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INVESTMENT MANAGEMENT

# Why Invest in Asian Private Equity? The Case for Outperformance

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Amid current financial market volatility, investors are revisiting asset allocations in their portfolios, hoping to identify attractive market segments with upside potential. Morgan Stanley Investment Management ("MSIM") views private equity in Asia as a potential bright spot for investors that offers the opportunity for outperformance, particularly at the current juncture. While Asian private equity can be a difficult segment to diligence and access, MSIM believes that its 20+ year history investing in private equity funds and opportunistic investments in Asia, combined with the broader resources of Morgan Stanley, can help bridge this knowledge gap.[1] MSIM's upcoming series on "Why Invest in Asia Private Equity?" will look to demystify the opportunity, starting out with "The Case for Outperformance," which explores some of the drivers of outperformance including accelerated growth/leapfrog potential, valuation arbitrage, and the opportunity for company-level professionalization and efficiency improvement. In subsequent papers, the team will go into further depth on the region, covering topics such as the opportunity for venture capital in India and the current state of private equity in China.

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## Asian Private Equity: Where's the Risk Premium?

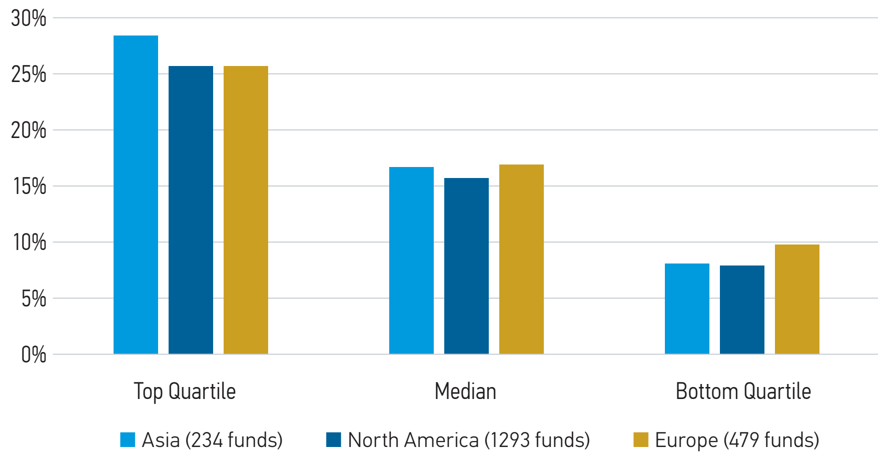
Investors looking to Asia usually ask, "Can I expect a risk premium?" In short, yes—at least based on MSIM's analysis. On the surface, historical private equity ("PE") performance in Asia has been shown to be on par with performance numbers generated in other regions. However, top-performing Asian private equity funds show historical performance that often exceeds top-performing North American and European funds.[2] This outperformance has generally been delivered with lower levels of underlying leverage, as company-level debt is less readily available and/or less attractively priced in Asia versus Western markets, and private equity subscription lines of credit are less commonly used by funds in Asia.[3] General partners ("GPs") in the region that are able to identify the right market opportunities and execute accordingly have shown that they can indeed deliver that much desired "risk premium".

This paper covers a few of the drivers of outperformance in Asia—accelerated and leapfrog growth, valuation arbitrage and efficiency improvement—and why these observed characteristics make the Asian market particularly attractive.

