Consumer demand presents huge opportunities

It was the extraordinary returns seen by Yale University that made private equity a household name. In the 1980s, its chief investment officer, David Swensen, made a radical change to its endowment fund, switching out of the traditional asset classes of shares and bonds and into the higher risk, illiquid private equity, hedge funds and real estate.

Yale's endowment fund made a return of 11% per annum for the decade ended June 30, 2013 — far surpassing US equities, which made an annual return of 8.1%, and US bonds, which made 4.5% annually. During this period, the fund grew from US$11 billion (RM34.9 billion) to US$20.8 billion.

Other universities, institutional investors, sovereign wealth funds and pension funds have since adopted the "Yale model" of asset allocation, which allocates a significant amount — more than half the investment portfolio — to illiquid alternative assets, such as private equity. Yale lowered its exposure to private equity last year, but the asset class remains the largest in its portfolio, with an allocation of 31% for this year.

Private equity — the buying of companies privately, using some equity capital and a lot of leverage raised through debt issuance — is at the vanguard of alternative investments, observes Howard Marks, chairman of Oaktree Capital Management, a leading global alternative investment management firm.

"It [private equity] began to be seen on a one-off basis in the mid-1970s, largely a result of the very low prices at which companies could be bought at the time. Four factors have contributed to its growth. First, the creation of private equity funds in the late 1970s, so that equity capital could be assembled in advance and deals didn't have to be one-off. Then, leverage became increasingly available through the issuance of high-yield bonds, which began in the late 1970s and gained steam in the mid-1980s. In the late 1980s, private equity became a household word and finally, the confiscatory interest rates on bonds and the disappointing performance of equities since 2000 drove investor interest toward alternatives," says Marks.

A number of institutional investors in the region, such as China Investment Corp and Korea Post, the pension fund for the South Korean postal service, are reported to be increasing their portfolio allocations for private equity this year. Last June, Japan's Government Pension Investment Fund, the world's largest pension investor, announced that it was looking at investing in private equity. Even a small allocation of 1% of its assets under management would send US$12 billion into the global private equity market.

"With high-grade bonds yielding between 1% and 4% and stocks widely expected to return between 5% and 7%, many investors feel they must invest in alternative investments [including private equity] in order to reach their return targets," says Marks, adding that illiquid private equity investments require a long-term approach.

"Private equity funds generally invest over a five-year period and hold their investments for several years more. The funds themselves generally have lives of at least 10 years. And I think in the less-developed regions, it [returns] might take longer for what 'should happen' to happen," he says.

Nicholas Bloy, managing partner of Navis Capital Partners, a local private equity firm that manages assets totalling US$5 billion, agrees that potential market-beating returns is driving interest. "Of course, this asset class is becoming more popular, and for obvious reasons. Pension funds and insurers have long-term liabilities against which they need to match and grow the value of their assets. Private equity over the medium to long term demonstrably outperforms the return profile of other asset classes of comparable risk.

"The matter of long-term liability matching is less of an issue for high net worth individuals.

Yes, deals are smaller here than in developed markets in terms of absolute value. However, it is important to note that size does not really matter that much vis-à-vis a healthy entry or investment valuation.
| **MOHAMAD HAFIZ**

There are good opportunities in the right sector. For example, the consumer sector is always more interesting than the commodity sector.
| **BRAHMAL**

Nevertheless, if and when a wealthy individual is ready to outsource his investment decision-making, many will now naturally allocate a portion of his or her wealth to private equity," he says.

According to a 2014 survey by Bain & Co, private equity deals in Southeast Asia are expected to outperform those in the rest of Asia-Pacific. The global management consulting firm sees Malaysia as a key destination for global private equity investors looking for ample opportunities in the region.

FERTILE GROUND

Private equity firms in the region like consumer-driven industries when looking for investment opportunities. Regional economic integration with a freer flow of capital supports increasing domestic demand. "Increasing intra-regional trade is expected within the region with the advent of the Asean Economic Community in 2015. Integrating industries across the region presents many investment opportunities that are underpinned by a young population, a burgeoning middle class and increasing urbanisation," says Loong Mei Yin, managing director and partner at TAEL Management Co (Malaysia) Sdn Bhd.

Loong likes the food, healthcare, housing and energy sectors. "Asia as a whole will consume as much as 80% of the food in the US. This is an increase of 45% from present levels. Food consumption among the Asean 5 (Malaysia, Singapore, Indonesia, Thailand and the Philippines) will grow at a compound annual growth rate of 5.6% to US$606 billion by 2020.

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"There is also massive potential for healthcare to grow. The world's more developed economies spend an average of 10% of gross domestic product on healthcare. With the exception of Vietnam and Cambodia, most Southeast Asian countries do not spend half of this amount. Indonesia, for example, spends about 2.3% of its GDP on healthcare," she says.

"Housing will grow 2.2 times in Asia to a value of US$3.7 trillion by 2020. Asean private developers will continue to dominate primary residential sales. In Malaysia, the top seven listed developers already dominate 54% of the [housing] market and listed developers in Thailand take up 65% of the market," she adds.

Loong likes the energy sector as demand for oil in Asia is expected to grow some 40% by 2020. Developing countries, mainly in Asia, will account for 93% of the projected increase in the world's energy demand, she says.

Brahmal Vasudevan, founder and CEO of Creador Sdn Bhd, is also looking at the consumer-driven sectors in emerging countries, including Malaysia. "Healthcare, financial services, online commerce and logistics tend to drive the region's economies and private equity investors' interests. There are good opportunities in the right sector. For example, the consumer sector is always more interesting than the commodity sector," he says.

Within a sector, investing opportunities are mainly found in small and mid-sized enterprises (SMEs) that employ a significant proportion of the workforce, says Zubin Rada Krishnan, operating principal at Tuas Capital Partners. "In Malaysia, SMEs contributed to 33% of the country's GDP in 2013, compared with around 75% in Germany and 40% in the US and the UK. This points to a relatively underdeveloped SME space in Malaysia, which may not be as productive and innovative as those in more advanced markets. This speaks of ample opportunities for private equity firms to invest in companies that can fill the gap," he adds.

Since most private equity investments are growth-capital deals made with SMEs, deal transactions will be at lower values than those made in developed economies. But this is no indication of the potential returns that can be made by private equity funds.

"Yes, deals are smaller here than in developed markets in terms of absolute value. However, it is important to note that size does not really matter that much vis-à-vis a healthy entry or investment valuation. Investment sizes in developed markets, for instance, can be typically larger but it also comes with a higher valuation multiple relative to its growth forecast. This could be due to liquidity and the lower relative risk undertaken in a developed market," says Mohamad Hafiz Kassim, head of private markets at the Employees Provident Fund. Local sectors that he finds attractive include consumer goods, oil and gas, and services. ∎

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