



**HK私投募資VCA**

Hong Kong Venture Capital and Private Equity Association

— 香港創業及私募投資協會 —

# A New Leaf in Asia Private Equity

HKVCA **Journal**

First Issue | Fall | 2014



# Where experts go for expert advice.

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# Foreword

Private equity fund investing in Asian countries “Asia Private Equity” has come a long way to being accepted today by international institutional investors as a mainstream strategy in their global private equity portfolios.

The increased acceptance is due to a number of important factors. First is the growth in transactable opportunities in the region; second, the rise of proven managers; third, the need for an effective diversifier after the experiences with the global financial crisis, the Euro debt crisis and the recent surge in US private markets valuations.

At HKVCA, we believe that Hong Kong has a special place in the development of Asia Private Equity. For a long time, our city has been an important hub for regional private equity managers. Practitioners in Hong Kong have an excellent vantage point from which to identify and pursue new industry trends and opportunities region-wide. We are thus both pleased and indeed honoured to present you with the inaugural issue of the HKVCA Research Journal, which aims to serve as the platform to communicate our members’ unique insights on the emerging trends and opportunities represented by Asia Private Equity.

This inaugural issue will seek to highlight some of many features that the lay at the core of evolutions in the depth and breadth of the region’s private equity industry. It profiles a number of differentiating strategies, such as the capabilities to capture opportunities in cross-border M&A, in direct secondaries, in nexus oil and gas deals, and in situations where proven operating expertise matters.

We are grateful to the Emerging Markets Private Equity Association for providing a snapshot of the state of Asia Private Equity. Alongside this, we have prepared a focused discussion on the Asian venture capital opportunities that are emerging outside of Mainland China and locally in Hong Kong, as well as opportunities found through crowdfunding as an innovative alternative funding route.

Finally, this issue offers some technical insights in Asian fund formation with respect to tightened regulations on private equity worldwide. In particular, we bring to your attention the HKVCA’s efforts working with the Hong Kong Government on tax reforms highly relevant to private equity general partners and funds.

We want to express our gratitude to all our members who contributed to this inaugural issue of the Journal, and to Messrs. T.K. Chiang and Joseph Ferrigno for their work as editors. We hope that this and the Journals to come will be a useful platform for the sharing of HKVCA members’ stories and ideas, and that they may inspire investors and members of the private equity community worldwide.

**Denis Tse**

**Chairman of Research Committee, HKVCA**

## HKVCA Journal 1st Issue: A New Leaf in Asia Private Equity

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# HKVCA Membership... has its benefits

## Networking

Established platform and extensive opportunities for meeting and networking with industry participants

## Resources

Receive feedback on questions and queries from informed members and have access to industry research and information

## Skills Upgrade

Upgrade professional skills and acquire cutting edge, up-to-date knowledge of the latest trends, deals, and market and regulatory changes

## Representation

Help influence policies that affect the industry through representations before government, the media and other important institutions

## Dealflow

Have unrivaled access to government and business players in Hong Kong, mainland China and across the Asia region

## Events

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## Information Exchange

Exchange information and share experiences with industry players who share common interests and goals

## Standards

Be involved in setting standards and creating benchmarks that help raise the profile of the venture capital and private equity industry



“ HKVCA is the premier Association of its kind in Asia with the longest history and the biggest membership body. It connects industry players, large and small, regional and global. It not only networks GPs with each other but provides a platform to connect them with LPs and government bodies ”

Johnny Chan  
Chairman,  
Membership Committee  
Crosby Asset Management

“ HKVCA membership is a great tool for one key reason: it allows me to meet and interface with other professionals, which helps find answers to questions we face and allows us to know others who have similar issues or problems ”

William Ho  
Vice-Chairman,  
Membership Committee  
CVC Asia Pacific Ltd

# A New Leaf in Asia Private Equity

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# State of the Private Equity Industry: Something Old, Something New, Something Borrowed, Something Blue

By Mark Shipman, Partner of Clifford Chance  
Jeff LeMaster, Registered Foreign Lawyer of Clifford Chance

There's an English rhyme from the late 19th Century that includes the phrase "Something Old, Something New, Something Borrowed, Something Blue". It was thought that a bride wearing these four items on her wedding day brought good luck to the couple. A little bit of luck is always welcomed by newlyweds, as it is by a fund manager and investors in the "union" formed in a private equity fund. Thankfully, for both fund managers and investors, the same four core elements found in this 19th Century rhyme, admittedly in different forms, can be seen in today's private equity fund market, both globally and in Asia.

## Something Old

Continuing on from trends seen in the global private equity fund market in 2013, investors have continued to favour more established fund managers in 2014, with 32% of investors in a recent industry survey rating past performance as the single most important factor in determining which fund manager(s) with whom to partner.<sup>1</sup> Additionally, as noted by an industry insider in a recent interview,<sup>2</sup> "capital continues to flow to existing relationships and traditional strategies ...". Not only has the placement of such capital persisted to familiar fund manager destinations, the source of such capital has also continued to come from familiar places, with North American investors providing a large portion of private equity funding. In Asia, North American investors typically make up 50% of private equity funding.

The consistent presence of large amounts of North American investment (the majority of which comes from the United States) in private equity funds require fund managers based in Asia to weigh the regulatory burden caused by having even a single US investor against potentially higher management fees resulting from larger fund raisings. With ever-increasing US regulation, including filings or registration with the US Securities and Exchange Commission (SEC) potentially being required of fund managers, "bad actor" certifications that must be obtained from various individuals and entities involved in offering shares of private equity funds in the United States and Volcker Rule restrictions that must be complied with, the decision faced by fund managers in accepting US investors continues to be one that dramatically shifts their compliance landscape.

**“ private equity fund managers and investors look towards 2015 with hopeful optimism ”**

## Something New

In opposition to the continued regulatory changes present in the United States, which have the potential effect of chilling US

investment in Asia, regulators in Hong Kong have been involved in discussions regarding methods to better facilitate international investment. This includes the issuance in December of 2013 by the Financial Services Development Council in Hong Kong of proposals to extend the profits tax exemption for offshore funds to include private equity, as well as discussions surrounding the potential for a domestic limited partnership structure.

Currently, a large percentage of non-US private equity funds are established in offshore jurisdictions, such as the Cayman Islands or the British Virgin Islands, in the form of limited partnerships, with a general partner responsible for the day-to-day management of the partnership; however, this structure is not available in Hong Kong. As such, private equity fund vehicles are simply not established in Hong Kong. This may change, as work has begun to explore the legal and regulatory framework for limited partnerships in Hong Kong. There is no doubt a desire to update and modernise Hong Kong's long-standing Limited Partnerships Ordinance in a way which fulfils the following criteria: (i) creating attractive conditions for setting up limited partnerships compared to other global investment fund centres; (ii) providing greater certainty, flexibility and relevance to investors and fund sponsors, in particular seeking to better suit the needs of private funds; and (iii) ensuring investor protection through appropriate measures and requirements. To the extent the legislature in Hong Kong does indeed introduce a change to the existing laws, and allows for private equity funds to be established in Hong Kong as limited partnerships, Hong Kong may begin to see a steady increase in domestic fund structures.

The interest of the Hong Kong regulators in private equity funds does not stop with the current review of the limited partnership framework, as the Securities and Futures Commission of Hong Kong (SFC) has recognised that many managers have gone entirely unregulated in Hong Kong, due in part to reliance on an exception available to managers that only provide investment advice to their wholly-owned group companies. As such, the SFC has recently been looking into the activities of private equity fund managers domiciled in Hong Kong (although recognising that private equity fund managers are at the lower end of the risk scale). Due to this increased scrutiny by the SFC, and as regulators globally continue to push fund managers towards registration (for example, in the European Union as alternative investment fund managers under the EU's Alternative Investment Fund Managers Directive (AIFMD) and in the United States as registered investment advisers with the SEC), private equity fund managers may wish to revisit their licensing status to ensure that they are relying on the correct exceptions (where unlicensed) or otherwise have the correct type(s) of licence.



Hong Kong regulators have been active not only domestically, but also on the international front, with the SFC entering into co-operation agreements with most European Economic Area regulators for the purposes of AIFMD to enable a private equity fund managed in Hong Kong to be marketed to investors in the EU.

As a result of AIFMD, the same cost-benefit analysis required of fund managers when considering whether or not to accept US investors is of equal (or greater) importance when the potential investors are European. AIFMD generally allows private funds to be offered only if such offerings meet the requirements of both (i) the EU country into which such funds are being offered and (ii) the AIFMD transparency rules as a whole. As a result of needing to comply with the requirements of multiple jurisdictions, the costs associated with marketing private funds into the EU by non-EU managers have increased exponentially. Additionally, the current framework of AIFMD has caused investors in several European jurisdictions, including Spain and Italy, to essentially be "off limits" for non-EU fund managers. Due to the increased complexity and cost resulting from AIFMD, private equity fund managers have to carefully consider the potential capital that may be raised in each European jurisdiction in order to determine whether capital raising in the EU currently makes sense.

### Something Borrowed

Due in part to the potential benefit to a fund's internal rate of return (IRR) through the employment of leverage,<sup>3</sup> and the flexibility leverage can provide fund managers in terms of the timing of cash outflows, its usage by private equity managers continues to increase from the levels seen immediately following the global financial crisis.

However, despite the similarities seen in today's use of leverage with that of pre-2009, the bevy of terms and covenants now surrounding such leverage, which serve to restrict borrowings in multiple ways, differentiates the leverage of today. Fund documentation frequently now contains specific restrictions related to the duration of borrowings, as well as maximum borrowing levels vis-à-vis fund size. The expectation, however, is that such restrictions will continue to be whittled away by fund managers as we move further away from the global financial crisis.

### Something Blue

In the third quarter of 2014, 199 private equity funds reached a final closing, representing the lowest number to do so since the third quarter of 2010. In line with the lower number of fund closings, the aggregate capital raised in the third quarter of 2014, US\$80 billion represents the lowest amount since the third quarter of 2011.<sup>4</sup>

However, unlike the works of Pablo Picasso circa 1901-1904, not all is blue (i.e. sad). What the most recent quarter's fund raising statistics also show is a very healthy average deal size of US\$402 million, with more than half of all private equity funds that closed in the third quarter exceeding their targeted capital raise. Additionally, the dry powder present in private equity funds has continued to increase. As of 31 September 2014, private fund managers had US\$1.17 trillion available for investment, which represents an 11% increase over the levels seen at the end of 2013.<sup>5</sup>

Furthermore, investor sentiment appears to show an increased confidence in the private equity fund sector, with a recent industry survey showing that 63% of investors believe that the interests of private equity fund managers and investors are properly aligned; a key component to facilitating the continued growth of the private equity sector. Additionally, 57% of investors surveyed stated they are looking to work with both fund managers with whom they have existing relationships and new fund managers in the next 12 months; a fact that bodes well in terms of further expanding the scope of the private equity market.<sup>6</sup>

So, as private equity fund managers and investors look towards 2015 with hopeful optimism, whilst still keeping an eye on the opportunities currently present in the market, it appears that such hopeful sentiments (sentiments shared by newlywed couples) are not misplaced.

