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2012 Wharton Private Equity Review:

UNCOVERING VALUE

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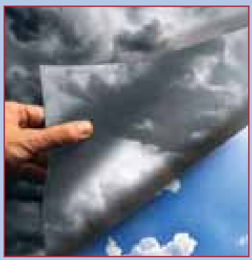

Tough economic conditions in Europe and the United States, stiffer competition and tight credit continue to tamp down growth in the private equity (PE) industry. But successful firms are still uncovering opportunities. Today, that often involves longer-term investments with a focus on bringing new talent to under-managed portfolio companies. More PE firms are also looking to Asia for opportunities, including investments in small- and medium-sized enterprises. In this special report, based on the 2012 Wharton Private Equity and Venture Capital Conference, as well as additional research, Knowledge@Wharton looks at new directions in PE.

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Setting New Value-creation Strategies

A decade or two ago, a private equity (PE) fund could scan the landscape, pick off companies at bargain prices, tidy them up and then sell them at a profit amplified by leverage. Simple. But today, the industry is more mature, and each firm faces more competitors scouring the market. Underpriced firms are harder to find, sometimes impossible. Money is harder to borrow. Flipping bargains for profits is not so easy.

So, how do successful PE firms make money in this increasingly efficient environment?

Today, many firms agree that value creation begins with due diligence — the research that identifies a target firm's unrealized potential before the acquisition is made, said Bob Juneja, senior managing director of Irving Place Capital, speaking on the "Value Creation" panel at the 2012 Wharton Private Equity & Venture Capital Conference. "You have to be right," added Andy Africk, senior partner of Apollo Global Management. "You cannot make money on the buy-side as you could in the early days — but you can hurt yourself."

Nor can a PE firm step in and create value by simply cutting costs, said David Hooper, a partner at Centerview Capital. "I think most of the [PE] companies have gotten aggressive on costs, but now the focus is on 'How do we grow the top line?'"

It's not that purchase price doesn't matter. The PE firm, said Africk, must pay a "safe and sane price" to acquire a company. But the real value is created afterwards through operational improvements. Apollo, he recalled, once bought a satellite company for a reasonable price of 6.5x EBITDA (earnings before interest, taxes, depreciation and amortization) and later sold it at a multiple of 9.5. The gain came from major upgrades like adding cellular and Internet service to the system, not from a bargain price.

"The only way to really create value is by having operational expertise, insights, contacts," said Hooper. To achieve that, Centerview draws on a stable of executives with deep experience in the industries it invests in, such as consumer products.

> Most private equity firms have gotten aggressive on costs, but now the focus is on growing the top line.

Justin Miller, a partner at Bain & Company, said his firm stays focused by sitting down at the start with managers of portfolio companies and hammering out a list of the three to five key goals to achieve over the ensuing few years.

And at KKR Capstone, the process of remaking the portfolio company begins with a 100-day plan that includes a very clear idea of the target's profit potential, said director Todd Cooper. "When the deal closed, on day one I had a target, I had a number in my head," he said of one acquisition. Often, value is created by zeroing in on the potential improvements unique to each portfolio firm, but also by finding similar needs in two or more firms in the portfolio. Office supplies, for example, can be purchased more cheaply in bulk.

The process, added Hooper, generally begins with a deceptively simple question: "One, do we understand what this company does and how it makes money? It sounds like a very basic question, but it's a very important one." Centerview evaluates the firm's position in the market and the talents of its management, and asks what has to be done to take the firm to the next level.

One of Centerview's acquisitions was a frozen-pizza maker that was doing well. But Centerview believed annual sales could be boosted from $200 million to $500 million.

"We could bring resources to the company that they could not get by themselves, including things like superior sales talent," he said. Because of its size, Centerview could get sales meetings with large retailers that would not sit down with the pizza firm itself. Centerview also boosted its access to retailers by placing former executives from big-name firms like Kraft, Gillette and Nabisco on the pizza firm's board.

"For the [pizza firm's] CEO to be able to pick up the phone and talk to these guys is very important, and something he might not be able to do under the previous management," Hooper said. Centerview also brought in additional executives and directors with industry expertise. "We're one year in – maybe, to use a baseball analogy, in the second inning. But it feels good."

Part of the Team

At many portfolio firms, management focuses too much on the next quarterly board meeting, devoting excessive time and effort to making an effective presentation, Africk stated. "I tell my management teams I don't want that. If I learn something at a board meeting, I'm not really doing my job." Instead, Africk works to reduce the stress of facing big quarterly deadlines by making managers at portfolio firms feel Apollo is part of the team on the ground, not just overseeing from on high. "I'll call management maybe every two or three days." The trick, he said, is to keep up-to-date with the portfolio firm without interfering with day-to-day management.

