Enter the Dragon
Private equity opportunities for accessing the Asian growth story

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Nearly 50 years after the birth of private equity in Asia¹, the marketplace for privately placed transactions in the region has matured to the point that Asian private equity may be one of the most compelling investment stories—if not the most—in the world today.

In our view, PE may offer more attractive dynamics than other investment strategies in Asia. This opportunity exploits an unfulfilled demand for intellectual and financial capital due to structural inefficiencies involving constraints on managerial capacity and other latent catalysts for improving valuations.

While these constraints and catalysts are evident throughout much of Asia, we believe they are particularly relevant to China—and therefore imply greater opportunity for PE investment in the Chinese market than in any other economy in the region. This stems from the tremendous opportunity afforded by China’s rise as a global engine of economic growth and, perhaps more importantly, the unique socio-political environment where an entrepreneur-led transformation of the Chinese economy is taking place.²

In this paper, we seek to first define private equity, then describe the landscape for PE in Asia and, finally, present our analysis of the potential for PE investors. While we consider the Pan-Asian region to have strong merits, our primary focus is China due to its sheer size, number of quality investment

¹ Private equity debuted in Asia with the establishment in 1963 of Tokyo Small Business Investment Co., a direct investment boutique, as documented in "The Evolution of Private Equity in Asia," a 2003 report by Asia Private Equity Review. The report also notes that the region’s first proper venture capital firm (also Japanese) was the Long Term Credit Bank, which was set up in 1972. It wasn’t until then that Arral & Partners of Hong Kong became Asia’s first private equity firm modeled on the U.S. general partnership structure.

opportunities, growth characteristics, consumption driven middle-class, and quality of investment professionals and entrepreneurs. As such, we will explore the overall Chinese growth paradigm and highlight characteristics of PE specific to China, including the role of domestic and overseas funds, as well as exit strategies. In addition, we will lay out some of the larger micro and macro risks that may be involved for PE overall, Asia in general and China in particular.

We believe the strength of the case for China rests on the country’s ability to promote its robust entrepreneurial culture, primarily through the efforts of a highly educated and rapidly growing class of small business owners, many of whom have studied or worked overseas and, increasingly, have prior successful entrepreneurial experience. Indeed, in our view, China’s expanding pool of capitalist risk-takers is a necessary, but not on its own sufficient, condition for developing its private sector by fostering multi-stage business growth.

Based on our analysis and first hand knowledge of the market, the key “missing pieces” in China include access to growth capital and, more critically, operational expertise to assist under-managed private businesses with the skill sets required to grow into large and successful enterprises. These are the obvious entry points for seasoned PE fund managers. Of course, as noted above, other geographies in the Asia-Pacific region also present attractive opportunities, such as growth equity in India and buyouts in markets like Australia, Japan and South Korea—each of which will be explained in greater detail below.

Before discussing the relevance of PE in an Asian context, we should outline the general parameters of what we mean by “private equity” in terms of how it differentiates from public equity, the typical stages of engagement and the respective roles of general and limited partners. As detailed in a companion J.P. Morgan publication “Private Equity: Exploring the Full Equity Spectrum” (November 2009), PE refers to transactions that involve negotiated investments, primarily in privately-held companies. Most involve controlling stakes in target companies and, importantly, include an active operational role in setting policy and strategy in partnership with entrepreneurs to enhance the value of the enterprise (For more, see “Defining Private Equity” sidebar).

DEFINING PRIVATE EQUITY

Unlike a passive public equity investment, the objective in private equity is to unlock latent value by injecting both capital (at attractive entry valuations relative to public markets) and managerial expertise. In so doing, however, PE tends to be characterized by low liquidity, long time horizons and quarterly market-based valuation guidelines. At the same time, it can offer enhanced diversification, exclusivity, a strong alignment of interests and, historically, returns above public equity benchmarks. Indeed, most private equity strategies aim to achieve aggregate returns in excess of 500 basis points above the returns generated by a public equity portfolio.

PE investments tend to fall into two broad categories: venture capital and corporate finance. The former usually involves providing funds for early stage expansion or growth capital, while the latter includes funding for buyouts, industry consolidation, expansion and/or restructuring. Most private equity investment vehicles are structured as a partnership managed by a General Partner (GP) with a 10 year life, including a four to five year investment period in which portfolio company investments are made, sold and the proceeds are returned to investors. As part of that process, an Offering Memorandum (OM) is prepared for potential investors that describes the terms of the partnership covering economics, governance, and investment strategy, and the types of investments the GP intends to make. An investor becomes a Limited Partner (LP) upon execution of a subscription agreement to commit a specified amount of capital to the partnership as specified in a limited partnership agreement.

