge tech team that develops all our internal systems, the WMS [warehouse management system], the fleet management, all that kind of stuff,” he says. “We’re leveraging all the technology that we basically build in house and that makes it extremely scalable.”

This focus on backend support means that aCommerce is not a highly visible component of the online retail ecosystem, but this is also seen as a positive. A company that acts as an ally to the brands and the retailers can not only save the money that it might otherwise have to spend on advertising, but can also maintain a strong network with connections to both sides.

Now aCommerce hopes to use the tools and connections it has built up in the e-commerce space to build its presence in local services. When messaging app Line held a promotion providing online deals for grocery products, it turned to aCommerce for same-day and next-day delivery. The company saw this as a chance to sharpen its logistics skills.

aCommerce is also experimenting with kiosks in Bangkok's mass transit system. These kiosks, which are currently operating in six stations, serve a variety of purposes. Customers can choose to pick up online orders there instead of waiting for home delivery, and merchants can drop off orders for aCommerce to handle the last-mile delivery. The strategy makes the company more visible, but still serves its primary goal of providing support.

“We see ourselves more as the arms dealer in a war,” says Kopitz. “We’re equipping brands and e-commerce players with all the tools and resources they need to be in this war, without actually fighting at the front.”

CHINA

Guahao

Online healthcare

Valuation: **\$1.5b**

Funding: **\$516m**

CHINA

Koudai

Online marketplace

Valuation: **\$1.4b**

Funding: **\$362m**

SOUTHEAST ASIA

Lazada

Online marketplace

Valuation: **\$1.3b**

Funding: **\$735m**

CHINA

Tujia

Online vacation rentals

Valuation: **\$1b**

Funding: **\$464m**



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customer satisfaction and inconsistent service quality," Zhao observes.

A platform like 58 Daojia is intended to consolidate and standardize: enabling consumers to pay a set fee and choose a quality service provider, either based on past experience or customer reviews. The cleaners, removal men, babysitters and beauticians benefit too: they manage their own time and pay the platform a 25% commission compared to the 60-70% taken by offline establishments that have higher fixed costs to cover.

The second common characteristic is high transaction frequency. Whether a platform is processing taxi rides, food delivery or manicure services, enough people have to be placing enough orders for the commissions to reach a reasonable amount. Or, to put it another way, a platform must attract sufficient users to suggest it could be profitable in the future, and therefore justify the subsidies paid out to build market share today.

"Didi Kuadi is a high-frequency transaction platform – you might make 2-3 taxis journeys a day – but it is a smaller addressable market than dining," says Vincent Huang, founder of Juntong Capital. "Takeout delivery services could be used 3-4 times a day, and although the ticket size is smaller than for dining out, once you are delivering food to people's homes you can deliver other products as well. The ticket price goes up and average revenue per user goes up."

Volume vs. value

This raises the question of how broadly an O2O player can leverage the consumers and service providers that use its platform. Ele.me, for example, claims to have 4,000 full-time couriers plus over 200,000 more on a part-time basis through arrangements with third-party providers. Their primary task is to transport food from 300,000 restaurants to the estimated 40 million consumers Ele.me serves nationwide. But across how many product groups or verticals could they meet consumers' demands? And what does this mean for the value of the company and the dynamics of the industry as a whole?

According to NSI's Chesson, Go-Jek enters a

new market with its core taxi service, gets riders and users comfortable with the service, and then gradually introduces new product offerings. The ease with which other players can do this depends on the amount of local competition – and by extension the roll-out costs – and the level of sophistication involved in providing a high-quality service.

Singapore-based online grocery marketplace RedMart is a case in point. The company wants to become a regional e-commerce and logistics platform by controlling its entire supply chain, from fulfillment to last-mile delivery. The challenge is scaling the business to meet

penetration still only extending to a relatively small number of neighborhoods.

"They have enough to do without going into new categories," Bhattacharya adds. "Where we have seen integration it hasn't been horizontal, but vertical – food delivery guys are getting into discount coupons for restaurants."

In China, meanwhile, even among the established players, there is a pressing need to create sustainable business models. Horizontal expansion can contribute to these efforts, but at the same time they may add to the confusion, making it harder to identify potential winners. DST prefers to invest in market leaders where

"We are quite conscious of the fact that different markets have different dynamics and you have to look beyond the hype of hyper-local services and consider the economics of the model"

– Shane Chesson

consumer demand in an operationally complex category.

"It took Amazon seven years to figure out online grocery out and expand beyond Seattle. Now they've cracked it they are going into many other markets pretty rapidly," says Roger Egan, co-founder and CEO of RedMart. "But it takes a while to build out the expertise and capabilities. We've spent the last four years doing that so we have a bit of a head start."

India has also seen a proliferation of technology-enabled delivery services, with the likes of BigBasket, Grofers and Delhivery working their way through rounds of institutional funding. However, there is little sign of these or smaller players in the space looking to extend their reach into other segments.

