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Southeast Asia takes on the neighbors

Southeast Asia is increasingly popular as an investment destination for private equity firms, but can it compete with China and India?

EDIBLE BIRD NESTS, RUBBER GLOVES and abalone have all drawn private equity money to Southeast Asia in 2011, alongside more predictable favorites such as coal mines, financial services groups and food processing manufacturers. Grounded in a broad range of consumer plays and natural resources, the region's investment potential is such that some industry participants say the likes of Indonesia will divert attention from perennial leaders China and India.

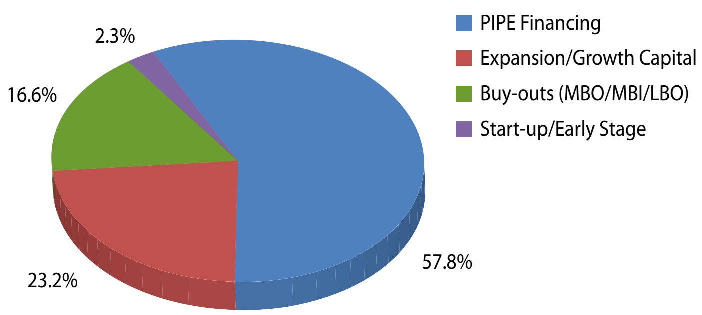
"I clearly see a pickup in interest from our investors globally, and Southeast Asia is now probably up there behind China and India in that respect," says Sigit Prasetya, partner of CVC Capital Partners in Singapore. "Stock prices are very volatile these days. Even though valuations are generally going up, the public market multiples in SEA are still significantly below China and India, and public market is a good indication of the private markets."

Professionals in both countries confirm that valuations are squeezing expected returns. Investing in India was 25-30% more expensive last year than average prices leading up to 2010, says one Indian fund manager. Although levels may fall due to a worsening economic climate, there is no guarantee stay there. A Chinese GP adds that expected valuations have risen 30% in 2011 on previous years. Prasetya notes that valuations in Indonesia have experienced a 20% increase in the last two years, but says the rise has been less than elsewhere in Southeast Asia.

While Southeast Asia represents an alternative to these markets, it is still in its nascent stages. A Bain & Company survey released in July found that three times as many people ranked Southeast Asia the "most attractive" region to invest compared to the year before – but the figure was still only 7%.

Southeast Asian nations appeal in different ways. Indonesia and Vietnam are excellent consumer growth stories, driven by rising disposable incomes; Singapore, Malaysia and Thailand boast more mature industries that add a level of regulatory clarity other destinations may lack. Natural resources can be found across the region.

PE Investment in Southeast Asia by stage, 2011 ytd



Source: AVCJ Research

Gary Ng, director of CLSA Capital Partners, notes that the region has a combined population of approximately 600 million people, which comprises roughly 45% of China's population and 50% of India's population. And they are young: nearly half the citizens in each of Indonesia, the Philippines, Vietnam and Malaysia are below the age of 25. "These factors will drive domestic consumption over the next decade," Ng says.

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> – Sigit Prasetya

This translates into opportunities in areas such as food and beverage, financials, education, retail and healthcare goods and services The global appetite for resources will also drive growth in commodities, energy, agriculture and infrastructure.

There have been a number of notable investments across these industries. In April, KKR completed Vietnam's largest-ever PE deal with the acquisition of a 10% stake in Masan Consumer Corporation for $159 million. The transaction valued the company – a producer of condiments and dried noodles – at $1.6 billion, underscoring the power of Vietnam's consumption story. One month later, CVC made its first investment in the Philippines in more than a decade, buying a 15% stake in Rizal Commercial Banking Corporation (RCBC) for approximately $115 million.

Few large deals

According to AVCJ Research, three of the top-five largest deals in Southeast Asia year-to-date took place in the consumer or financial services area, topped by UAE-based Aabar Investments' $1.49 billion commitment to RHB Capital of Malaysia. Temasek Holdings' $402 million investment in Singapore-based produce supplier Olam International and the International Finance Corp's multi-tranche $182 million investment in VietinBank were also on the list.

However, large-scale transactions are few in number. While 57.4% of funds in Southeast Asia are buyout vehicles, only 16.6% of deals fall into this category. The majority – at 57.8% – were PIPE transactions.

Strategic investors haven't been slow to pursue big ticket deals, however, as evidenced by Suntory's battle with The Carlyle Group for a stake in Indonesia's GarudaFood. In May, the private equity firm was thought to have secured up to 30% of GarudaFood for around $200 million, paying a high valuation to outbid the Japanese conglomerate. A few weeks later Suntory

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announced a drinks joint venture with the Indonesian operator and took a large minority stake in its distribution arm.

There's a chance this competitive activity will increase as confidence in consumer – as well as other – assets fades in other Asian markets. China's economy expanded 9.1% in the third quarter, its slowest pace in over two years, and Standard Chartered has revised its 2012 growth forecast from 10% to 8.5%. In India, Goldman Sachs and Morgan Stanley now predict economic expansion of 7.2% for the 2011-2012 fiscal year, down from 8% and 8.2%, respectively.

Meanwhile, in July, Indonesia's government raised its GDP 2012 growth forecast to 7% from 6.9% in May. Though marginal, the increase reflects optimism about exports and investment. "Indonesia's rating may reach investment grade by 2012 and several infrastructure projects are expected to start next year," Finance Minister Agus Martowardojo told media at the time.

