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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

5 Factors Driving Private Equity In Asia

By **Scott Jalowayski and James Jackson** (April 23, 2018, 12:08 PM EDT)

Scott Jalowayski

James Jackson

Private equity in Asia is booming. In 2017, $75.3 billion in new capital was raised, $121.6 billion was invested, and $44.6 billion in exits were achieved in the region.[1] This article examines five important factors driving the private equity market in Asia — the macroeconomic environment, middle-class consumption patterns, the credit fund space, sovereign limited partners and the prevalence of co-investments, and Asia-based tech leaders spurring innovation.

The Asian Macroenvironment Is Strong, Yet PE Penetration Remains Low

The fundamental macroeconomic environment in Asia is strong, and all indications are that it will remain that way in the coming years. Gross domestic product per capita in China grew from $9,252 in 2010 to $16,624 in 2017, and in India it grew from $4,425 to $7,174 over the same period, representing a compound annual growth rate, or CAGR, of 8.73 percent and 7.15 percent, respectively. By comparison, the United States GDP per capita CAGR for the same period was 3.02 percent. These high growth rates in GDP per capita are projected to continue in the coming years, as China, India and other developing economies in Asia continue to close the gap with the developed world.[2] In this case the rising GDP tide really is lifting all, or at least many, boats. The ranks of the middle class have swelled in China and India, and are projected to continue growing at a fast clip in the coming decades, reaching 22 percent and 17 percent of total global middle-class consumption, respectively, by 2030.[3]

This all adds up to a very strong investment thesis for private equity sponsors, yet private equity investment as a percentage of GDP is nearly an order of magnitude lower than developed economies. For example, in 2017, buyouts by private equity sponsors were 0.10 percent, 0.21 percent and 0.87 percent of GDP in China, India and the United States, respectively.[4] This large disparity in private equity penetration indicates there are many untapped opportunities in the region and that the booming Asian PE market still has lots of room to grow.

Middle-Class Consumption Is Driving PE Deal Activity

The growing middle class in Asia is fundamentally altering the overall makeup of the regional economy, as the buying patterns of this burgeoning class of consumers leads to huge profits for the companies that successfully cater to them. Based on investment patterns in the region in 2017, it is apparent that PE sponsors are well-aware of the compelling investment opportunity this presents. The services and consumer goods sectors represented 20.8 percent and 16.9 percent of total PE investment transaction volume in Asia last year.

Two of the largest deals in Asia in 2017 are indicative of this trend.[5] The proposed $5.8 billion take-private of Belle International, a women's shoe retailer, by CDH and Hillhouse shows these sponsors' confidence in the retail sector and their ability to turn this struggling offline retailer around. The $5.5 billion growth equity raise by Didi Chuxing valued the company at $50 billion and showed how regional consumer-facing companies are using the strength of their domestic markets to fuel global ambitions — Didi Chuxing plans to use the funds raised to support its global strategy.

The Rise of Credit Funds Continues

In recent years, credit funds have established themselves as part of the increasingly robust private equity market in Asia, and 2017 was no exception with $5.2 billion raised,[6] including nearly $2 billion funds — Secured Capital Real Estate Partners VI at $1.9 billion and SSG Capital Partners IV LP at $1.7 billion. Distressed debt is a big part of this regional credit fund picture, with $2.5 billion in dry powder as of October 2017.[7]

China and India are both key target countries of credit fund sponsors. China's growing levels of bad corporate debt have led the government to further open up the domestic debt market to overseas lenders, illustrated by the People's Bank of China's January 2017 circular, which relaxed rules on foreign lending to domestic companies.[8] Meanwhile, India has been pressuring public-sector banks to reduce their debt exposure. This has resulted in credit funds and other private equity investors stepping in to refinance existing bank debt of large Indian corporates. Finally, the promulgation of India's new Insolvency and Bankruptcy Code should expedite bankruptcy proceedings and is generally viewed as shifting the balance of power in favor of creditors.