**DISPLAY 1**

**Private Equity & Venture Capital Net IRR from 2002-2017 by Primary Geographic Exposure**

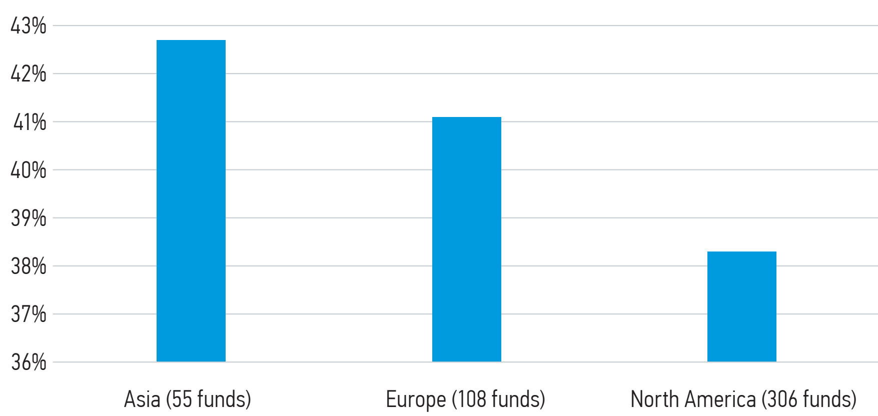
*Net IRR %*




Source: Preqin Pro as of September 30, 2022

**DISPLAY 2**

**Average Top Quartile Fund IRR from 2002-2017 by Primary Geographic Exposure**




Source: Preqin Pro as of September 30, 2022

## Accelerated Growth/Leapfrog Potential

### COPYCAT MODELS ACCELERATING GROWTH

Unsurprisingly, growth is a leading factor that makes Asia an appealing target for private investment capital. Beyond robust GDP growth, under-penetration in many sectors creates opportunity for accelerated growth. The adoption of technology within China over the past two decades is a good example. In the early 2000s, China's tech industry followed a copycat model, with consumers adopting technology that had proven successful in the U.S. This trajectory led to faster adoption; based on data from 1997-2015, 'unicorn' status Chinese Internet startups took an average of four years to reach their $1 billion valuation—versus seven years for their U.S. counterparts. Among this cohort, 46% of Chinese unicorns reached that status within two years—versus only 9% of U.S. unicorns, suggesting this hyper-accelerated growth as the 'norm' rather than the exception among successful Chinese startups.[4]

[2] Preqin, data as of September 2022. Vintage years beyond 2017 have been excluded as performance is less mature and may be too early to tell. Note that the data discussed here is limited to only what is reported to Preqin; as a result, the dataset may suffer from survivorship bias. Performance data quoted represents past performance, which is no guarantee of future results, and current performance may be lower or higher than the figures shown.

[3] Preqin, data as of July 2022

[4] Source: BCG, "Decoding the Chinese Internet" Sept 2017

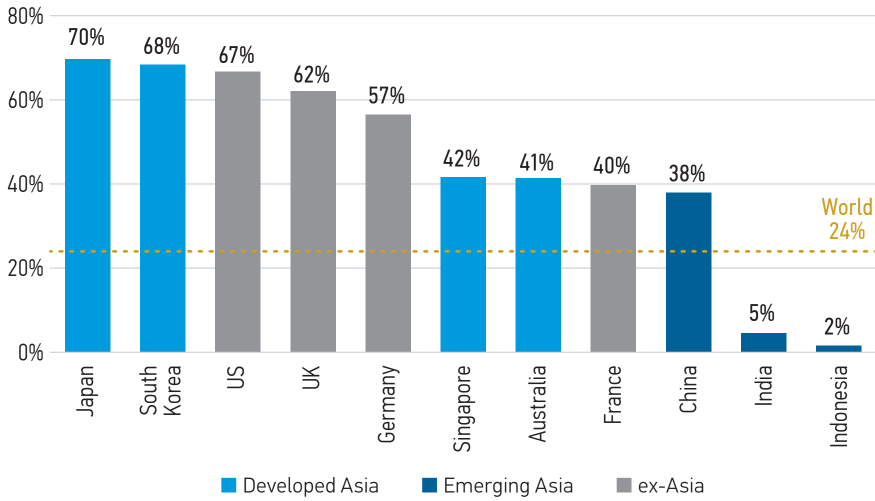
### TECH AS A LEAPFROG OPPORTUNITY

In addition to the "copycat" model, Asian markets have demonstrated a "leapfrog" phenomenon—whereby one region replicates and rapidly improves upon an innovation witnessed elsewhere. For example, while China tech was initially a copycat play, China's Internet sector has surpassed the U.S. in several areas (e.g., mobile payments, online shopping). Under-penetration of financial services and modern retail presented an opportunity for China to develop more advanced solutions than what existed in the West.