Gourav Bhattacharya, a vice president with Matrix Partners India, explains this is because the only vertical in which local companies have achieved scale is ride-hailing apps, where Ola is engaged in a fierce battle with Uber. No clear winner or even a sub-set of market leaders has emerged in the grocery segment, with

there are barriers to entry or clear competitive advantages. Didi Kuaidi and Ola are both in the firm's portfolio but it has so far resisted food delivery and local services.

"The market leaders are definitely emerging, but it will take time for things to shake out," says Lindfors. "The Dianping-Meituan merger creates a very strong player in two key areas where they have significant complementarity – restaurants and the long tail of different services in China."

The problem is the sheer length of this tail. Dianping has expanded its restaurant listings and group-buying business to encompass other leisure-related areas, including a few forays into O2O local services. Meituan started in group-buying and now also covers hotel booking, where it faces incumbents Ctrip and Qunar (which recently announced a merger); movie ticket booking; and food delivery, competing with Ele.me, Baidu Delivery and others.

Indeed, the prospects for food delivery are uncertain in a post-subsidies world. The current market leaders gained momentum by serving the student population, but this demographic

INDIA

Quikr

Online classifieds

Valuation: **\$1b**

Funding: **\$350m**

INDIA

Zomato

Online restaurant listings

Valuation: **\$1b**

Funding: **\$223m**

SOUTHEAST ASIA

InMobi

Mobile advertising

Valuation: **\$1b**

Funding: **\$221m**

SOUTH KOREA

Yello Mobile

Mobile services

Valuation: **\$1b**

Funding: **\$129m**

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“There has to be a depth of knowledge and technicians who are skilled professionals so it is hard for firms running large platforms to do it themselves. You need this barrier to entry”

– Choon Chong Tay

is unlikely to remain loyal if there is a cheaper option in the market. While Baidu is a relative newcomer to the space, it brings a different target customer base and one of China's best location-based mapping systems. Baidu Delivery could end up offering a differentiated service to customers that are more willing to pay for it.

A similar debate is taking place among O2O local services providers, although 58 Daojia is one of few that can claim significant scale. The market remains characterized by the presence of smaller players targeting particular niches that cannot hope to match larger rivals in terms of transaction frequency. It remains to be seen whether specialization, and the higher service quality this infers, is enough to sustain them on a stand-alone basis.

“We looked at lower frequency models – such as appliance repair services – but we decided to put that on hold, because the easiest entry point is still at the higher frequency end. If you plug into higher frequency businesses then you can do some lower frequency services as well,” says Helen Wong, a partner at Qiming Venture Partners.

She offers Helijia as an example. The company started out as a platform dedicated to connecting consumers with manicurists, but has since broadened its scope of services and generates higher transaction velocity as a result. However, expansion is limited to the beauty

CASE STUDY

India: Grofers

India's grocery delivery space has attracted a significant amount of investor interest, and Grofers is one of the biggest successes so far, receiving \$45 million across two funding rounds this year. Now, having made its name in the food space, the company believes it can convince customers to turn to it for more.

Grofers began with pickup and delivery of commonly purchased items from local stores, or kiranas, at which India's middle class traditionally buys food, flowers, and baked goods. Partner merchants list items on Grofers' mobile app, and when customers place orders, drivers collect the items and take them to their homes.

The team has steadily added more product categories, such as electronic accessories and books; the challenge was educating consumers that the option was there. “Millions of people shop online, but what they're buying is mostly electronics and fashion,” says Kshitiji Torka, Grofers' vice president of marketing. “Most of them are not aware of the other categories that we provide, and have no concept of hyper-local delivery.”

The company is working to address the awareness gap with its most recent advertising campaign, organized around the theme “We get it.” This slogan works on two levels: Grofers can deliver the goods that consumers want; and it understands the pressures that its young, career-oriented, tech-savvy target customers face, and wants to make their lives easier.

A more ambitious promotion saw Grofers partner with electronics retailer Reliance Digital and positioning itself as the only source for home delivery of the iPhone 6S on launch day. The company's delivery teams picked up phones from stores at midnight distributed them to all the customers who had registered in advance, days before they would have arrived through regular e-commerce channels.

“It was effective in three ways. Number one is just the fact that Grofers, which has been around for such a short time, could do something like this, where even the largest e-commerce players were not delivering at that time,” says Torka. “Second, by doing this we built up awareness of the fact that we deliver electronics now. And the third thing was penetration, whether through social media, or through people going to their office to tell their colleagues.”

The publicity boost has helped build traction for hyper-local delivery in general, as well as for Grofers in particular. For example, more vendors are becoming aware that the internet can connect them with a younger customer base and ease their reliance on foot traffic.

Though the numbers are gratifying, Grofers is focused on maintaining a satisfactory customer experience. “Depth is equally if not more important than breadth right now for us,” says Torka. “We already have enough categories to cover 80% of consumers' needs right now. What we need is to do that at a deep enough level that consumers know they can come to Grofers and find everything that they want within that space.”

and wellness segment, which Wong believes gives Helijia an edge over 58 Daojia. The latter's strengths are its size and ability to standardize, whereas the former's focus can deliver customers a more personalized service.