#### Mark Shipman, Clifford Chance

Mark Shipman is the Global Head of the Funds and Investment Management practice as well as the Asia Pacific Regulatory practice. He has extensive experience advising on the structuring, establishment and promotion of all types of investment funds, including private equity funds. He also specialises in providing regulatory advice to fund managers. Mark was appointed a member of the Hong Kong Government's Financial Services Development Council, tasked with exploring ways to help facilitate the further development of Hong Kong's financial services industry. He is also a member of the Hong Kong Securities and Futures Commission (SFC)'s Advisory Committee.

<sup>1</sup> The Q3 2014 Preqin Quarterly Update, page 7

<sup>2</sup> The Q3 2014 Preqin Quarterly Update, interview of Steve Sandbridge of Capstone Partners, page 8

<sup>3</sup> As the calculation of a fund's IRR begins once capital is called, the use of leverage to defer such capital calls can serve to increase a fund's IRR.

<sup>4</sup> The Q3 2014 Preqin Quarterly Update, page 6

<sup>5</sup> The Q3 2014 Preqin Quarterly Update, page 13

<sup>6</sup> The Q3 2014 Preqin Quarterly Update, page 7

# First Half of 2014 Emerging Asia Private Equity at a Glance

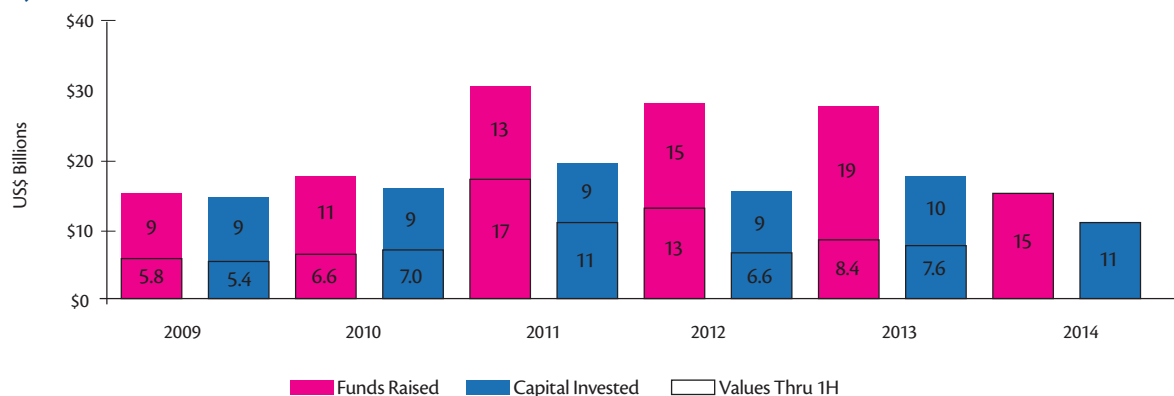
Contributed by EMPEA

According to EMPEA's First Half 2014 industry statistics, private equity fund managers raised US\$15 billion for Emerging Asia in the period, an 80% increase from first half of 2013, due largely to a record capital raise in the Chinese venture capital (VC) space. Attracting US\$4.1 billion, China-focused VC funds accounted for 27% of total capital raised for Emerging Asia, their highest share of regional fundraising activity since EMPEA began tracking funds in 2006. At the large-cap end of the market, final closes for just three pan-Asia buyout funds raised by Affinity Equity Partners, CVC Capital Partners and TPG contributed US\$5.1 billion to the first-half fundraising total, representing 34% of total capital raised. The increasingly diverse range of fund strategies on offer in the region was also apparent in

India. Led by a US\$825 million final close for special situations fund Aion Capital Partners, Indian fund managers raised US\$1.3 billion in the first half of 2014, more than was raised in all of 2013.

On the deal side, China-focused VC fund managers matched a record fundraising haul in the first half of 2014 with a sharp uptick in investment activity. Capital invested through VC deals in China increased more than fourfold compared to the same period in the previous year, contributing to an overall increase in capital deployed in China of 96%. In contrast, other major markets in Emerging Asia presented a mixed picture, with capital invested in India up 3% and in Southeast Asia down 40% from 1H 2013.

## Emerging Asia Fundraising and Investment, 2009 – 1H 2014 (US\$B)



## Emerging Asia Fundraising and Investment, 2009 – 1H 2014 (US\$B)

	2009	2010	2011	2012	2013	1H 2014
Full Year Funds Raised	15	18	31	28	28	15
Full Year Capital Invested	15	16	19	15	18	11
Funds Raised in 1H	5.8	6.6	17	13	8.4	15
Capital Invested in 1H	5.4	7.0	11	6.6	7.6	11

Source: EMPEA. Data as of 30 June 2014.

### A Closer Look at China and India

Activity in China's venture capital (VC) space pushed private equity fundraising and investment totals in the first half of 2014 to heights not seen since 2011. Of the US\$6.7 billion raised for China-dedicated funds in the first six months of 2014, a staggering US\$4 billion accrued to VC funds—the largest percentage of capital raised by VC vehicles since EMPEA began tracking fundraising statistics. This was partly a cyclical phenomenon as many of the largest VC investors in China returned to market at the same time. However, the speed at which investors such as Shunwei Capital Partners and Lightspeed Venture Partners wrapped up fundraising and the warm reception

first-time fund managers such as Banyan Capital and ClearVue Partners enjoyed suggest there is strong demand amongst LPs for the strategy.

As fundraising totals increased, so too did capital invested, with VC again accounting for an outsized 38% of the US\$5.9 billion deployed in China. The surge in VC investment totals was partly due to activity in the late-stage VC space by multi-strategy firms such as Warburg Pincus, Orchid Asia and General Atlantic, increasing the number of investments at the larger end of the spectrum and pushing average VC deal size from US\$14 million over the last two years to US\$27 million in 2014.



Buoyed by rising investor confidence upon a clear mandate emerging from India's general elections in May, fund managers raised US\$1.3 billion in the first half of 2014, more than doubling the amount raised in the same period in the previous year. ICICI Venture Funds Management and Apollo Global Management's AION Capital Partners led the way in fundraising, reaching a US\$825 million final close, making it the largest India-focused private equity fund raised since 2008. Also notable in the fundraising space, only one fund with a growth capital strategy reached a close in the first half of 2014, in comparison to seven venture capital funds and two special situations funds.

The exit environment, long a challenge for the country's private equity players, may also be improving as India's S&P BSE Sensex Index reached record highs in the second quarter of 2014. Bain Capital's partial divestment of Hero Motocorp shares and Wolfensohn Fund Management's public market exit of Repco Home Finance both resulted in reported returns of 2x. Challenges, however, remain around regulatory issues, including uncertainty in India's tax regime.

Clear decisions from regulatory bodies will hopefully bring stability to India's private equity industry and help fundraising continue to bounce back from 2013 lows.

The second half of 2014 has thus marked a resurgence in confidence amongst investors in a multitude of different strategies; from private equity to venture capital, for established firms to new entrants and from China to India.

#### EMPEA

EMPEA is the global industry association for private capital in emerging markets. We are an independent non-profit organization. As EMPEA celebrates our 10th anniversary in 2014, we have over 300 member firms, comprising institutional investors, fund managers and industry advisors, who together manage more than US\$1 trillion of assets and have offices in more than 100 countries across the globe.

### Largest Emerging Asia Funds Achieving a Close, 1H 2014

Fund Manager(s)	Fund Name	Fund Type	Geographic Focus	Currency	Capital Raised, 1H 2014 (US\$m)	Capital Raised to Date (US\$m)
Affinity Equity Partners	Affinity Asia Pacific Fund IV	Buyout	Asia	USD	1,300	3,800
CVC Capital Partners	CVC Capital Partners Asia Pacific IV	Buyout	Asia	USD	1,500	3,500
TPG	TPG Asia VI	Buyout	Asia	USD	2,300	3,300
CDH Investments	CDH China Fund V	Growth	China	USD	350	2,550
Navis Capital Partners	Navis Asia Fund VII*	Buyout	Southeast Asia	USD	410	1,270
Yunfeng Capital	Yunfeng Fund II	Venture Capital	China	USD	500	1,100
SSG Capital Management	SSG Capital Partners III	Special Situations	Asia	USD	915	915

\*Fund currently raising.

Source: EMPEA. Data as of 30 June 2014.

### Most Active VC Dealmakers in Emerging Asia, 1H 2014

Fund Manager	No. of Deals
Sequoia Capital	21
IDG Capital Partners (IDGVC)	15
Shenzhen Capital Group (SCGC)	13
Matrix Partners	12
Accel Partners	11
SAIF Partners	11

Source: EMPEA. Data as of 30 June 2014.

### Most Active PE Dealmakers in Emerging Asia, 1H 2014

Fund Manager	No. of Deals
ChryCapital	4
Hopu Investment Management	4
Sequoia Capital	4
CVC Capital Partners	3
KKR	3
Yunfeng Capital	3

Note: PE includes growth, buyout, mezzanine and PIPE transactions.

## Largest Investments in Emerging Asia, 1H 2014

Fund Manager(s)	Company Name	Country	Sector	Investment Type	Investment Amount (US\$m)	Investment Date
The Carlyle Group	Tyco Fire & Security Services Korea (ADT Korea)	South Korea	Professional Services	Buyout	760	May-14
KKR	Qingdao Haier	China	Appliances & Electronics	PIPE	545	Apr-14
Hopu Investment Management	Noble Agri	China	Logistics	Buyout	500	Jun-14
IMM Private Equity, IMM Investment	Hyundai LNG Shipping	South Korea	Ports, Waterways, Shipping	Buyout	484	Apr-14
Headland Capital Partners	Kreuz	Singapore	Oil & Gas	Buyout	353	Feb-14
KTB Investment & Securities	Dongbu Express	South Korea	Transportation	Buyout	303	May-14
General Atlantic, Sequoia Capital	Meituan	China	Retail	Venture Capital	300	May-14
Hony Capital	Chengtou Holding	China	Real Estate	Growth	298	Jan-14
KKR, Baring Private Equity Asia, Boyu Capital, Hopu Investment Management	COFCO Meat	China	Animal Production	Buyout	270	Jun-14
CX Partners	Aditya Birla Minacs	India	Technology	Buyout	260	May-14

Source: EMPEA. Data as of 30 June 2014.