Most PE funds are closed to new investors following a pre-determined fundraising period and/or a specific deadline or whenever a certain amount of capital has been raised. After closing, the GP begins to make investments in companies consistent with the strategy outlined in the LP agreement by making “capital calls” that are funded by investors on an as-needed basis. The year in which a private equity partnership commences its investment activity is known as its “vintage year.” A common measure of a partnership’s performance is vintage year performance, which compares the partnership’s performance to other PE funds raised in the same vintage year. Companies are typically held as investments in the partnership for an average of three to five years. Exit strategies for portfolio companies include IPOs, M&A transactions (sales to strategic buyers or financial buyers) and recapitalizations.

As noted above, PE aims to produce risk-adjusted returns above those of public markets to investors with a long-term investment focus. Unlike many other alternative investments, PE generally does not have investor-driven reinvestment or redemption features (however, there is an active PE secondary market.) Therefore, investors must carefully consider both liquidity requirements and the time horizon for investment, as well as equity risk. Furthermore, because the dispersion of returns can be large, we believe an investor should aim to invest with top-tier PE managers since they have traditionally outperformed lower-tier firms.¹

I. The Chinese Century

In recent years, China’s annual GDP has grown at or near double digits, which has catapulted the country into the ranks of the world’s top economic powers. In fact, measured on a purchasing power parity (PPP) basis adjusted for price differences, China became the second-largest economy after the U.S. in 2009 (although its per capita GDP ranking is much lower due in part to its large population). Much of that growth has been fueled by Chinese export industries, which have sprouted up along the mainland’s coast to service strong overseas demand for everything from “Made in China” plastic baggies to flat screen televisions. However, some three decades into China’s great economic awakening, it has started to diversify its growth away from that export-centric expansion toward a more domestic consumption based model. The Chinese government has helped engineer this shift by tapping into the latent buying power of 1.3 billion domestic consumers.

China has learned that economic growth begets greater wealth and higher discretionary spending, which creates a virtuous cycle of domestic demand-fueled growth. Not only has this pulled more Chinese into the middle class, but it offers the potential to reduce China’s over-dependence on overseas markets. In practice, this shift has taken the form of a growth explosion in a private sector clamoring to meet the demand for everything from baby food and jewelry to cars and hotel rooms. In fact, China surpassed the U.S. as the world’s biggest market for car sales in 2009, ending more than a century of dominance dating back to the Ford Model T. The boom isn’t limited to the world of bricks and mortar. On the web, China supplanted the U.S. in the number of Internet users in 2008 with some 253 million people logged on. By 2025, consumption is forecast to account for nearly half of total Chinese GDP, up from just over one-third in 2005. This is projected to coincide with the rise of the world’s single largest middle class (some 612 million Chinese), who will account for 75% of China’s population, up from about 43% today (see Exhibit 1).

The global credit crisis has proved to be somewhat of a catalyst in this transformation to the extent that it has helped reverse the prevailing trends of overconsumption (and under-saving) in the West and over-saving (and under-consumption) in China. Still, turning today’s “factory of the world” into tomorrow’s “showroom of the world” will be a multi-stage process. The Chinese government has sought to accelerate that transformation to promote more balanced growth by, for example, pursuing a gradual appreciation of its currency (the renminbi, or yuan), lowering export incentives and adopting policies specifically designed to stimulate private consumption. So far, those initiatives have had only a limited impact. Why that has been the case is a complex issue and not the focus of this study. However, to obtain a better sense of conviction as to whether the shift away from export dependency and toward boosting domestic consumption will ultimately prove sustainable—and open opportunities for PE investment—we believe it is important to note what strategies are being executed by China’s policymakers. These steps include:

(i) Higher overall government general budget expenditure on education, health and infrastructure
(ii) Targeted government stimulus packages
(iii) An intensified focus on inland/Western China (as opposed to coastal/Eastern China) development through a “Go West” policy initiative

Using provincial real GDP per capita personal income, there have been a number of studies that have shown inter-provincial inequalities have been widening since 1978. See, for example, (i) Chi Keung Marco Lau (2010), New evidence about regional income divergence in China, China Economic Review, forthcoming; and (ii) P. Pedroni and Y. Yao (2006), Regional income divergence in China, Journal of Asian Economics, 17, 294-315.

