◄ and particularly Asia, the big opportunity for private equity. "Global private equity is moving to the situation of being one-third US, one-third Europe and one-third Asia," declares Tycho Sneyers at fund of funds provider LGT Capital Partners. "Half the Asian opportunity will be in China, whilst 25% will be in India and the rest spread throughout the region." LGT has expanded its exposure significantly over the past three years to around 20% of global portfolios. "There was no crisis and little impact on the portfolios or fundraising."

Private equity in emerging markets is essentially growth equity, not leveraged buy-outs. As Simon Faure, a director of Prudential Portfolio Management's private equity fund of funds activities, says, there is nothing wrong with leveraged buyouts, per se. "But growth is a constant and stable way of making money and some business can grow in both good times and bad," he notes. "The biggest problem with no leverage is that unless growth rates are very high, you cannot make exits at three-times the purchase price – the sort of return that justifies the risks."

However, the challenge that private equity investors in Asia face is, first of all, identifying management teams with expertise in each sector and, secondly, selecting those who have the genuine ability to assist company management in executing growth. There is little evidence yet as to whether the immense flows we have seen has been smart money or dumb. As Faure points out, there has been no proof of concept that private equity actually works in markets like Asia, and even if it does, many managers come from an investment banking or consultancy background with little direct private equity experience. "It takes time to learn about doing private equity investment and ideally managers need to have done an apprenticeship that has taken them through the highs and lows of the business cycle," he says.

There can also be challenges in finding a rationale for private equity in Asia. India, for example, has very developed capital markets and an extreme concentration of wealth among a relatively few families, not dissimilar to Italy or Brazil. "Is private equity the 'dumb money' that chases deals that no one else would touch?" asks Faure.

Faure's worries about 'dumb money' are most severe when it comes to China and India, which have attracted the bulk of interest and investment. Is there really the capacity and talent to justify the growth we have seen in just a few years – from 30 to more than 350 private equity firms in India alone since 2004? Hans Markvoort, LGT's head of private equity investment solutions, argues for his firm's tilt towards China rather than India because private equity fills a capital-allocation niche in the absence of a well-developed banking sector.

Unrein says that JP Morgan takes a similar view: valuations are more attractive but he also sees a better culture and government support for private equity there. It also helps that China also has a robust exit market: "If you look at wthe global statistics for IPOs during the last two or three years, it has been dominated by China" he says.

India

India's growth rate and sheer size makes it comparable to China in terms of potential for private equity, but investors have to be wary of who they place their money with. "A lot happened in 2007," says Nitin Deshmukh, CEO at Kotak Private Equity. "Sixteen of the top 20 global private equity firms established offices in India. Around $1bn was invested in 2004, while in 2007, the figure was over $14bn. These new players did not do much in 2009, but they came back into action in a hurry in 2010, undertaking transactions at high prices and driving up valuations significantly."

> *"Today, you can count on one hand the number of top quality venture firms, so the market is below the critical mass it needs to survive"*
>
> Hanspeter Bader

In China, unlisted companies usually trade at a discount to listed companies, providing an incentive for flotations. But as Deshmukh points out, unlisted companies in India have been traded at valuations even higher than listed companies because the market is highly intermediated, as new players pay high valuations to source dealflow and demonstrate deals.

This fits with what Sneyers sees from the perspective of LGT, which has invested in a handful of managers in India compared with about 15 in China: "It is a much smaller market with more competition, more players, high valuations, very few exits and somewhat disappointing returns."

Still, alongside the multinational megafunds and second-tier global firms, a number of independent firms have also set up – some, like ChrysCapital, with long track records – and, perhaps most significantly, there are also subsidiaries of major financial and industrial groups such as Tata Capital, Kotak Private Equity, ICICI Venture and IDFC Private Equity.

In developed markets, investors have been wary of these so-called 'captive firms' for fear that third-party investment flows might be used to support parent company investment strategy, to the detriment of investors. But in the context of a market like India, there can be considerable advantages to having access to high quality dealflow without being subjected to an auction process.

For example, when Kotak identified aerospace and defence as the next big opportunity, it partnered with Mahindra & Mahindra to make a major investment in Mahindra Aerospace that enabled two acquisitions – a niche aircraft manufacturer and an Australian aerospace components and assemblies manufacturer.

"We were able to add considerable value to the transaction partnering with the Mahindra team in negotiations, structuring the transactions, legal agreements, and so on, besides working on the strategic plan ahead to scale up the business in India," explains Deshmukh. "We see a significant amount of dealflow from Kotak and we have benefitted from that. There is also a lot of credibility associated with Kotak which is a strong brand in the capital markets: mid-sized enterprises benefit from the association."