## Notable Exits and IPOs in Emerging Asia, 1H 2014

Country	Company Name	Fund Manager(s)	Sector	Year(s) of Investment	Capital Invested (US\$m)	Transaction Date	Exit and Return Detail
Thailand	Wall Street Institute Thailand (WSI)	Navis Capital Partners	Education Services & Training	2006, 2007	N/A	May-14	Navis and Government Pension Fund strategic sale of 100% stake to Wave Entertainment for THB800m (US\$24.6m)
China	JD.com	Capital Today, Sequoia Capital, Bull Capital, Insight Venture Partners	Information Technology	2007, 2009, 2011	245	May-14	IPO on NASDAQ Stock Exchange raised US\$1.8B; Capital Today was the only investor to partially exit its stake, returning US\$53m
Vietnam	Mobile World	Mekong Capital, CDH Investments	Retail	2007, 2013	4, 20	Apr-14	Mekong and CDH pre-IPO placement raised US\$22.7m and US\$7.4m, respectively
South Korea	Oriental Brewery	KKR, Affinity Equity Partners	Food & Beverage	2009	800	Mar-14	Strategic sale of 100% stake to AB InBev for US\$5.8B
Indonesia	Bank Tabungan Pensiunan Nasional (BTPN)	TPG, Northstar Group	Banking	2008	200	Mar-14	Strategic sale of additional 16% stake to SMBC for US\$504m
Indonesia	Cardig Aero Services	Baring Private Equity Asia	Aviation & Aerospace	2011	41	Feb-14	Strategic sale of 42% stake to Singapore Airport Terminal Services for US\$94m

Source: EMPEA. Data as of 30 June 2014.

# Venture Capital and Private Equity Activities in Hong Kong: The Last Six Years

By Denis Tse, Chairman of Research Committee, HKVCA

The Hong Kong Venture Capital Association (HKVCA) has assembled data on all institutional private equity and venture capital investments in Hong Kong companies since after the Global financial crisis in 2009, and the results are discussed in this paper. HKVCA will continue to track these activities and release an update annually.

Highlights of the past years include venture funding into local start-ups such as 9GAG, GoGoVan and WeLend, and the private equity fund participation in Hong Kong businesses such as A.S. Watson, TVB and HK Broadband Network.

## Venture Capital

For the first 11 months of 2014, 24 cases of venture capital funding in Hong Kong startup companies were reported, the highest since 2009. Nest and Fresco have been the most active investors, having invested in a total of 17 Hong Kong startups between them since 2009. Compared with other Chinese economic clusters, Hong Kong still lags behind Beijing, Shanghai, Shenzhen, Jiangsu-Zhejiang and Guangdong (ex-Shenzhen) in terms of year-to-date venture capital deal quantum. Based on the numbers, Hong Kong is ahead of Tianjin and Sichuan, which are emerging hubs of medical device and online game companies, respectively (source: Zero2ipo). The recent level of venture capital activities in Hong Kong is similar to that of Singapore 4 years ago. The city state has had more than 70 cases of venture investments annually (source: Preqin/SVCA).

## Private Equity

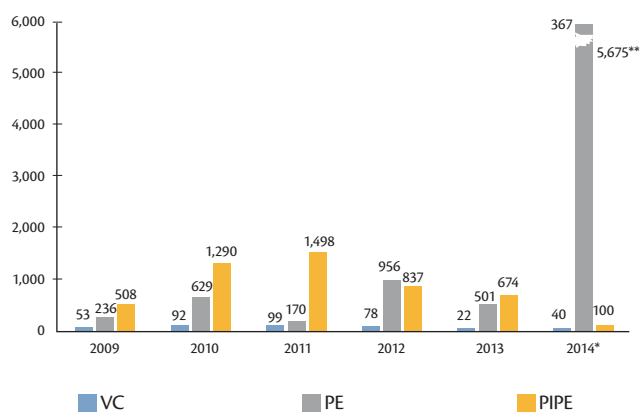
While a number of regional and global private equity managers base their Asian headquarters in Hong Kong, there are no clear trends in private equity investments in Hong Kong enterprises. With the exception of the 2010-2012 period during which the cheap valuation of public stocks relative to the private markets attracted a surge of Private Investment in Public Enterprise (PIPE) transactions in listed Hong Kong companies, the number of private equity investments transacted in Hong Kong per year has hovered in the sub-15 range since 2009. The aggregate deal value of Hong Kong private equity investments was only US\$367 million in 2014 not including Temasek's US\$5.7 billion privately-negotiated investment in A.S. Watson. Carlyle, CVC Asia and EQT are the few private equity groups that have organized systematic efforts to cultivate private equity opportunities in Hong Kong.

## Looking Forward

We believe that as the Hong Kong economy matures and local business groups implement their strategic ambitions, there will be more private equity opportunities arising from succession, corporate divestitures and management buyout attempts.

Likewise, while the volume of venture capital investments is still small in Hong Kong, the emergence of homegrown private incubators and venture capital firms will lead the way in the future.

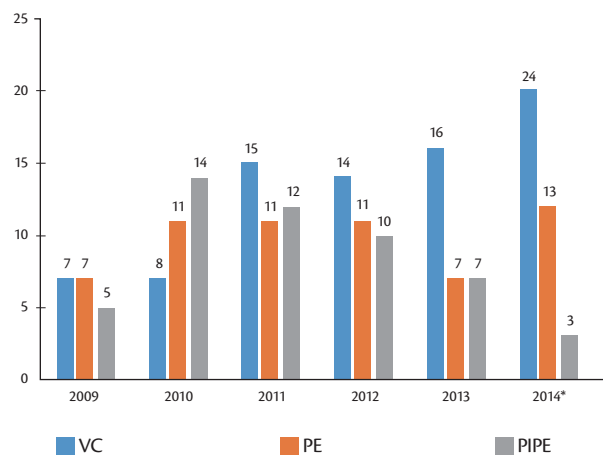
Deal Value since 2009 (in US\$ million)



\* First 11 months

\*\* 2014 deal value of private equity investment hits US\$6,042 million, including Temasek's US\$5,675 million investment in AS Watson.

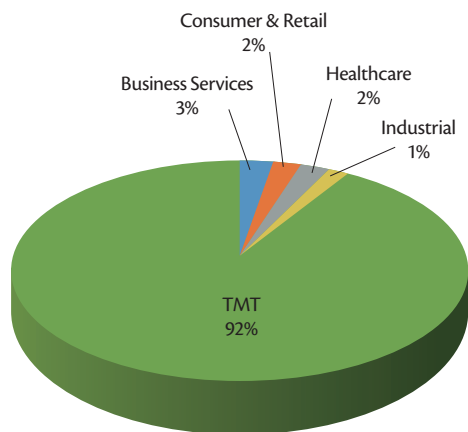
Deal Value since 2009



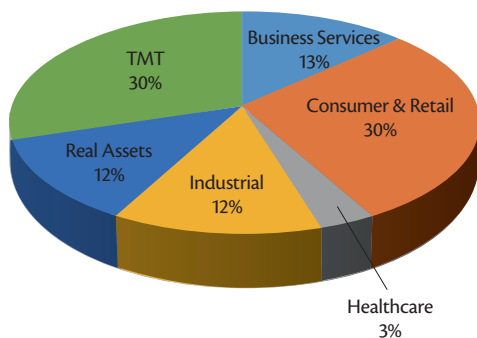
\* First 11 months

Source: HKVCA Research Committee

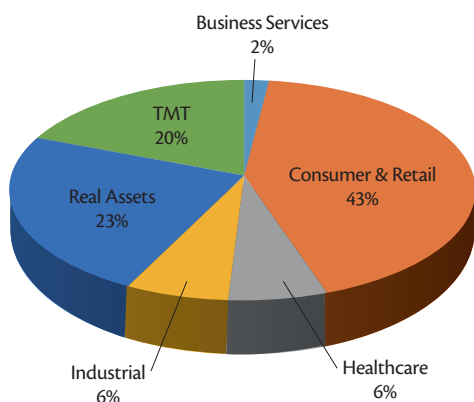
**Venture Capital Deals by Industry (2009 – 2014 YTD)**



**Private Equity Deals by Industry (2009 – 2014 YTD)**



**PIPE Deals by Industry (2009 – 2014 YTD)**



Source: HKVCA Research Committee

**Most Active Investors**

Venture Capital	No. of Deal
Nest	9
Fresco Capital Advisors	8
500startups – seed fund and incubator program	5
Leitmotiv Private Equity	5
Red Chapel Advisors	4
Velocity Capital	4

Private Equity	No. of Deal
Carlyle Asia	4
AID Partners Capital China	2
Media Capital	2
CLSA Capital Partners	2
CVC Asia Pacific	2
EQT Partners Asia	2
New Horizon	2
Partners Group	2
RRJ Management	2
Saban Capital Group	2

PIPE	No. of Deal
CDH China	3
Yunfeng Capital	3
Orchid Asia Group	3
Carlyle Asia	3
Temasek Holdings	2
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Source: HKVCA Research Committee

# Tax Matters...

By John Levack, Chairman of Technical Committee, HKVCA

For many years tax has not been a pressing concern for the partners of PE firms based in Hong Kong: the offshore fund, managed by an offshore manager and carefully advised by a Hong Kong entity – worked very effectively. Unfortunately there are a number of reasons why tax has been demanding more attention in recent months.

There are two levels where we need to look at new trends that are impacting tax management: firstly fund and investment taxation and secondly taxes on management activities.

## Fund level

An increasing number of Asian countries are stating that tax treaty benefits will be applied only to investors that have real ‘substance’ in the jurisdiction from which they are investing. Many funds have invested into portfolio companies through intermediary entities (special purpose vehicles or SPVs) in countries that have good Double Tax Agreements (DTAs) with these countries. There will, however, be significant costs to these SPV arrangements if the Fund has to demonstrate substance in the intermediary vehicle.

As a long term solution to this, we are discussing with the HK Government the updating necessary to the Partnership Law and taxation in HK that would allow Fund entities to come onshore in HK together with the Manager – creating real substance – and then being able to confidently access HK’s (improving) network of DTAs.