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5 Policies to promote domestic consumption as a key engine of long-run sustainable growth are a focal point of President Hu Jintao’s “balanced” growth strategy. For example, see Hu Jintao (2004), “China’s Development is an Opportunity for Asia,” a presidential speech delivered at Boao Forum for Asia Conference, April 24, 2004.

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Exhibit 1: China’s Rapidly Emerging Middle Class, 1985–2025E

Source: McKinsey Global Institute, 2006
II. The Big Picture for Asian PE

As with investments in other asset classes, the key challenge for PE is finding attractive ways to exploit the tremendous macro economic activity in China and elsewhere in the Asia-Pacific region. To be sure, the investing world has become exponentially more global over the past decade and PE has been no exception. Fund raising for PE investment beyond the shores of the U.S. and Britain comprised less than 10% of the total as recently as 2002, but climbed to more than 40% by 2006. Some $23.1 billion in fresh capital flowed into Asia in 2009, down 53.9% from the $50 billion raised the previous year. Notably, more than 40% of that total raised was earmarked for China, while another 18.3% went to India.

Although the Asian PE climate (in terms of the number and value of transactions, along with the amount of funds raised) has waxed and waned over the past two decades, the cumulative capital pool has grown inexorably upward each year. In fact, Asian PE has been transformed from something of an afterthought into one of the most sought-after target areas by savvy investors. That trend line has become even more prominent over the past two decades. In 2009, PE capital under management hit an all time high of $282.9 billion, up from just $25.7 billion in 1993 (see Exhibit 2).

Of course, high savings rates are at the root of China’s low consumption problem. Historically, China has experienced below average rates of consumption and an above average savings rate—even compared to other emerging markets. For example, China’s share of GDP derived from household consumption over the past two decades (43%) is 20 percentage points lower than has been the case for India (64%). The equivalence is clear: when savings are too high, consumption will be low. Clearly, this is one of the key challenges for China going forward.

But if the aforementioned policy efforts are even partially successful, then we believe they will go a long way toward getting Chinese households to part with more of their hard earned renminbi (RMB). While much can be said about the undeniably impressive macro story supporting investment in China, the thrust of this paper is, of course, focused on the unique characteristics relevant to investors in PE. These macro factors may not seem obvious at first, but they do, in fact, form what we view as an integral—and necessary—component of the broader foreign and PE investment story in China.

(iv) Promoting a shift in the make-up of manufacturing from low-end assembly to higher value-added products to cultivate new demand.

(v) Effectively managing the mass migration of workers from rural to urban areas and encouraging an expansion of skill sets to narrow inland/coastal wage differentials.

(vi) Promotion of infrastructural development to both enhance productivity and also boost consumption of natural resources sourced domestically.

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How this capital is being raised and deployed sheds light on some of the unique characteristics of Asian PE investment. Reflecting the global slowdown that had taken hold by early 2009, both the amount of funds raised and the value of PE investments made in Asia fell to the lowest levels since 2004. Similarly, the number of PE funds contributing fresh capital dipped to 136 in 2009, down from 207 in the prior year.\(^n\) In terms of what type of PE transactions attracted the most interest from investors, funds dedicated to growth equity and late investments accounted for the lion’s share of new money raised—$11.4 billion.

While the amount dedicated to growth equity investments in 2009 was 44% below the $20.6 billion of the previous year, it marked the third year in a row that this type of PE predominated in Asia. Buyouts raised $7.7 billion last year—the smallest amount since 2004—and infrastructure funds raised $2.4 billion. Venture capital rounded out the top categories, with $1.6 billion—and 70% of that was dedicated to China.\(^n\) That conforms to a pattern visible in the past few years. In 2006–2009, venture capital and growth capital investments in China and India dwarfed the sum of investment in all other countries in the region combined (See Exhibit 3).

China’s status as the leading venture capital market in Asia makes sense amid its boom in start-ups. Indeed, the number of privately owned companies has skyrocketed from 655,000 in 1995 to more than 6.6 million in 2008. More than 70% of Chinese enterprises are now privately owned, up from just 3% in the early 1990s. What’s more, a grand total of $12.7 billion was invested in the mainland Chinese private equity market in 2009, down from $14.4 billion the previous year.\(^n\) But that two-year total was by far the highest of any country in the Asia-Pacific region, including Australia. In terms of the number of deals, 506 were transacted on the Chinese mainland in 2008 and an additional 380 took place in 2009. By comparison, India welcomed only $4.1 billion in PE investment through 183 deals in 2009 and $10.6 billion invested through 336 deals in 2008.\(^n\) One reason for that differential may relate to China being somewhat more insulated from the effects of the global credit crisis. In any case, both India and China remain the pre-eminent targets for PE investors in the region.

