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Asia investors take stock

A regulatory crackdown, ongoing pandemic disruption and an uncertain macroeconomic environment has some investors rethinking their approach to China, write Alex Lynn and Amy Carroll

Beijing's 2008 Olympics coincided with what some consider to be the peak of China-mania. "In the period after the global financial crisis, everyone wanted access to the China growth story," says Doug Coulter, partner and head of private equity Asia-Pacific at LGT Capital Partners.

China's private equity outlook feels a little less certain in recent years, with geopolitical tensions, ongoing pandemic disruption and macroeconomic uncertainty on a global basis all contributing to hesitancy among some corners of the investor landscape.

"While investors have not given up on China, many are more cautious and have pressed pause, so to speak," Coulter says. "We are extremely lucky to have closed our Asia fund last year. We have seen investor interest for anything China-related continue to slow."

Heath Zarin, founder, chairman and CEO of EmergeVest, adds that LPs have concerns around the restructuring

of the global economy and, in particular, the role that China is likely to play. "There is a greater wariness regarding China than I have seen since first coming to the region in 2005," he explains. "We have seen this issue of a decoupling of China and the US raised intermittently over the years, but it does feel more real and more intense this time around."

That is not to say that appetites for China-focused strategies have disappeared altogether. Sequoia China notably closed \$9 billion of funds for the country this summer. Its cluster of four separate vehicles was oversubscribed by around 50 percent, off the back of a host of successful investments, including ByteDance and JD.com. Indeed, Shawn Yang, a partner at Debevoise & Plimpton, says that, while there is weakening demand in the China funds space, established sponsors with differentiated capabilities are still able to attract significant investor demand.

What remains clear is that a proven track record of returning capital



Doug Coulter

Partner and head of private equity Asia-Pacific, LGT Capital Partners

Doug Coulter heads the private equity Asia-Pacific team for LGT Capital Partners. Prior to joining the firm in 2007, he was a senior investment officer for the International Finance Corporation, based in Hong Kong and Washington. Coulter previously worked at Nomura Securities and was a lawyer at Fasken Martineau DuMoulin.



Shawn Yang

Partner and foreign legal counsel, Debevoise & Plimpton

Shawn Yang is part of Debevoise & Plimpton's investment management group and is based in Hong Kong. He focuses on private equity fund formation and secondaries. Yang has represented clients including Baring Private Equity Asia; KKR; Clayton, Dubilier & Rice; Ontario Teachers' Pension Plan and HarbourVest.



Shane Gong

Managing director, Evercore

Shane Gong heads Evercore's Asia-Pacific private capital advisory team. He was previously CEO and executive director of the Singapore office of CPE Capital, formerly known as CHAMP Private Equity. He was also head of Asian consumer M&A at NM Rothschild & Sons, and previously worked at the Macquarie Group.



Kelvin Yap

Managing director, HarbourVest Partners

Kelvin Yap joined HarbourVest Partners in 2006 to focus on growth equity and buyout co-investments in Europe and Asia-Pacific, later transferring to the Hong Kong office to focus on primary fund investments and co-investments. He relocated to Singapore to help set up a new office last year. Yap joined HarbourVest from Deloitte and previously worked at PwC.



Heath Zarin

Founder, chairman and CEO, EmergeVest

Heath Zarin began his career as a fund formation lawyer with Schulte Roth & Zabel, before joining DLJ Merchant Banking. He relocated to Hong Kong in 2006 to form Credit Suisse's Asian private equity business, before leaving to form Emergent Investment Group. In 2010, Zarin joined HSBC in Hong Kong, before creating EmergeVest in 2013.

through the cycles is essential for raising money in the market today. Distributions to paid-in capital is investors' number one priority.

"If you have not been selling companies and distributing cash over the past five years, which has probably been the single best environment for selling in the market's history, then why should investors believe you are going to be able to do so in a far more challenging market?" says Coulter.

"Looking beyond China to greater pan-Asia funds generally, it's likely to be a story of haves and have-nots," says Yang. "Established sponsors with institutional LP relationships and consistent returns in recent years are likely to continue to hit fundraising targets, but others may be less fortunate."

"The handful of managers that have been able to sell well and are coming to market with a strong track record are comfortably raising funds, and we have seen a number of one-and-done closes," Coulter agrees. "But those managers represent a very small proportion of the overall industry. A large number of managers that have been around for a long time and performed adequately will probably get their funds raised, but may not reach their target. That means a large number of firms will probably never raise a fund again."

