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UPDATE

Catching the next wave for APAC PE firms

Update prepared by Paul Christopher (Managing Partner, Hong Kong)

Asset managers and private equity firms in the Asia Pacific region have a golden opportunity.

Making the most of each stage of the business cycle has always been pivotal to succeeding in private equity. Astute PE firms understand that future success depends on maintaining the right fundamentals. Firms are currently facing challenging headwinds, both economic and geopolitical, that have hampered dealmaking and created a cautious holding pattern in parts of the industry. PE's sparkling 12-year run has finally been interrupted and the resulting slowdown requires a different strategic focus. This need for a strategic rethink is particularly acute for China-focused funds with plentiful dry powder or designs on further fundraising.

Bain's 2023 Global Private Equity Report predicts that the long-term outlook for the industry remains fundamentally sound, but a turn in the cycle at the back end of 2022 has sparked uncertainty in the market. The report showed global buyout value dropped by 35% year-on-year in 2022 to $654 billion. Asia-Pacific experienced a 59% drop, approximately double that of Europe (28%) and North America (30%). A similar picture emerged in growth equity and late-stage venture investing which saw a 28% year-on-year drop off, ending the year with a total deal value of $644 billion. But looking past the short-term numbers, the industry still had a collective $3.7 trillion in dry powder at the end of 2022, according to Bain. There may be a slowdown, but this is not an industry short on activity or options.

Making the right choices in the current environment is paramount. According to Bain, the winners in the last downturn avoided panic and instead assessed their risk scenarios, created mitigation plans and set themselves up to accelerate out of that stage of the cycle. "Deals done through a downturn generate superior returns over time," the consultancy said, citing supporting historical data. "Leaders keep finding deals that they like and can underwrite confidently by making sure the macro factors are accounted for."

Checking the foundations

This suggests the current environment is a bad time to take a breath. Decisions made in today's market conditions are arguably some of the most vital a PE firm will make for some time. There is no one-size-fits-all method for LPs or GPs to follow if they want to advance successfully into the next upswing, but there are some general areas that all firms can consider if they want to sure up the foundations.

Taking the temperature of both the geopolitical and macroeconomic climates is a sensible place to start for PE firms reassessing their business during a less active stage of the market cycle. Tactics are important, but strategy is the driving force and the big trends inform strategy. Do the assumptions that were made in previous years still hold up? How have factors such as inflation, energy prices, interest rates, regulation and China-U.S. relations changed the investment climate? Answers will vary depending on your position in the industry, but a thorough examination of these trends is worthwhile and could lead to previously unseen opportunities in areas such as the secondaries market.

What worked well before may not be suitable for the future.

An adjusted view on political and macroeconomic issues could lead GPs to an examination of their own ownership structure or downstream investment holding structures. The recent decision by venture capital giant Sequoia Capital to split its China business into a separate entity and also separate its Indian and south-east Asian business is a high-profile example of a company that has chosen to implement significant structural change. The changes are due to take place by March next year. The chances are that this will not be the last large, strategic structural decision we see in the APAC private equity industry and all such moves have the potential to impact activities in the deal pipeline or in the operation of portfolio companies.

Changes in the deal pipeline or in the operation of portfolio companies can be prompted by the deployment of scenario planning. Rigorous scenario planning can enable firms to ensure they stay on top of legal responsibilities such as shareholder agreements, directors' duties and regulatory filings. For those incorporated in the Cayman Islands or BVI, the flexibility that comes with an offshore structure could prove to be key in successfully navigating change.

Ensuring the deal pipeline is still robust is an important task when analysing strategy during a slowdown in the cycle. Uncertainty can complicate the pipeline for PE firms and the wisdom of some active deals could be questioned. Taking a second look at anticipated deal multiples may lead to a review of the figures or second thoughts on whether to complete. PE firms may feel that some existing portfolio companies are a good fit for a secondaries deal, particularly while there are difficulties in securing an initial public offering. It is also an opportune time to conduct a wide-ranging review of financing options as the era of cheap money declines and traditional financing sources become less attractive. Growth areas such as NAV financing may be seen as a more desirable option for the future.

Taking the wheel

The current climate provides a useful opportunity for funds to get more closely involved in the management of portfolio companies, which could lead to cost improvements and assist with strengthening returns. Fund managers are increasingly prepared to roll up their sleeves and take more control in a bid to drive companies forward. Improving portfolio performance through identifying companies that perform strongly during adverse conditions and capitalising on that advantage could provide a crucial edge.

Finally, the case for funds to undertake a comprehensive review of their corporate service providers is very strong. There is now a useful window for GPs to consider the effectiveness of their relationships with service providers, potentially leading to changes and a reduction in provider concentration. The potential increase in value that funds could gain from service provider reorganisation may prove to be a key strand in boosting overall performance.

Staying mindful of changes in legal responsibilities is a vital element to making changes in your business. Shifts in strategy should be accompanied by expert advice on any legal implications. Our wealth of experience in restructurings at both management company and portfolio level means we are well-suited to provide guidance to current and prospective clients. Current market conditions represent a rare opportunity for PE firms to get their houses in order and an experienced legal adviser can ensure that process runs as smoothly as possible.

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