This view is echoed by Choon Chong Tay, managing director at Vertex Ventures China, with the added caveat that achieving substantial scale shouldn't necessarily be the goal. In Ayibang and QingSong, Vertex has two portfolio companies

CHINA

Apus Group

App developer

Valuation: **\$1b**

Funding: **\$116m**

CHINA

Fanli

Online marketplace

Valuation: **\$1b**

Funding: **\$130m**

CHINA

Mogujie

Social commerce

Valuation: **\$1b**

Funding: **\$230m**

CHINA

Beibei

Online marketplace

Valuation: **\$1b**

Funding: **\$134m**

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that focus solely on maid services and household repairs, respectively. The emphasis is on winning consumers' trust and establishing a reputable brand.

"In the long term companies have to develop loyal customer bases so they aren't just competing on price," Tay says. "There has to be a depth of knowledge and technicians who are skilled professionals, so it is hard for firms running large platforms to do it themselves. You need this kind of barrier to entry; it's not just about getting a lot of users on board."

Impending shakeout

A number of industry participants have difficulty reconciling this strategy with their general expectation that O2O local services will consolidate around a handful of platforms, much like the other verticals. This tension between scale and sustainability will likely last as long as investors are willing to continue pumping in money – and, in the case of India and Southeast Asia, to what extent the hunger for exposure to ride-hailing apps spreads into other verticals.

While Aashish Bhinde, executive director with Avendus Capital in India, believes there would be ample demand for professional O2O services providers in the laundry segment, he appreciates that building out supply where there currently is none would be a challenge. For the market to take off, companies would have to achieve a reasonable scale so capacity is fully utilized.

However, under the market dynamics present in the country's ride-hailing space, sustainability has more to do with the level of competition than fundamental economics of the business. "At some point in time, either one company will emerge as a clear winner and become profitable or a couple of companies may co-exist and as their business scales they will stop offering incentives and subsidies," Bhinde says.

The more time that passes before this shakeout occurs, the greater the risk to which investors are exposed, particularly if they are continuing to support companies at ever higher valuations. It is difficult to tell how soon this day of reckoning might arrive in China, India or Southeast Asia, and so investors must rely on

CASE STUDY

China: Helijia

Rather than target a mass market vertical like takeout delivery, Chinese start-up Helijia found its own niche within O2O local services. Its mobile app was used exclusively by women wanting to book beauticians for at-home nail-polishing appointments

In April, the company received \$50 million in Series C funding led by Qiming Venture Partners at a valuation of \$300 million. Existing investors IDG Capital Partners and China Broadband Capital also participated alongside new backers Maison Capital and GX Capital.

Helijia has since moved aggressively into additional beauty and lifestyle categories – its services now encompass eyelash extensions, facials, hairstyling and makeovers, to name but a few. The most recent initiative has seen personal trainers introduced to the platform as well as attractive professionals who offer to teach music and languages.

This change in strategy means the company can operate on a higher transaction frequency basis. There is more demand for services and therefore a greater opportunity to achieve scale. However, Helijia has been careful to stay within its domain of expertise. "Category expansion is possible when you have a loyal customer base," says Helen Wong, a partner at Qiming. "Their user base is middle-class women. It's quite easy to imagine what they might need on the beauty side."

All service providers on the platform are small beauty enterprises or individual beauticians. Wong draws comparisons between Helijia and Alibaba Group's C2C e-commerce platform Taobao in that service providers are not restricted by the fixed costs of running a store and their compensation rate is biddable, based on the level of demand. Helijia takes a flat rate commission.

For example, the company launched a promotional campaign on September 23, offering special beauty packages in every category. One premium nail polishing package sold for as much as RMB5,000 (\$786) and Helijia generated approximately RMB19 million in total revenue for that one day alone. The company claims that its top manicurist earns upwards of RMB240,000 per month.

Helijia has seen numerous competitors emerge in the O2O services space. At the larger end of the scale is 58 Daojia, a broad-based services platform controlled by US-listed Chinese classifieds site 58.com. However, Wong believes Helijia's position is defensible – despite 58 Daojia's wider marketing reach – because it has taken time to build its brand among female users.

Furthermore, 58 Daojia has adopted a B2C model that is based on standardization. Helijia is able to do more in terms of merchant engagement, for example providing training to the beauticians registered on its platform, which can in turn lead to a higher quality of service for customers. "At the end of the day, it's about a service – whether people are satisfied with that you are offering and whether they will come back," Wong adds. "You can charge higher fee for quality services."

their confidence in management teams and the belief in the underlying fundamentals.

"We are conscious of the fact that different markets have different dynamics and you have to look beyond the hype of hyper-local services and consider the economics of the model," says

NSI's Chesson. "If you can show that demand stays strong even as subsidies are being reduced; if you are able to deliver value to vendors who are prepared to pay a percentage of gross merchandise volume; then you are creating a lot of value." ▀

CHINA

Panshi

Mobile advertising

Valuation: **\$1b**

Funding: **\$220m**

CHINA

Aiwujiwu

Online property listings

Valuation: **\$1b**

Funding: **\$200m**

CHINA

China Rapid Finance

Online P2P lending

Valuation: **\$1b**

Funding: **\$56m**

Source:
CB Insights,
AVCJ Research



Open to alternatives

With China's public markets still dogged by uncertainty – and, at time of writing, new share offerings suspended – PE investors are looking at other options. Trades in particular are getting more traction

THANKS TO SHANGHAI JIN JIANG

International's recent acquisition of budget hotel operator 7 Days Inn and Shenzhen Energy's purchase of China Hydroelectric, the total value of announced private equity trade sales in China this year has nearly doubled.