In the shorter term, the amendment to the Offshore Funds Tax Exemption to include private investments will allow Managers to be based in HK without jeopardising the Fund’s offshore status. Importantly the Inland Revenue Department (IRD) has understood the importance for SPV’s of the Fund to be based in HK and have substance – and has stated that the IRD will not use the substance of an SPV to claim the Fund is subject to HK taxation. The HKVCA Technical Committee is working with the Government to try to find a solution whereby an unregulated Manager (by the SFC) will be able to benefit from this amendment. We understand that the necessary legislation for the inclusion of Private Equity is now in the queue at Legco.

## Manager level

At the Management Entity level there have been two significant changes in the IRD’s approach. Firstly, there is a new method for determining the level of Advisory Fee payable by the offshore Manager to the HK Advisor. For many years, Advisors in HK were paid a fee based on a ‘Cost plus 10-15%’ formula that was accepted by the IRD. Some two years ago the IRD re-assessed how this fee should be calculated – and concluded that an apportionment of value added was more appropriate. This methodology is derived from OECD Transfer Pricing principles.

The outcome of this change is that some Advisors have been subject to investigations and the general conclusion is that future Advisory

Fees should be calculated based on computations of how much of the Manager’s activity is performed in HK. The accounting firms say that the overall outcomes may not be hugely different to the cost-plus arrangement, but it is recommended that any firms that have not addressed this issue should contact their professional advisors.

Secondly, the IRD’s scrutiny on fees from the Fund to the Manager (as described above) revealed flows of payments labelled ‘carry interest’. The IRD has come to an initial view that some of these payments may in fact be caught under its definition of fees and would then be subject to the apportionment treatment. The result is an increase in the notional fee attributed to the HK Advisor (and thus a higher tax charge in this entity).

Having discussed this issue with a number of the accounting firms, it is clear that some of the ‘carried interest’ schemes established by HK PE firms have not been sufficiently rigorously designed and/or maintained. In these cases the IRD’s opinion may be correct. There does however appear to be a consensus at Technical Committee discussions that we should aim to establish a ‘safe harbour’ definition of a model ‘carried interest’ scheme that would ensure that these distributions are accurately labelled as ‘capital gains’. The Technical Committee is working on how this can be documented and presented – and plan to arrange further discussions with the government on this subject.



Once again, it is recommended that individual firms review their carried interest structures and documentation to ensure that both aspects will hold up to external inspection. The IRD has undertaken investigations of a small number of PE firms' carry schemes in the last year – and may well continue this exercise.

As many of you will be aware, HKVCA has increased its engagement with the HK government in response to a need for updating of structural issues here. The government has understood that private equity, though a small sector, does provide a positive impact in Hong Kong – and has generally been receptive to our requests. We have however signalled that retro-active amendments to tax undermines confidence in a tax system that should offer certainty, clarity and consistency.

### **Role of the Technical Committee**

The Technical Committee seeks to provide a forum where leading experts from accounting and law firms can work with CFOs and

General Counsel of Private Equity firms to ensure we have the latest information on, and can develop responses to, new technical issues that impact our industry. Whilst HK taxation and regulation are major topics for the committee, the group covers a wide range of technical issues and tries to ensure that members are notified of new developments through seminars or publications through the website. In addition, we try to act as the sounding board for views on subjects that impact the industry: for instance, we are preparing a 'round table' event to bring together members who would like to provide feedback to HKEx on two subjects (i) variable voting rights and (ii) a possible updating and simplification of Chapter 21 listing rules that would allow HK IPOs of collective investment schemes.

We are keen to develop the Technical Committee as a valuable resource for HKVCA members, so please feel free to contact any committee members (a list is on the HKVCA website) if you have any concerns on technical matters that you believe might have relevance for the industry.



*HKVCA Technical Committee*

# The Good, the Bad and the Ugly: Is Your Approach to Due Diligence Robust Enough?

By Greg Hallahan, Senior Director of FTI Consulting

As the recent wave of short-seller reports has vividly demonstrated, the Asia-Pacific region – and in particular China – continues to present significant challenges for investors. Conducting enhanced due diligence can potentially protect investors from risks, whilst also enabling them to add value to a business before they become a stakeholder.

An array of off-balance sheet risks are not always visible from financial or legal reviews, as these can leave significant gaps in the overall understanding of a potential portfolio company. There is a high need to go beyond a review of financial statements to assess whether revenue is sustainable and whether commercial agreements have value. Investors need to also thoroughly evaluate key local, political, and cultural aspects of a target company, its industry, and operating environment.

To do this, due diligence efforts must address the backgrounds, reputations, and track records of a company and its key principals, as well as related third parties. Increasingly, due diligence must also address other risk factors. Such risk factors can be categorized into three general groups: operational; reputational; and regulatory.

**“ due diligence should include efforts to identify any other businesses to which the individual shareholders and senior management might be connected ”**

## Operational Risks

Operational risks result from breakdowns in internal procedures, and systems and inadequate competence of people managing them. They are separate to the external risks that a company may be exposed to as a result of market-wide forces.

First and foremost, company ownership and management should be closely examined. Questions to ask include:

- Is there a high proportion of related family members amongst the owners?
- Is ownership concentrated post-investment (e.g., more than 30 percent in the hands of one individual)?
- Are personal and professional connections between shareholders clearly disclosed and known?
- Are the senior management appropriately qualified to hold the roles they have in the company? Have they demonstrated integrity and business acumen in past dealings?

Operational issues often extend beyond the company management and involve third parties, ranging from nominees of related parties, purported customers, and so on, through to local government officials and regulatory authorities, including tax departments, customs, banking and land registration. To that end, due diligence should include efforts to identify any other businesses to which the individual shareholders and senior management might be connected. For example, do they have any obvious connections to major suppliers, customers, or other key third parties, which is common in Asian companies where the personal and professional relationships are so intertwined?

Other factors that should be examined prior to making an investment include:

- Has the company been involved in labor disputes or health and safety violations, which is prevalent across the region?
- Likewise, has the company been (or are they likely to be) impacted by environmental concerns?
- Has the company been involved with any intellectual property disputes?

## Reputational Risks

Research should be conducted on the profile of the company in the public domain, in press reports, trade journals, and social media postings. Such research is vital to corroborate and consolidate all information sources to enable a more detailed understanding of a company's business activities. Efforts should also be made to determine:

- If the company has been involved in any civil litigation, either in the past or ongoing (note that information on criminal records is not available in the public domain in most countries in Asia).
- If the company has been involved in any disputes with industry peers and/or related enterprises, etc.

In addition, it is critical to understand which of the key principals and shareholders have political connections, either to local government authorities and/or on a national level? If so, what do these connections mean for the company, given that all political connections have the potential to be a double-edged sword.

## Regulatory Risks

Due diligence efforts should include attempts to uncover whether the target company and/or its key principals are currently under investigation or likely to be in the future by State authorities, for example, the increasingly active Central Commission for Discipline Inspection in China, or local regulatory offices.

Clearly authorities, both domestic and international, are keener than ever to investigate corruption and impose staggering fines when they find it. If the due diligence done prior to an investment does not dedicate resources to determining whether or not the target company – and the third parties it is using – are involved in corrupt behavior, it is dangerously insufficient.





# Cross-border Private Equity Case Study: The Chinese Expansion of PizzaExpress

By Joseph Wan, Partner of Cinven

The acquisition of PizzaExpress by Hony Capital highlighted the attraction of a well-established Western brand with a cash generative growing UK business and strong proven Chinese growth potential.

Tapping the growing demand of China's emerging middle class is a frequently cited investment thesis but the business reality is more complicated. Cinven's recent sale of PizzaExpress to a Chinese investor provides an interesting case study of its successful prosecution.

Cinven first acquired Gondola, the owner of PizzaExpress (along with a small number of other restaurant brands), in a £1 billion take-private from the London Stock Exchange in late 2006. The Cinven team had already identified the international roll-out potential of the PizzaExpress brand prior to acquisition. However, the operational focus was firstly on improving the performance of the UK business; secondly on acquiring the international business when this could be achieved at an attractive entry multiple in 2010. From 2010 onwards, international expansion could then be executed as a central part of the value creation strategy.

At acquisition, the international PizzaExpress business was a disparate group of franchise operations spread across various parts of Western Europe, the Middle East as well as Hong Kong and Shanghai. This network of franchise operations had been starved of support from the 'mother ship' for the five years preceding the acquisition in 2010.

“**At acquisition the international PizzaExpress business was a disparate group of franchise operations...**”

Post-acquisition, onlookers in Hong Kong and China may have been surprised by the increase in executives in suits at PizzaExpress restaurants in early 2010 as a thorough review of its international operations, including these markets, kicked off.

This detailed review of the potential of each international market – and consumption of numerous pizzas – identified China as the key region to pursue, given the strong growth it was experiencing in eating out, attractive demographics and, crucially, proof of concept in the region. In addition to the small and well-run franchise business already operating in the market, the quick service restaurant giant Pizza Hut already had around 700 sites across China and Hong Kong, while a number of casual dining brands were beginning to expand in the key cities, effectively preparing the ground for PizzaExpress's expansion.

With this supportive market backdrop, the PizzaExpress board undertook detailed market research on the Chinese market. The work revealed a clear consumer interest in a higher quality dining experience based on more authentic Italian or European cuisine. The high quality food, service and ambience of the PizzaExpress proposition combined

with its price positioning would resonate strongly with the rising, affluent middle-class consumers in China.

The main strategic dilemma was how to enter China. During 2011 and 2012 PizzaExpress board members and senior executives visited China on a regular basis as part of a broader international development assessment that also encompassed the Middle East and India. With on-the-ground guidance from Cinven's Asian portfolio team, PizzaExpress executives were able to spend their time effectively, becoming immersed in the local market; and engaging with the region's major real estate agents and competitors, to form a clear picture of the relative feasibility and upside potential of different market entry strategies.

As part of the international development process, PizzaExpress re-engaged with existing franchisees, bringing them up to date with UK brand and food innovations. Many had been operating with little or no contact with the UK headquarters, and were often significantly off-brand, with corporate ID and logos sometimes a generation out-of-date. The benefit of private equity ownership was clear, not least through its 'best practice' approach towards the franchise operations.

Following the 2010 transaction, a detailed manual 'the Pizza Express Way' was made available to all franchisees to ensure world-wide standardisation of the consumer experience (from menu to service style and restaurant look-and-feel), in order to build customer trust and true brand consistency. Prior to private equity involvement, some franchise partners could only learn of the latest innovations by making personal visits to PizzaExpress restaurants in London.