This kind of interaction can be constant at the start, but then the PE team is well advised to back away and let the firm's managers run the company, getting more involved again only if things are going wrong, Cooper added.

"If you get to the point where you need to micromanage the chief executive, you need a new chief executive," Juneja said. "The most important decision we make is the hiring and firing of that CEO."

This is another area where a PE firm with a good reputation can wield more clout than the portfolio firm on its own, said Miller. Because a CEO wants to work with the PE firm, he or she may be willing to join a portfolio company in a less-than-ideal location, he added.

"If you don't get the right person as the CEO of the company, you are going to fail," said Hooper.

It's also critical for the portfolio firm's board to include people who not only have expertise in the firm's line of business, but who also understand the life a CEO leads, said Juneja. "The CEO job is really a very lonely one," he said, noting that some of the best board members are former CEOs "who can serve as a source of non-judgmental information."

'The 1% Possibility'

While PE firms have long employed leverage to boost results and still do, in today's environment it is critical to be conservatively levered, so management does not face a constant stream of balance sheet alarms. In doing so, managers are then willing to spearhead initiatives even if they are costly in the short run, Juneja said.

However, if the strategy does rely on significant amounts of leverage, the PE firm should not select a target that requires a major overhaul, added Africk. "A wholesale transformation in a highly leveraged environment is not a good idea. It just doesn't give people degrees of freedom to make it work."

Despite all the due diligence, careful hiring, cost cutting and monitoring, things often don't go as planned, said Africk. "One thing that's not well understood is how great [internal rates of return] are made," he noted. "It's as much about the saves as about the wins.... It's going to happen that your thesis was wrong, and it's going to happen that the macro-environment [goes] against you. What [distinguishes] the great private equity firms is how they react to that."

It is critical, he added, to control emotions when things go wrong and to have "safety factors" built into the plan from the start, such as capital structures that can withstand setbacks.

It is also important to look backward at why some deals worked and others did not, said Juneja. In an analysis of opportunities it had considered over the years, his firm found that the deals it should have done — but did not – in retrospect caused it to miss out on chances to triple, quadruple or quintuple its investment. The deals the firm completed — but should not have, given the outcome — typically caused it to lose half of the investment. In other words, the good opportunities that were missed were more costly than the bad deals that were done. On a close call, it could therefore make sense to do the deal, since on balance the potential gains might well outweigh the potential losses.

Often, the potential gains are hidden, and the successful PE firm is "open to the 1% possibility," Miller added.

"It's a full-contact sport," Cooper concluded. "It's a lot of fun. It's very fulfilling. But it's very hard."

Leveraged Buyout Specialists Find Ways to Prosper amid Global Uncertainty

Panelists at the 2012 Wharton Private Equity & Venture Capital Conference saw clear paths for the leveraged buyout industry to prosper despite slow economic growth in the U.S., uncertainty over the upcoming presidential election and major global financial threats from Europe. Among the reasons for optimism: new energy resources in the U.S. and new private equity models.

Global uncertainty produces challenges for all businesses — but also opportunities. How can the leveraged buyout (LBO) industry prosper as major economies struggle to emerge from the financial crisis?

> Difficult times can produce attractive opportunities for LBO firms that are nimble enough to adapt.

In a wide-ranging discussion at the conference, five panelists discussed market conditions that could affect their firms' LBO strategies for 2012. The consensus: Difficult times can produce attractive opportunities for LBO firms that are nimble enough to adapt.

The panelists believe the U.S. economy will continue to strengthen slowly, though debt issues and the presidential campaign cloud the future. Europe, the panelists agreed, has bigger problems, though none of the speakers predicted a broad economic collapse.

LBO firms, like all private equity (PE) firms, must look for new types of investments as the market changes, the panelists concluded. Over the past 15 to 20 years, for example, big-box retailers have provided some attractive buys in the U.S., but now those opportunities are hard to find, said Sanjay Banker, a principal at Bain Capital Private Equity. Today's retail plays are more likely to be found with smaller companies that have more room to grow.

Change is also occurring in the energy industry, added Sam Oh, partner at Apollo Global Management. "There's really a renaissance occurring in the U.S." he said, describing new gas and oil fields opened up by "fracking," which uses water pressure to break up underground formations and release hydrocarbons. "We've opened up massive horizons of natural gas, crude oil and other hydrocarbons. We don't think 2012 will be any slower than 2011. In fact, we think the opposite."

North America, with its cheap natural gas resources, may well have an economic edge on emerging markets that rely on exports, as rising oil prices boost shipping costs, said Andrew Marino, managing director at The Carlyle Group. "It will give us a bit of a shield to grow our base."

