

## Private Equity in Asia

October 2010

*Asia private equity, in particular China, has increasingly attracted attention from institutional investors due to the region's faster economic recovery, greater growth rate and a positive macro economic outlook. The market has evolved from one previously dominated by U.S. or European sponsors offering US dollar denominated funds with a Pan-Asia focus to a more balanced mix that includes local sponsors offering local currency denominated funds with a single country focus. Additionally, the returns of Asia private equity investments have been attractive, outperforming U.S. and European peers over the past ten years. Meanwhile, unique political, regulatory and investment specific risks exist. Cliffwater believes that experienced Asian private equity managers are capable of assessing the risks and identifying attractive opportunities in the region in order to generate strong performance and that Asia private equity can be an attractive part of an institutional private equity portfolio.*

### *Asia Private Equity Partnerships*

The Asia private equity landscape can be divided by country and the level of capital development in each marketplace. Broadly speaking, there are the developed markets (Australia, New Zealand, Japan, South Korea, Taiwan, Singapore) and the emerging markets (China, India, Southeast Asia ex Singapore). Each of these areas has its unique characteristics and private equity sponsors may focus on one area or may take a broader Pan-Asia scope. A description of each category follows.

### *Pan-Asia Funds*

Pan-Asia funds invest across both developed and emerging markets in Asia, providing clients with broad exposure to the marketplace. Major Pan-Asia funds have been established by U.S. and European based private equity firms (TPG Capital, the Carlyle Group, Bain Capital) or spinouts from global investment banks (Unitas Capital, the former Asia private equity team of JP Morgan; Affinity Equity Partners, the former Asia private equity team of UBS). Investment professionals are typically comprised of a mix of local, and transplanted U.S., and European professionals. The funds are generally US dollar denominated and include investors located around the globe.

Pan-Asia funds tend to compete in the larger sized deals in the market due to their larger fund sizes and the investment strategy tends to be buyout oriented, although with lower levels of debt than seen in traditional U.S. or European buyout transactions. While club deals are infrequent in Asia, Pan-Asia funds have increasingly been partnering with each other in making investments due to increased deal sizes and to limit individual deal risk. While some Pan-Asia funds were active in Southeast Asia prior to the Asia financial crisis in 1997, others have focused on Greater China (includes mainland China, Hong Kong and Taiwan), India, South Korea, Japan and Australia but have become increasingly active in Southeast Asia recently due to the changing country demographics and improving capital development in those markets. One major trend among Pan-Asia funds is the movement of team members from Hong Kong, where most are domiciled, to Mainland China in order to be more competitive with the increasing number of local Chinese private equity firms that have recently been formed.

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### *Emerging Market Funds*

Emerging market funds are country specific funds or regional funds that invest in emerging economies such as Mainland China, India, and Southeast Asia (excluding Singapore). Growth equity and venture capital strategies are dominant strategies in Asia's emerging markets as a result of fast growing economies, rising domestic consumption, a cultural aversion to debt as well as less developed debt markets, and entrepreneur's reluctance to relinquish control.

Within Mainland China, funds denominated in Chinese Yuan ("RMB funds") have grown significantly since 2008, accounting for 64% and 76% of capital raised by China-focused funds in 2009 and the first half of 2010, respectively. RMB funds are typically formed by domestic private equity firms (CDH Investments and New Horizon Capital) or may be joint ventures between U.S./European private equity firms (the Blackstone Group, the Carlyle Group) and local partners. Investors are domestic and include government entities, insurance companies, high net worth individuals, banks, and state owned companies. Currently, foreign investor access to RMB funds is restricted. Some municipal governments, including the Shanghai government, are reportedly exploring the feasibility of allowing foreign investors in RMB funds.

The growth of the RMB funds has been driven by the Chinese government's intention to grow the domestic private equity industry as well as Chinese institutional investors' increasing appetite for private equity. For example, China's National Social Security Fund, with \$114 billion of assets under management as of December 31, 2009, is an active investor in RMB funds. RMB funds are allowed to invest in industry sectors restricted from foreign investors (such as certain sub-sectors within financial services, healthcare, media and telecom). Importantly, RMB funds typically require less or no regulatory approval to make investments, unlike US dollar denominated funds where it can take months to get governmental approval to invest in a China domiciled company. RMB funds are expected to co-invest as well as compete with US dollar denominated funds in China. As a result, concerns over conflicts arise for managers who manage both US dollar and RMB funds. Firms that raise RMB funds in parallel with US dollar denominated funds have the benefit of accessing certain local deals and networking with local investors. However, Cliffwater encourages managers to be transparent in providing their rationale for allocation between the two sets of funds. We expect the rising trend of RMB funds to continue.

