Transforming businesses with professional capital

It is now a little harder for critics to say private equity investors will destabilise Asean companies as they enter the region in search of deals. These firms, which acquire companies in an attempt to make market-beating returns, are more likely to play a constructive role in growing an economy. This is attributed to the business environment, where family-controlled small and medium-sized enterprises (SMEs) largely form the backbone of Southeast Asian economies.

At this point, many SMEs are ready to expand outside their domestic market, but leverage is not easily accessible even though there are many opportunities for further growth. This is an ideal environment for growth-capital private equity investors — the type of private equity firms that look for and work with passionate entrepreneurs to build a regional or global business.

Instead of being regarded as "vulture capital" or "job destroyers" (which may not be justified), private equity firms in Asia are seen as "corporate transformers" and potential business partners rather than as foes. In fact, a working paper by the US National Bureau of Economic Research found that net relative job loss at a private-equity-targeted company is less than 1% of initial employment.

"In a mature economy, you see more private equity deals involving management buyouts or takeovers and turnarounds of distressed companies. In Malaysia, like the rest of Asia, economies are still growing. Private equity firms have capital to be deployed and there are more opportunities to give it to high-potential businesses with good prospects. In many ways, private equity can be more suitable than a bank loan since capital is given based on the needs of a company. This way, you can say it is a true business partner of the enterprise, as they are aligned and working towards the same goals," says Syed Yasir Arafat Syed Abd Kadir, managing partner for investments at Ekuiti Nasional Bhd (Ekuinas).

SMEs often fall into a "mid-size" trap, where they are unable to seek the financing required to move to the next stage of growth. "For example, the revenue of the company is currently RM100 million and the business owner wants to double it in the next couple of years. He knows his market well and opportunities are abundant. However, the company has maximised all bank borrowings and cannot tap the capital market as it is not big enough. This is when growth capital is relevant. We [private equity firms] assist the company to grow to its full potential and accelerate its business to the next level. From a macro point of view, this is very important for a country like Malaysia," says Azam Azman, principal and managing director of CMS Opus Private Equity Sdn Bhd.

It is also possible for high-potential SMEs to be courted by several private equity firms, as the region is increasingly attractive to global investors looking for alternative assets. According to Bain & Co's *Asia-Pacific Private Equity Report 2014*, many limited partners (institutions or high net worth individuals who invest in general partners, that is, the private equity firm) continue to express confidence in Asia's long-term growth potential, but are increasingly selective with their commitments.

"When picking investments, we look for those with true competitive advantage. This is critical because the company needs to be able to grow quickly within a pre-determined time frame. The best companies — those with the highest potential to succeed — can find themselves courted by many [private equity] suitors. Each private firm offers its own unique business proposition. One firm may be connected to a global network, while another may have experience in growing companies in the same industry, and so on. It is up to the target company to decide which private equity firm to partner with," says Vincent Chin, senior partner and managing director of The Boston Consulting Group Sdn Bhd (BCG).

> Unconventional behaviour is the only road to superior investment results, but it isn't for everyone. In addition to superior skill, successful investing requires the ability to look wrong for a while and survive some mistakes.
> | **MARKS**

READY, SET, TRANSFORM!

Critics in developed countries claim that the short-termism and investment practices implemented by private equity investors focus on early and profitable exits. The invested company is left with a weaker balance sheet and ailing prospects, while the private equity firm walks away with its million-dollar fees.

However, proponents here say the exact opposite takes place — companies are transformed and left thriving because these private equity firms look to improve the businesses they buy with better management and strategies.

"Private equity can help SMEs to grow and to do so much faster than if they were to do it alone. Private equity practitioners bring value-creation initiatives and methodologies aimed at wealth creation for all shareholders," says Azam.

Growth-capital private equity investors take a hands-on approach to their investments and do so by closely defining the businesses in which they can find and create the most value. They usually take a seat on the board of their invested companies and are actively involved in strategic decision-making during their investment tenure.