Room was created for regional nuances and the sharing of ideas between regions. For instance, the original Hong Kong and Shanghai franchisee had developed innovations, some of which were retained and rolled-out further – such as more pasta, pizza served as a dish to share, and more side dishes.

During 2013 and 2014 four new sites were opened in Hong Kong (where the franchisee had been operating since 2001) and four new sites in Shanghai (the first had opened in 2005). At the end of October, PizzaExpress had 22 restaurants across China. Of the top 20 global PizzaExpress sites by EBITDA, four were in Hong Kong and Shanghai.

In addition to closely partnering with the franchisee in Hong Kong and Shanghai to accelerate store openings, PizzaExpress also opened its first fully-owned store in Beijing in May 2014 – the 500th PizzaExpress world-wide, and the first to be fully-owned outside the UK.

“**PizzaExpress opened its first fully-owned store in Beijing in May 2014 – the 500th PizzaExpress**”

The £900m sale of PizzaExpress (as a separate brand carved out of the Gondola holding company) in July 2014 was the largest European restaurant deal since the financial crisis, and one of the largest outbound investments by a Chinese buyer ever. The international expansion programme that Cinven put in place not only helped turn a UK market leading restaurant business into an international restaurant brand, it provided an exciting and demonstrably proven new growth engine for the business, and also raised awareness of that brand among international buyers. Under private equity ownership, the PizzaExpress UK business had shown resilient and strong performance even through the recession with EBITDA growing from around £60 million to approx. £90 million. The UK business remains highly cash generative with good growth potential, now coupled with a Chinese roll-out programme under the direction of Hony Capital which has a strong track record of helping Chinese enterprises expand globally.

**“The international expansion programme.... provided a demonstrably proven new growth engine for the business”**

There has been increasing evidence of Asian interest in acquiring European businesses, as well as European private equity firms keen to capitalise on the potential for further growth from their European portfolio companies in Asia. Cinven’s strategy of growing Europe-based business in Asia has been highly successful elsewhere. 2010 was a busy year for the Hong-Kong based portfolio team: they also worked closely with the board of Avio, the aircraft components manufacturer, to achieve two successful joint ventures in China.

Avio, headquartered in Italy, is a world leader in the design, manufacture and servicing of parts for commercial and military aircraft. Cinven’s strategy for the business was to capitalise on the strong worldwide growth in civil aviation – which included the fast-expanding Chinese aerospace market. Avio’s joint ventures with the two leading Chinese state-controlled aerospace businesses – Avic Harbin Dong’an Engine and Xian Aero Engine – played a critical role in access to this market which helped internationalise both Avio’s revenues and cost base. The Cinven Asian portfolio team was instrumental in the introduction and negotiation of these transactions. Avio Aviation was successfully sold to GE in early 2013 for €3.3 billion.

China and Korea are also the fastest growing markets worldwide for intellectual property (IP), fuelled not only by a significant increase in the number of patents being registered by domestic businesses, but also international businesses needing to protect their IPs in these markets. In 2012, Cinven invested in CPA Global, the world’s leading IP and patent renewal business, recognising the long-term growth in global Research & Development and the increasing value associated with IP. The Cinven



Asian portfolio team has been working successfully with the CPA Global board to help the business grow in Asia, identifying new customers, partners and potential acquisition targets. In November 2012, CPA Global expanded its office in Hong Kong to spearhead its Asia Pacific expansion. Earlier this year, the company further strengthened its presence in the region by opening an office in Taiwan and has plans to open in Beijing shortly. Its recent acquisition of Landon IP, an IP services provider, also increased its capabilities in Shanghai and Tokyo.

There is no question that selling high-quality Western fare – be it pizzas, aircraft components or IP services – to the growing Chinese market is a very real opportunity. But there is a world of difference between an interesting thesis on paper and its execution and successful roll-out in China. For Cinven, it came down to having years of experience on-the-ground, a team that is focused on “on-shoring” Western brands and concepts to Asia and a strong commitment to the region.

### PIZZAEXPRESS IN CHINA – TOP FACTS

**22,000:** PizzaExpress pizzas sold each week in China

**Beijing’s favourite pizza:** Pizza Calabrese. The brand’s hottest pizza, with toppings including Italian spicy sausage, red chili and jalapenos.

**Shanghai’s favourite pizza:** Peking Duck Romana. A fusion pizza with aromatic duck, hoisin sauce, mozzarella, chili and spring onions.

**1,115** pizzas eaten in the opening week of PizzaExpress Beijing.

#### Joseph Wan, Cinven

Joseph joined Cinven in 2008 and is a member of the Portfolio team, based in the Hong Kong office. In addition Joseph is part of the investor relations team looking after investors in Asia Pacific.

Prior to Cinven, Joseph was Partner and Managing Director of The Boston Consulting Group in Hong Kong, where he was Head of Office. His primary sector focus was in consumer goods, retail and telecoms in Greater China/Asia. In addition, he has served many clients in banking, industrial goods and healthcare.

# Growing Private Equity Investment in the Asian Oil and Gas Sector

By Jason Cheng, Co-Founder & Managing Partner of Kerogen Capital

Private equity's interest in the oil and gas industry, once largely concentrated in North America, has become increasingly global and Asia has become an area of focus.

Natural resources is an established asset class and has enjoyed increased attention as investors look to diversify their private equity portfolio and hedge against inflation. The energy-focused private equity model has been successfully developed in North America for over a decade, and has performed favourably against their counterparts in the alternatives class. Only recently has the private equity industry shifted its focus to international oil and gas, driven by the larger opportunity set, thinner competition and higher return potential. Within the international energy sector, Asia is a potentially attractive geography for private equity investors to seriously consider.

From a macro-economic perspective, the region is the key growth driver of global energy demand, with China and India together forecast to account for the majority of net oil demand growth over the period to 2035. The dynamics of gas demand are similar, with Asia accounting for approximately 70% of total LNG imports.

In response to the growing regional energy deficit, Asian national oil companies (NOCs) have become active investors in international energy, as long-term energy security remains a key policy priority for many Asian countries. Buying barrels has often proven cheaper than finding and developing them. Given the proximity to demand centres, Southeast Asia, in particular Indonesia, Malaysia, Thailand and most recently Myanmar, has been attracting significant interests from Asian NOCs. This has often resulted in significant strategic premia being paid in recent M&A transactions. For



“Asia has a large opportunity set of small- to mid-sized “junior” oil and gas companies with high quality management teams seeking capital and partners.”

example, Pertamina, the national oil company of Indonesia, has recently agreed to pay \$2 billion in cash to acquire 30% interest of Murphy's Malaysian portfolio, equating to over \$34 per proved reserve barrel. Asian NOCs' strong strategic interest, therefore, helps to generate pricing tension and provides exit opportunities for private equity investments in the Asian oil and gas sector.

In addition, Asia has a large opportunity set of small- to mid-sized “junior” oil and gas companies with high quality management teams seeking capital and partners. While Asia has been a proven hydrocarbon resources area over decades, its potential has become more and more significant. The growing oil and gas deficit in the Asian markets is also driving governments to provide more incentives to increase exploration, appraisal and development activities. This also means that companies require greater access to capital in order to capture and develop these opportunities. In terms a funding attentive, however, Asia has less developed equity capital markets for natural resources companies (Hong Kong and Singapore vs. North America and the UK); and private equity has become an attractive source of funding to oil and gas juniors in Asia. For private equity investors, there are many junior management teams in the region comprising oil industry veterans who chose to leave the regional offices of major or large independent oil and gas companies to pursue a more entrepreneurial career. With the long term need for energy security, the under-penetrated yet large opportunity set, we will continue to see growing private equity investment in the Asia oil and gas sector.

## Kerogen

Established in 2007, Kerogen is an independent private equity fund manager specialising in the international energy sector. Kerogen manages in excess of \$1 billion in committed capital on behalf of US, Asian, European and Middle East institutions.

# The Evolution of Asia's Direct Secondary Market

By Darren Massara, Managing Partner of NewQuest Capital Partners

While the Asian private equity market has grown considerably in the last decade and has begun to rival markets in Europe and the United States in terms of capital raised and deployed, certain aspects of the market remain less mature. One of those areas is the direct secondary market – where one private equity investor would divest a direct minority or controlling stake in an underlying portfolio company to another private equity investor. While such transactions are quite prevalent in Europe and the United States – representing about 40% of the exit activity in a given year – they remain rare in Asia, particularly emerging Asia. This is due to several underlying factors which will be discussed below. This article attempts to describe why direct secondary transaction volume has remained small until today, but is likely to increase over the next 5-10 years to become a meaningful exit route for Asian private equity investors going forward.

## Current State of Play in Asia: Proliferation of Investment Without Meaningful Distributions

Over the past ten years, Asia has become an increasingly important destination for global private equity allocation, reaching roughly 15% of the total global private equity market.<sup>1</sup> As of August 2014, the aggregate capital pool raised for Asia-focused private equity over the past decade reached US\$526 billion.<sup>2</sup> While lower than the more prolific years of 2007, 2008 and 2011, this year's fundraising total should be on par with the previous two years, coming in at approximately US\$50 billion.

Of the total funds raised since 2005, approximately US\$400 billion has been invested in growth, venture and control direct transactions in Asia through August 2014, thus leaving about US\$130 billion of dry powder still to be invested. See Figure 1.

Despite the robust fundraising and capital deployment activity during this time, distributions back to investors in Asia have lagged other regions. Generally speaking, for every US\$4 of principal invested in Asia, only US\$2<sup>3</sup> has been returned each year resulting in a net outflow of capital into the asset class. This net outflow of capital has created an overhang of un-exited principal which has been accumulating each year. From 2005 through August 2014, approximately US\$202 billion in distributions have been recorded, of which about half has been returned as principal. This means there is nearly US\$300 billion of un-exited principal in Asia today. See Figure 2.

With an average transaction size of about US\$40-50 million over the period, the US\$300 billion un-exited overhang represents about 6,000-7,000 individual un-exited positions which continue to sit within investors' portfolios. While a significant number on its own, it still likely underestimates the overhang by a margin as the median transaction size during the period is closer to US\$7-10 million. When you exclude the relatively small number of large buyout transactions and use median transaction size, the number of individual un-exited positions increases considerably. For example, two recent bottoms-up analyses by local research firms in China have pegged the un-exited positions in China alone to be somewhere between 7,500 and 10,000.<sup>5</sup>

This situation described above is in contrast to that witnessed in the United States and Europe where, for the past three years, both of those markets have experienced net distributions to investors rather than net outflows. For example, for private equity funds in the Cambridge Associates US Index, distributions have outweighed capital contributions by a multiple of 1.7x over the past three years. Record distributions in 2013 resulted in a distribution-to-contribution multiple of 2.4x in last year and 2014 is on a path to perhaps to have a similar distribution pattern. The data below depicts the record net distributions achieved in the United States over the past few years. See Figure 3.