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\(^{16}\) APER, 2009.

\(^{17}\) Ibid.

\(^{18}\) “Large and In Charge,” FT.com (Dragonbeat), July 14, 2008.

\(^{19}\) AVCJ, 2009.
There is reason to suspect that much of the PE activity in China over the coming years will target growth and expansion equity for small and mid-market sized enterprises entering their next stage of growth. In fact, a recent market sentiment survey of prospective PE investors in China conducted by KPMG noted that growth capital would likely continue to be the predominant area of investment targeting privately run Chinese companies. This appears to reflect a growing confidence in the management of PE-backed companies, a higher level of maturity in the Chinese market for PE investments and, increasingly, compelling valuations. Interestingly, most of the survey respondents viewed domestic demand-oriented fields as the most attractive areas for PE investment, including consumer products and services, medical products, and retailing (See Exhibit 4).

Although both China and India have positive macro growth outlooks (China’s is discussed in greater detail below), we believe that the relative opportunity set for PE investment is meaningfully higher in China for a number of reasons. Chief among these is what we view as a pervasive and likely enduring disparity between entry prices and valuations, according to our analysis of the private and public markets in China. Indeed, we have found that entry and exit multiples in other emerging markets, including India, tend to be much closer together, thereby limiting the potential for the appreciation of valuations. This appraisal of the investment opportunity for PE in China rests on several key assumptions about the suitability of the Chinese market, including the prominent role of highly educated overseas returnees, successful repeat entrepreneurs, and demand for Western expertise in areas such as accounting, governance, shareholder restructuring and operations. What’s more, these facilitating factors should be viewed as a corollary to the larger (and truly historic) macro growth dynamic in China.

Other recent research indicates that PE-backed companies in China tend to outperform their publicly-listed peers in terms of profitability; firms funded at least in part by PE saw profits rise by an average of 14 percentage points above those at publicly-traded companies, according to a 2009 survey commissioned by the European Union Chamber of Commerce in China. This type of empirical evidence, whatever its limitations, leads us to believe that not only do significant opportunities exist in emerging Asia for PE investors, but that China may be the most attractive market in the region for PE investors.

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**EXHIBIT 4: TOP INDUSTRY SECTOR PICKS FOR INVESTMENT IN PAST/COMING 24 MONTHS (AS OF 2008)**

![Bar chart showing top industry sector picks for investment in past/coming 24 months (as of 2008)](chart.png)

Source: KPMG

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20 “Private Equity in China: Market Sentiment Survey” 2008, KPMG.

21 “The Social and Economic Impact of Private Equity in China,” European Union Chamber of Commerce in China in partnership with Bain & Company (2009). This survey included mainland Chinese companies with at least $20 million in PE financing who were tracked from 2002 to 2008 and compared them to 2,424 Chinese companies listed on both domestic and foreign stock exchanges (Shanghai, Shenzhen, Hong Kong, U.S. and European).
III. Quantifying Entrepreneurship in an Asian Context

As alluded to previously, the role of entrepreneurial enterprise as an engine of financial development and economic growth is well documented. Entrepreneurship has also been linked to robust returns on investment across the asset spectrum (particularly relevant in the internet, mobile, consumer, clean energy and software sectors.) This is nowhere more apparent today than in Asia, where productivity growth is being driven largely by an explosion of entrepreneurship. Needless to say, private equity GPs play a critical role not only as a source of financing, but also as “honest brokers” through the due diligence activities they perform via screening, contracting with and then monitoring start-ups post-investment. While entrepreneurship is a common denominator present in all societies to one degree or another, it is an elusive attribute that can be hard to quantify not least because it often manifests itself differently depending on the economic, political and societal climate of a given country or region.