Amit Dev Mehta, who heads Tata Capital in Europe, agrees. As a group with a 140-year history and a leading brand in India and, increasingly, across the world, Tata is well positioned to find attractive deals. It currently runs five private equity funds, all with a target size of $1bn: a special situations fund; an 'Innovations' fund; a healthcare fund undertaken in conjunction with healthcare specialist HBP Partners; a growth capital fund; and, lastly and most significantly, the Tata Opportunities Fund, investing in opportunities arising from within the Tata Group and outside.

During the past decade, Tata has invested $40bn and expects to invest a significant amount over the next decade, so it is no surprise to find it looking to diversify targets of funding to include an element of private equity.

Indian private equity may not match China in size, but many of India's industrial groups have long and distinguished histories that enable them to source deals and add value through their own expertise. The key issue for private equity investors may be establishing the governance structures to enable them to be in a fair partnership; otherwise they may find themselves paying a premium for dealflow through independent groups.

The post-crisis panorama

The 2007-09 crisis has had visible and long-term consequences on the small world of private equity, writes **Cyril Demaria**

Commentary

If anything illustrates the relative state of denial in which private equity continues its activity since the financial crisis, it is the advent of dividend recaps in 2010.

The principle of dividend recaps is simple: a private equity general partner (GP) acquires a healthy company through a leveraged buyout (LBO). Theoretically, this company should be sold after a few years, which, in fact, was not possible because of the past crisis. With the leverage effect decreasing over time (the debt of acquisition being regularly repaid), there is still the option to re-leverage and distribute 'anticipated profits' to limited partners (LPs).

Theoretically, dividend recaps are putting everyone at ease. GPs can please LPs with distributions, and hence prepare comfortably their next fund raising. The underlying company has no right to voice any concern, but its management is relatively pleased to avoid any additional pressure to find a trade buyer which does not exist at that time. The LP gets cash in a period when liquidity and rates are low.

In 2010, $234bn (€162bn) was lent for leveraged loans (versus $77bn in 2009) according to S&P LCD. Some 84% of these loans were granted to distribute dividends to private equity funds. Clearwire Communications and HCA, among the

largest LBOs of the 2006-2007 bubble, were the target of dividend recaps. It is probable, however, that 2011 will bring a correction.

Dividend recaps have two main consequences. The first is to reintroduce risks in LBOs. In a classic LBO structuring, the highest point of the risk is during the first months, when financial leverage is high. Theoretically, this risk is compensated by the added value which will be created by the investor. Re-leveraging is not compensated by additional value creation – it is a 'wait-and-see' solution. The default rate of high yield bonds has evolved from 13.6% in 2009 to 2.9% in 2010 and Moody's projects a rate of 1.8% as of November 2011. If economic growth lags, meanwhile, this default rate might well increase – and re-leveraged companies will be the first to be hit. This risk is not compensated by an additional return potential.

The second aspect is that these dividend recaps have the inconvenient capability to 'break the return thermometer', that is to say to suddenly skew one of the private equity fund return measurements: the internal rate of return (IRR). A small example (figure 1) shows that an anticipated cash distribution by a dividend recap can simultaneously increase the IRR and impoverish the investor: the investor realises an IRR of 20% and multiplies his investment by three, when the investor who realises an IRR of 26% multiplies his investment by 2.5.

The classic answer of general partners is that LPs will always prefer liquidity to increased performance. This remains to be proven. First, there is no guarantee that the LP will find an investment opportunity performing at the same level as in the example.

Second, the transaction costs to find and invest in an LBO of the same quality will lower the overall performance of the LP's portfolio.

CalPERS is no longer your friend

The evolution of the attitude of private equity investors is the second major factor. LPs do not want to pay fees which are, according to academic studies from Harvard Business School and HEC Paris scholars, capturing the performance created by LBO investments. Large American institutional investors such as CalPERS have already started to adjust, notably by buying stakes in GPs with whom they have invested considerable amounts. This allows them to get a share of the management fees without forcing the general partner to lower these fees (notably through the application of the 'most favoured party' clause). Other investors have requested the set-up of co-investment programmes or asked GPs to manage segregated accounts.

So the trend is towards pre-defined budgets and progressive carried interest (which grows with the realised performance), and away from percentages of assets under management. GPs will need to align themselves with that trend if they are to attract LPs. On the other hand, the best are are already attracting too much capital and will continue to set up conditions which are favourable to them. The result could be a dual system of private equity fund management.

Funds of funds at the crossroads

Funds of funds are the great losers of the crisis. They have not attracted larger institutions for some time and are now experiencing an obvious lack of legitimacy. They will probably be the first victims of the 'war on management fees' that GPs are anticipating. Returns are declining and one of the surest ways to preserve a certain return is to reduce management fees (which are 0.8-1.0% of assets over 13 years at the moment, plus 5-10% carried interest).

We see a response to these pressures already.