### *Developed Market Funds*

Developed market funds are country funds or regional funds that invest in developed economies which include Australia, New Zealand, Japan, South Korea, Taiwan, and Singapore. Buyout strategies are prevalent in the developed markets due to mature economies, developed capital markets and sophisticated debt investors.

The financial crisis and global economic recession had a greater impact on private equity investments in Asia's developed markets than in the emerging markets due to the extensive use of leverage. However, some of the markets such as Australia and South Korea have recovered quickly from the recession. Private equity funds targeting developed markets in Asia expect to benefit from the economic growth of the emerging economies due to growing demand from countries like China and India for natural resources, raw industrial materials, and consumer products and services.

### *Performance*

As shown in Exhibit 1-A, Asia private equity funds have outperformed their counterparts in the U.S. and Europe across various investment periods over the last ten years. Dissecting the performance further, Asian funds formed since 1998 have in general outperformed U.S. and European funds formed in the same year. However, Asian funds formed prior to 1998 underperformed their counterparts in the U.S. and Europe, due to a relatively small talent pool, the Asia currency crisis, less mature capital markets as well as the early stage of the private equity industry in the region. As shown in Exhibit 1-B, Asia's public equity market has also

outperformed the U.S. public equity market over various time periods. Over a ten-year period, the MSCI AC Asia Pacific Index outperformed the Russell 3000 Index<sup>1</sup> by 1.7%.

Exhibit 1-A: Internal Rate of Return of Asia Private Equity versus Other Markets  
As of December 31, 2009

	One-Year	Three-Year	Five-Year	Ten-Year
Asia Private Equity	37.00%	9.60%	12.00%	7.30%
Emerging Market Private Equity	34.50%	9.80%	14.10%	7.30%
U.S. Private Equity	12.20%	0.70%	5.40%	3.90%
Europe Private Equity	7.70%	-3.90%	6.50%	5.30%

Source: Baring Private Equity Asia/Cambridge Associates for Asia and Emerging Market Private Equity; Venture Economics for U.S. and Europe Private Equity. Asia Private Equity includes 235 funds formed between 1986 and 2009, excluding U.S., Israel, Africa, Latin America, and Europe funds. Emerging Market Private Equity includes 311 funds formed between 1986 and 2009, excluding U.S., Japan, Israel, Canada, Australia and Western Europe funds.

Exhibit 1-B: Return of Asia Public Equity versus U.S. Public Equity  
As of December 31, 2009

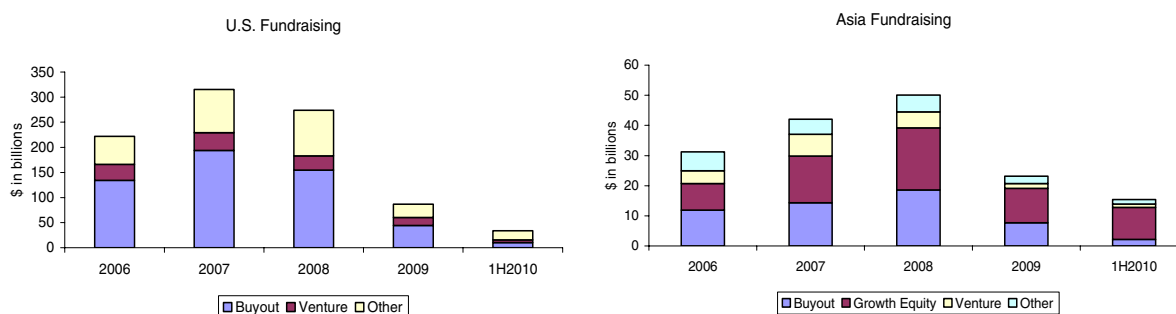
	One-Year	Three-Year	Five-Year	Ten-Year
MSCI AC Asia Pacific Index*	37.86%	-2.65%	5.94%	1.49%
Russell 3000 Index	28.34%	-5.42%	0.76%	-0.20%

\*Gross of dividends.