Jin Jiang is paying \$1.3 billion for 7 Days Inn, with The Carlyle Group, Actis Capital, Sequoia Capital and GIC Private due most of the proceeds, while the \$542.6 million China Hydroelectric deal represents a full exit for NewQuest Capital Partners and Tsing Capital. These are two prominent examples of a rising trend. According to AVCJ Research, a record 79 trade sales generated \$5.2 billion in 2014. So far this year, there have been 45 deals worth \$4.2 billion, exceeding the IPO and open market sale numbers on both counts.

This shift in the exit balance is largely a product of necessity. For all the relief that greeted the end of the embargo on new domestic share offerings in the domestic market in January 2014, IPOs have yet to recapture their previous highs. Moreover, approvals were paused again this summer in response to market turmoil. China's private equity exit problem has not gone away.

"Up until June, the Chinese stock market looked like a wonderful place to exit. So if you put together a plan and started spending money on lawyers and accountants, by August you would have been disappointed," says Kyle Shaw, managing director at ShawKwei & Partners. "We were actively looking at a Shanghai or Shenzhen listing for one of our companies. Unfortunately, the regulator took the option off the table."

Ups and downs

PE exits in 2014 were the fourth-highest on record, coming in at \$12.9 billion, with shares sold at IPO accounting for \$2.99 billion (although Alibaba Group and JD.com's offerings accounted for 80% of this). In total, the Shanghai and Shenzhen A-share markets, plus Chinxest and the SME Board, saw 62 PE-backed offerings.

The wave of IPOs carried through to July of this year, with 75 more PE portfolio companies going public. It coincided with a 59% gain in the Shanghai Composite Index between January and mid-June – public market exits accounting for over half of total transaction value – and the announcement of a slew of capital markets-friendly reforms.

The Shanghai-Hong Kong Stock Connect scheme was unveiled, allowing mainland investors to trade Hong Kong-listed stocks, and vice versa. It boosted both markets. Meanwhile, China's much anticipated switch from an approval-based IPO system in to a market-oriented registration model for being foreshadowed by the National Equities Exchange and Quotation (NEEQ), or New Third Board, to great effect. Many of the 600 or so applicants in line for mainboard listings turned their attentions to the New Third Board instead.

However, in July macroeconomic concerns prompted a massive slump in the domestic markets, which in turn hit Hong Kong and

backed Chinese company to complete an IPO. Within a few months it announced a take-private proposal.

The pick-up in trade sales has been helped by the acquisitive tendencies of listed Chinese companies. AVCJ Research has records 21 trade sales to A-share listed buyers in 2015, or 50% of the total. Last year, it was 59%, with a scattering of Hong Kong and US-listed Chinese companies making up the numbers. This represents a significant turnaround from the three years before that: in 2011, 2012 and 2013, mainland-listed companies were responsible for 16%, 15.8% and 18.9% of all China PE-backed trade sale exits.

The change mirrors a spike in overall M&A activity. Plenty of industries in China are ripe for consolidation and listed companies see acquisition as a means of opening up new avenues of growth. Chinese M&A reached a record \$454.1 billion last year, with more than 5,200 deals announced. Domestic companies were responsible for 75% of transaction value, compared to 61% in 2013, according to Thomson Reuters. As of September, 4,000 deals had been announced in 2015 worth a collective \$477 billion.

In addition to agreeing a deal for 7 Days, in last 12 months Shanghai Jin Jiang has snapped up properties in China and abroad. Notable acquisitions by state-owned group include Europe-based Louvre Hotels from US real estate investor Starwood Capital.

"The central government's reforms involve supporting outbound investments and acquisitions of businesses that can bring know-how and expertise to help improve the efficiency of the domestic market, things like precious engineering and finance services. They are streamlining regulatory approval process for domestic investors to make outbound acquisitions," says Rupert Chamberlain, another partner at KPMG.

Another example of a PE trade sale exit is Shanghai-listed Guangdong Yihua Timber Industry's agreement to buy an 18.21% stake in Meilele, an online-to-offline (O2O) furniture retailer. The company uses online traffic to drive customers to offline stores where they can look at the furniture and make purchases – a useful add-on for Yihua Timber's traditional wood manufacturing business.

"We like the buyer because it can help in

"We were actively looking at a Shanghai or Shenzhen listing for one of our companies. Unfortunately, the regulator took the option off the table"

– Kyle Shaw

other bourses. About half of the stocks listed in Shanghai and Shenzhen voluntarily halted trading. Then the plug was pulled on new offerings and there has been nothing since.