Health care reform could create some LBO opportunities in the U.S. too, but at this early stage LBO firms must be very careful in placing bets, said Ali Satvat, director of KKR & Co. "The idea of being able to predict what health care will look like 10 or 12 years in the future is very hard." The U.S. Supreme court will rule, probably in June, on the constitutionality of a key health care reform feature requiring most people to buy medical insurance if they don't get it through their employer, and Republicans are campaigning hard on promises to repeal the new health care law.

Amid the uncertainty, Satvat said, KKR tries to focus on what is knowable: that the pace of growth in health care spending is unsustainable over the long term. KKR therefore looks for "companies that solve the problem," such as firms that can bring more efficiency to the system, like providing care in the home, which is cheaper than care in hospitals or nursing homes.

Europe—Serious, but Not a Surprise

Government debt and economic problems in Europe are worrisome, but some panelists felt that LBO funds can still find opportunities on the continent. The worst outcome, said John Maldanado, managing director of Advent International, would be a complete collapse of the euro. But "we're hopeful that the [eurozone] does stay together."

"I'm generally confident when it comes to Europe," Marino added, noting that the region's government-debt problems, while serious, are not a surprise, which would be more disruptive. Austerity programs may cause difficulties in some countries, but are not likely to do serious damage to the zone as a whole. "I believe — and we believe as a firm — that global growth will continue."

The ongoing deleveraging process in Western countries "is painful," added Oh. "We're in early innings. It is by no means over, but we're making progress."

If the developed economies do resolve their problems and return to economic health, commodity prices will move higher, he noted, suggesting that this would be "good for producers, bad for consumers." That could change the landscape for LBO firms.

Marino and Oh both expect high commodity prices to be a long-term feature of world markets given that the supplies of some commodities are being depleted. "The difference between today and 10 years ago is that we are bumping into spare-capacity issues, Oh said.

But in the short term, Marino added, low natural gas prices will help boost the U.S. economy, creating LBO opportunities. Credit issues, however, remain a problem in Europe and the U.S., Oh warned, predicting that tight-credit conditions will persist, making LBO financing difficult.

Unpredictability in the U.S.

What are the biggest factors facing the U.S. economy in 2012? Unpredictability, said Banker, pointing out that it is far from clear how the government will address its debt problems. It is also not clear when consumers, who remain over-leveraged, will increase spending, which is key to economic growth.

"It's jobs," added Oh. "The jobs issue in this country is a big problem. Apollo surveyed CEOs in its portfolio companies and found that most are very reluctant to hire. "It still doesn't feel like we're out of the woods." The unemployment situation varies dramatically around the country, and economic conditions — notably in the distressed housing market — exacerbate the macro problems, leaving workers less mobile and thus less able to take advantages of distant opportunities. "I think until we [solve] that, it's going to be tough." Marino agrees: "I think we're far away from being out of the woods in the economy. To me, it feels like we are just starting to get on with things."

In the U.S., the presidential election creates another layer of uncertainty, Maldanado pointed out. Slow economic conditions, tight credit and investors' heightened sensitivity to risk are causing some changes in the LBO industry, including the relationship between general and limited partners, the panelists said.

Marino noted, for example, that in recent years many PE firms have developed closer relationships with limited partners and are making special efforts to comply with specific requests. A number of pension funds, for instance, want their PE investments to respect issues important to pension plan participants, such as environmental, worker-safety and corporate-governance practices. "All the big firms have adopted ways of dealing with what I would call those 'softer issues,'" Marino said.

Limited partners have also become more attentive to their overall risk exposure, said Oh, explaining that pension plans, which often invest in multiple PE funds, are now more likely to look at whether overlaps in the portfolios create too much concentration. "There's definitely a movement toward more transparency."

In addition, fees are a bigger issue for limited partners than they were a few years ago, added Maldanado, noting that PE firms must be more responsive to this issue, because finding investors is harder today than a few years ago. Furthermore, PE firms are placing less emphasis on once-popular strategies like boosting returns through high leverage, or flipping target firms that can be bought cheaply, held briefly and sold at a high multiple. Instead, PE firms strive to improve their portfolio firms' operating results. "Eight-five percent of [PE] returns to investors have been from earnings growth," Maldanado stated.

While economic uncertainties are significant, several panelists noted that private equity is in an especially good position to deal with uncertainty because PE firms can hold a steady course. As a group, the panelists believed there can still be a bright future for LBO funds, though market-beating gains may be harder to come by than in the past.

"I think we have the ability to think longer-term," said Satvat. "That's one of the great advantages of this industry."

Big Potential, but Slow Growth for Now in Asian Private Equity

To much of the world, East Asia looks like the powerhouse that will drive global economic growth in the 21st century. If so, that ought to make it a prime hunting ground for private equity (PE) firms from the West and elsewhere, which are paying increasing attention to the region.

