



PA Insights: The Asian Opportunity

Last year's global equity market uncertainty, higher interest rates, escalating trade tensions and geopolitical crosscurrents largely masked what may be a particularly attractive time to consider private market investments in Asia.

Volatility among Asian equity markets increased dramatically in 2018, national market indexes dropped steeply and the Chinese economy has been impacted by a trade war with the U.S. In turn, slowing domestic demand and tightening liquidity are impacting China's ongoing transition from an investment- and export-led economy to one driven by service industries and domestic consumption. Across the region, the U.S. dollar's strength continues to have adverse economic consequences.

Asia in general (and China in particular), however, began experiencing a valuation adjustment at the start of 2018, i.e., several quarters before a similar retrenchment began in the U.S. Indeed, many markets were already in bear territory long before the U.S. equity markets decided to finally react to the arrival of post-peak earnings growth, rising wage pressures, narrowing fixed income spreads and declining oil prices. For China, the trade war with the U.S. has exacerbated the slowdown in economic activity; recent weak readings in manufacturing metrics and new export orders illustrate the impact. In fact, China's purchasing manager's index fell below the key 50 level late last year and has stayed there since, suggesting the possibility of economic contraction for the first time since mid-2015.¹

As valuations on public markets in Asia have adjusted downward, so have those for private companies. Lower purchase price multiples

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are a welcome development for private equity managers in Asia with available capital to deploy. Asian buyout and venture capital funds entered last year with a record \$246 billion in dry powder². An additional \$37.8 billion was raised through September of last year, according to Private Equity International, with more than half going to pan-Asian mega-funds³.

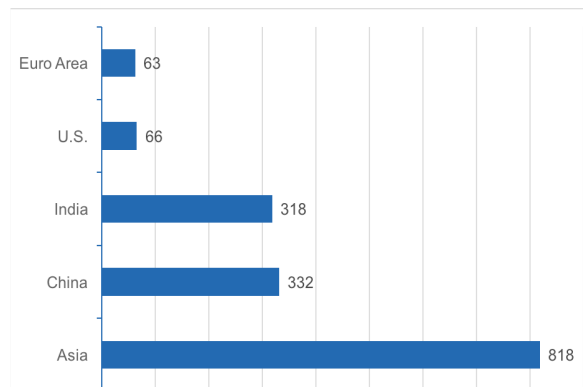
Ongoing concerns about valuations, and fears that the China/U.S. trade spat would intensify, kept many private equity investors from re-balancing their portfolios toward Asia and other emerging markets as prices fell last year. Taken together, this resulted in significant pent-up demand for deal flow, decreased transaction velocity/liquidity, lower exit multiple expectations, and delayed exits. Conversely, we believe the current environment for private investments in Asia is increasingly attractive from a capital deployment perspective.

The long-term optimism on Asia is merited. Although Asian private markets are perhaps more illiquid and often subject to greater volatility than

their developed-economy peers, the secular long-term trends in the region are attractive to investors uninterested in timing the ebbs and flows of publicly traded instruments. When viewed strategically, Asia's macro fundamentals are anchored by a young and tech-savvy demographic that boasts rising incomes and promises greater domestic consumption.⁴

The Millennial Factor

2017 Population Aged 25-39 (mil.)



Source: United Nations World Population Prospects 2017.
See Endnote #4 for more information

Meet the Members of Our Asia Team



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Market Conditions

The current Asian private equity market is much more sophisticated and mature than in prior years. Investment activity has shifted from minority growth investments – which typically have limited exit avenues available – to control and joint-control deals. Lower valuations and an increase in deal opportunities, coupled with an improved transaction mix should lead to a stronger, more robust recovery.

With the rising prevalence of shared control transactions, entrepreneurs and management teams are more willing to accept the influence of operating partners employed by private equity sponsors. Operating partners typically have years of experience in multinational corporations and bring large, global operating networks with them. Often, they apply their technical skills at a local level, instill industry best practices and potentially make substantial improvements to a company's top and bottom lines.

In addition to the increase of available buyout opportunities in developing Asia, another interesting development is the emergence of a viable secondary market. As the Asian private equity asset class continues to mature, the secondary opportunity set has expanded to include not only tail-end fund positions but, increasingly, funds that are either finishing their investment periods or are entering their harvesting cycles.

Secondaries present an interesting investment opportunity for many private equity investors looking to increase exposure to Asia. Secondary transactions can provide an efficient way to gain initial exposure to the Asian private equity market while mitigating J-curve effects and shortening hold periods that typically accompany primary investments.