In China and India, for example, the government plays a very active role in certain strategic sectors that stands out from the more laissez-faire tradition of the West. Both countries have significantly liberalized their respective economies, but in important aspects each retains a heavily “socialistic” component. In India, that is best represented by the historical role of public sector undertakings (PSUs), which are essentially government-sanctioned monopolies. In China, state-owned enterprises (SOEs) wield immense influence over vast swaths of the economy. Most of China’s recent 4 trillion yuan ($585.9 billion) stimulus package, for example, was directed to state-owned banks and then parcelled out to fund infrastructure projects dominated by well-connected SOEs.22

For all of the aforementioned reasons, there is no direct way to “measure” the extent of entrepreneurialism in a given country with any degree of precision. But we posit that data on the total number of patents filed by residents and non-residents may serve as a proxy for entrepreneurial activity. This is because entrepreneurship is commonly driven by innovation, which, in turn, is closely linked to the filing of patents. Even patents, however, may not be an adequate yardstick if intellectual property rights are not iron clad. Still, in terms of gross patent filing, China has a huge lead over India—and that gap has only grown wider over the past decade. More than 200,000 Chinese patents were filed in 2006, nearly 10 times greater than the number of Indian patents, according to data from the World Bank’s World Development Indicators (see Exhibit 6).

IV. Assessing Strategic and Tactical PE Opportunities in Asia

Having identified Asia as a key opportunity for the PE investor—and having highlighted China as the most compelling market in Asia—the next logical question is: how can Asia, and more specifically the Chinese market, best be accessed? We will discuss today’s landscape below by focusing first on China and then turning to a few other markets in the region where we see more limited, but still attractive, opportunities.

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22 “After 60 Years, China’s Communists Mean Business,” Reuters, September, 29, 2009.
Whereas corporate finance (usually in the form of buyouts) is a predominant form of PE transactions in much of the developed world, including advanced Asia-Pacific economies such as Australia, Japan and South Korea (which are discussed in greater detail below), it is not prevalent in most emerging markets. That’s because buyouts tend to involve larger, more mature companies that are not typically candidates for PE investments in developing economies. Moreover, since many large corporate entities in the emerging world have varying degrees of public orientation (through monopolistic pricing power and/or partial ownership by government agencies), there may be “non-market” complications involving political, regulatory and transparency hurdles. For instance, it can be difficult to obtain a fair market value for quasi- or wholly-public entities that is both economical for the buyer and politically palatable for the seller. There may also be issues concerning tangled cross-shareholdings or a web of debt obligations with other state-owned or quasi-public entities. Further, governments may be more tempted to intervene in major corporate mergers where greater consolidation implies higher concentration and large-scale layoffs. What’s more, few local lenders in the developing world provide financing for leveraged buyouts (although some Hong Kong-based banks have done so on the Chinese mainland). And even where leverage is available, the equity portion tends to be much higher than average.

PE with Chinese Characteristics

As discussed previously, we believe that venture capital and growth equity is the preferred method for exploiting the Chinese growth story. While low barriers to entry and strong growth prospects have led to a profusion of start-ups, the majority of early stage Chinese enterprises are still family-owned. Needless to say, whatever capital needs are unmet by excess cash generation must be supplemented in order to expand a business—and at some point this is often beyond the capacity of the founder to self-finance. A decade or two ago, this might have been an insurmountable bottleneck. But as China’s financial system has steadily developed, today’s moderately successful Chinese start-up has options for raising capital ranging from local lenders to listing shares publicly on domestic stock exchanges. So why would the savvy Chinese entrepreneur turn to PE? This may appear all the more puzzling since PE funds routinely demand stakes in promising early stage businesses for earnings multiples that are often far below the “comp trade” equivalent of public equity via an IPO. The reason has less to do with the opportunity cost of monetary capital than with the premium associated with the intellectual capital received in the form of “first world” business know-how. According to our research, there is a tremendous demand among successful entrepreneurs in China for access to a global customer base and multinational supply chains, professional brand building and cutting edge market intelligence, and first rate managerial teams fluent in the languages of GAAP financial statements and business analytics such as OLAP (online analytical processing). These are all intangible assets offered by GPs that partner with early stage businesses seeking to scale up with a vast array of tools designed to upgrade their balance sheet metrics and build out a managerial structure to accommodate faster growth. To us, the desire for such business acumen on the part of the local partner demonstrates just how far China has come compared to even 10 years ago.