The Power of Sovereigns and the Prevalence of Co-Investments

Globally, sovereign wealth funds, including pension funds, have been increasing their allocation to the private equity asset class in recent years.[9] Fundamentally, this is driven by the same force that is increasing allocations by all institutional investors to the asset class — private equity simply outperforms public markets and other asset classes. This outperformance is projected to continue, with McKinsey predicting that returns in public markets will be significantly worse in the coming decades than they have been over the last 30 years. The global trend toward increasing investment in PE by sovereigns has been particularly true in Asia. China Investment Corp. has increased its allocation to PE by 68 percent from the end of 2015 to the end of 2016 (the latest date for which it has released allocation figures). Pension funds in Japan, Malaysia, Australia and South Korea have all increased their PE allocations significantly as well.[10]

With these increased investments in PE funds, sovereigns and other institutional investors have increased leverage to negotiate for the right to invest alongside the sponsor in portfolio company investments. These co-investments are typically on a no or very low-fee basis, which reduces the limited partner's overall fee burden. Many high-profile transactions highlight the trend of sovereigns and pension funds increasing direct investment activity in the region — the Canada Pension Plan Investment Board's over $500 million investment in Homeplus alongside MBK Partners; participation by CPPIB, GIC Private Ltd. and the China-UAE Investment Cooperation Fund in China Internet Plus Holding's $4 billion fundraising; and Qatar Investment Authority and British Columbia Investment Management Corp.'s investment alongside AMP Capital and Macquarie in the $5.6 billion buyout of Endeavour Energy.[11] This swell of direct investments by sovereigns shows no signs of abating.

Tech Leaders

Gone are the days when Asia was seen as a follower in terms of technological innovation. Now China is by all accounts leading or at least giving Silicon Valley-based tech companies a run for their money in emerging technologies, such as big data, artificial intelligence and electric vehicles. Baidu, Alibaba and Tencent have plowed money into both their own artificial intelligence and big data projects as well as into startups focusing on these cutting edge technologies by investing. PE sponsors are piling in as well. SenseTime, a computer-vision technology company, is backed by Alibaba, CDH Investments, IDG Capital and other strategic and financial investors, and its Series C fundraising round in late 2017 valued it at nearly $3 billion.[12]

China is currently the largest market in the world by far for electric vehicles, accounting for over 40 percent of the total sold in 2016, more than twice the number sold in the United States.[13] Chinese companies such as Geely and BYD Auto are meeting much of this demand, and Chinese manufacturers collectively plan to be producing 4.52 million electric cars annually by 2020.[14] Private equity sponsors have invested heavily in this sector, committing $4.4 billion to electric vehicle manufacturers in China since 2015.[15] Many of these high-growth tech leaders in China and the region are poised to eclipse their competitors in Silicon Valley and other developed economies, and sponsors are eager to invest in what many see as the innovators of the future.

Scott A. Jalowayski is a Hong Kong-based partner and co-chairman of the global private equity practice at Gibson Dunn & Crutcher LLP.

James Jackson is an associate in Gibson Dunn's Hong Kong office.

[1] Asia Private Equity Review — 2017 Year End Data Issue.

[2] IMF World Economic Outlook Database. GDP per capita figures are based on the PPP methodology.

[3] The Unprecedented Expansion of the Global Middle Class, Homi Kharas, February 2017.

[4] Preqin (aggregate buyout figures) and International Monetary Fund (nominal GDP estimates).

[5] Asia Private Equity Review — 2017 Year End Data Issue.

[6] Asia Private Equity Review — 2017 Year End Data Issue.

[7] Preqin, Private Debt Spotlight, November 2017.

[8] People's Bank of China Circular on Matters relating to the Full Bore Macroprudential Administration

of Cross-Border Financings.

[9] McKinsey Global Private Markets Review 2018: The Rise and Rise of Private Markets.

[10] Asia Private Equity Review, March 2018.

[11] Asia Private Equity Review — 2017 Year End Data Issue.

[12] Cruchbase.

[13] International Energy Agency, Global EV Outlook 2017.

[14] International Energy Agency, Global EV Outlook 2017.

[15] Asia Private Equity Review, March 2018.