CONDUCIVE ECOSYSTEM FOR PRIVATE EQUITY

The private equity space in Malaysia has been slow to develop, largely because of the cheap cost of bank funding and a business culture that has not been open to the concept. But this is changing. Malaysia's private equity ecosystem and its demographics are increasingly supportive of further growth for the industry.

ALL STORIES BY ELAINE BOEY

Private equity investments, which fell during the 2008 global financial crisis, is coming back. This time, Asia is on top of the list of destinations. Now, there are more Asian companies with sufficient scale and/or growth prospects that appeal to global private equity firms looking to have a return on the equity invested within a three to seven-year holding period, as dictated by the typical 10-year life span of a private equity fund. There are also more options for private equity firms to successfully exit their investment.

Furthermore, private equity firms are able to gain outright control of an invested company or obtain a minority position with control rights. This allows them to be actively involved in decision-making, a prerequisite for a successful investment (see story on "Transforming businesses with professional capital").

According to the AMP Capital/Institutional Investors Research Report May 2014, 35% of global investors looking at the Asia-Pacific region are planning to boost their private equity allocations in this market this year. The opportunity in this region is extraordinary, says global management consulting firm Bain & Co in a recent report. "The region's diverse set of economies still outperform the global average," it adds.

This illiquid asset class has garnered more mainstream interest in recent years, with an increasing number of investors looking for ways to gain exposure to this alternative asset. In the past, private equity investments were only distributed to institutional investors, sovereign funds and extremely high net worth individuals (HNWIs).

"Private equity has always been around. We have just put a label on such activity now. In the past, it was the super wealthy tycoons that executed such deals," says Vincent Chin, senior partner and managing director of The Boston Consulting Group Sdn Bhd.

The industry started to grow when professional private equity firms entered the market. "These firms raise funds from institutions and HNWIs to invest in companies. Another wave occurred when corporations started to wake up to the idea of private equity and started building a portfolio of companies that they have invested in to leverage business synergies," says Chin.

The private equity vehicle comprises general partners (GPs), who manage the investment fund, and limited partners (LPs), who provide the money for the fund. The GPs use the money in the fund to buy companies. A typical fund is "closed-end" with a life span of about 10 years, which can be extended by a few years. At the end of the period, the fund is wound up and the LPs receive their share of the proceeds. For a private equity fund to compete in the market, Chin says it should be capable of doubling its capital within five years.

Private equity in Asia-Pacific posted surprisingly strong inflows in the first quarter of this year. According to Bain & Co, mega deals in 1Q pushed up private equity investments to US$22 billion (RM69.7 billion), more than double the amount for the same period last year. The acquisition of a 25% stake in Hong Kong-based retailer AS Watson Group by Singapore's Temasek Holdings for US$5.7 billion was one such mega deal that took place during this period.

"There are several drivers behind the increase in foreign direct investment [such as private equity deals] across the region. These include an increase in economic liberalisation, regionalisation and intra-regional trade; a rise in demand for resources; urbanisation; a swelling middle class and a shift in manufacturing from China to Southeast Asia," says Mohamad Hafiz Kassim, head of private markets at the Employees Provident Fund.

PRIVATE EQUITY IN MALAYSIA

The private equity industry in this country is relatively nascent compared with venture capital. "Private equity and venture capital often overlap in practice, so the difference can sometimes be confusing. Private equity investments usually involve acquiring an existing company together with its products and cash flows. The private equity investor would initiate and drive value adding activities to optimise its financial performance," says Mohamad Hafiz.

"Venture capital investments are arguably higher in the risk spectrum. It often starts with an idea or a stage where companies are not generating sufficient cash flows. Venture capital investors decide if they want to pump in cash to be used as seed capital. These are usually technology and biotechnology start-ups. While venture capital can generate attractive returns, such investments do not suit the EPF's risk appetite at this juncture. As a custodian of members' savings, the EPF is fairly conservative," he adds.

The Malaysian private equity space has been slow to develop in recent years, largely because of the cheap cost of bank funding and a business culture that has not accepted private equity with open arms, says Syed Haizam Jamalullail, operating principal at Tuas Capital Partners.

But this is changing. Private equity practitioners say the business environment in Malaysia is increasingly conducive for private equity and the outlook for this industry is promising.

Headline numbers don't indicate progress, as private equity mega deals in the past caused the total value of deals to spike and then fall. "The industry is still immature, and it is hard to pin a growth rate on the industry as the aggregate deal values bounce around a bit from year to year, and can be skewed by one or two very large transactions, such as Khazanah Nasional Bhd's acquisition of Parkway Holdings Ltd," says Nicholas Bloy, co-founder and managing partner at Navis Capital Partners.