At that time, the financial markets were much less developed, currency controls made profit repatriation nearly impossible, financial reporting was less transparent, the legal system was underdeveloped and the overall experience levels and quality of entrepreneurs was lower. Coinciding with the development of a more professionalized entrepreneurial class, the Chinese legal, financial reporting and regulatory framework has improved dramatically in recent years, so much so that we believe the structure of PE transactions on the mainland to be fairly standard by global norms. This applies to areas such as negotiated economics, fees, governance provisions and relevant laws applicable to PE deals. Most investments for foreign investors in China are Cayman Islands-based due to currency conversion complexities. However, the once daunting task of repatriating proceeds from mainland businesses is no longer an issue for most investors. What remains unique to China are the so-called “ratchet terms” attached by GPs. These goal-setting mechanisms establish a right to invest additional capital at a pre-determined valuation if certain financial milestones are not achieved (e.g., revenue growth rates). This affords GPs greater downside protection and incents the entrepreneur to achieve aggressive growth objectives.

The Chinese legal, financial reporting and regulatory framework has improved dramatically in recent years.
One other idiosyncratic facet of China’s PE market are local currency funds, many of which have been sponsored by government entities. While these “RMB funds” compete with foreign funds to some extent, they may also co-invest in certain sectors of the market on a case-by-case basis. Because the Chinese government has attempted to nurture a home grown PE industry in recent years—in some cases providing seed capital—cooperating with RMB funds can be a way to smooth access to certain deals and prevent friction with local authorities. The operating environment for these funds tends to be less restrictive, especially where exits are concerned. Currently, most RMB funds are open only to domestic investors, but we believe that may change in the future.

The end game of any PE transaction is the exit and here, too, our research indicates that China has had a strong track record in terms of exit valuations. This has been possible due primarily to the fact that most investments culminate in initial public offerings (IPOs) for which there has been extremely strong demand over the past five to seven years. Indeed, a trend is emerging in which the majority of IPOs take place on local Chinese stock exchanges. The advantages of a local trading debut includes generally less stringent listing requirements than many overseas exchanges, a better understanding among domestic investors of local brand names and business strategies, higher valuations and improved liquidity. It has not been unusual for shares to debut on the Shenzhen and Shanghai bourses with gains above 100%. In late 2009, almost every stock listed in China saw double or triple-digit percentage jumps on the first day of trading. Although the IPO market was more subdued early in 2010 (amid concerns about the impact of tighter monetary policies), by April it had regained most of its fervor—with three local Chinese IPOs seeing double-digit first-day gains.

Our research indicates that China has had a strong track record in terms of exit valuations.

PE in Asia Ex-China

Outside of China, we approach the Asia-Pacific region on a more opportunistic basis. This is not only because we see more growth potential on an absolute basis in China, but also because we believe PE valuations are relatively more attractive in China. That said, in terms of emerging Asia, we view India as having the most potential in early stage and growth equity, rather than the more common private investments in public equity (PIPE) transactions. PIPEs usually involve the purchase of an equity stake in a publicly traded company. While PIPEs afford access to deals, they are often minority, passive stakes with no controlling governance provisions and whose valuations are closely tied to the public market. But more broadly, in our appraisal, India has fewer experienced, highly trained entrepreneurs with overseas experience and strong local track records than is the case in China.

The other Asia-Pacific markets where we see the greatest opportunity for PE are Australia, Japan and South Korea. Each of these is characterized by having relatively few venture capital and growth equity opportunities, but increased corporate finance opportunities. What makes Australia attractive to us is the opportunity to participate in the commodity-related industries, media and consumer space, especially in light of the symbiotic relationship with demand from China. In South Korea, we are attracted to the fast growing financial services and technology sectors. However, the PE industry faces competition from local chaebol conglomerates, restrictions on foreign capital, and relatively high valuations. Japan, for all its technology and wealth, remains largely a macro play; if the Japanese economy—still one of the world’s largest—enters a sustained recovery, then equity valuations could improve (a promising rally in mid-2000s was dashed by the 2008 global crisis.)

V. Assessing Macro and PE-specific Risks in Asia

To be sure, any overseas market presents a host of risks to capital accumulation and preservation—and China certainly is no exception. It might be argued that emerging markets such as China represent more of a risk precisely because of their peculiar socioeconomic challenges, which can result in greater volatility. There are innumerable exogenous variables that might come into play in a way detrimental to investors in PE and other strategies. But to help quantify the most pertinent (if not necessarily imminent) of these, we have compiled a table of what we consider to be the key macro risks that investors in China may face over the coming decade (see Exhibit 7). These include the formation and bursting of asset bubbles, volatility and illiquidity, systemic bank failures and political instability.