Once a common vision for all shareholders of the invested company has been established, its goals, as well as how the private equity firm will add value, are agreed upon during the negotiation period.

"Business growth will definitely be a shared vision. Private equity firms are the growth catalysts. To make an internal rate of return (IRR) of 20% per annum, an invested company has to grow its business by 2.4 times. This can happen by expanding or by being more cost-efficient," says Syed Yasir Arafat.

To achieve 25% gross IRR through growth, companies need an annual revenue growth of 12% to 20%, depending on the variables, says The International Finance Corp (IFC), a member of the World Bank Group and the largest global development institution focused exclusively on the private sector in developing countries.

The due diligence process uncovers a company's competitive advantage as well as low-hanging fruit, or opportunities and business areas, that would benefit from business process improvements and streamlined costs. The process is resource-intensive and requires the input of many professionals.

"A single investment requires hundreds, maybe thousands, of man-hours to learn about the company and industry. We engage lawyers, accountants, administrators and other specialists to advise us on our investment," says Loong Mei Yin, managing director and partner at TAEL Management Co (Malaysia) Sdn Bhd.

Ironically, this process means that smaller deals with SMEs may take longer than the larger ones, observes Zubin Rada Krishnan, operating principal at Tuas Capital Partners, a local private equity group established in 2012. "Larger deals involving bigger companies are often already set up and prepped by intermediaries and advisers, thus allowing for quicker execution. In smaller deals, we spend time discussing and explaining the benefits of private equity investment — the value-added benefits that come with our financial capital are not always immediately apparent to the entrepreneur.

"We also uncover and look to understand the real underpinnings of the business model, from financial performance to how value is generated. These are often aspects that are more transparent in large enterprises, but can be harder to uncover with smaller, less structured and less process-oriented businesses. The outcomes of this process of dialogue will be sufficient trust, information and comfort on both sides to enable a deal to be cut," he says.

Eugene Lai, managing director and co-managing partner of Southern Capital Group, gives examples of how a growth capital private equity firm adds value. "Besides providing capital to the company to fund further growth, we may help them undertake a follow-on acquisition or penetrate new markets. Perhaps we can introduce new customers to the company; strengthen the management team through new hires; improve governance, controls and reporting; improve systems and IT; and optimise its capital structure."

Expanding regionally is a common theme among Malaysian SMEs, say Loong and Brahmal Vasudevan, founder and CEO of Creador Sdn Bhd, a local private equity firm that invests in listed and unlisted companies. Known as the poster boy of the local private equity industry, Brahmal has a wide following of investors who quickly pick up shares in the companies he acquires.

"Many Malaysian companies want capital and advice on how to expand and play a regional/global game. This is where we value-add. Private equity investors, like Creador, have a lot of business management experience in different industries and can use this knowledge to help an entrepreneur grow his business," says Brahmal.

> In many cases, we supplement the management team with additional expertise. The key is finding the best management possible, and this is challenging. World-class talent is not easy to find and oftentimes, needs to be imported.
> | **SIGIT**

It is unlikely that a private equity firm will ignore value-added activities and sell the business assets to realise a quick profit as it has to exit its investments. "To exit via a trade sale or initial public offering, the company needs to have the characteristics that buyers want. This could be a certain size, a certain market share, a high growth rate, profitability, and governance and/or transparency. And to achieve the size required for a trade sale or IPO, the smaller the company is at acquisition, the faster it would need to grow," says BCG's Chin.