"There are some uncertainties about when these companies can list and they have to consider other exit channels. A Hong Kong IPO is one of the options. It's similar to the A-share market IPO suspension in 2012-2013. A lot of companies couldn't get listed in China so they came to Hong Kong. There are many Chinese applicants in the pipeline in Hong Kong and they want to list before the end of this year," says Paul Lau, a partner at KPMG China.

Nevertheless, Hong Kong is still a highly selective market in terms of size and sectors. So far this year, only 18 PE-backed Chinese companies have achieved listings in the city, compared to 37 last year, and 40 in 2010. The US market has also dried up with WoWo the only VC-

other aspects of Meilele's business and that was why we just did a partial exit – we see more upside in combining Yihua's expertise with that of Meilele," says Choon Chung Tay, managing director at Vertex Ventures China. Lightspeed China and China Renaissance K2 Ventures also sold part of their stakes in the business.

Succession issues are another factor. Vanzo Communication Technology, a Chinese mobile handset maker backed by Spring Capital, was sold to Shanghai-listed Hubei Kaile Science & Technology in a deal worth \$140 million. Vincent Chan, Spring Capital's CEO, notes that Hubei Kaile is not only wanted new intellectual property and customers, but was also keen to add new blood to its management team. "The founder of is about 60 and his kids don't want to take over the business. He saw in Vanzo's founder a 33-year-old

company fail to achieve three consecutive years of profitability there is an additional financial penalty.

With this in mind, some GPs are willing to wait for the IPO window to re-open. "Managers should be looking at a variety of choices," says Shaw Kwei's Shaw. "But if I am talking to a trade buyer or a listed company about selling, it would be better if the China market is doing well, because then I could tell them I have alternatives. If they know the market is closed, that means I have less leverage in negotiation."

In reverse

For those unwilling to bet their fortunes on shifts in the regulatory mind-set, especially if they are sitting on substantial unrealized investments, there is another, higher risk option: a backdoor

Giant Interactive, an online games developer that was also taken-private, in this instance by Baring Private Equity Asia and Hony Capital, is also being primed for a backdoor listing.

However, reverse mergers are harder to pull off than trade sales and include a higher degree of risk. Focus Media's plan to relist through Jiangsu Hongda was terminated as the chairman of the shell company resigned in response to a probe by authorities. A new shell had to be found. Hong Kong regulators have also made companies more difficult to list via reverse merger. For example, the reverse merger is treated like an IPO and therefore subject to all listing requirements.

In terms of secondary market appeal, Focus Media and Giant are large and cash generative. Smaller companies in less fashionable industries may find it more challenging to drum up interest.

Focus Media and Giant are also notable in that companies partnered with PE investors to privatize the businesses with a view to going public in China. As such, there is an alignment of interest in choosing this exit route, as there is with a standard IPO. This is not necessarily the case with a trade sale, where the founder may be reluctant to give up control.

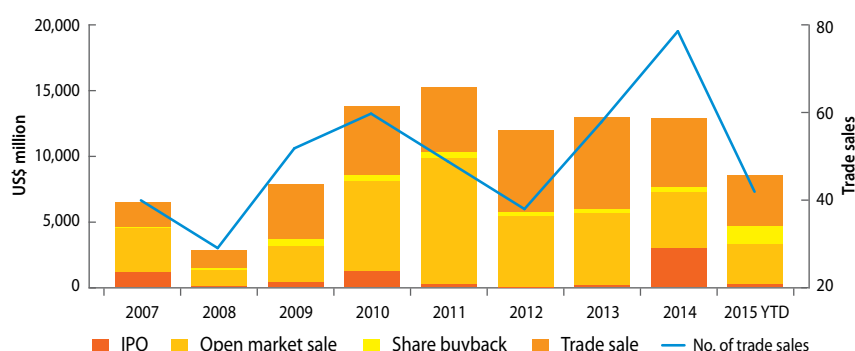
As minority investor in a company, it is incredibly challenging to preserve that alignment of interest while maximizing exit options available. There are examples of founders looking to get out due to advancing age or a more complicated commercial environment, but they are the exception rather than the rule.

"The on-and-off scenario in the A-share market is always there and it is actually part of the uncertainty of emerging markets in general," says John Zhao, CEO of Hony Capital, "When you invest in China, understanding the uncertainties associated with the market is part of the deal."

Hony has been on the wrong side of a regulatory decision before, having structured most of its portfolio companies for onshore listings only to see the A-share market shut down in 2009-2010. As a result, the majority of investments in the firm's fifth US dollar fund and second renminbi fund have been structured offshore. Hony also adds a provision to its investment agreements stating that, even as a minority investor, if a domestic listing is less likely it can opt for a trade sale or an offshore IPO.

"When we do the due diligence, we don't negotiate how to make an exit. We negotiate how we can come together and have upfront discussions about growth strategies," Zhao adds. "We are also very direct in saying that we are a financial investor – we invest for a certain period of time and then they must support our business model and allow us to exit. When that is clear, we start to work together." ■

China private equity exits by type



Source: AVCJ Research

who has the passion to run the business," he says.