Second chances

This could, of course, provide a catalyst for Asia's secondaries market, which remains limited when compared with the rest of the world. "Asia's secondaries market currently represents a lower share of global activity, compared to the primary market," says Shane Gong, managing director at Evercore. He adds that this is partly due to Asian private equity having a larger focus on growth and venture capital, while the majority of secondaries capital is currently focused on buyouts.

GP-led secondaries in the region are nonetheless on the rise, driven in part by the evaporation of alternative

exit routes. This growth may involve solutions for tail-end funds, including those where there is unlikely to be a successor. But while the Asian secondaries market has historically been associated with restructurings – including renminbi to US dollar restructurings – Gong says: "This has shifted, in line with the US and Europe, to well-performing GPs seeking to hold quality assets for longer."

In part due to the challenges of raising new AUM in the current market, Yang is seeing more sponsors exploring GP-led opportunities as a means to access different pools of capital: "We are seeing more managers explore GP-led secondaries, sometimes because they have been slower to deploy capital as

a result of current market conditions. We are also seeing a fair share of broken deals for continuation funds that do not offer a compelling narrative for long-term value. In a way, we are seeing continuation funds as a litmus test for execution capabilities and investor confidence. We are also seeing more interesting strategies, like bespoke strip sales and warehousing facilities."

Furthermore, according to Gong, the bar for Asian GP-led secondaries is currently higher, particularly for China deals. "Investors with US or European [investment committees] running global programmes may not have fixed Asian allocations, so higher levels of conviction are needed to compensate for regulatory, currency or geopolitical

"We don't say no to China, but we are staying clear of sectors that are subject to regulatory pressures when it comes to our co-investment"

KELVIN YAP
HarbourVest Partners

The India opportunity

India is increasingly becoming a beneficiary of money cycling out of China, as Asia's biggest economy loses some of its appeal for investors. Is this necessarily an astute move?

“China is a \$17 trillion economy and India is a \$3 trillion economy, so the scale of the opportunities is very different,” says LGT Capital Partners’ Doug Coulter. “The macro economy is also never as good as it looks during boom times.”

In particular, Coulter points to India’s foreign exchange reserves, which are the fourth-highest globally and still near record highs despite efforts by the central bank to defend the rupee: “The structurally weak currency needs to be integrated into your underwriting, in particular for direct deals. We assume a three to five percent annual depreciation against the US dollar.

“There are definitely opportunities in India, but you need to be highly selective. There are relatively few managers that have demonstrated that all-important DPI – that have proven themselves to be able to not only buy well, but to sell well too.”

HarbourVest’s Kelvin Yap, however, says playbooks that have been effective in China can be exported to India, so long as they are localised and that a slower pace of execution is taken into account.

It is in the realm of technology that India really has the opportunity to shine. Heath Zarin of EmergeVest points

out that, while the US leads the world in the creation of unicorns, with China sitting at number two, India is rapidly closing the gap.

Yap adds that, in addition to those direct tech opportunities, there are also indirect tech openings. “The tech services sector in India has been favoured by private equity for the past four or five years,” he says. “Everyone has seen positive returns on those deals, and that trend looks to be continuing. Tech now permeates every sector, and people are no longer just employing IT to create efficiencies, but also to drive sales. When something is indexed to sales, it is far more powerful than when it is indexed to cost.”

As a result, Yap adds, there is a growing recognition that IT is something that must be continuously invested in and improved. This, of course, requires IT engineers to facilitate implementation.

“There are insufficient IT engineers in the US and Western Europe, and inflation is driving up wages,” he says. “But India produces more than enough IT engineers for its own needs every year, and so I see this as a sector with both long-term and more immediate tailwinds.”

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SHAWN YANG
Debevoise & Plimpton

risks. I think the number of Asian GPs seeking secondary solutions will rise as traditional exits slow, reducing distributions. We are having many discussions on the supply side. But at the moment, on the demand side, global buyers – who represent the bulk of capital – are focused on quality.”

Indeed, Gong believes the current market provides opportunity for homegrown Asian secondaries players, such as NewQuest Capital Partners. “I think there is space for more capital with Asian [investment committees] to address a growing supply of regional deals, which global players may discount or overlook, given competing US and European priorities.”