1. Multiples and IRRs of an investment with and without dividend recap

	Without dividend recap	With dividend recap
Initial investment	-100	-100
Year 1	0	0
Year 2	0	0
Year 3	0	150
Year 4	0	0
Year 5	0	0
Year 6	300	100
Multiple of investment	3	2.5
Internal rate of return	20%	26%

2. Summary of added costs from new regulation (in basis points)

	LBO	Venture capital
Adaptation costs		
Delegation costs	8.25	8.25
Relocation	19.7	19.7
Legal structures	14.1	14.1
Total adaptation costs (bps)	**33.8**	**23.2**
Total adaptation costs (in €m)	**45 451**	
Annual costs		
Communication portfolio companies	2.9	3.7
Delegation	0.2	0.2
Evaluation	4.3	9.2
Capital	1.5	1.9
Custodian	5 10	
Total annual costs (bps)	**13.8**	**24.8**
Total annual costs (in €m)	**248 33**	

Source: Charles Rivers Associates, October 2009

"Funds of funds are the great losers of the crisis... They will probably be the first victims of the 'war on management fees' that GPs are anticipating"

APG and PGGM have sold AlpInvest (a private equity fund of funds manager running $32bn) to a joint venture between Carlyle and AlpInvest management. This, in turn, should help to fuel the listing project of Carlyle, which is less diversified than its competitors KKR and Blackstone. Other GPs, such as Apollo in the US, are also preparing for listings.

This is a race towards large size. AXA Private Equity has been a frontrunner with the acquisition of portfolios from Bank of America and Natixis in 2010. With Basel III toughening bank solvency ratios and the Volcker rule limiting the stake of banks in GPs to a few hundred basis points, we can expect this to be just the beginning of the trend.

The targets are not lacking, either because they do not have the critical mass (Unigestion, Adveq, FondInvest, SCM, Alpha Associates, Capvent), or because they have weathered difficult times (Capital Dynamics has lost one of its main mandates) or both (see Access Capital Partners' involvement in the 'pay-to-play' scandal in the US). Quite a few have not raised funds for some time, which questions their value-add. Moreover, they do not benefit from any special treatment due to their reduced risk profile under Basel II or III, nor under Solvency II.

Regulatory inflation

The advent of the AIFM Directive in Europe, but also of the Foreign Account Tax Compliance Act (FATCA) in the US, should bring some additional changes. GPs argue that multiple regulations (Basel III, Solvency II, AIFMD, Volcker rule) will dry up the sources of private equity financing, and hence of private companies. Given that banks have severely reduced their exposure to SME lending, any change in the capital flow towards SMEs could have considerable consequences on already anaemic economic growth.

The consequences of the AIFMD or the FATCA are not yet fully known, but it is probable that they will result in a massive and durable slowdown to the emergence of new GPs due to costs (see figure 2), and the temptation to go around the regulation either through innovation, or by exploiting loopholes. The latter might remind us of what happened in the past with junk bonds and securitisation: the misuse of interesting innovation to circumvent legislative excess, which leads, finally, to another crisis.

One of the unexpected consequences of the regulatory changes from the mid-2000s is a strict avoidance of IPOs. The development of private markets – SecondMarket, NYPPEX and Fidequity, for example – has allowed certain private companies, such as Facebook and Groupon, to avoid IPOs. Investors are rushing to participate in private placements. Groupon, once rumoured as a $6bn acquisition target for Google, has raised $500m with the option to raise additional $450m. With this private liquidity available, an IPO is not necessary.

The emergence of private markets offers the possibility to get liquidity for existing investors. Of the $500m raised by Groupon, $345m was reserved for the exit of current investors. Facebook investors used SecondMarket to exit from their investment. Private companies can also keep their key employees in the firm if private markets allow existing investors to exit, they are not facilitating the exercise of stock options and do not offer sufficient liquidity to handle the resulting shares. Staying private hence becomes a competitive advantage against public companies.

Back to basics

GPs will have to face the consequences of a major trend – the decrease of future returns. In LBO, this will force GPs to extract most of the value of their investments, and will put many out of business – it is estimated that 20-40% of LBO teams could disappear over the next few years.

In venture capital, European (and even North American) under-performance is structural. Seed investing did not recover from the internet bubble burst of 2001-03. Incubators have almost totally disappeared, and seed funds barely attract investors due to lacklustre returns. According to Thomson Reuters, the average performance of early stage venture capital funds was -3.8% as of the end of 2009, versus -2.2% for venture capital. Median multiples of investment were respectively 0.85 and 0.9 times. Start-ups are valued at notoriously high levels. Government measures in favour of direct investments in SMEs from individuals in certain countries, for example, can only strengthen this vicious circle – and hence reinforce the problems of venture capital funds.

As for the temptation to go into Asia, the experience of past failed diversification of general partners during the internet bubble should be a very clear warning: private equity is a local business. LPs surely remember clearly the excesses of the internet bubble. It is now time for GPs to look into the problems and make the necessary efforts here and now.

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