True, there are many great opportunities. But Asia is a diverse market, where business conditions are often very different from what Western PE firms are accustomed to. Opportunities may look enticing in Korea, mediocre at best in Japan and somewhere in between in China.

The PE industry in Asia today is relatively small, according to three speakers at the 2012 Wharton Private Equity & Venture Capital Conference. The speakers, all from the "Investing in Asia" panel, said that while this might suggest there is plenty of room to grow, each of the three major economies in East Asia presents obstacles.

Japan is a difficult environment because of its long-standing economic troubles, said Takajiro Ishikawa, general manager for the financial business development division at Mitsubishi Corp. "It's sad, but private equity is in decline in Japan," he said. "If you talk to Japanese investors, there is hardly any appetite to invest in Japanese private equity."

The first PE firms entered the Japanese market in 1987, and the industry grew slowly to a peak fundraising year of 2005. Since then, economic malaise has hindered the stock market and made PE exits through initial public offerings unappealing, illustrating one of the main difficulties PE firms face in Japan, said Ishikawa. "The IPO window is basically shut." A key underlying problem: Japan's rapidly aging population threatens to undermine the growth needed to fuel the PE industry.

Some room for optimism remains because only about 2% of investable assets in Japan are in alternative investment classes like private equity and hedge funds, Ishikawa pointed out. But PE has been a hard sell, even though the issues associated with an aging population, sluggish economic growth and poor returns in the public markets would seem to make the higher returns offered by alternative investments enticing.

Asia is a diverse market, where business conditions are often very different from what Western PE firms are accustomed to. Opportunities may look enticing in Korea, mediocre at best in Japan and somewhere in between in China.

"So, we are ... almost on a mission to provide an excuse to the investment community — that they really need to get out and invest in the alternative investment class," he said. "Otherwise, it's going to be too late" to get the investment growth that Japanese institutional investors will need.

Growth in Korea, Challenges in China

Conditions are more favorable in South Korea, said Young Gak Yun, founder and chairman of

Samjong Investment Advisory. After the Asian financial crisis of 1997, "we saw a lot of foreign private equity funds coming to Korea and buying distressed assets, and they made lots of money after a few years." Seeing that, the government in 2004 enacted a PE law to encourage the industry. "In the beginning, it was a government-sponsored industry, and now the industry is growing."

About 180 PE funds now operate in South Korea, managing about $30 billion. The national pension fund, with $350 billion to manage, is a major PE sponsor, Yun said, typically providing half of a fund's assets, finding a strategic investor for the other half and then selecting a general partner to manage the fund.

China, while offering a fast-growing economy, also presents some serious challenges to PE, said Michael Sung Wook Chung, founding partner and head of distressed strategies for Arrowgrass Capital Partners. "As a general matter, Asia is the growth engine of the world right now," he said. While China's economic growth rate looks to be slowing somewhat, it still draws investor attention. What is more, the regulatory environment is loosening "slowly but surely." PE is not large, "but the growth potential is tremendous."

Ishikawa noted that his firm, which invests outside of Japan as well as inside, "has not done a private equity deal in China." Reasons include the high cost of potential acquisitions and regulatory roadblocks that make it hard for outside investors to get money out of the country. "There really aren't too many examples yet of people making a lot of money [on] private equity in China," he said.

Chung suggested that in order for private equity to grow in China, "the credit markets need to get deeper." Easier credit would allow PE firms to use more leverage, a key to boosting returns. Unfortunately, the debt crisis in Europe is hindering expansion of credit markets, he added.

Because the PE industry's footprint is small in Asia, a significant portion of the Asian funds allocated to PE investments chases opportunities in the West, the panelists said. "I see these limited partners looking for opportunities in Europe," Yun said, noting that the United States is also drawing Asian money. "The phenomenon of Asian capital moving out West is, I think, real and here."

With the slow economy depressing lending in Japan, many of the country's banks are looking to invest in western countries, added Ishikawa. A final difficulty for PE firms thinking of investing in Asia: a shortage of personnel with the required skills. "The talent pool of general partners will continue to be in the U.S. and Europe," he suggested.

And so, despite huge PE potential in Asia over the long run, it will likely be some time before conditions create a true PE boom in the East.

Strategy, Top Management Talent Get New Emphasis in Private Equity

Fundraising for private equity firms (PE) has certainly been challenging, given the recent market turbulence and increasing scarcity of capital worldwide. At the annual Wharton Private Equity Partners dinner, members of a panel discussed fundraising trends and offered insight into what may lie ahead.