Beyond China (which is currently facing its own challenges), "leapfrog" potential exists in other parts of Asia. While emerging Asian countries generally lag in terms of adoption of traditional banking products (e.g., credit cards),[5] consumers in emerging Asia over-index on adoption of fintech products.[6] Knowledge gains from more established regions can serve as the foundation for even better solutions in more emerging Asian regions. In Indonesia, for example, stakeholders including entrepreneurs, venture capital ("VC") funds and politicians, are working in concert to pre-empt potential fintech-related regulatory issues observed in the U.S. and China, such as crackdowns in the peer-to-peer lending space. This can lead to less friction as industries grow. Mobile solutions such as real-time online loans to the unbanked, leveraging digital information, cross-border transfers at lower friction/cost, etc., are all helping to boost financial inclusion in Southeast Asia. "Leapfrog" tech potentially has the ability to further accelerate growth, thereby offering the opportunity for outsized returns.

**DISPLAY 3**

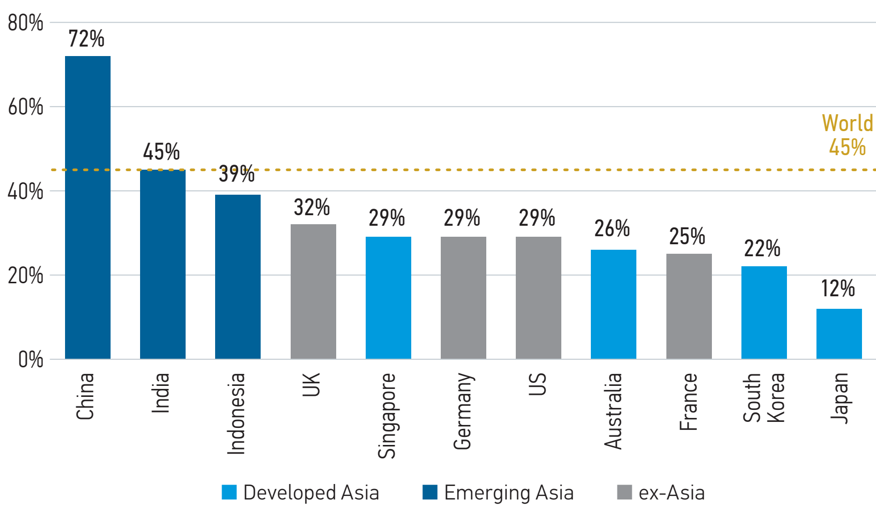
**Credit Card Penetration by Country, 2021**




Note: Credit Card Penetration as defined by percentage of people age 15+ who use credit cards
Source: Statista, data as of June 2022

**DISPLAY 4**

**Digital Wallets as a Percentage of Total Payments, 2021**




Source: PPRO Asia Pacific, Western and Central Europe, North America Payments and e-commerce report 2022

[5] Source: Statista, data as of June 2022. Credit Card Penetration defined as percentage of people 15+ who use credit cards.
[6] Source: PPRO Asia Pacific, Western and Central Europe, North America Payments and e-commerce report 2022.

## Accessing a Valuation Arbitrage

### OPAQUE ENTRY VALUATIONS

While there is generally broad appreciation for growth potential in Asia, there is often an implicit assumption that markets are efficient with commensurate valuations, or, said differently, that higher growth potential means higher valuations.[7] That is not necessarily the case in Asia. The complexity and idiosyncrasies of Asian markets usually result in greater opacity to valuations. Paired with lower valuations—public market valuations trading as much as 40-50% lower than the US on a P/E basis,[8] and private markets valuations that have almost halved from their peak[9]—there should be a particularly attractive opportunity at hand.