However, not every trade sale to an A-share listed company makes sense. Clothing manufacturer Kaiser, for example, bought mobile games developer Youkia despite the absence any recognizable synergies between the two businesses. Industry participants observe that fashionable technology start-ups are popular targets for some listed companies because the presence of these new assets can shore up a dropping stock price.

For the sellers, trade sales can be less attractive because the exit multiples are lower than for IPOs. Neither are they guaranteed a pile of cash: many deals – particularly where an offshore investor is involved and approvals take longer – are predominantly structured as share swaps. The PE investor would then be subject to three year lock-up in the listed company.

Furthermore, share swaps seldom happen at equal valuations. If the listed company is trading at a price-to-earnings (P/E) multiple of 30-40x, the target company's shares are valued at 10-15x, Spring's Chan says. Should the target

listing. There are several reasonably high-profile examples of companies opting to list domestically via reverse mergers. This involves a listed shell absorbing the privately-held asset and then issuing securities to the investors. "The popularity of reverse mergers is a symptom of investors needing a liquidity event," one GP says.

Outdoor advertising business Focus Media was taken-private in 2012 by a PE and management-led consortium in 2012 at a valuation of \$3.5 billion. In May, Shenzhen-listed Jiangsu Hongda New Material said it would acquire the firm for RMB45.7 billion (\$7.37 billion).

One month before the transaction was announced, a group of Focus Media's offshore shareholders, including Carlyle, FountainVest Partners, Fosun International, CITIC Capital Partners, China Everbright and Primavera Capital, made partial exits to 36 domestic institutional investors at a valuation of RMB45 billion. The move was to remove the "red chip" offshore listing structure and become an onshore-controlled entity. The investors are understood to have reaped a 3.8x return on the sale.

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Media mogul

Ruigang Li forged a career with Shanghai Media Group and then left to start media-focused private equity firm CMC Capital Partners. He explains why capital is entering the sector and where he sees it heading

Q: CMC claims to run the first media and entertainment-focused fund approved by the National Development Regulatory Commission (NDRC). What does that mean?

A: CMC was founded in 2010. There weren't many renminbi-denominated funds in the space; most of them were US dollar funds. To raise a domestic fund, you were required to register with the NDRC, and with its certification you can raise capital from large Chinese financial institutions. When we registered, we had to pick sectors we were looking at. For example, manufacturing, broadcasting and transportation, you name it. We wanted to focus mainly on media and entertainment, and so we became the first firm to manage a renminbi fund focused on the cultural industry.

Q: How has CMC diversified its LP base since then?

A: We closed our first renminbi fund at RMB2 billion (\$315 million), with contributions from China Development Bank Capital, Shanghai Dongfang Huijin Cultural Fund (a holding company of Shanghai Media Group, SMG), an investment fund unit owned by China Merchants Bank, and Wenhui Xinmin United Press Group, among others. The fund was fully deployed by 2013. Then we raised \$350 million for our first US dollar fund in early 2014, after spending six months in the market. It has a diversified LP base comprising fund-of-funds as well as six corporations from the US, Japan and Australia.

Q: What kind of deals was CMC looking at in the early days?

A: In our debut renminbi fund, we

mainly focused on media and entertainment companies. Our first deal was the acquisition of a 53% stake in Star China TV from News Corp. in 2010. Star TV China, which was set up a joint venture (JV), was in distress at that time. We changed the management team and restructured the operational model. Last year, we took the full ownership of the company. The business is making impressive profits now and we will consider listing it next year. Although the deal came from the renminbi fund, we converted renminbi to US dollars to make this investment. It was the same with the DreamWorks Animation JV in 2012. Our primary focus remains media and entertainment, but traditional movie and TV businesses are no longer attractive to us. A firm has to demonstrate its potential to operate along the entire value chain – from content creation to distribution. It's a totally different model from the past.

Q: CMC also has invested in start-ups in areas such as education and online food-ordering. What is the thesis?

A: Over the last two years, we have developed two more core focuses – lifestyle and internet and mobile. The technology, media and telecom (TMT) sector is very broad and what interests us is that a lot of content is created across mobile platforms. So we have invested in examination prep platform Yuantiku as well as start-ups operating in the online-to-offline (O2O) space, like Ele.me. We also believe every consumption business is a branding process, in order to draw attention from the



“The internet is becoming the most critical channel for content distribution”

masses. With this in mind, we are looking at emerging companies with brand value, such as online music operators and virtual reality (VR) technology-based lifestyle products.

Q: CMC has formed partnerships with the likes of FremantleMedia, IMAX and Warner Brothers Entertainment. How do you help them expand in China?

A: In China's media and entertainment industry, it takes a long time to build up experience and networks. It's a very local business. International companies usually find it hard to pursue greenfield projects in China because they have yet to develop professional systems to run these businesses. We have the domain expertise and resources to them. For example, we know how to use our advertising techniques to

establish brands in China. IMAX China is a classic case of how we add value. The US-listed parent decided to spin-off its China business and structure it as a JV so Chinese investors could come in. CMC and FountainVest Partners invested in the JV and took the company public in Hong Kong within two years. During the holding period, we helped IMAX China develop a new business line – building film theatres in luxury homes. We also jointly launched a film-focused fund that invests in local movie production and distribution.

