An Inside Look at the Private Market in Asia

Jeff Diehl, Managing Partner & Head of Investments, recently moderated a Q&A with Primary Investment Team Partners Yar-Ping Soo and Andy Wang on how Asia private equity managers are navigating the COVID-19 pandemic. Yar-Ping and Andy provided updates on key investment hubs in the region, discussed how different sectors and strategies are faring, shared observations from Adams Street's Asia managers and portfolio companies, and highlighted the opportunities that they expect to present themselves as a result of the economic disruption.

Q: How are you thinking about strategy in view of a potential second wave of the coronavirus compounded with the US-China trade war worsening?

YS: While we couldn't anticipate COVID-19, the construction of the portfolio is one of the driving factors that helped it be resilient during the pandemic. Our strategy is largely consistent - focus on high-quality managers who invest in high-quality companies, and give preference to growth and innovation themes, particularly in the tech and healthcare sectors. We prefer businesses focused on the domestic markets, especially in China. The trade tensions between the US and China have made us focus on the domestic market even more. Our investment pace accelerated recently, compared to the past two to three years, as we think now is probably a good entry point.

As for a potential second wave, we would expect the impact to be smaller as governments have more experience dealing with the virus. However, GPs are still quite vigilant - they continue to focus on the health of their existing portfolios and recognize COVID-19's potential impact when reviewing and underwriting new deals. Most of the deals getting done now are in sectors not impacted by the pandemic, or those that benefit from it.

Q: Are you seeing LPs seek liquidity in the secondary market?

YS: Yes. Interestingly, in addition to traditional broker-led secondary opportunities, we are also seeing secondary deals directly from select LPs. As a potential buyer, Adams Street can be helpful to a potential seller who might want to reposition a portfolio. We are also seeing investors who need to sell stakes in specific, high-quality companies.

Q: What do you think of the recent news that foreign companies are moving their manufacturing facilities out of China? How will that impact the economy in general, and PE investments in particular?

AW: While this possibility has created a lot of headlines, on the ground and among the team we don't currently think it will ultimately have a major impact on the economy or private equity, for a couple of reasons:

- Manufacturing facilities relocating as companies seek to optimize their production and profitability globally is not a new phenomenon. Even before trade tensions heightened, some of the export-oriented manufacturers were moving to regions with lower costs, such as Southeast Asia.
- It is not anticipated any move will happen quickly, particularly while the market environment is so uncertain. Additional expenses associated with relocating will just add to operational costs. Surveys conducted in March by the American and European Union Chambers of Commerce in China reported that over 80% of US companies said they have no plans to move manufacturing out of China; 85% for EU companies.
- Many companies are focused on China's domestic market. Tesla's Shanghai Giga factory was completed within a year from scratch to production, and at a much lower capex per unit than in the US. The Model 3s produced by the Shanghai Giga factory are sold directly to Chinese consumers. This helped ramp up Tesla's production capacity and profit margins.
- Despite the headlines, China is actually opening up its market to foreign capital. Auto and financial services are probably the two most notable sectors. Foreign capital continues to be interested and the market remains attractive.

Q: Geopolitical relationships between major countries seem to be further negatively impacted by COVID-19. How does this impact Asia and China?

JD: The virus and subsequent political tensions have caused some Western businesses with single-threaded Asian supply chains to contemplate adding additional supply sources to de-risk their operations. So it is possible we will see some weaknesses in Asian manufacturing businesses that rely heavily on exports to the US and Asia, and that private equity investors will invest in these high-quality Asian manufacturers to provide capital and assistance in diversifying their customers bases. Adams Street's private equity strategy in Asia has largely focused on sectors with significant domestic demand, so we don't currently expect to see significant negative impacts due to the coronavirus or geopolitical tensions.

Q: What's the exit environment like currently and will it feel any impact from the geopolitical issues between China, US, Hong Kong, etc.?

AW: Although we expect M&A activity in Asia to be relatively slow this year, volumes should gradually return to normal as the economy recovers and the markets reopen. We are more positive on IPOs.

China and Hong Kong's IPO activity was very strong during the first half of this year, and we believe this will help private equity exits in the near term. Despite the geopolitical issues, we still saw Chinese companies get listed in the US market in the second quarter of this year. The situation is still developing, and how the Chinese and US regulators will work together to improve company disclosure requirements and restore investors' confidence remains to be seen. But from what we have seen, we don't think this has impacted new IPOs in the US. Neither have we seen this impact Chinese companies already listed in the US - investors aren't turning away from companies like Alibaba. Some companies have even considered a dual listing in other stock exchanges, particularly Hong Kong.

Overall, we are hopeful this IPO momentum continues as we see it boding well for overall PE portfolios and exits.

Q: Where do you see Q2 valuations in Asia?

YS: Comparing public market trading comps, Q2 is higher than Q1, so private equity will feel the benefit. Q1 was basically a wash for many of the portfolio companies because of the economic lockdown. With the economy re-opening, the revenue EBITDA numbers are set to rebound. Therefore, we expect valuations will go up compared to Q1. We are also seeing a lot of our companies try for IPOs, particularly those in healthcare. We anticipate a few big healthcare IPOs out of China, which will lift the portfolio even further. Finally, we are seeing strong distributions for Q2, mainly from IPOs that previously occurred six or eight months prior. We currently expect this wave of IPOs to continue over the next six to eight months.

JD: The early valuation read usually comes from Adams Street's direct investment activity in the tech and healthcare sectors. The Growth Equity Investment Team just wrapped up valuations for Q2:

- Our public stocks were up over 40% after having declined to the low 20s in the first quarter.
- Our private holdings are up in the low to mid-teens for the second quarter after being down 10% or 11% for the first quarter.

Those are preliminary, but they are the leading indicator of what's likely to come as you look through our tech and healthcare portfolios across the globe, including our Asian investment activity.

Q: Looking at venture versus growth versus buyout, what are your views on the attractive opportunity between these three stages?

YS: Buyout transaction volume is about 10-20% of the total PE market in China. We see buyout opportunities from countries like Australia, Japan, and Korea. The buyout activity coming from the larger emerging markets is typically at an earlier stage.

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Venture and growth deals are still most of the PE market in China. Venture has historically generated strong returns and played to the following themes: technology, healthcare, innovation, and secular growth. Growth for the last few years has split between later stage venture and the typical minority growth that we're seeing today. We think, in the end, it really depends on if you can source and secure allocations from good managers.

Q: Where is your investment focus right now?

JD: We are really focused on sectors going through dislocation, change, and growth. It can be difficult for public companies to disrupt themselves. The private markets are the place to find that value; that's true across the globe, including in our Asian investment activities. ■