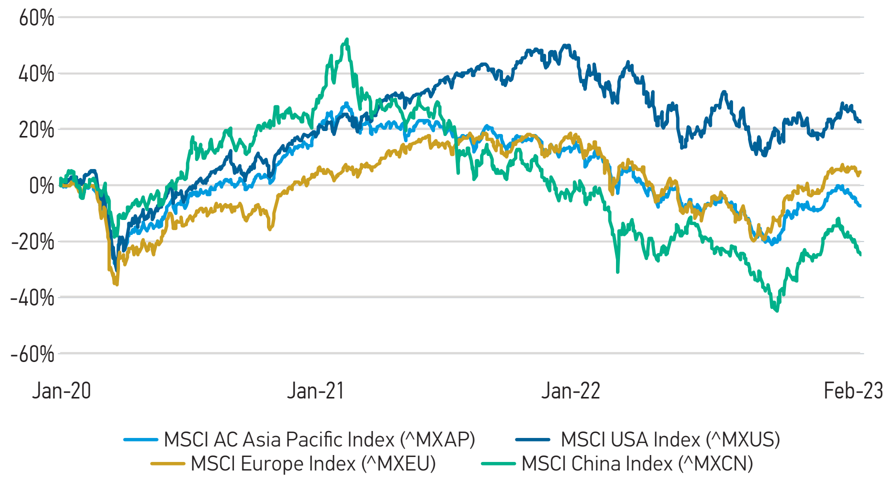
### IT'S NOT JUST THE PRICE

A defining characteristic of Asian markets is the way geopolitical and cultural factors inform how business is done. The Covid-19 pandemic re-emphasized the importance of localized operations, as closed borders made it impossible for non-local managers to undertake transactions. Beyond localized operations, the ability to adapt to unique customs can be both a hurdle and opportunity. For example, in Japan, deals are often won based on trust, not price, as sellers look for buyers who will preserve their legacy post-transaction. In India, where valuations are persistently high, GPs can structure a 'win-win' two-stage deal that involves an initial investment at a reasonable entry valuation, work alongside the entrepreneur to improve the operations and positioning of the company, and eventually exit together at a premium valuation. There are also pockets where capital supply/demand dynamics remain reasonable, resulting in attractive entry valuations—e.g., in Thailand, there is a paucity of PE managers facilitating investment opportunities in high quality, growing companies.

**DISPLAY 5**

**MSCI Indices (January 2020- February 2023)**

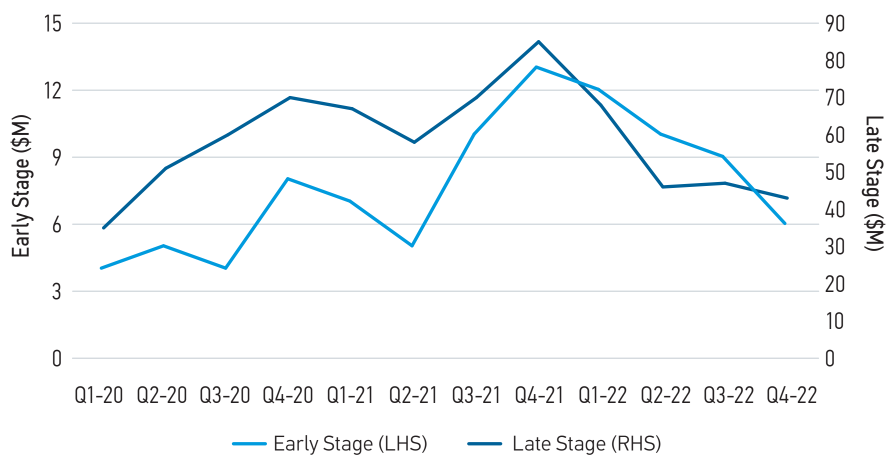
*Percentage change of index value*




Source: S&P Capital IQ as of 28 February 2023.

**DISPLAY 6**

**Private Market Valuations in Asia**




Source: AVCJ Research, as of 31 December 2022. Private market valuation refers to round size, as determined by capital invested divided by no of deals.