Similarly, further analysis on a individual transaction basis, shows that the ratio of new deals to exits has remained considerably lower in the United States and Europe as compared to Asia. For example, in 2013, there were 8.8 new investments for every single exit in China as compared to 2.2 new investments for every single investment in the United States. See Figure 4.

This lack of exits has been reflected in fund performance as well. Distributions-to-paid-in-capital (DPI) metrics have generally been more challenged in Asia as a result of this un-exited overhang. For vintage year funds from 2008-2012, the DPI recorded by Asian funds lag those achieved by peers in the United States and Europe in many of the last few years. This is despite the fact that exit multiples on those positions actually divested have remained fairly robust. See Figure 5.

Figure 1: Asian Private Equity Capital Raised and Deployed (2005 – August 2014)

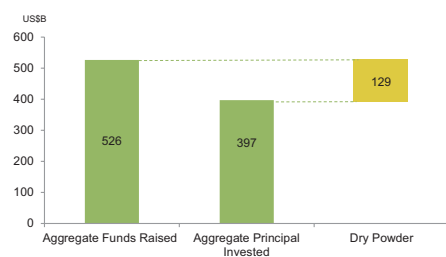


Figure 2: Un-exited Overhang in Asia by Volume (2005 – August 2014)<sup>4</sup>

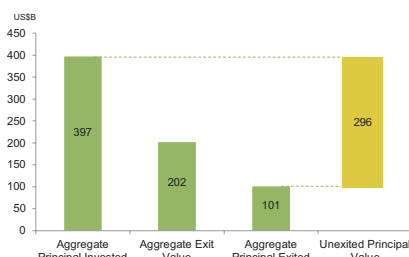
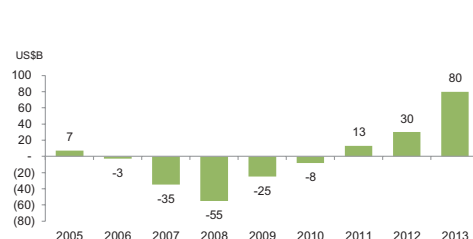


Figure 3: Net Private Equity Cashflows in the United States Cambridge Associates PE Index (2005 – 2013)<sup>6</sup>



So why is there this discrepancy between Asia and the rest of the world when it comes to exits? Why are Asia's distributions so far behind?

There are several reasons for this. First, there has been a lag effect in terms of overall exit volume. The level of private equity investment only reached a meaningful size beginning in 2006. Accordingly, it has taken some time for distributions to reach a significant level due to the initial ramp-up of private equity activity in Asia in mid-2000.

Second, the traditional exit routes (trade sales, IPOs, recaps) are less developed than those in the US and Europe. IPO markets have been choppy for Asian firms in Asia and abroad, trade sale markets are not yet mature, and leverage recaps, by-and-large, do not exist. Such challenges are compounded by the fact that most private equity investors in Asia do not hold a controlling stake, either individually or collectively, and thus are less able to directly influence an exit.

Finally, the situation is further exacerbated by the lack of a vibrant direct secondary market. Such a path can provide a meaningful alternative liquidity solution when IPOs and trade sale opportunities do not exist. Direct secondary transactions are much more prevalent in the United States and Europe and have helped to bring those regions to a point of net distributions to investors in recent years rather than net outflows. See Figure 6.

In fact, the un-exited overhang in Asia is likely to only increase in the near term. With US\$129 billion of dry powder still to be accessed by GPs, and an additional 353 funds currently in the market fundraising for an aggregate target of US\$113 billion, another US\$242 billion could be added to the un-exited pool within the next five years. This would nearly double the current un-exited overhang. See Figure 7.

### Alternative Exits in Asia: Direct Secondary Market Remains Nascent

With such a large amount of un-exited principal and less reliable trade sale and IPO markets, why has there not been more direct

secondary activity in Asia? Why has it only hovered around 10% of total exits when the United States and Europe are at 40%?

The answer to this question, in our view, rests with buyer attitudes rather than with seller motivations as most private equity investors in Asia have preferred not to acquire shares on a secondary basis – instead opting to invest fresh capital into growing companies. The reason is several-fold.

First, since most of the private equity investors in Asia focus on growth or venture transactions, they typically use fresh capital to achieve meaningful growth (20-30%+ annually) in underlying portfolio companies. Accordingly, such investors will limit the amount of secondary shares they may acquire to ensure enough new capital is invested in the underlying company to fund growth.

Second, in providing portfolio companies with fresh capital, private equity firms often seek to tailor rights/concessions associated with new investments so that they can feel adequately protected and aligned with other shareholders and management. In a direct secondary transaction, however, the buyer may not be able to implement such rights as it is largely just stepping into the shoes of the exiting shareholder and thus inheriting all rights – whatever they may be. Such a situation is not ideal for many private equity investors if they have never dealt with this dynamic before.

Third, there is a perception that direct secondary transactions place the buyer at an information disadvantage and thus triggers a certain level of concern among investment committees. Why is that firm a seller? What do they know that we don't? Many inexperienced direct secondary buyers can get hung up on this point, thus making certain types of direct secondary transactions of off limits to those firms.

The final reason, and probably the most basic, centers around the amount of capital raised to pursue this strategy in Asia. Since there are only just a handful of investors in Asia that have meaningfully

Figure 4: Ratio of New Deals to Exits – China vs. United States (2008 – 2013)<sup>7</sup>

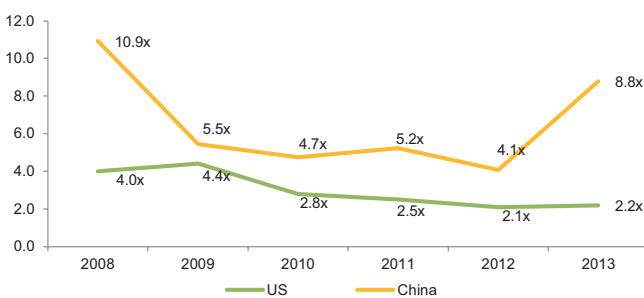


Figure 5: Distributions to Paid-in-Capital (Fund Vintage Years 2008 – 2012)<sup>8</sup>

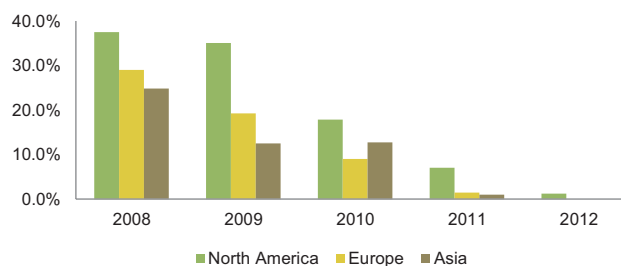


Figure 6: Direct Secondary Exits as a % of Total Exits (2006 – June 2014)<sup>9</sup>

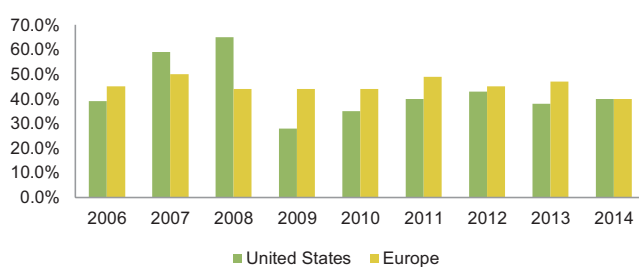
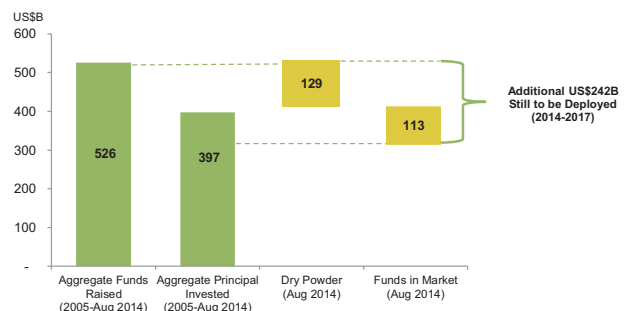


Figure 7: Additional Funds to be Invested in Asia (2014 – 2017)<sup>10</sup>



operated in the direct secondary space over the past decade, not much capital has been dedicated to the strategy. Accordingly, less interest in acquiring secondary shares has been registered and thus less number of transactions consummated.

**“overall pricing for the sale of secondary assets has been improving”**

### Changing Tides: Asia’s Direct Secondary Market Poised for Growth

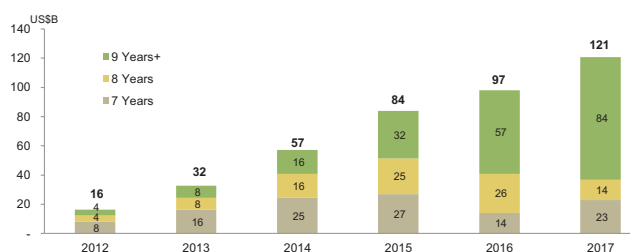
We believe the tides are about to change in Asia where the direct secondary market will become a more meaningful exit option for private equity investors, thus relieving some of the un-exited overhang described above and converging closer to the markets of the United States and Europe. There are several reasons for this coming evolution.

First, older vintage investments are now becoming more mature and the lag effect has finally subsided. Beginning in 2017, over US\$121 billion of the un-exited overhang will exist from vintage years seven years or older and investors will begin to proactively seek exits for such positions. See Figure 8.

Second, private equity investors have now begun to feel external pressure from LPs or parent companies to deliver more exits due to new planned fundraisings, fund lives coming to an end, or an overall change of investment strategy. All of these factors will increase the motivation of private equity investors to explore alternative exit avenues to trade sales and IPOs.

Finally, overall pricing for the sale of secondary assets has been improving. Since the lows of 2009, pricing has steadily increased over the past five years and sellers are more readily able to divest positions on a secondary basis to other financial investors at, or around, fair market value. We can see this trend by tracking the pricing of fund positions on a secondary basis. See Figure 9.