Q: How have you built up your team?

A: The composition of our team has changed a lot since CMC's inception. When we started, the key people were from SMG and they had a lot of experience in content production and business operations in the media industry. Over the past five years, we have expanded the team to 20 – and 90% of them were previously investment managers in TMT or working elsewhere in the financial sector. We haven't hired new people from SMG or any other traditional media company. In today's world, the internet is becoming the most critical channel for content distribution, helped by deeper mobile internet penetration. That's also one of the reasons of why I founded another new company – Whaley Technology. It develops internet-enabled TVs and competes with the likes of Xiaomi. We see ourselves becoming the largest content distributor in this space, as there will be a variety of content that can be aggregated on the Whaley platform. ▀

Perception vs reality

Chinese GPs have generated more volatile quarterly returns than their global peers, but a portfolio of China funds offers a surprisingly good risk-return profile, say INSEAD's Claudia Zeisberger and Michael Prah

THE RECENT EXTREME VOLATILITY CHINA

has experienced in its public equity markets, as well as its currency devaluation and a number of downward GDP revisions have put risk at the forefront of investors' minds. These concerns extend to private equity where many investors around the world, and even on the ground in China, have formed a view that returns have been lower and riskier than those generated by managers in developed Western markets.

Indeed, while quarterly global PE performance has fluctuated during the last three years, returns from Chinese private equity have been significantly more volatile over the same period. During the year and-a-half prior to the first quarter of 2015, this volatility translated into higher returns relative to the global industry while Chinese private equity underperformed during most of 2012 and early 2013.

Yet when these volatile short-term returns are assessed across the life of a fund, we see a smoothing effect to performance and a sharp reduction in volatility, challenging conventional wisdom.

Outperformers

In the latest Private Equity Navigator – a biannual analysis of the global PE industry produced by INSEAD in partnership with eFront's Pevara – we find that Chinese PE funds have performed well relative to their global peers for fund vintages 2005-2012. In fact, examining returns for this period, the 48 institutional-grade Chinese funds considered in the study have outperformed, generating a pooled mean IRR of 12.5% compared to 9.9% for the industry globally. Funds of the same vintages investing in North America, Europe and Asia have generated pooled mean IRRs of 9.98%, 10.2% and 8.3%, respectively.

Further, the range of returns between the best and the worst-performing funds in our sample (bounded by the 95th and 5th percentile funds to remove outliers) by region – representing a simple measure of volatility – is the narrowest for China. The country has a high of 28.2% and a low of minus 2.56%, while Europe has the largest range including the best-performing (top quartile at 30%) as well as the worst performing funds (minus 14.4%).

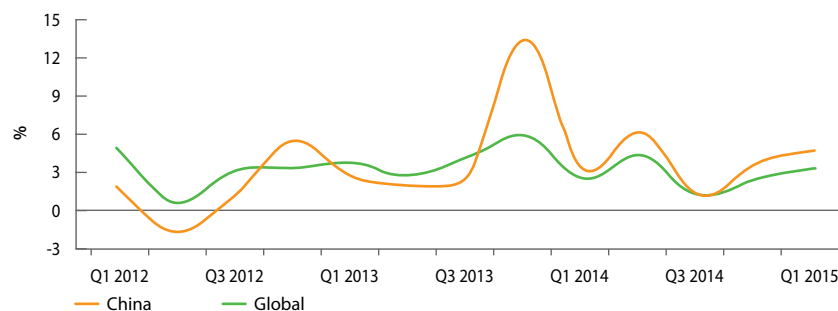
The latter finding is especially instructive given the perception among global investors

in PE that China is an unstable and risky market for the asset class. Although at a regional level this sentiment holds partially true, as PE funds across Asia (including China data) of the same vintages have produced an 8.3% pooled mean IRR with high volatility – our findings suggest a significantly better risk adjusted return for China.

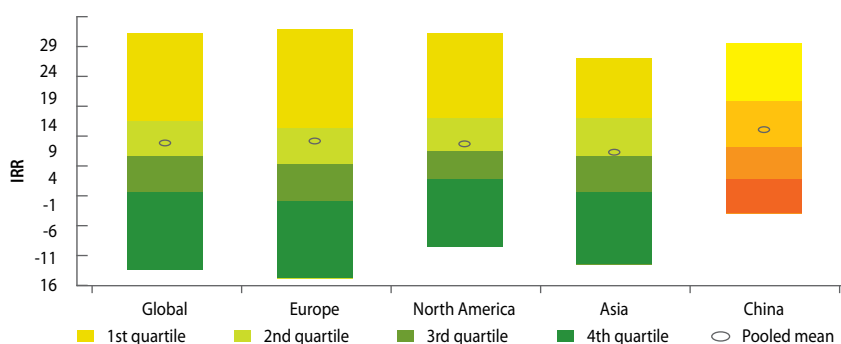
non-intermediated deal flow, or multiple arbitrage in pre-IPO investments.