### SCARCITY VALUE DRIVES SIGNIFICANT EXIT PREMIUMS

Exits in the region are notoriously complicated, as tighter public markets limit IPO options and geopolitical uncertainty clouds valuations. Yet, high-quality assets in segments where there is perceived scarcity value can often achieve premium valuations at exit. An example of this are the shares of Indian banks and non-bank finance companies ("NBFCs") where the highest quality banks/NBFCs

[7] An efficient market is one where the market price is an unbiased estimate of the true value of an investment.

[8] Source: Bloomberg, data as of February 28, 2023.

[9] Source: AVCJ, data as of September 30, 2022.

trade at Price/Book multiples 3-7x that of the market median.[10]

Further, there is a local-global arbitrage opportunity—identifying a company at a well-priced local market entry valuation, repositioning the company for global markets, and exiting at a premium valuation commensurate with a global company. This has played out among Korean tech companies where early-stage investments are limited to local VCs, keeping valuations modest. Companies with cutting-edge tech and design can be positioned for Asia and/or global expansion and sold at a premium valuation. Similarly, Australian software companies can be invested in at modest high single-digit/low double-digit EV/EBITDAs and sold on to global strategics at premium double-digit EV/EBITDAs.

By navigating unique cultural and geopolitical situations, arbitrage opportunities, and positioning companies well for exit, sophisticated GPs can capitalize on the inefficiencies of this market dynamic to "buy low, sell high."

## Professionalization and Efficiency Improvement – An Additional Source of Alpha

### OPERATING EFFICIENCY – AN OVERLOOKED RETURN DRIVER

To date, top-line revenue growth has been the largest contributor to Asian PE returns.[11] This is unsurprising, given that until recently growth has been easy to come by in Asian markets, making efficiency (and hence margin) improvement less of a focus. From a GP's perspective, effecting operational change requires more effort and a specialized skill set, as well as significant influence on a company which is often lacking in minority stake deals (the predominant deal type in much of Asia). However, GPs who are willing and able to do the hard work have an additional lever to create value in companies and can potentially deliver alpha above their peers. As overall GDP growth slows, efficiency improvement will become increasingly more important.

### ASIAN BUSINESSES – RIPE FOR PROFESSIONALIZATION

Many attributes of businesses located in Asia are well-suited to operational improvements that can both further growth and increase margins. In China, state-owned enterprises make up approximately 40% of GDP.[12] These companies have traditionally been less nimble and commercially focused than their private counterparts, with many straightforward areas for operational improvement. In Asia overall, family businesses and small and medium enterprises make up 85-90% of companies.[13] Many of these businesses operate at low margins due to limited implementation of systems and technology. Anecdotally, as little as five years ago, many businesses in the region managed trucking logistics via paper on a clipboard. Automating these manual, inefficient processes are potential 'easy-wins' to improve efficiency. Going forward, shifting macroeconomic conditions will make efficiency initiatives an increasingly important value driver in Asian private equity.

## Conclusion

Investing in Asian private equity comes with a unique set of challenges and risks beyond what this paper has explored. Geopolitical risks, currency risks, and exits/liquidity are important considerations for investors contemplating an allocation to Asian private equity, and adequately addressing these risks are undoubtedly key to achieving positive performance in Asian markets. MSIM will look to address these risks/opportunities in future briefs.

Notwithstanding these risks, a variety of factors—accelerated growth/leapfrog potential in underpenetrated industries, opaque and attractive valuations relative to developed markets, and overlooked opportunities for improvements in operational efficiency—contribute to the region's potential for outperformance. The market environment in the next few years will present further dislocation and opportunity for fundamental value creation. Critical in this endeavor is the identification of private equity managers which possess the appropriate skills and requisite experience to manage the region's unique challenges. For those that can identify and partner with such private equity managers, there exists a promising opportunity for outperformance in the region.

[10] Morgan Stanley Research, "Investor Presentation – India Banks", November 11, 2022.
[11] Bain & Company, "Asia-Pacific Private Equity Report 2022".
[12] Weforum.org "How reform has made China's state-owned enterprises stronger" October 2020.
[13] 11 Russell Reynolds, "Transitioning to the Next Generation: Leadership succession within family businesses in Southeast Asia", November 2021.

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