Figure 8: Estimated Unrealized Principal in Asia By Age of Investment<sup>11</sup>



<sup>1</sup> Source Preqin (2014).  
<sup>2</sup> Capital raised from 2005 through August 2014. Source Preqin (2014).  
<sup>3</sup> This US\$2 is comprised roughly of US\$1 of principal returned and US\$1 of capital gain.  
<sup>4</sup> Assumes average historical 2.0x return on principal.

### Challenges Remain: Direct Secondary Market Has Obstacles to Overcome

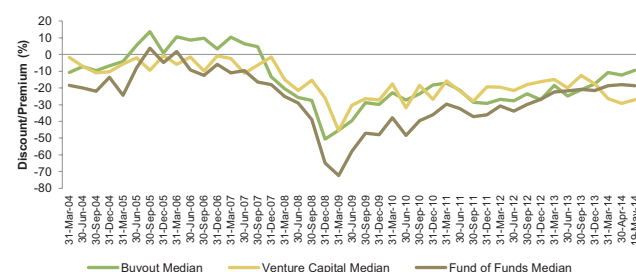
While the supply of un-exited positions in Asia is likely to continue to increase and sellers are likely to become more motivated to pursue such alternative liquidity paths, challenges remain that will prevent direct secondary transactions to rise all the way to the levels experienced in the United States and Europe.

As transactions in Asia private equity are predominately for minority stakes, direct secondary transactions can ultimately be difficult to consummate. In many transactions, cooperation is required from founders and controlling shareholders which can make due diligence and negotiations complex as one investor takes the place of another and no new capital is being provided to the company.

Additionally, pricing can be challenging for certain transactions. Some private equity investors hold their assets at levels that are significantly higher than current fair market value. Such situations can make it difficult to reach a market clearing price as buyers seek to pay at, or around, fair market value for assets. While bid-ask spreads have decreased in recent years, gaps for many transactions will still remain.

Finally, there has still only been a small amount of capital raised for dedicated direct secondary strategies in Asia and growth-oriented GPs are unlikely to devote significant capital to such transactions. Accordingly, more capital must be devoted to pursuing direct secondary strategies in order to help alleviate the illiquidity overhang and allow the Asian private equity market to become more mature.

Figure 9: Listed Private Equity Discount/Premium to NAV by Fund Type (2004 – 19 May 2014)<sup>12</sup>



**Darren Massara, NewQuest Capital Partners**

Darren is presently Managing Partner of NewQuest Capital Partners, a Hong Kong-based private equity firm focused on growth markets across the Asia-Pacific region. The firm is one of Asia’s direct secondary platforms, specializing in providing alternative liquidity solutions to private equity asset owners. Darren has over 15 years of experience in private equity in emerging markets and prior to NewQuest was Managing Director at Bank of America Merrill Lynch where he led the Asian Private Equity Group based in Hong Kong.

<sup>5</sup> See China First Capital (2013) and Zero2IPO (2014).  
<sup>6</sup> Source Cambridge Associates (2014).  
<sup>7,9</sup> Source Pitchbook (2014) and PWC (2014).  
<sup>8, 10, 12</sup> Source Preqin (2014).  
<sup>11</sup> Source APER (2014).

# Venture Capital Spreads Across the APAC Region

By Melissa Guzy, Managing Partner of Arbor Ventures

Over the last five years, the success in Silicon Valley, the development of incubators such as Y Combinator and the development of a viable seed investor market has been contagious in almost every country in Asia. Since China and India are well-developed markets for venture capital, this article will cover the emerging venture capital markets in Asia.

There are currently over 150 incubators in Japan, Hong Kong, Australia and ASEAN countries. These incubators are providing initial capital, office space, and mentorship for startups in the region. While the quality of the programs varies, they all provide support and mentorship for an entrepreneur. What has been lacking is follow-on capital, often referred to as the Series A and Series B as well as the funding rounds that provide the bridge between the seed round and growth capital. Series A funding is often the most difficult to raise as the company is likely to be at a very early stage of customer engagement or traction and is losing money. It needs money to fund operations and for R&D, the highest risk activities..

While a few traditional venture firms such as DCM and Infinity Ventures are in Japan, corporate investors such as Cyberagent, Gree, DoCoMo and Softbank still dominate the field. In 2013, Japanese investors committed 66 billion yen, or approximately \$660 million to domestic opportunities compared to 94 billion yen or \$940 million in Southeast Asian opportunities. The median investment amount was a mere 50 million yen or \$0.5 million.

In recent years, accelerators have contributed to an increasing interest in ventures. In fact, last year Japan was amongst the top 10 (ranked sixth) amongst global venture capital hotspots. Another crucial factor in the support of Japan's startup ecosystem is the availability of talented engineers at a competitive salary.

South Korea, according to Bloomberg News which publishes the Global Innovation Index, is ranked first among all nations when compared on the basis of a basket of factors such as research and development capability, productivity, technology density, and patent activity. South Korea's ranking is not surprising. In recent decades, South Korea has transformed into a technology heavyweight, having systematically applied substantial resources to research and development. As a result, South Korea has become the world leader in patent activity and TMT technology. As an example, South Korea has the highest broadband penetration in the world at 97% and is a leader in broadband speed with an average peak connection close to 50 megabits per second.

In South Korea, there has been a growing interest from overseas VCs as well as a rise of angel groups and accelerators to promote entrepreneurship in Korea. The number of Korean startups nearly doubled from 15,401 in 2008 to 28,193 in 2012. In 2013, South Korean President Park Geun-Hye announced the desire for a more "creative economy" and launched the new Ministry of Science, ICT and Future Planning. The ministry's budget increased to more than \$12 billion in 2014, with over \$2.5 billion going directly into fostering growth for the startup ecosystem.

In contrast to Japan, the Singapore venture capital market has been incubated by the Singaporean Government. Singapore is

pulling out all the stops to build its own version of Silicon Valley as it attempts to create a startup hub for Southeast Asia. The Singapore government has been working diligently not only to provide seed capital to 20 firms, but recently recognized the shortage in Series A and Series B and funded eight venture capital firms to address the shortfall. Additionally, the Singapore government, with offices in Silicon

Valley, has been recruiting leading technology companies such as Facebook, Google, PayPal, SAP and future IPO candidates such as Palantir, backed by Peter Thiel, cofounder of Paypal, to locate their regional headquarters in Singapore and bring engineering talent to the country. Additionally, the Government made it relatively easy for foreigners with venture capital experience to obtain a work visa, eliminating the hurdle for expats.

Singapore's government has largely followed the policy template used in Israel, which has developed a robust technology industry over the years. One government program designed to assist early stage startups is the "Technology Incubation Scheme," which began in 2010. Under this program, the government co-invests up to 85% of capital in select startups, capped at the equivalent of S\$500,000.

What has this meant for startups based in Singapore? In 2013, funding soared to \$1.79 billion up from \$27.9 million in 2011; a 60-fold increase. There are many local firms such as Monks Hill and Jungle Ventures as well Silicon Valley firms such as Sequoia that have a local office to address the opportunity. Singapore now has over 20 active venture capital firms, which cover the region.

Indonesia is an emerging venture capital market and currently the most dynamic, commanding the highest valuations in ASEAN. There are more than 20 active firms in the Indonesia VC market, but the amount of venture capital actually deployed is probably close \$300 million from our research at Arbor Ventures. Most of the capital being invested in Indonesian startups comes from Japanese corporate VC funds, German

**“ Hong Kong has its own unique place in the venture market, given its proximity to China and being an international finance center. ”**



**"I don't want your wallet, I want venture capital."**

venture builder Rocket Internet, and Singapore-based VC firms which have an office in Jakarta. Unlike Japan and Singapore, most of the entrepreneurs are returnees from the United States with education from schools such as Stanford, Harvard, Purdue and Michigan. Also unlike Singapore, which is a small market that requires companies based in Singapore to address a regional market to scale, Indonesia is a large enough market to be the single focus of a startup.

Today, the top Indonesian Internet sites have market values of around \$100 million. While billion-dollar Internet companies do not yet exist in Indonesia, more \$100 million tech companies will emerge over the next three years. These valuations will partly be due to a rising internet user base. Internet users will grow from 55 million today to 125 million by 2015, partly due to higher levels of online spending by the growing Indonesian middle class, and partly due to improved business focus and discipline.

At the same time, the broader e-commerce market has grown. With a compound annual growth rate of 31.8%, Indonesia is the second-fastest growing business-to-consumer market in Asia, surpassed only by China which has a compound annual growth rate of 39.2%. By the end of 2014, the market is expected to be worth about \$1.8 billion further rising to about \$5.5 billion by 2017. Interestingly, Jakarta is the Twitter capital with the most "tweets" per day.

The Philippine startup ecosystem is young, and along with its neighbors Thailand, Vietnam, Indonesia and Malaysia, is a relatively untapped and highly promising region for technology startups. As of March 2014, the Philippines had hardly any 'local' VC money beyond the seed stage. There have been 47 identified angel investors/venture capitalists that have made at least one investment in the Philippine tech startup scene. The most active foreign firm is 500 Startups.

The Bangkok startup scene has only begun to explode over the last year with an influx of young Europeans. The number of Internet users in the country will reach 52 million by end of the year, which translates into nearly 75 percent penetration (penetration in the U.S. is 80 percent). Thailand also has 76 million mobile subscriptions, greater than the population, and there are more than 18 million social media users in Bangkok alone. In fact, Bangkok is the

Facebook capital of the world. Bangkok has produced some very successful start ups including Agoda, an online travel site, and App, acquired by Priceline, which was founded by an American who chose Bangkok for its low cost engineering center.

Historically Malaysia's venture capital industry was dominated by local venture capital players and lagged behind developed countries like Japan, Singapore, Hong Kong, Taiwan and Korea. However, the emergence of independent venture capital firms in Malaysia made significant strides in recent years. In the past, a majority of the VCs were either government- or bank-owned. Given Kuala Lumpur's proximity to Singapore, it is a short flight for VCs to make to cover the growing market in Malaysia.

Cities throughout Asia are providing the next generation of entrepreneurs with bases from which to innovate and contribute to local economies. At Arbor, we chose to locate our base in Hong Kong, which is equidistant from Tokyo and Jakarta. In 2014, we added local offices in Shanghai, Tokyo and Singapore to be involved in community gatherings, both informally and formally. Hong Kong has its own unique place in the venture market, given its proximity to China and being an international finance center. The talent base around financial services is deep, both with locals as well as expatriates.

The U.S. is no longer the epicenter of Internet usage. The development of new entrepreneurial hubs does not diminish the opportunity in China, but perhaps given the rapid pace of innovation in the region, there is no longer "one right" location from which to make successful venture capital investments.