MOHD IZWAN MOHD NAZAM/THE EDGE

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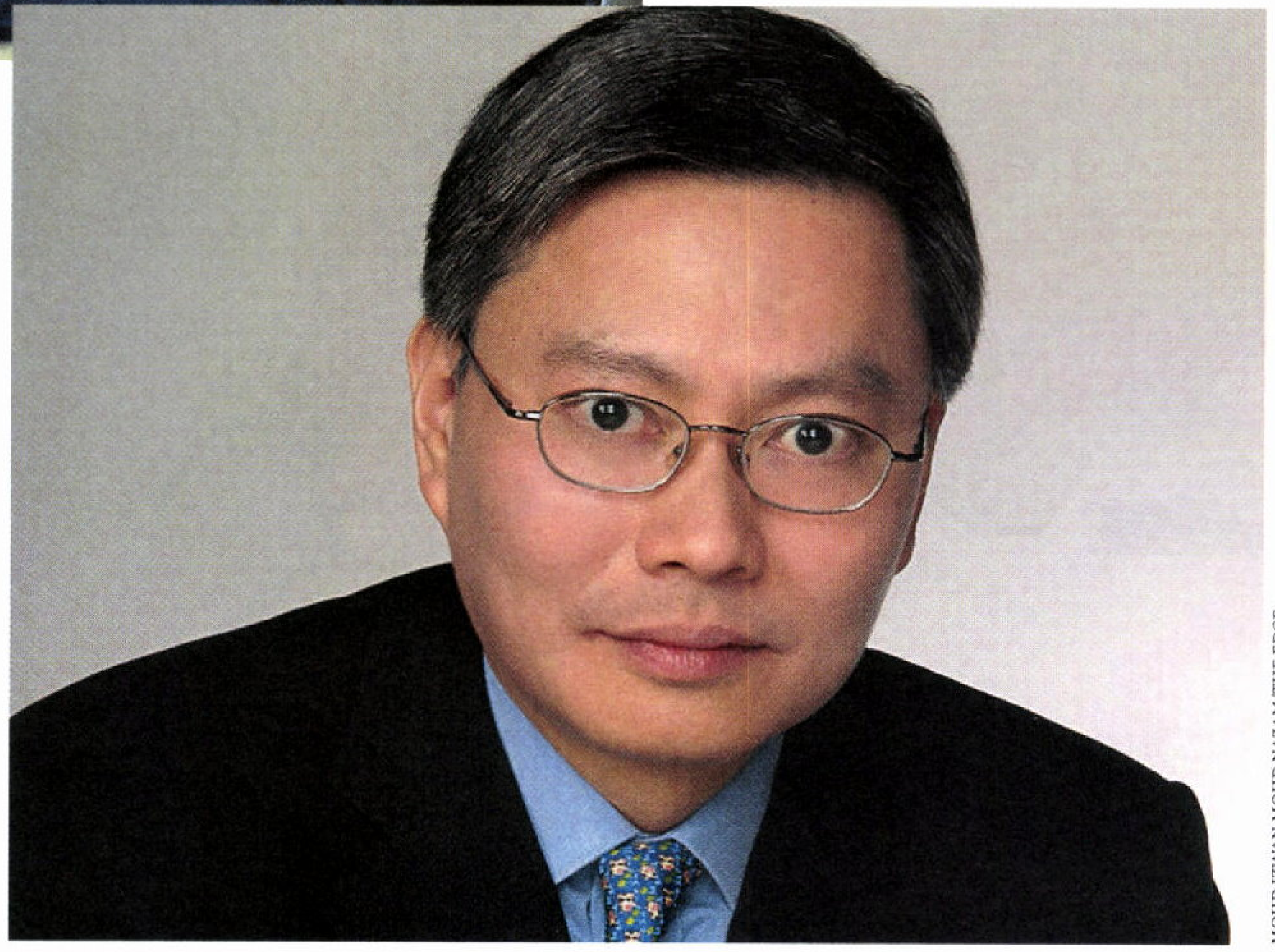
> | **SYED YASIR ARAFAT**



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> I think private equity can be a positive driver in helping the business community. It is not relevant in many situations, but in the cases where it is relevant, it can provide a solution to a problem and/or add significant value.
> | **LAI**

The business model of growth-capital private equity also addresses claims of overcompensation since investors only benefit if the invested company is successful. Governance proponents often recommend this pay-for-performance model as a best practice for commercial firms.

"Private equity investors are ranked after creditors if the business were to liquidate. This ensures their interests are aligned with other shareholders. It is in their best interests for the company to succeed," says Syed Yasir Arafat.