Fund-level transparency was a key concern voiced by Andrea Kramer, managing director at Hamilton Lane, and it became a key panel theme. Other notable concerns included issues ranging from the effects of increasing acquisition-price efficiency for portfolio companies in developed countries to the fragile economic environment in the U.S. and Europe. These concerns were highlighted by Brad Atkins, CEO and founder of Franklin Park, an investment advisory firm in Philadelphia, and Tom Dorn, CIO of the Private Equity Fund of Funds for Morgan Stanley Alternative Investment Partners.

> Notable concerns include fund-level transparency, the effects of increasing acquisition-price efficiency for portfolio companies in developed countries and the fragile economic environment in the U.S. and Europe.

Moderator Antoine Dréan, who also is the founder, chairman and CEO of Triago, a PE firm based in Europe, pointed out that close to half of the $4 trillion raised in PE funds since 1970 went to equity buyout funds. While most of the panelists conceded that a fair proportion of their capital at present also is committed to buyout funds — both in the traditional and turnaround spaces — all agreed that they now prefer a bottom-up selection process.

As Dorn noted, "what's becoming more and more prominent is specialization. In the U.S. and Europe — highly developed markets — we look for competitive advantage.... We find that the most compelling funds have a pretty carefully defined scope of investment activity, a well thought-out set of skills, and team members to attack that kind of strategy and to demonstrate competitive advantage." Noting that those requirements trump any macro theme, Dorn added, "We're looking for lots of individual bricks, each one individually advantaged to build a diversified portfolio."

Performance Matters

For Dorn, the process starts with finding talented managers. "Assessment doesn't start with a track record — it starts with the strategy.... The track record is a validation, not a leading indicator."

Atkins pointed out that "it really starts with picking the right strategy and then finding someone that has an edge ... or that is able to source deals on the table to add value, to propel cash flow." Kramer said that at her firm, "performance does matter.... The manager trumps all. When we're doing our bottom-up analysis, we look at what the strategies are, diversifying across the portfolio, making sure that we're finding the top performers. We have very concentrated portfolios, with sufficient diversification, but concentrated in the sense that we're willing to back the best performers, best-of-breed in a big way."

Given that both Kramer and Atkins emphasized the importance of a portfolio company's track record and management team, Dréan asked whether they invest in first-time funds. Atkins' firm does, and he noted that "the challenge with them is that they're not always institutional quality.... Secondly, we don't always know the teams. You're investing with a 10-year-life private equity fund in a blind pool. You have to therefore trust the managers.... It takes years to get to know and trust a manager. Typically, when we invest in [first-time funds], we know them from a prior organization." Kramer added that "you actually have to work with [first-time funds] very carefully on setting up their own infrastructure. Without that, we don't have a great chance of making sure we can track with ... transparency."

The panelists each resisted the notion of top-down manager selection when questioned about regional portfolio themes. While conceding they had a bearish view on some regions — like Europe — they all said they focus on the quality of the manager, and that opportunities can be found in nearly any market.

Emerging Markets: 'A Lot of Talk'

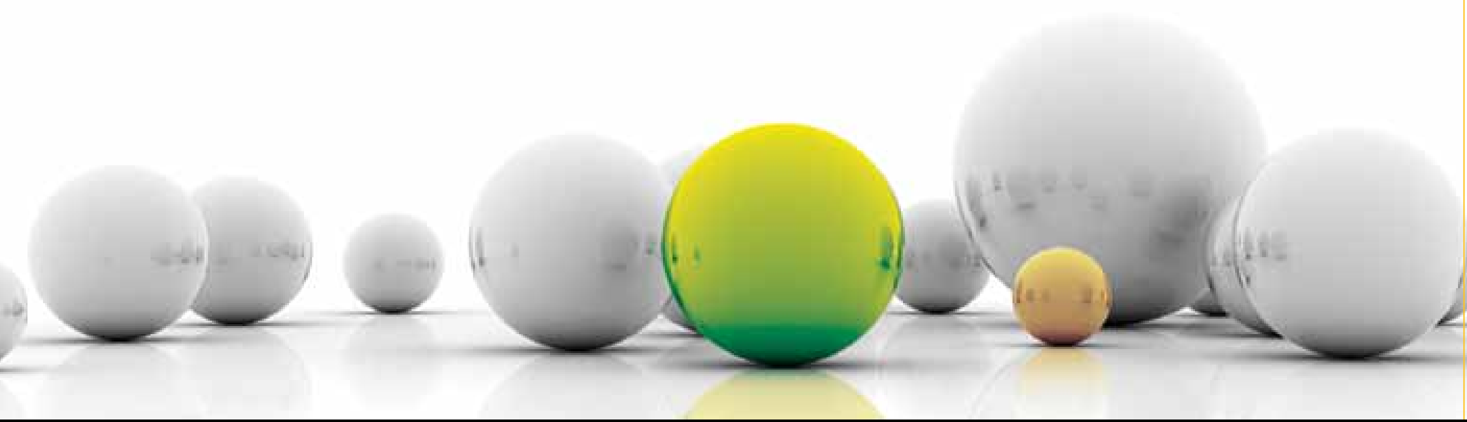
That said, Atkins' firm is increasingly looking to emerging markets, given the mounting efficiency in developed markets that makes favorable deals harder to uncover. Regarding emerging markets, Dorn noted that "capital flows a lot more quickly than the private equity talent pool develops, so emerging markets are where you get the wildest step-ups in fund size relative to capability." According to Kramer, "There's a lot of talk in the LP (limited partner) market about emerging markets — around chasing growth to be willing to derive yields from investments. The challenge is, when push comes to shove, nobody wants to invest in those regions.... It's good cocktail party discussion, but [LPs] don't really put a whole lot of capital to work [there].... You need to actually be local to evaluate any of these managers and find the opportunities."