While these are by no means the only possible scenarios, in our view they are the most plausible and should be kept in mind to leaven any undue enthusiasm for Asia’s ascendancy as a global economic power. At the same time, we believe that these risks need not be a disincentive to investors as long as an investment in China remains just one part of a well diversified portfolio. Beyond those macro risks to investments in general, emerging markets such as China face a number of unique challenges for PE investors in particular. In our view, these include: a rapid currency revaluation (especially a free float untying the RMB from the U.S. dollar) which could hurt China’s still export-dependent economy; competition from RMB funds that crowds out foreign investors; government intervention in the form of taxes on companies in a given portfolio and, lastly, slower growth rates as China’s economy matures.

VI. Conclusion

As asset classes go global, the eyes of investors are increasingly turning to Asia, one of the few areas in the world where the organic growth dynamic is expected to remain intact due to long-term trends such as industrialization and urbanization. To us, China is “first among equals” as it is well on its way to transitioning from an agrarian, export-oriented, socialist economy to more of an urbanized, domestic demand-led and market-based economy. That epic shift promises to provide many opportunities for investors through any number of investment vehicles. It is our contention, however, that PE may outperform other assets based on a unique combination of factors described above.

In sum, we believe that Asia offers a compelling opportunity set across the full spectrum of PE and that China, in particular, has the most potential for exploiting valuations and attractive investment returns. The Chinese market offers a mushrooming pool of experienced and highly educated entrepreneurs with a plethora of promising business models. Many have exhibited a real appetite for value-add that only foreign GPs can offer—and some are willing to sell stakes at low entry valuations in exchange for the skill sets required to take their enterprises to the next stage. This investor-friendly climate, plus a rapidly maturing public equity market that has offered an attractive exit alternative via IPOs in recent years, leads us to conclude that PE investments in China offer global institutional investors an attractive gateway to access the Asian growth story.
EXHIBIT 7: KEY MACRO RISKS FACING CHINA OVER THE NEXT DECADE