Loong Mei Yin, managing director and partner at TAEL Management Co (M) Sdn Bhd, gives examples of other mega deals that took place, but points out that "the real deal flow is much smaller and involves small and medium-sized enterprises (SMEs)".

"There were two large buyouts in 2011. The first was CVC Capital Partners and its consortium, which bought QSR Brands and KFC Holdings for US$1.6 billion, and Aabar Investments' acquisition of a 24.9% stake in RHB Capital for US$1.9 billion," she says.

In 2012 and 2013, there were 20 and 26 private equity deals in the country, with a total value of nearly US$2 billion and US$758 million, respectively. "Deals in Malaysia are mostly growth capital investments into SMEs. Generally, private equity deals in Asean are generally smaller than in developed markets. When you examine this industry in this region, you will see that the more mature markets, such as Singapore, also record larger private equity deals. Most of the deals in this region, just over 60%, are below US$100 million," says Loong.

The overall trend, however, shows deals increasing in value over the years. "This is in tandem with the maturity of companies in Malaysia. The outlook is generally positive and we expect to see more funds made available for investments. The size of deals will also increase in tandem with the growth of the company and the economy," says Azam Azman, managing director of CMS Opus Private Equity Sdn Bhd.

"The average size of private equity deals has increased over the years, ranging from RM1 million to RM5 million in the early 2000s to between RM10 million and RM30 million currently. The number of transactions has also increased over the years, funded by an increasing number of institutional investors, such as pension funds and corporations. Their asset allocation strategy includes alternative assets, like private equity," says Azam.

SAM FONG/THE EDGE

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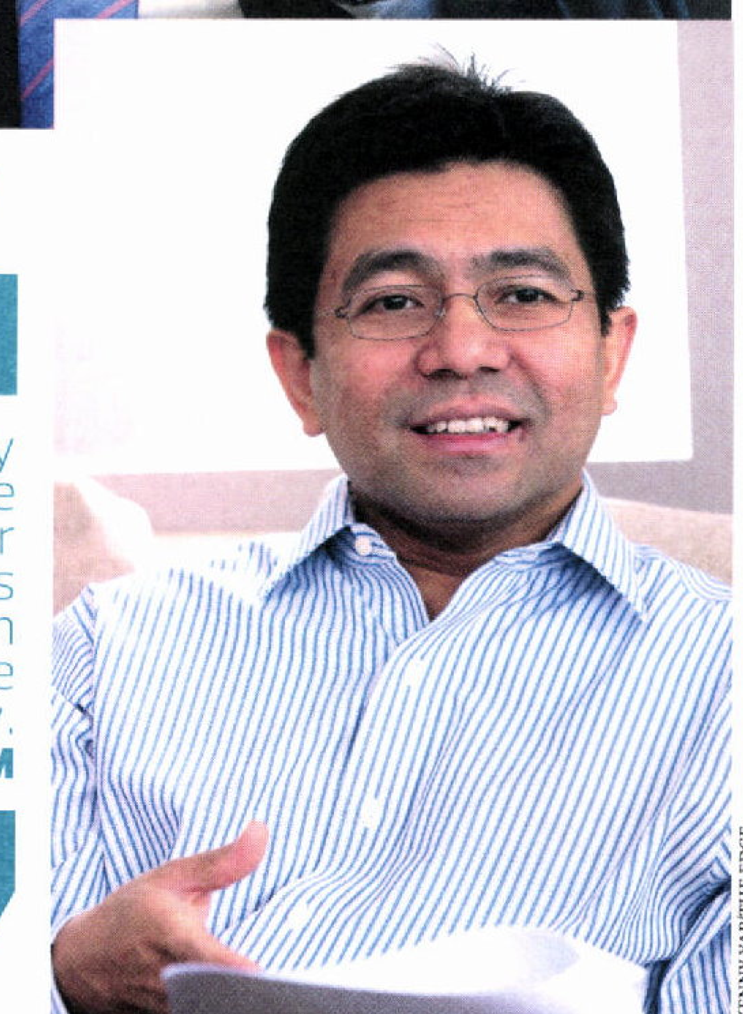
> **CHIN**