### Asia Private Equity Market Environment

While the global economic recession slowed private equity fundraising across the board, Asia was less impacted than the U.S. As shown in Exhibit 2, private equity fundraising<sup>2</sup> in Asia reached a record high of \$50 billion in 2008 but dropped by 54% to \$23 billion in 2009 while total capital raised in the U.S. dropped by 68% in 2009 to \$87 billion. During the first six months of 2010, private equity funds in Asia raised over \$15 billion of capital (with 79% of this being raised by funds focused on Greater China), representing an increase of 49% compared to the same period of 2009. This compares with a further decline of 36% to \$34 billion private equity raised in the U.S. during the same time period. Additionally, growth equity represents an increasingly larger percentage of total capital raised in Asia due to the more recent predominance of emerging market funds.

Exhibit 2: US vs. Asia Private Equity Fundraising by Strategy



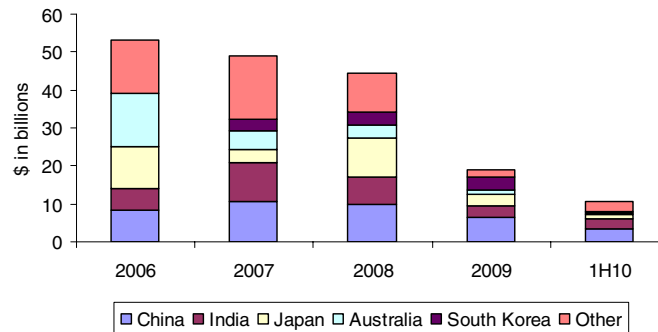
Source: Venture Economics; Asia Private Equity Review

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<sup>2</sup> Source: Asia Private Equity Review

In terms of where the capital is being invested, China and India are the preferred markets following the global economic recession. Exhibit 3 shows Asia private equity investment by country since 2006. Notably, China and India combined represent approximately 50% of total invested capital in 2009 compared to 26% in 2006. Southeast Asia has also attracted increasing attention recently, driven by rising domestic consumption and a recovery in exports. In contrast, Japan and Australia's combined share of total invested capital declined from 48% in 2006 to 23% in 2009. Transactions in Japan and Australia typically require leverage, which became less available during the financial crisis and the subsequent economic recession.

Exhibit 3: Asia Private Equity Investment by Country

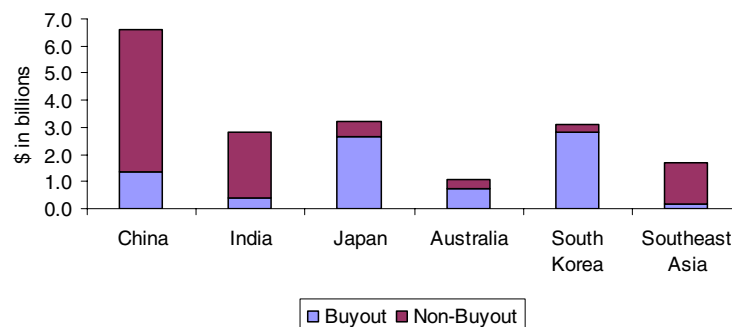


Source: Asia Private Equity Review

Asian countries vary substantially in economic development and culture. As such, successful private equity strategies adapt to what works best in each country. While all of the typical private equity strategies (growth equity, buyout, and venture capital) are utilized in Asia, in 2009, 52% of capital was invested in growth equity and 41% of capital was invested in buyout transactions. As shown in Exhibit 4, non-buyout investments (includes venture capital and growth equity) are more prevalent in emerging markets such as China and India due to rapid economic growth while buyout transactions are more typical in developed markets such as Australia, Japan, and South Korea where companies are more mature and debt financing is available.

Venture capital investments have generally performed poorly in Asia relative to growth equity investments which have performed well due to the large universe of companies with positive cash flow that are seeking capital to expand or to monetize value. Control oriented buyouts of these same companies would be preferred over minority growth equity investments; however, many company owners in the emerging economies of Asia are first time entrepreneurs who are reluctant to relinquish control.