Zarin agrees that relative value is a problem. “There is strong appetite among managers for single-asset GP-led deals, but there is not enough capital out there to fund all of those opportunities,” he says. “The fact that these deals are coming out of Asia is enough to put them way down on the list. However, that will create a compelling backlog of opportunities in the years ahead when sentiment around the region is not so weak.”

Changing metrics

Meanwhile, as with much of the world, LP-led secondaries are largely on hold while pricing disconnects remain insurmountable. Uncertainty around zero-covid policies has also made underwriting 2022 financials difficult, if not impossible, for secondaries players, according to Coulter.

“You just don’t know how long these lockdowns are going to last or how they will be implemented,” he says. “The other problem is that, while there are a lot of venture assets out there for sale, there is little appetite for cash-burning companies and bubble-era metrics like revenue multiples. Until there is a renewed appetite for tech, this part of the secondaries market will be challenging.”

Yang adds that LP sales are less

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LGT Capital Partners

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SHANE GONG
Evercore

prevalent in Asia, in part because there simply isn't a reliable supply of mature portfolios in the region. “Everyone is looking for more exposure, not less, but we expect that to change in the coming years and would not be surprised to see LP portfolio sales become a larger part of our practice,” he says.

Kelvin Yap, managing director at HarbourVest Partners, agrees: “In general, LPs have a bias towards increasing exposure to private equity. The starting point is they want more. Clearly, there is a denominator issue at present, but we see LPs openly talking about accelerating their next strategic asset allocation discussion in order to avoid selling.”

Indeed, Yap believes that the secondaries market represents a phenomenal opportunity for GPs in Asia. “GPs that struggle to raise another fund may morph into secondaries players,” he explains. “But it makes sense to wait

until the public markets come back, because secondaries investors tend to favour a quick liquidity profile... Given the dominance of venture and growth capital in Asia, the public markets have an important role to play.”

Place your bets

Of course, the Asia narrative will not only be about secondaries in the months to come. Interesting direct investment opportunities remain; the key, as always, is to be selective.

“We don't say no to China, but we are staying clear of sectors that are subject to regulatory pressures when it comes to our co-investment,” Yap says. “We are not in the business of betting on how regulation will pan out. It's a wait-and-see approach.”

Yap adds that there are sectors where regulation is less of a pressing issue, including consumer: “We still have to be cautious about reduced consumption,

but, compared to Western countries that have already used up all the monetary and fiscal tools at their disposal to shore up their economies, the Chinese government still has lots of options.”

For Zarin, meanwhile, one key consideration in the current environment is the identification of sectors and businesses that have pricing power. “It is not just a China issue. You need to focus on businesses that have the ability to pass through inflationary increases, protecting and even expanding margins, which is why we feel good about supply chain and logistics. That is a sector where we do have real pricing power. There is also increased need for digitalisation and a focus on sustainability.

“Businesses that are focused on enabling digital transformations to help other companies grow, regardless of rising labour costs, are highly attractive. So are businesses that are providing the

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HEATH ZARIN
EmergeVest

tools to enable companies to execute and perform against their carbon-reduction objectives.”

It is technology, of course, that has historically been China’s showpiece. But while demand for digitalisation remains strong, the country’s tech stocks have been treated harshly by the public markets. That could make now the ideal time for opportunistic buying.

“The public markets have punished this sector more than any other, and all tech companies have been lumped in the same bucket,” says Yap. “GPs are therefore hunting for take-private opportunities among mispriced assets.”

Zarin adds that companies delivering enterprise-grade tech that is indispensable to customers regardless of the economic backdrop are particularly compelling, and should be available at better entry valuations than six months ago. “I also think the next year will reveal where capital has been deployed into tech businesses that may be great at fundraising and marketing, but which have been unable to generate free cashflow, or even a path to it. The change in economic environment is going to reveal where money has been misspent.”

While pockets of opportunity undoubtedly exist in China today, for many, economic and geopolitical volatility has led some to believe that – for now, at least – it is better to hold fire. Coulter, for example, doesn’t envisage falling short of his firm’s 50 percent strategic allocation to China. He does, however, expect to have a quiet 2022.

“Tactically, we have slowed down,” he explains. “We expect prices to have fully adjusted by the end of this year or early 2023, and that is when we will see more attractive buying opportunities. We have a long-term conviction in this market. Once current uncertainties are resolved, I think we will see a flood of capital and people returning. I don’t think the China story is over – it is just on hold.” ■