#### **Melissa, Arbor Ventures**

Melissa Guzy is the Managing Partner of Arbor Ventures. She has more than 25 years of experience as an entrepreneur and as a venture investor. Prior to Arbor, Melissa was the Managing Director and head of VantagePoint Asia. In 2007, Melissa moved to Hong Kong to build VantagePoint's investment practice in the region, establishing offices in Hong Kong, Beijing and Shanghai, and invested in early stage technology companies in both Asia and in Silicon Valley.



# Emerging Investment Innovation: Online Peer to Peer Investment Models

By Markus Lampinen, CEO of Crowd Valley Inc

The Internet's impact on financial services has been limited so far. While we do have services with online distribution and information capabilities like online banking, efficient payments and brokerage, true disruptions to financial services, particularly investment markets, have been vague. That is until now. New online securities models have started to challenge and disrupt established value chains in financial services, in the form of peer-to-peer investment networks (peer-to-peer lending, peer-to-business lending, crowd investing, etc). While these networks create many opportunities in the financial services market, they also makes some traditional business models redundant. Changes are vast and global, and their impact is becoming undeniable cross the market.

Various countries and financial regulators from the United States, the UK and other European countries, as well as countries in Asia Pacific, have adopted new measures to set a framework in place for online investment markets to emerge with the right investor protections in place. In this article, we will examine these regulatory changes with a few case examples, their implications and the opportunities they present in the nascent but ultimately vastly disruptive marketplace.

## Regulatory Developments, New Rules for Peer-to-Peer Networks

The call for new marketplaces has been echoed globally and certain frameworks have been erected to set in place initial rules of engagement in the market. However, it is important to note that while there are certain regulations already in place, most are still in development, unfinished or still being written. The discussions are most vocal in North America and Europe, but there are also new rules emerging in Asia Pacific and increasing activity around the world.

### The "JOBS Act" in the United States

The most notable regulatory development has undoubtedly come in the shape of the JOBS Act in the United States, consisting of different provisions ("Titles") aimed at accelerating capital formation and employment in the shape of updating certain securities laws. It is important to note, that while the JOBS Act is often associated to "equity crowdfunding", it is a broad set of provisions which have an impact on a variety of provisions governing the marketing and sale of securities offerings. In fact, the regulation includes a total of six Titles, which we will summarize as an introduction to the topic below.

Title I attempts to streamline the process of going public for certain companies (i.e. pursuing an initial public offering) and creates a new reporting regime for certain young or growing companies (emerging growth companies or EGCs).

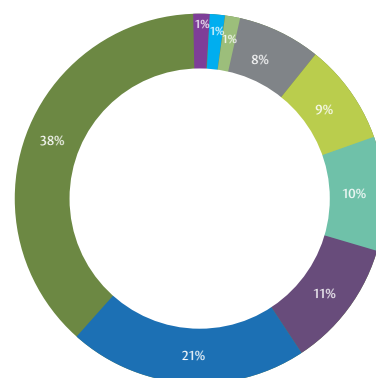
Title II concerns how private offerings are marketed (i.e. the removal of the prohibition on general solicitation and general advertising, creating the new "506c" rule allowing general solicitation of securities offerings) and creates a new exemption from registration for entities (or people) engaged in certain broker dealer activities for "accredited investor only" offerings.

Title III is the "crowdfunding exemption" that everyone is talking about but which is not available yet. Basically, Title III allows companies to raise small amounts of money from a large number of non-accredited investors without registering the securities with the SEC.

Title IV directs the SEC to exempt certain offerings of up to \$50 million per issuer, per year from registration under the Securities Act. It is known as Regulation A+ (because Regulation A currently exempts similar offerings but with a cap at \$5 million).

Title V and Title VI are less revolutionary than the other sections, but still important. Together they will essentially give certain companies more time before they are required to register their securities with the SEC (i.e. stay private).

Title I is already in effect, as is Title II. Title III is much anticipated but not yet in effect. The timing for Title IV, pertaining to modifications on Regulation A rules, is unknown.



Breakdown of Organization Types Interested in Crowdfunding in Crowd Valley's 2014 Q2 Market Report

### OK, So the US Has the JOBS Act. What Is Happening There?

The breadth of the new regulatory development with the JOBS Act has implications for capital structure, IPO on-ramp process, fund structures and investment vehicle designs. The JOBS Act also enables existing broken dealers and investment advisors to engage in crowdfunding activities largely under existing rules and regulations (see the figure above for operator profiles).

For instance, Title II, that is the public marketing and solicitation of securities offerings (i.e. the new Regulation D, rule 506C), may be applicable to crowdfunding marketplace, allowing a broader use of advertising in securities offerings.

### First Movers in South East Asia

The Malaysian Securities Commission (MSC) drafted regulation for securities crowdfunding, looking closely at what countries like Australia, New Zealand and the US have done in this regard. The rules have ended a period of public consultation on the 5th of September

2014, which means the development of the rules is still in nascent stage. There is clear interest in these initial frameworks, from the broad investor community as well as the general public, and surely they will play an important reference template for the region. The MSC has already reviewed these initial guidelines and proposed amendments to the new rules.

While countries like Malaysia, New Zealand and Australia have been getting active in the regulatory debate, the absence of professional investment companies in the marketplace is still apparent. Like we mentioned in the United States, where licensed and regulated broker dealers and investment advisors conduct the majority of activity under existing regulatory frameworks in the marketplace, it seems there is a lot of untapped potential and opportunity in geographies with a strong investment culture and track record.

### Other Regulatory Developments

The JOBS Act has also served as a benchmark or case study in various countries, and even within the US, where intra-state crowdfunding exemptions have emerged as a way to operate new marketplaces and investment models within state borders. There are currently a dozen or so intrastate exemptions to allow for a crowd investment model of sorts, but similar to broader activity in the new market, activity within state borders has remained largely conducted by professional investment firms.

The FCA in the UK has possibly the most sophisticated framework for these new marketplaces, including peer-to-peer lending business loan and equity crowd investment marketplaces. The passage of these frameworks has been incremental, with parties learning about the markets successes and challenges side by side in healthy collaboration. Similarly, many other European countries have adopted new frameworks that generally follow or mirror the aims and models of other countries. A general aim could be seen as to foster a vibrant and viable development of new capital formation, and limit intervention where it is not productive.

It should be noted, that regulatory updates in the United States securities regulation may have been more direly needed given the broad and strict prior provisions around for example the marketing of securities offerings in the United States, as compared to regulations in Europe. However, there are other challenges in Europe, such as the market fragmentation and lack of uniform regulatory frameworks within private securities markets.

### Top Down Support Speeds up Market Penetration

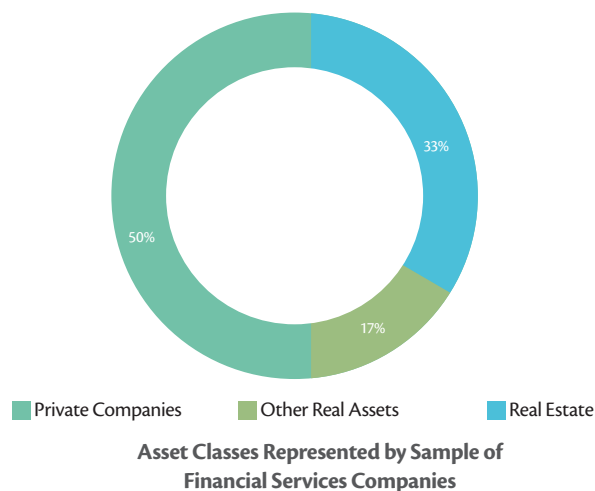
The UK also offers other support for the ecosystem in order to create complementary funding mechanisms for needed causes. These include tax incentives (known as the enterprise investment scheme, EIS and seed enterprise investment scheme, SEIS) for investors in early private companies, as well as tax discounts to peer-to-peer lending, which was announced by Her Majesty's Treasury on July 1st, 2014, as part of the Individual Savings Account (ISA) system.

These systems can be seen to speed up maturation of the nascent crowdfunding market, by providing supportive provisions and models for operators and participants alike. Their impact in the investment process is undeniable.

### Market Implications

These new marketplaces can be seen as a source of capital for underrepresented asset classes such as early stage companies

(startups), later stage private companies in need for expansion capital, renewable energy projects and so on (see the figure below on asset representation). On the other hand, these marketplaces often allow access to new investor demographics that previously did not have the access or ability to participate in such asset classes directly without going through their asset manager or through a fund structure.



### Opportunity or Threat?

To date, we have observed a relatively even distribution of interest from established financial services companies, half of which represent an interest in private companies, a third in real estate and the rest in other real assets. Given that interest in assets such as properties accentuated in certain regions such as South East Asia (Singapore and other cities which have seen significant income rise), the rise of property marketplaces could be expected.

Another way to consider the progress in online investment markets would be to think of what investments are currently prominent in the existing marketplace and appealing to what investors and what geographies. The opportunities would likely give rise to new online investment marketplaces organized around certain hubs.

We already see the gears in motion, and despite often talked about developments looking far into the future, the opportunities are real today. There is a real opportunity in the market for professional financial operators; and more and more credible and well-established companies are building their instant marketplaces as well as their expanded instant offerings as channel for the future.

### Concluding Thoughts

The Grow VC Group works and collaborates with several companies in South East Asia, for example Singapore, Hong Kong, Mainland China and Malaysia. There are clearly still outstanding questions about fundamental changes to crowdfunding marketplaces in the long-term. However, it is certain that these changes are making a shift in the fundraising landscape. There is no going back in the development, but seizing this opportunity presents a chance for financial services firms to put a stake in the ground and lay claim to new business opportunities.

#### Markus Lampinen, Crowd Valley Inc.

Markus serves as the CEO of Crowd Valley Inc, a US-based crowdfunding marketplace platform provider and part of the Grow VC Group. He is also a global investor and partner in the Grow VC Group.

# 2015 Events Highlight

- **HKVCA Gala Dinner 2015**  
20 January 2015
- **HKVCA 5th Asia Private Equity Forum 2015**  
21 January 2015
- **Hong Kong Venture Capital Forum**  
13 March 2015
- **Young Professionals Mixer**  
March, June and November 2015
- **HKVCA Wine Tasting Event**  
April and November 2015
- **HKVCA Annual Golf Day 2015**  
24 April 2015
- **HKVCA 14th China Private Equity Summit 2015**  
1 June 2015
- **Private Equity Fundamentals Course 2015**  
September - October 2015

For more information and registration, please visit [www.hkvca.com.hk](http://www.hkvca.com.hk)





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