KENNY YAP/THE EDGE

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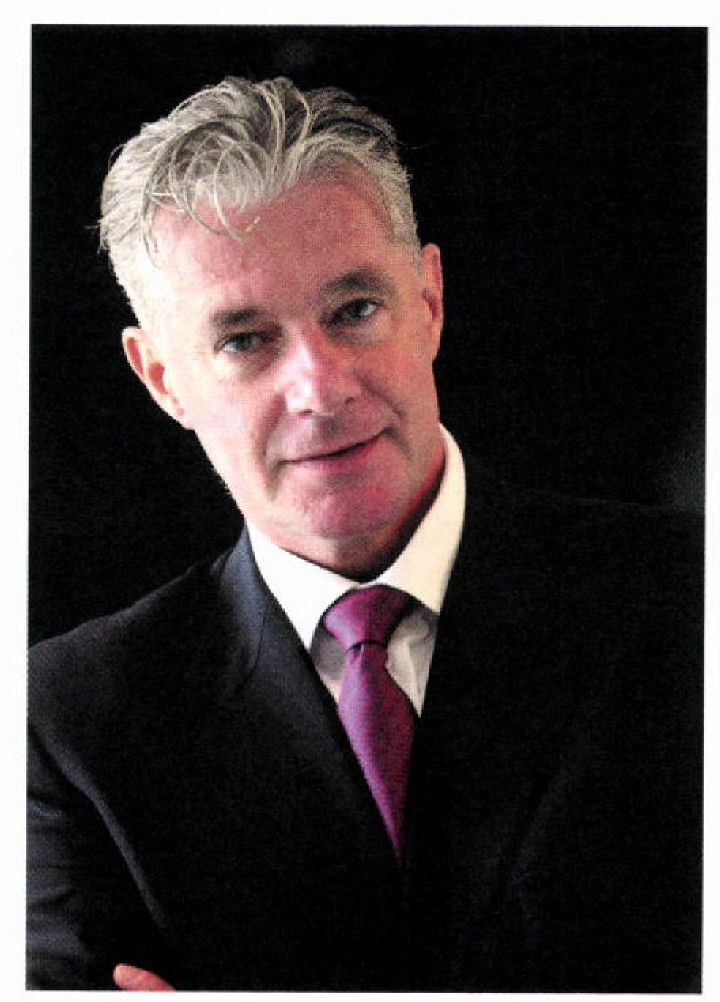

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> **BLOY**

The Malaysian ecosystem for private equity and its demographics is supportive of further growth for the industry. "People often refer to the 'ecosystem' for a successful private equity industry. This is a multi-faceted concept that involves the existence of experienced private equity practitioners who can rely on qualified and capable service providers — lawyers, accountants, bankers, management consultants and so on — to assist in due diligence and post-acquisition services. It requires efficient and liquid capital markets, as well as a sensible and transparent foreign ownership and taxation regime. It also requires understandable and effective legal and governance frameworks to protect and enforce shareholder and commercial rights. Frankly, it is a long list, but I believe Malaysia scores very highly on almost all of the relevant dimensions," says Bloy.

"But what makes the country interesting, beyond the ecosystem that I described earlier, is that Malaysia is at an interesting level of relative GDP/capita versus its Asean neighbours. We [private equity investors] can find great Malaysian companies that have honed their capabilities over the last two decades. There are also certain industries, where for a variety of historical reasons, Malaysia has been able to develop world-class expertise in niche areas, such as oil and gas, palm oil, rubber and electronics. This expertise can be deployed globally and can be the basis for good value creation," he continues.

A unique characteristic of the local private equity industry is that investments are not solely in privately held companies. Companies such as Tael and Creador Sdn Bhd often make private equity investments in public-listed companies. "There are 366 companies with a market capitalisation of RM100 million to RM600 million on Bursa Malaysia, and they represent SMEs with higher growth potential than large mature companies," says Loong.

UNIQUELY ASIAN

Since the business climate in Malaysia and this region is shaped by its own set of unique social, political and cultural characteristics, private equity investors are said to do better if they understand and adapt to distinct business customs.

Local practitioners say global private equity firms looking to invest in this region must be willing to do smaller and more minority deals, accept longer lead times for extensive due diligence and cultivate a deeper understanding of the different business climates.

"Markets in Asia are not homogenous. Each country has its own nuances, and it is the locals who really understand their own country. To invest in this region, we hire locals in each country. This is important as every country differs in character, custom and culture," says Brahmal Vasudevan, founder and CEO of Creador.

Loong shares the sentiment. "Each market has its own networks for sourcing transactions, its own quirks in due diligence, and businesses have their own way of operations. For example, a family business may be able to open doors in the business community. In Asia, local insight matters," she says.