Another hot-button issue: fee structure. PE fees have generated a fair amount of bad press, with the most visible case involving Republican nominee Mitt Romney's run for the U.S. presidency, which has created an uneasy, high profile for the traditionally discreet industry. As Kramer noted, "private equity has always preferred flying below the radar, but obviously some PE deals have become so large that they can't do that." Atkins added that "there's bad press around taxation, excessive use of financial leverage and lack of transparency. There's obviously a need for good PR. Private equity does create wealth, economic development and jobs. Remember, the goal of the managers is to increase profits, and all of that is good for the economy."

With private equity payouts under intense scrutiny in recent months, particularly in terms of transparency, the discussion inevitably turned to fee terms. As Atkins noted, "In a perfect world, GPs [general partners] would be paid well and entirely out of carry [carried interest]. The market dictates fees and carry and waterfall [the order of the distribution to various investors], and we are big supporters of a fee schedule that would better align interests between GPs and LPs. But there hasn't been a very big movement in fees." That said, however, "we would rather invest with an 'A' manager that had 'B' quality terms than vice versa," Atkins stated, echoing the night's theme that quality and talent are paramount.

As tough as the fundraising environment has been, none of the panelists' firms engaged in "early bird discounts," an evolving trend of offering conciliatory fees for early investors in funds. Dorn said that the "early bird discount addresses something that's always been a problem." The most difficult thing about raising funds is making the first close, because "the first close is in no individual investor's interest. It's like a prisoner's dilemma.... An interest rate charged on the fund that accrues from the time of the first to last close has never been sufficient to compensate investors to incent them to a first close.... Maybe it doesn't have to be an early bird discount — it could also be a dramatic increase in the interest rate on the fund that's charged to late closers for the benefit of first closers. You have got to treat first closers better."

A continuing belief in PE as an enduring asset class will ultimately determine fundraising capacity, and the best way to convince capital providers is through performance, Dorn said. The prevailing industry themes going forward will likely continue to be quality managers with idiosyncratic advantages, incentive-alignment through mechanisms such as fee structure, and an ability to find opportunities in both up and down markets.



Asian SMEs Are Exciting Investments, but Street Smarts and Rolled-up Sleeves Are the New Must-haves

With strong economic growth, surging middle class populations and a hunger for capital and business expertise, emerging markets in Asia look like rich hunting grounds for private equity (PE) firms. But there are hurdles: slowing growth rates in some areas, political uncertainty, unfamiliar business cultures and today's tighter lending standards.

Private equity investments in Asia, while often profitable and still promising, are not easy pickings. "Today, no discussion on private equity is considered comprehensive without touching upon PE in emerging markets," say the authors of a research report, *SME Private Equity 2.0: GDPs, Accounting Deficits, Proprietary Sourcing and Operations*.

The authors of the study are Saumil Annegiri, a recent Wharton graduate who has worked on private equity deals in India and the U.S. and now works as an investment banker; Suhas Kulkarni, former executive director of UBS Investment Bank and CEO of Hydrolines Group in India, who now is a dealmaker in industries such as natural resources, energy and technology products; and Stephen M. Sammut, a senior fellow and lecturer at Wharton who has long studied private equity in emerging markets. They find that small- and medium-sized enterprises (SMEs) are the sweet spot for PE investments in Asia. The PE firms that succeed, they say, will be those best able to develop good personal relationships with potential target firms and other industry players, along with skills for providing portfolio companies with significant operational upgrades, not just financial engineering.