<table>
<thead>
<tr>
<th>Key Risk</th>
<th>Sources, fallout and implications</th>
<th>Probability based on objective and subjective considerations</th>
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<tbody>
<tr>
<td>DISORDERLY U.S. DOLLAR (USD) DEVALUATION</td>
<td>Given on-going and escalating dollar-denominated debt issuance, questions about the USD’s “sustainability” have led to a weakening of the currency in recent years. The implications of continued futility in the USD could translate into an effective weakening of the RMB against a broad basket of other currencies (as it is pegged to the USD). That would, in turn, boost the competitiveness of Chinese exports and lead to an even larger current account surplus. There are two major repercussions to this scenario: (i) GDP could accelerate at faster than optimal rates; (ii) higher inflation may trigger a further tightening of monetary policy in China.</td>
<td>Even in the event of continued USD weakness, the likelihood that it will be substantive or disorderly enough to cause a major dislocation seems rather low over the short to medium term. There are a number of factors supporting this argument: (i) there is still no credible global alternative to the USD as a reserve currency; (ii) currency baskets, should they be adopted, will likely have a formidable weighting in the USD; (iii) dollar weakness will likely be curbed due to the substantial weighting Asian central banks have in USD reserves and dollar-denominated assets; (iv) the U.S. still constitutes the single most liquid and deepest of all global markets and that is unlikely to change over the short to medium term.</td>
</tr>
<tr>
<td>EXTERNAL DEMAND DESTRUCTION</td>
<td>Even though China is becoming less dependent upon exports, its export-oriented sector accounts for around 35% of its GDP. Net exports made a sizeable contribution to growth during the period 2005-2008. A shock to global demand will undoubtedly impact China’s overall growth rate and, barring supplemental government stimulus (like that initiated in late 2008), a severe global slowdown would not only negatively impact the Chinese economy but also global markets that have priced in robust demand from China (e.g., commodities, currencies, and some public markets).</td>
<td>The global financial crisis was perhaps the closest “lab experiment” to test the de-coupling theory by answering whether China could remain resilient to a negative demand shock. In fact, the Chinese economy largely escaped the worst of the global downturn due to a combination of resilient domestic demand and prompt fiscal stimulus. The question remains to what extent China can further diversify its growth engine beyond exports. But we are confident it can weather most shocks as long as it pursues strategies like its “Go West” economic diversification initiative.</td>
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<td>FORMATION AND BURSTS OF ASSET PRICE BUBBLES</td>
<td>In an environment in which corporate liquidity is ample, and in which loose monetary conditions have been largely supportive of attracting capital into public markets and real estate, investors have aired concerns about the formation of asset price bubbles. If China indeed faces “bubbles” (which are largely a function of overly aggressive forward valuations), the ramifications of them bursting and spilling over into the real economy could be very destabilizing. This stems from the fact that, although about two-thirds of stocks in China are owned by institutional investors or state-run entities, the remainder are held by volatility-adverse retail investors.</td>
<td>Any financial system that is evolving itself by reforming and improving corporate governance is likely to be subject to bouts of volatility. Higher degrees of state ownership in an economy like China’s does imply that the potential fail-out of an asset bubble deflating may be manageable. But the “wealth effect” is still likely to seriously impact investor sentiment in a negative way. Even so, stock market capitalization is relatively small in China. And, although real estate has enjoyed steep appreciation due to abundant liquidity, strategic migration and urbanization in China’s growing metropolises are also likely to be supportive of real assets. These factors should be considered when the “overvaluation” issue is brought up in a Chinese context.</td>
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<td>VOLATILITY CAUSED BY SUDDEN STOPS TO CAPITAL INFLOWS</td>
<td>Almost all emerging markets that are open to investment that seek to attract capital inflows and are alleviating capital controls may be vulnerable to sharp declines in capital flows (i.e., “hot money”). However, most of the capital inflows into China are in the form of long-term-oriented foreign direct investment (FDI). Should FDI inflows grind to a halt, however, that would have a second-order impact on a broad swath of productive capacity and, eventually, on overall GDP growth if prolonged.</td>
<td>Since much of China’s capital inflows are in the form of FDI—the most stable form of investment—the probability of a drastic drop in inflows is low. In fact, FDI liabilities account for more than half of China’s total liabilities (made up of equity, debt, trade credit, etc). And as the level of aggregate debt-to-GDP in China is low (in the vicinity of 15% to 20%), this can hardly be considered a glaring vulnerability. The size of Chinese currency reserves (now north of 2.1 trillion USD) is yet another buffer to any credit market shocks or dislocation.</td>
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<td>SYSTEMIC BANKING FAILURE</td>
<td>As China transitions to more consumption-driven growth, it must prudently manage the provision of credit which fuels that growth. Too little constrains private sector investment and expenditure, too much may lead to overheating, inflation and asset price bubbles. Sources of systemic banking sector failure that might impact China are twofold. First, non-performing loans (NPLs) have receded significantly since the late 1990s, but a slowdown in the Chinese economy could reverse that trend. Secondarily, policymakers are trying to relieve pressure on the RMB-USD exchange rate by encouraging capital outflows. This may inadvertently trigger a broad-based increase in NPLs that prompts banks to constrain lending. However, we believe that both of these scenarios are improbable since China’s bank deposit ratio is a healthy 160% of GDP.</td>
<td>A failure of China’s banking system would likely cause a seizing up of credit, making leverage much harder to obtain and freezing up channels of liquidity. The implications of that could be potentially damaging not just to domestic investment but also to consumption as consumers tighten their purse strings. As China is culturally more attuned to high savings rates, this would magnify the problem and large-scale government intervention might ultimately be needed to restore financial order. In our view, the probability of such a credit crisis and economic slowdown emanating from China’s banking system is low, but not entirely absent. The lack of exchange rate flexibility, as well as halting regulatory reforms and uneven adherence to corporate governance principles could be considered “dry tinder” that may worsen a banking crisis.</td>
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<td>POLITICAL INSTABILITY</td>
<td>Regional income disparity in China has resulted in substantial differences in living standards between city, town, and village dwellers. A lack of transparency in the political system adds to the pressure on the social structure. The need for a social safety net and educational reforms will not be easy to implement across the diverse Chinese population base. The ramifications of political instability are extremely challenging to either predict or measure, but as China saves less and consumes more the tensions between the haves and have-nots seem likely to intensify.</td>
<td>The prevailing political system in China can be seen as supportive from a foreign investor’s perspective. So far, China has managed to quell fears of an uprising but the possibility remains as latent as ever given the country’s sometimes wrenching transition towards a free enterprise-based economy. The weakness of some of China’s core institutions should remind investors of the importance of local presence and understanding of domestic priorities, social norms and cultural practices.</td>
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Source: J.P. Morgan Asset Management

Notes: The table summarizes, based on objective and subjective analysis, some of the key risks facing China, and, in select cases the extent of greater Asia. This list is by no means exhaustive and one could identify other risks such as a spike in energy prices, environmental and demographic factors such as the rise in the dependency ratio and implications for labor supply. While these should not be dismissed, they should be considered in the context of the key risks summarized above.
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