Moreover, secondaries may allow investors to purchase fully or partially seasoned assets at discounted valuations. Secondary fund managers are able to price in the region's risk factors, including currency movements, impact of trade tensions, valuation dynamics and viability of capital markets. Given the recent market volatility, secondary funds have gained the attention of investors, and we're optimistic that the secondary market in Asia will continue to offer attractive opportunities.

Why Portfolio Advisors?

Over the fourteen years that Portfolio Advisors has been active in Asia, there have been a number of economic cycles. We focus on experienced managers with whom we have longstanding relationships and who have deep market knowledge as well as an understanding of local nuances.

Because Asian markets are diverse and still developing, local knowledge is especially important. It can be very challenging to see the region's opportunity set in total, across markets, cultures and countries. Building a robust, dedicated portfolio of Asian private equity managers requires an understanding of the issues from a local perspective. Through our office in Hong Kong, Portfolio Advisors (Hong Kong) Limited, we have developed the local knowledge and presence to source, evaluate, gain access to and capitalize on a variety of investment opportunities throughout the region.

Understanding a manager's capabilities and conducting deep dives into how the principals will source, research and monitor investments are among the key attributes we carefully diligence when considering a fund opportunity.



Investors unfamiliar with Asia often don't understand the nuances involved in researching Asian managers. Does the GP have experience buying well? Are they conscientious when entering positions? Can they structure downside risks properly through redemption rights or other mechanisms? Can they add any value to an asset once they've acquired it? Importantly, have they demonstrated an ability to exit through multiple jurisdictions, methods and structures?

The PA Advantage

- » **Local knowledge - 14 years in the Asia Pacific Region**
- » **Relationships with 45+ general partners across 115+ investments**
- » **Experience managing through multiple cycles and economic environments**
- » **Early mover in the Asian Secondaries space**
- » **Access to global PA platform**

Even within Asia, local issues can differ widely from country to country. Managers need to be familiar with each national culture, their respective legal, tax and regulatory environments, various economic trajectories and crosscurrents, and any number of disparate investment climates in order to fully understand each specific country and the opportunities it may hold.

Local expertise becomes crucial in evaluating one market over another. Global investors trying to manage a portfolio of Asian private equity exposures are thus faced with not only having to stay abreast of their individual general partners and respective positions, but also tracking the dynamic environments across each market in which they're active.

There may even be differences within a country's various regions – nations like China and India have broad regional diversity that essentially results in sub-markets inside each country, and requires an even more granular understanding of local perspectives. In order to invest effectively and properly diversify, practitioners must be able to view a market from a boots-on-the-ground perspective, developing an inherent understanding of what makes sense.

In our case, we anchor our Asian fund-of-funds portfolios with pan-Asia managers we know well and who have successfully gone through both bull and bear markets, and supplement them with managers who deliver the requisite single country expertise and experience. Private equity investing in Asia requires a unique mix of fortitude, foresight, experience and patience. We believe that blending these characteristics in a consistent approach to Asian private equity can lead to attractive risk-adjusted returns.

We believe experienced general partners with local knowledge, an ability to source proprietary transactions at reasonable entry valuations, typically, with little to no acquisition leverage, an ability to add operational value to portfolio companies and a demonstrable track record of exiting investments through multiple methods and geographies offer the most attractive risk and reward propositions in Asia.

As an asset class whose performance relies on discipline and focusing on strategic value generation, private equity presents a compelling opportunity set and we believe the next few years will be an attractive period for new primary, secondary and co-investment opportunities in the region. The seeds are in place for Asian private equity to have a strong recovery. A slowing



economy and continued trade tensions have brought valuations meaningfully lower over the past several quarters. Structural and fundamental improvements in human capital, governance and corporate professionalism bode well for the next phase of growth among Asian general partners and their portfolio companies. Comprehensive local knowledge, combined with more than a decade of deep investment experience, should be key advantages in prudently deploying capital in this evolving and dynamic region. ■

Endnotes and Chart Citations

- 1) “Purchasing Managers Index for February 2019”, National Bureau of Statistics of China, http://www.stats.gov.cn/english/PressRelease/201903/t20190301_1651561.html
 - 2) “Preqin Asian Private Equity & Venture Capital Special Report”, <http://docs.preqin.com/reports/Preqin-Special-Report-Asian-Private-Equity-September-2018.pdf>, page 7.
 - 3) “2018 in Asia: The Rise and Rise of Mega-Funds”, *Private Equity International*, <https://www.privateequityinternational.com/2018-asia-rise-rise-mega-funds/>
 - 4) United Nations, Department of Economic and Social Affairs, Population Division (2017). World Population Prospects: The 2017 Revision, custom data acquired via website.
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