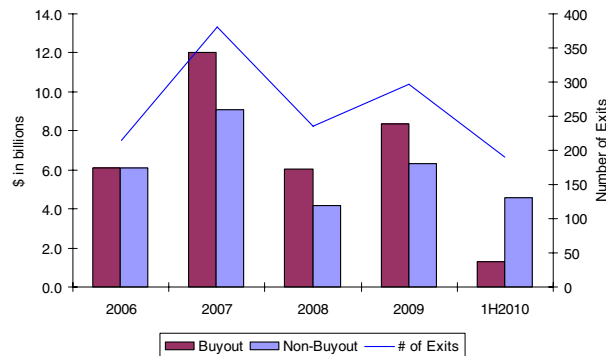
Exhibit 4: Asia Private Equity Strategy by Markets in 2009



Source: Asia Private Equity Review

Private equity investments in Asia have been exited through both trade sale and public markets, which represented 69% and 27% of exit value respectively in the first half of 2010. Secondary transactions (sales to other private equity sponsors) also occur in Asia but mainly in developed markets such as Australia and Japan. Exhibit 5 shows the number and dollar amount of Asia private equity distributions since 2006 by investment strategy.

Exhibit 5: Asia Private Equity Distribution by Investment Strategy



Source: Asia Private Equity Review

Exit via the public equity markets has been a viable strategy as the public equity markets in Asia have expanded substantially over the last five years, driven by the emerging economies. According to FactSet, the market capitalization of Asia ex-Japan grew by 212% from 2004 to 2009 and represented 21% of total world market capitalization at the end of 2009, up from 8% in 2004. Notably, the market capitalization of companies traded on China's domestic stock exchanges increased by six times from \$500 billion in 2004 to \$3.5 trillion in 2009. As a result, China has become the second largest public equity market in the world, after the U.S. According to PricewaterhouseCoopers, there were 99 initial public offerings ("IPO") on China's domestic stock exchanges in 2009, which in total raised \$27.5 billion of capital. This compares with 69 IPOs and \$25.2 billion of capital raised on NYSE and NASDAQ combined. The launch of ChiNext, the Chinese equivalent of NASDAQ, in October 2009 has provided an additional liquidity option for private equity backed companies in China. By the end of 2009, 42 companies had launched IPOs on ChiNext, 28 of which were backed by private equity funds,

#### *Asian Funds in an Institutional Private Equity Portfolio*

Asia is a significant and expanding geographical location for private equity investments. We expect private equity fundraising by Asian oriented funds to materially increase over the next year with a large number of funds coming to market, including both Pan-Asia funds and regional/country specific funds. Among the risks to be considered by investors are political and regulatory changes and low transparency in certain countries. How private equity firms deal with each of these risks is a distinguishing factor. In addition, attention must be paid to private equity firm staff turnover as new private equity firms are being formed and existing private equity firms are expanding with talent being drawn from the more established firms. As such, compensation and incentive structures are important due diligence factors. With that said, Cliffwater believes that experienced Asian private equity managers are capable of assessing the risks and identifying attractive opportunities in the region in order to generate strong performance and that Asia private equity can be an attractive part of an institutional private equity portfolio.

#### *Cliffwater Summary Observations*

Below are our summary observations of Asia private equity:

- Private equity investments in Asia have outperformed those in the U.S. and Europe over the last decade, driven by strong economic growth, developing capital markets, financial reforms and an increasing availability of experienced investors.

- Private equity in Asia is expected to be driven by rising domestic consumption in emerging economies such as China, India and Indonesia. Developed countries in the region can potentially benefit from growing trade with these countries.
- Asia's capital markets continue to mature, driven by emerging markets such as China and India with enhanced liquidity for private equity backed companies.
- The trend of RMB funds in China is worthy of close monitoring as they will continue to shift the private equity landscape in China.
- Political risks, regulatory changes and low transparency remain in certain countries. Fund investors must be prepared for issues related to government intervention, regulatory uncertainty, corporate governance and social instability.
- Private equity team turnover remains a concern as new private equity firms are being formed and existing private equity firms are expanding.
- Asia private equity should be a component of an institutional private equity portfolio with the level and type of exposure driven by the quality of the deal flow as well as the institutional investor's objectives and existing portfolio characteristics.

Kathleen Barchick  
Lan Qian  
Cliffwater LLC  
310-448-5000