Emphasizing the unfamiliar characteristics of many Asian markets, the authors observe that: "Amidst a constantly adapting and dynamic landscape, most [general partners], even successful ones, are relegated to learning along the way, or to practicing a trial-and-error approach.... As the industry evolved in these geographies, SMEs have now become the flavor of the month, given smaller deal sizes available, a robust deal pipeline of family-owned businesses and the lack of leverage for large [leveraged buyouts]."

> Today, no discussion on private equity is considered comprehensive without touching on emerging markets.

That doesn't mean profits will come easily. PE and venture capital firms reported a plunge in returns in Asia for the year ended in September 2011, from 30.9% to 10.9%, closely matching results of PE and VC funds in emerging markets worldwide. Overall, conditions in Asia were sobering in 2011, the authors write, noting that some Asian currencies lost value, some countries experienced deficits, and even powerhouses like China and India are displaying some economic weaknesses.

"While concerns of investing in the 'East' had been well documented, this was the first time that investor bullishness saw a re-evaluation," the authors say, observing that "not even 2008 really shook the emerging markets story as much."

Asia's Appeal

Still, Asia remains appealing. Asia-oriented funds drew more fundraising in 2011 than any region except the United States, with surveys showing that the chief attraction was the potential for high returns rather than issues like portfolio diversification. A November 2011 survey of PE investors by Ernst & Young found that 70% expected to significantly or slightly expand holdings targeted to the Asia/Pacific region, while only 1% said they would cut back significantly. The survey showed that "Asia bullishness will sustain in the medium term," the authors write, noting that China and India continue to get the lion's share of PE allocations to Asia.

Each of the major economies in the region offers a unique mix of opportunities and risks:

China

Though still enviable by Western standards, economic growth is slowing in China, with gross domestic product expected to increase by 7.5 % in 2012 and 7.1% in 2013 compared to 9.1% in 2011.

Among the concerns: Domestic consumption still remains only 40% of GDP, low compared to developed nations, and the country's heavy reliance on exports makes it susceptible to "export shocks" from factors like lower demand in Europe, the authors write.

"Moreover, beyond concerns over a questionable growth model, with more money going in (investment) than coming out (consumption), a weakening currency, manufacturing and services output, [and a] stressed banking sector all are serving to be a drag on the overall economy. If this wasn't sufficient, possibly [for] the first time since China started its March toward double-digit growth, the country is starting to feel rumblings of dissatisfaction politically."

Nonetheless, there are positive features, such as an expected rise in per capita income and lending rates in the low single digits. The migration of the rural population to cities remains strong, privatization of state-owned firms creates a demand for PE capital, and the government has been easing regulations to attract PE firms.

China, the authors note, "still has a treasure chest of foreign reserves to protect against external shocks and is still the fastest growing economy with a massive trade surplus. Moreover, we have still not seen global brands emerge consistently from China, and this may just keep the aspiration of the next big wave alive. Despite the concerns, possibly dangerously, investors have not backed down in part because the country still offers them one of the best risk-adjusted returns relative to any part of the world.... With over $10 billion deployed just in 2011 and local LPs starting to emerge, this [PE demand] is bound to keep growing."

India

GDP growth is expected to slow in China and may also slow in India, to less than 6.5% in 2013 compared to 7.3% in 2012 and 6.8% in 2011. Lending rates are higher, however – 6.0% in 2012 and projected for 2013 – and the stock market has fallen by more than 25% since November 2010, while the rupee has depreciated about 20% since summer 2011. Government deficits are growing.

"Inflation rates and interest rates have held at a steady high, agricultural efficiencies are low and, although domestic consumption was supposed to be the big story behind growth, it is not near the level of exports-based growth, with per capita income oscillating around a dismal $1,500," the authors write. "To worsen matters, not dissimilar to China, political instability/competence is a prominent investor concern. The lure of a deregulated retail sector vanished when political factions blocked the way."

PE investments have recovered somewhat from 2009 levels of about $4 billion, but at $6.17 billion in 2011 they were actually behind the 2010 level of $6.22 billion. Nonetheless, PE firms find promise in India, with more than 250 opening shop in the past five years.

Indonesia

Once again, growth is strong compared to developed countries, though wavering, with

GDP up 6.5% in 2011 and expected to be 5.8% in 2012 and 6.2% in 2013. Per capita income is relatively high, at about $3,500 in 2011 compared to about $5,300 in China and $1,500 in India. Unfortunately, lending rates are sky-high, at 14.8% in 2011, 14.4% in 2012 and an expected 14.9% in 2013.

"One of the better geographies to weather the storm during the financial crises, Indonesia, along with Singapore and Malaysia, is increasingly catching investors' fancy," the authors say. "Although issues with physical infrastructure, high unemployment and [a] slower growth rate bog [down] the country, investors are finding appeal in the strategic location between the Indian and Pacific Ocean and its resource richness...."