In fact, the often heard argument that private equity is a superior way to invest into emerging economies over public equity markets is supported by comparing Chinese PE returns with returns on public equity as measured by the

Quarterly returns (MIRR) Chinese vs Global PE



Benchmark IRR quartiles (vintages 2005-2012) by region



A number of explanations can be offered for these results. First of all, Chinese GDP has grown at an annual rate of 8-10% over much of the past decade, and this has allowed private equity funds to back successful entrepreneurs and invest in winning companies expanding at a multiple of the average market rate. The size of the economy versus its maturity also creates pockets for arbitrage, be it the early identification of new trends, roll-ups and fast expansion strategies,

MSCI China Index. Over the eight years ended December 2014, the MSCI China Index has provided returns of 5.9% compared to an 11.4% MIRR for Chinese private equity. (MIRR can be used for comparison with public markets as it accounts for the cost of capital until investment and assumes reasonable re-investment rates.)

As discussed, Chinese private equity returns have been more volatile than global returns on an annual basis, yet this volatility is dwarfed by

that seen in the public markets.

Massive swings produced highly variable annual returns in public equity of 66.24% in 2007, minus 50.83% in 2008, and 62.63% in 2009. Over the same period, Chinese PE returns were significantly less volatile, with MIRR of 12.91%, minus 11.25% and 24.40%, respectively in those three years. Note, however, that this is partly due to private equity firms' infrequent, conservative and delayed valuations, while public markets reflect real-time returns.

Where's the cash?

There is another observation on these returns that might chime with the aforementioned negative perceptions held by some investors. Compared to Western markets, Chinese private equity returns include a significantly higher portion of unrealized returns.

While exits in Europe and in particular North America have approached record levels in recent years thanks to favorable market conditions, the same pace of realizations has not materialized in China. For example, pooled multiple returns for North American PE funds for the 2005-2012 vintages are 1.41x total value to paid-in (TVPI) versus 1.57x for China. However, North American funds have realized half of that value, distributing 0.76x of invested capital, while Chinese funds

have returned only 0.46x or just 30% of the overall reported returns.

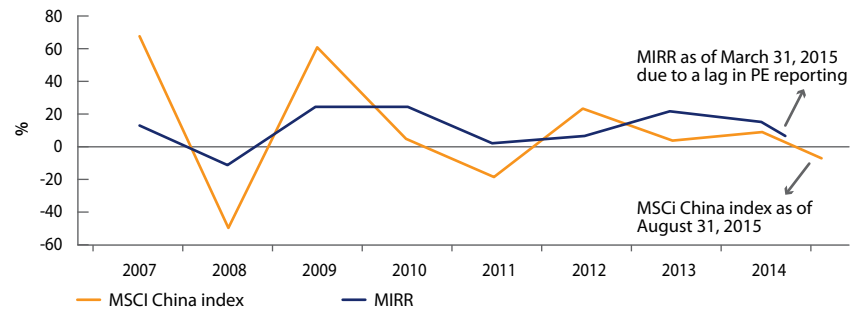
Assuming that the unrealized returns do have a basis in reality – marked to market on the basis of either partial exits, follow on investment rounds (venture in particular) or performance of listed comparable companies – the recent headwinds in China's public markets suggest that these unrealized returns are at risk of being corrected downwards.

At the end of the day, LPs rate GPs based on cash-on-cash returns, meaning the jury is still out on China's recent fund performance. For

the moment, however, long-term investors in a portfolio of institutional quality PE funds in China should feel vindicated in their strategy. ▀

Claudia Zeisberger is senior affiliate professor of decision sciences and entrepreneurship and family enterprise at INSEAD and academic director of the Global Private Equity Initiative (GPEI). Michael Prahl is a distinguished fellow with the GPEI and adjunct professor for entrepreneurship and family enterprise. For more information, go to: <http://centres.insead.edu/global-private-equity-initiative>.

PE and public equities returns China



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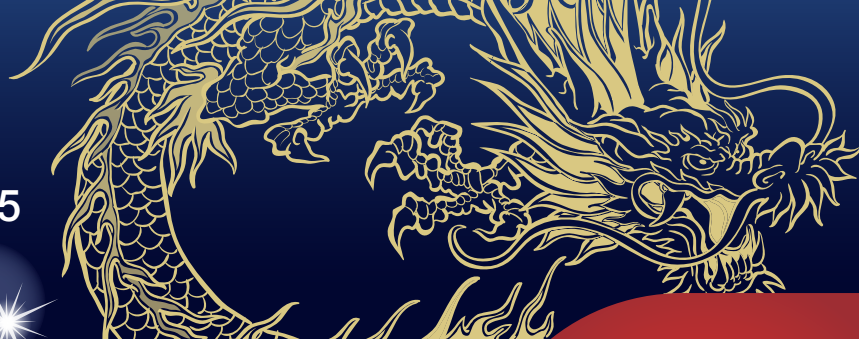
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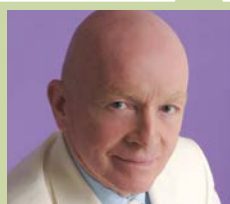
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