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UPDATE

APAC private equity is entering a brave new world and smart strategy is vital

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The last few years may come to be regarded as a halcyon period for Asia-Pacific's private equity industry. A report earlier this year by consultancy firm Bain showed that total private equity investments in the region hit a record-breaking USD 296 billion in 2021, growing Asia-Pacific's share of assets under management to 30% of the global total.

All the major markets in the region hit highs compared with previous years and private equity firms are still sitting on impressive amounts of dry powder. The fact this stellar year was achieved during the height of the Covid-19 crisis makes it all the more impressive and is a testament to the resilience of private markets.

But that optimism is now turning to concern as the industry approaches a new phase of the business cycle. Dealmakers are having to pivot as a threatening cocktail of inflation, higher interest rates, supply chain disruption and slowing growth disrupts the pipeline and floods the market with uncertainty.

Geopolitics is also an increasingly large cloud on the private equity horizon in Asia-Pacific. Dealmaking tends to thrive in a calm and predictable environment and uncertainty can scare money into sitting tight or finding a new home. Cross-border private equity deals involving the United States and China are becoming increasingly complicated, partly due to political tensions. Chinese outbound deals into the U.S. face a much more hostile environment than previously with concerns around national security raising the level of scrutiny for deals. In addition, Beijing is facing a wave of Chinese companies being de-listed from U.S. stock exchanges due to a simmering conflict over adequate audit disclosure. There are 261 companies with Chinese business listed in the US and a substantial number of those are Cayman Islands and BVI companies. The true flexibility of the Cayman Islands and BVI as jurisdiction for incorporation is set to be tested. The dual listing of these companies on the Hong Kong Stock Exchange may be the first step in a strategy to cope with the tensions.

On the flip side, China inbound deals are facing more uncertainty after a prolonged regulatory crackdown across multiple industries. A change in emphasis from a policy of high growth to themes of 'common prosperity' and 'sustainable development' has meant a number of industries are dealing with a new reality. Sequoia China's recent USD 9.5bn fundraising and its focus on early-stage technology investments is a prominent example of the new mood. For other funds looking on, some old certainties are being brushed away and until new ones emerge, China-focused dealmakers may take a more considered approach.

The prospect of an extended period of political and economic uncertainty could lead to longer hold periods on assets. One factor encouraging increased hold periods is the depressed state of the IPO market, which cuts off an important exit route for private equity funds. And until stock exchange indexes show signs of a rebound, it will remain difficult for general partners to pursue a float. But while not ideal for funds looking to stick to a timetable, the prospect of keeping an asset in the portfolio longer could present an opportunity for value creation. A strategic re-assessment for the asset could result in bolt-on acquisitions or disposals that may raise the final price on exit. And additional time for internal restructuring could lead to a more attractive asset for acquirers. The flexibility of an offshore holding structure such as the Cayman Islands or BVI is key for any company looking to remain strategically nimble in this manner.

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As the changes take hold, the Asia-Pacific market is watching closely for new trends and one type of deal that has already gained traction in other regions is funds selling companies to themselves. These processes, which tend to be highly bespoke include continuation funds and are GP-led secondaries which have begun to establish an ecosystem in Asia Pacific with a limited number of high quality specialist secondaries asset managers. It is important to keep in mind that as such deals become more popular, those carrying them out will need to be sure that they have carefully considered conflicts of interest that occur when the same private equity firm is on both sides of a deal. Pricing in particular, as well as legal considerations of the detail of the limited partnership agreements, needs to be carefully considered as part of the transactions.

This new phase of the business cycle no doubt poses challenges for the private equity industry. Both general partners and limited partners are facing a new landscape and will need to adapt quickly to succeed. The right strategy formed from astute advice will be key when navigating these choppy waters.

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