



# Global players best-placed for Asian LBOs

*Market likely to become much more regional and less concentrated on Korea*

It is a good time to look back at 2001, a watershed year for private equity worldwide and in Asia. In the US and Europe, the sky was falling. (See box). For most major funds, it was a time to reassess portfolio investments and to face up to a possible nuclear winter for fundraising.

For the Leveraged Buy-Out (LBO) market, history is repeating itself. This feels like 1990, when LBO investing was down almost 70% from 1989 to 1991, while bond defaults and business failures were up 5x. But there are some things different in 2001. Over the last 10 years, the private equity market has grown substantially because of increasing allocations from endowments and pension funds. Venture capital now accounts for a much larger proportion of funds available. The number of mega funds has grown from five in the late 1980s, to 39 today. LBO deal size has almost doubled. Importantly, there is a pool of \$125 billion of un-invested capital, which could take years to invest at current market transaction volumes.

Asia is now much more similar to the US and Europe than a decade ago. When we first calculated average LBO deal size in Asia in the early 1990s, it was only \$1 million. Asia now has mega funds. Asia has large deals over \$100 million. Asia even has available debt. What Asia does not have are high profile exits and wealthy partners at private equity funds. In almost all cases, the big payoff is yet to come, and is not expected until after 2004. The next two vintages are expected to be very good for investing, but not for exit.

Who will the winners be in this new environment? We see:

- First, the branded mega funds. They have scale, experience, infrastructure and a strong LP franchise
- Second, the investment banks, with guaranteed deal flow and access to significant, flexible capital
- Third, focused funds. They have proprietary networks and deal flow, with the right expertise to pick winners
- Finally, value-added GPs. These are the funds that affect outcomes through strategy, turnarounds and earnings improvements

Value adding will be critical in the next wave of LBO investing. If you look at the exits in the early 1990s, 40% of the upside was generated through leverage. Less leverage is now available, and we expect that changing the earnings trajectory will be the primary determinant of success. Most LBO funds are poorly positioned to make this transition.

### A watershed year

- NASDAQ off 70% from peak
- Rapid decline in consumer spending and confidence
- Increasing unemployment
- 50%+ decline in corporate earnings and M&A activity
- Bond defaults highest in 80 years
- Evaporation of high yield debt market
- LBO transactions off more than 60%
- Declaration of recession

### Exploiting the recession

The leading funds in 2010 will exploit the 2001 recession in a number of ways:

- Entered 2002 with at least two years cash in the bank. Closed few deals in 2001, waited for asset prices to drop 20% in 2002
- Leveraged deep industry expertise to invest in sectors they understood during the best vintage years of the downturn. Exited in the last half of the decade
- LPs were happy with diversified cash flows from a family of funds in 2002 and 2003. Recognized the need to invest in low-price investment opportunities
- Retained all of the pre-recession team and added some strong performers
- Built global support infrastructure in back office, training, knowledge management. Hit critical mass in each location and fund

Recognized for success stories. Changed portfolio company trajectories through improvements to strategy, operations, organization and acquisitions

Our expectation is that few, if any, of these successful mega funds will be Asia-focused. They will all be global. The ability to add value to businesses comes from understanding the industry sector, the company, the management team and the local business environment. Global funds will have all of these capabilities locally in scale country markets, making country funds less viable.

In 2002, we expect the Asian LBO market to become much more regional and less concentrated on Korea. A number of acquisitions of Chinese manufacturers will close in the next few months. The restructuring of companies in Japan, Hong Kong, Singapore, Taiwan and Australia will generate a range of private equity transactions. Deals will still have the same sector focus in financial services, telecoms, technology and consumer goods. Our one hope for the New Year is that prices and seller expectations will drop as banks begin to take a more aggressive stance on major debtors in default.

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