A rise in Islamic financing and strong performance by the equity markets and economy during the financial crisis make Indonesia an attractive PE location.

Singapore

Here, economic growth has been weaker than in the big Asian powerhouses, with GDP up 4.8% in 2011 and expected to fall to only 2.6% in 2012 and 3.5% in 2013. An inflation rate near 5% and loss of exports are key factors.

Still, there are significant positives: a strong account surplus, the government's power to manage the currency, and the potential for economic diversification. "Diversification opportunities exist in developing and expanding high tech, biotech and pharmaceuticals with supportive policies from the government and make-it-happen partnerships from local funds, corporations and universities," the authors say. Per capita income is very high, topping $51,000 in 2011 and expected to keep growing.

Malaysia

GDP growth is similar to Singapore's, at 4.5% in 2011 and projected to be 3.2% for 2012 and 4.6% in 2013. Per capita income is not as stunning as in Singapore, but still robust, at about $9,100 in 2011. Malaysia is transforming from a commodities-based economy to a computer and electronics producer.

Despite a decline in the growth rate, there are numerous positive features, the authors say, including "a high level of foreign reserves, a strong account surplus, proactive policies by the government to handle inflation, and moderate and stable politics." According to the authors, Malaysia has an "opportunity to develop and expand high tech, biotech, IT solutions and Islamic financial products with make-it-happen partnerships with local corporations and financial institutions."

Vietnam

Growth trails that of China and India, but is strong by Western standards, at 5.9% in 2011 and projected to be 5.8% in 2012 and 6.5% in 2013. Incomes, however, remain very low, at about $1,350 in 2011.

Vietnam, the authors say, is on the upswing. "In the last 20 years, Vietnam's poverty rate has fallen from 58% to 10% and it has earned its place as one of the top five fastest-growing economies in Asia," the authors point out, cautioning, however, that "account and trade deficits and an overall weak currency inhibit some of the country's potential."

Nonetheless, Vietnam benefits from political stability and membership in the World Trade Organization, which gives it access to foreign capital and financial markets. PE investors are also attracted by the country's urbanization, demographic features and pace of privatization.

Strategies

How can PE firms insure the best chance of success in Asia? The authors identify two key strategies.

First is to develop "proprietary sourcing" of PE acquisitions, to get the lowest purchase prices possible. This requires developing an "insider network to get better terms on the deal," thus allowing the PE firm to avoid the bidding wars that often accompany auction-based purchases.

To improve their information and gain an inside track, the PE firm should nurture personal relationships with a range of knowledgeable sources: accountants, lawyers, credit rating officers, tax inspectors, executive coaches, personal wealth mangers and journalists.

The PE firm should also realize that the owners of a small or mid-sized target may have a range of interests aside from earnings, making personal relationships essential. “Creativity, empathy and an inherent interest in people are necessary to build such relationships,” the authors explain. “To invest in an SME, an investor must first appreciate the personal needs of the founder and those who are in his circle of trust. Is it succession planning that worries him? Does he wish his children were more involved in the business? Can you push forward the aspirations of those in his circle of trust somehow?”

The second key to success is “operational involvement,” as the owners of SMEs are typically wary of PE firms that simply hope to provide capital and then ride the company’s coattails as it grows. SMEs that make attractive acquisitions often do not need PE capital, “but can see the lure of growing business to the next level, either with a higher profile or a larger-scale customer,” the authors write.

“However, to get to the next level, you don’t just need capital and business development but also a retooling of the organization to ensure you don’t feel like a fish out of water while meeting with such a potential customer. PE firms that appreciate such nuances are attractive....”

Clearly, deals vary, and it is not possible to establish a universal formula for allocating resources to strategies like generating proprietary networks and developing operational improvements. But the authors say PE firms should keep on top of distinctions between the deals won with a proprietary advantage and those done without it. Among the measures to watch: the price paid, the stake acquired versus the stake sought, and the time and money spent during the process of originating the deal to closing the purchase.

In addition, PE firms should study the contrasts between the deals and funds that emphasize operational improvements with ones that do not. That should involve looking at the composition of teams of professionals used, tracking the time and money spent on internal and external operations, and measuring factors like numbers of factory visits, calls handled and potential acquisitions researched, and the revenues and margins achieved.

The best opportunities, the authors emphasize, will continue to be among small and medium-sized firms. Operational improvements are especially important to such firms, which are abundant in most Asian countries. “The lure of SMEs for PE firms started once [PE firms] came to terms with the reality that neither large targets nor significant leverage was available for deals, and that SMEs offered high growth, quickly.” That has been the case in recent years, and is likely to be so for some time to come – as long as investors go about things the right way.

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