Cultural and traditional practices may have posed a challenge to private equity firms in the past, especially among the typical home-grown family-owned SMEs. "Many families believe that they will lose control of the business and family wealth if they bring in outside investors," observes Azam.

But companies are increasingly open to third-party investors, as the opening of more economies to trade and capital flow creates both opportunities and competitive pressures. Professional capital offered by private equity firms has helped to develop their reputation for assisting companies in many ways, namely by improving efficiency and expanding offshore.

"It is the second-generation business owners who are more open to outsiders coming in with capital and expertise. I see more businesses that are willing to participate in private equity deals, and this bodes well for those in the industry. There is a lot to be said about the first-mover advantage as it can be much harder to find value when the market gets crowded [with more private equity firms] in the future," says Chin.

Although the industry is nascent, a number of private equity firms are already in the market and more global players are expected to establish Asean operations. "Smaller private equity players are typically entrepreneurs who are ex-investment bankers. There are a number of private equity players in Malaysia who have raised some funds and are making investments quite successfully. Pension funds and insurers typically do not make direct investments with the same modus operandi of a private equity firm, but they do make investments with a more strategic and long-term perspective. They also allocate some of their funds to private equity funds with a five to eight-year fund life. Bigger private equity players in Malaysia are typically government or bank-banked," says Azam.

Those with established operations are working to improve their capabilities and further understand each market in the region. This knowledge mitigates the risk of overpaying for an investment. This is a concern, as overpaying for an asset will impact future cash flows and profitability, which in turn will affect potential exit valuations.

"To avoid overpaying for an asset, private equity firms must understand local markets and base their calculations on a realistic assessment of the current growth trends of each country and how they fit into the market. It is critical to pick businesses that can deliver on their promises because economic growth alone will not guarantee positive returns. This is a skill, as an asset may appear expensive, but its potential growth justifies the price," says the EPF's Mohamad Hafiz.

Brahmal thinks asset prices are no longer "cheap", and now looks to buy investments at fair valuations. "In the US, companies typically have a lot of debt, so if they don't perform as expected or the market takes a beating, the company suffers and the private equity fund falls in value. In contrast, leverage is not as common here, so this risk is not as prevalent.

"A much more common mistake is to invest in an asset at the wrong valuation, in which case, the outcome is that the returns is not as high as expected. What I look for now is a fair valuation and if the business has a true competitive advantage and high potential to grow," he says.

Local private equity firms have been able to gain experience and hone their skills in this global industry, which has extremely high barriers to entry, with the support of government programmes. "The Ekuinas Outsourced Programme has enabled private equity players to contribute positively to the Malaysian market space," says Tuas' Syed Haizam. Tuas is one of Ekuinas' outsourced fund managers.

"Private equity is a 'skill position'. This means the investors (LPs) are highly dependent on the fund manager (GP) to manage it with a high degree of skill. The risk is substantial, but hopefully it can be countered through skilful management," says Howard Marks, chairman of Oaktree Capital Management L.P.

"Every private equity firm has its own investing thesis. What is interesting to note about this industry is that firms that are successful somehow manage to keep being successful in the long run. The best private equity companies can perform on a sustained basis," observes Chin.

Industry players and observers say some changes will further develop the sector. "One concern is that certain segments of the economy are overly protected in terms of foreign ownership, or are overly regulated in unpredictable ways. All unpredictable variables are undesirable, whether it is related to government, taxation, industry cyclicality or disruptive technologies," says Bloy.

What has been done correctly, he points out, is the gradual relaxation of restrictions on the various Malaysian pension plans and insurance companies. "This allows them to allocate a greater percentage of their assets to private equity and within that, a greater proportion overseas. Higher and less correlated returns are the outcome of this increased latitude," he adds.

A robust private equity industry is one with ample funds from the public and private markets. "The biggest limitation of the venture capital industry in Malaysia is funding. Its sister, the private equity industry, is growing. But for this to sustain, private equity firms must be able to raise funds from the country. It is not important for a global private equity firm to be based in Malaysia. As long as they see potential, they will invest here," says Jamaludin Bujang, CEO of Malaysia Venture Capital Management Bhd.

While a robust private equity industry will see heightened competition among practitioners, it will also create a virtuous cycle for private equity capital. "This is when capital is invested, returns are made and it is a happy experience for everyone. Then capital is redeployed or reinvested. Yes, valuations for assets will go up when there are many firms trying to buy companies, but this also means that exiting an investment is easier. Malaysia's private equity industry is still young but in the long run, I believe it will be robust enough to help drive the economy," says Syed Yasir Arafat Syed Abd Kadir, managing partner for investments at Ekuinas. E