IMPROVING BUSINESS PRACTICES

For a company to benefit from private equity, the private equity fund must have significant influence over the decision-making. This puts it in a better position to create value and exit within a limited period. In Malaysia and the rest of the region, a private equity firm tends to have outright control of a company or a minority position with significant control rights through a shareholders' agreement.

"Once the deal is closed, the private equity investor must instil strict discipline to implement the transformational changes while being flexible enough to manoeuvre and adapt to changes in the global economy," says Mohamad Hafiz Kassim, head of private markets at the Employees Provident Fund.

"Once an investment is made, it is about executing and adjusting. The private equity firm needs good persuasion skills since it relies on the business owner and managers to run the business. Here the company's operations also improve, as decisions are no longer made by gut feel, a practice that is often adopted by family-owned operations. As professional investors, we use statistics, data and analytics to make informed decisions. So, we get this and put it down on paper and show it to key management, or ask them to do it, so that there are hard facts as to why they should support and execute a certain decision or idea. This gets their buy-in," says Syed Yasir Arafat.

Another practice common to growth-capital private equity investors in local SME deals is to introduce shared ownership. Traditional Asian values manifest in continuity and succession planning, and Asian family-owned businesses tend to avoid dilution of ownership. Private equity firms say this ownership should be shared.

"One ingredient in the secret sauce of a successful private equity deal is to keep management happy with the way business is running. They must work for themselves. A good private equity investment often spreads ownership from the entrepreneur to his management team," says Chin.

Private equity practitioners apply this approach as they agree that people are the key behind a successful investment. "I believe people are the most important aspect in a successful private equity investment. In mature markets, private equity has a reputation of causing job loss. This is part of the cycle of a turnaround deal or buyout. They cut jobs then rebuild the company," says Sigit Prasetya, managing partner at CVC Capital Partners.

"It is a growth environment in Asia, so the approach is different. The focus is growing the company's business. In many cases, we supplement the management team with additional expertise. The key is finding the best management possible, and this is challenging. World-class talent is not easy to find and oftentimes, needs to be imported. This is where we leverage our global network to find the best person to grow the business," he adds.

Besides sharing equity and putting the best people in decision-making roles, private equity investors also look at improving the remuneration packages of the company's key managers. "We ask what is needed to align the senior management and/or the management team's interests with ours. In a family-owned SME, the entrepreneur usually keeps ownership within the family. Our approach is that we are prepared to share the equity. We carve out a meaningful stake for management so that everyone is super charged up," says Brahmal.

POSITIVE MULTIPLIERS

Based on research done in 20 industries in more than two dozen countries between 1991 and 2007, a team from the Stockholm School of Economics, Harvard University and Columbia University found that industries with private equity involvement grew 20% faster than those that did not see such investments. The research concluded that the lessons learnt from private equity firms helped entire industries to be more efficient.

Private equity firms are also strongly incentivised to identify and support the fastest-growing companies, those that create jobs at a much higher rate. Generally, an organisation that gains market share in a free market is likely to positively impact its home economy.

"Private equity funds in emerging markets are reaching fast-growing companies, which in turn are creating jobs at a much higher rate than local and regional averages. Fast-growing companies are expanding companies, often expanding beyond their home market as they grow, and are in the process of helping to integrate regional economies," says the IFC in a 2013 report titled "The Benefits of Private Equity Investments".

"I think private equity can be a positive driver in helping the business community. It is not relevant in many situations, but in the cases where it is relevant, it can provide a solution to a problem and/or add significant value," says Southern Capital's Lai.

"I would say that private equity helps nation building in a way. It creates employment for more people in the region. It also builds talent, encourages continued innovation, research and development, and instils business processes into SMEs that makes them much more scalable," says CMS Opus' Azam.

Brahmal shares this sentiment. "A private equity industry is important in any economy. High-value jobs are created by a private equity investment. In many cases, we bring in talent to a country and this enhances local expertise and capabilities," he says. E