These trends have yet to be reflected in private equity fundraising levels, where Southeast Asia, which doesn't register strongly on many LPs' radar, still trails China and India. According to AVCJ Research, China has seen capital commitments of $25.2 billion so far this year, up from $18.8 billion for the whole of 2010. India has raised $2.8 billion, already in excess of last year's $2.5 billion.

Still young

For Southeast Asia as a whole, fundraising appears to have fallen drastically from a year ago, moving from $3.3 billion in 2010 to $1.4 year-to-date. Indonesia, the market generating the most hype, registered a big jump in fundraising, from $285 million in 2010 to $820 million in 2011, but even those numbers are skewed. Northstar Pacific's bumper third fund accounted for all the capital. Malaysia and Singapore, meanwhile, saw fundraising decline by 86% and 75%, respectively.

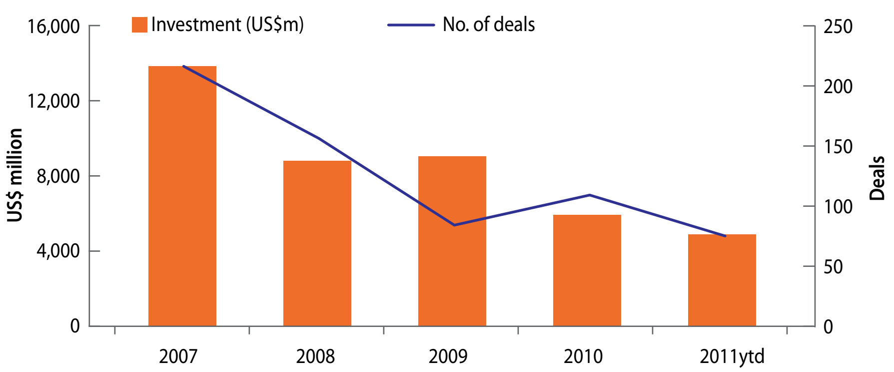
Private equity is still a growing industry in this region, but its a challenging market and experience and connectivity count for a lot,'" says Gary Addison, head of Actis in Southeast Asia.

"Most people are targeting over 25% IRR on their Southeast Asia investments by the time they exit," CVC's Prasetya says. "CVC has seen a 2.5-3.5x return on the three investments it has recently exited in the region. It's difficult to generalize, but that's a reasonable expectation if you invest in the right assets and manage them well."

According to Bain & Co.'s Southeast Asia survey, nearly 75% of poll respondents said they expect both fundraising levels and deal activity to increase. Furthermore, 70% said they plan to invest as much as $100 million annually into the region over the coming two to three years. In 2010, only 50% of respondents expressed such sentiments. About one-third also expect deal sizes to become larger, setting the stage for more robust returns.

The case for Southeast Asia is clear, but that's not to say its argument trumps that of China or India. A lack of experienced fund managers remains a key problem.

Private equity investment in Southeast Asia



Source: AVCJ Research

There are only a handful of domestic GPs in places like Indonesia and Vietnam, compared to hundreds in China and India. Redressing the balance is a challenge given that on-the-ground talent is extraordinarily difficult to come by. Although private equity professionals stress that good professionals are hard to find in China and India as well, but there are undoubtedly more options because of these countries' industries are comparatively more mature.

"Southeast Asia is unlikely to compete with India and China anytime soon in terms of either volume or value of PE activity," CLSA's Ng says. "It is still a relatively opaque PE market, requiring local knowledge and networks to generate good deal flow."

Another obstacle is the region's apparent inability to absorb capital. For big returns, investors generally need to deploy at least tens of millions per investment, but these transactions are few and far between.

"In Vietnam, you saw the Masan deal where you could certainly invest a large amount of money, but that was the only one," says Anil Ahuja, 3i's head of Asia based in Singapore. "In a market-specific sense, we've been raising an India fund that's $1.5 billion. I would think that if you were doing a Southeast Asia fund, it's reasonable to raise $300-$400 million. The big difference is that the India fund is for one country, and the Southeast Asia fund – at a fraction of the raise target – would be at least four."

Capital uncertainty

It is also uncertain where the new influx of capital will come from. While Western LPs aren't necessarily reducing their allocations to Asia, the pool of available capital is finite. Are Southeast Asia funds a sufficiently strong draw to attract commitments that might otherwise be made to China and India? Will they emerge as competitors to pan-Asian vehicles? Or can they draw investment from emerging LPs in other regions?

"From a lot of Western LPs' perspectives, China and India are already pretty adventurous markets," Ahuja adds. "I think for Southeast Asia there's a higher likelihood that capital will come from Asian or pan-Asian funds, or maybe the Middle East. But I'm expecting private equity capital to move East significantly from its current homes, and that will spread to Southeast Asian markets."

In the meantime, some Southeast Asia-focused funds are looking to bridge the two categories of Asian emerging markets. In September, Clove Capital Partners, a spin out from EMP Global's Asia business, announced plans for a $250 million growth capital fund that will target mid-size companies in Indonesia, the Philippines and Thailand as well as Malaysia and Indochina. It will seek to exit assets to Chinese and Indian strategic players.

The firm noted that the natural resources, agri-business, logistics, infrastructure and business services sectors correspond most closely to this remit.

This also may also be the goal for CHAMP Private Equity. The Australasian firm said in August that it would target acquisition opportunities in Southeast Asia for its A$1.5 billion ($1.55 billion) third fund. Given CHAMP's news came the same week it agreed to sell its 75% stake in Manassen Foods to China's Bright Food Group, more China exits for its Southeast Asia plays wouldn't appear out of the question.