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Research

PRIVATE MARKETS IN ASIA: TOO IMPORTANT TO IGNORE

By Mingchen Xia, Co-Head of Asia Investments

Think back for a moment, all the way back to the last decade...Summer 2019 to be precise, when we took you on a country-by-country tour of the Asian private markets landscape (for a refresher, click here). Admittedly, it was a bit of a whirlwind tour, but we looked at this vast, complex region and some of the nuances of each country.

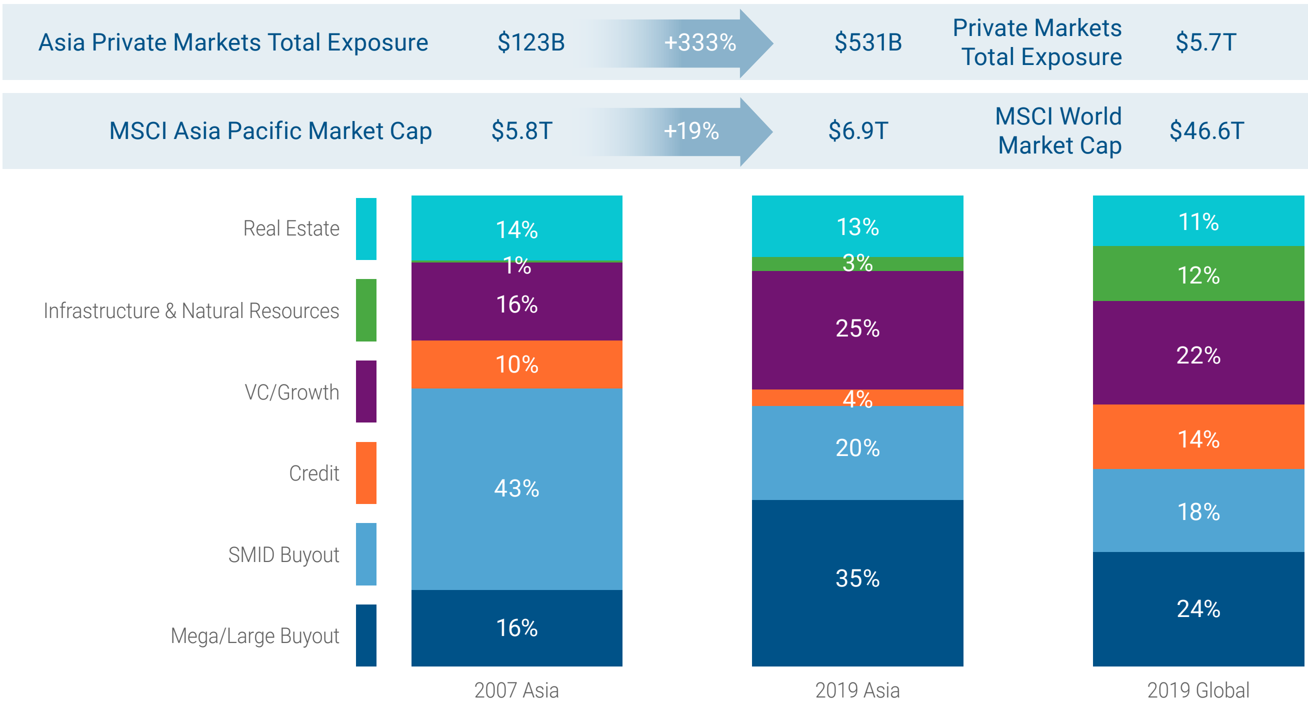
We also shared our view on why we think this market has experienced the growth it has historically. And then, we had the nerve to tease you with "Part II: Coming Soon." For the many of you who have waited with bated breath for this second installment of our Private Markets in Asia series, wait no more. This time, we'll offer some considerations for adding exposure in Asia within your private markets portfolio.

Scaling the Platform

When it comes to economic growth, "The center of gravity is clearly moving to Asia. This is a good thing," according to Ian Goldin, a former World Bank vice president.[1] Favorable economic growth, long-term fundamentals and the burgeoning middle class are shaping Asia as a force to be reckoned with. In 2018, Asia contributed over 46% of global GDP in purchasing power parity ("PPP") - terms – yes, you read that correctly.[2] If that's not convincing enough, annual GDP growth in Asia from 2016 to 2018 was over 5%, more than double that of Europe and North America in the same period, and a trend that is expected to continue.[3] China and India are leading the region in terms of GDP expansion, with more than 6% growth expected in both countries for 2019.[4] Growth in Asia is largely fueled by the continued expansion of spending power, urbanization, regional integration, structural reforms and surging internet use. Consumption-driven investment themes will continue to be the focus, where technology, healthcare, education and financial services sectors present attractive opportunities.

Total Exposure by Strategy

% of NAV + Unfunded in 2007 and 2019



Note: Total exposure and market cap as of year end for 2007 and ending Q2 for 2019
Source: Hamilton Lane Data, Bloomberg (November 2019)

Turning to the private markets specifically, total private markets exposure in Asia has tripled over the past 10 years but still makes up less than 10% of global exposure, thus leaving plenty of room for further growth. Expansion of mega/large buyout strategies in the Asian private markets over the past decade (35% of total Asian private markets' exposure in 2019 vs. 16% in 2007) has allowed a wide range of LPs to join the region's allocation party. So, why the spike in interest in the Asian private markets? To put it simply, they remain relatively under-penetrated. The private markets penetration rate in 2018 was 2% in the U.S., compared to less than 0.5% in India and South Korea, and even less in Japan and China.[5] In China, less than 30% of listed companies are private, which means that gaining exposure in China through a traditional public market portfolio could result in exposure dominated by state-owned enterprises that are generally not as productive and innovative as private firms, potentially leaving growth on the table.[6]

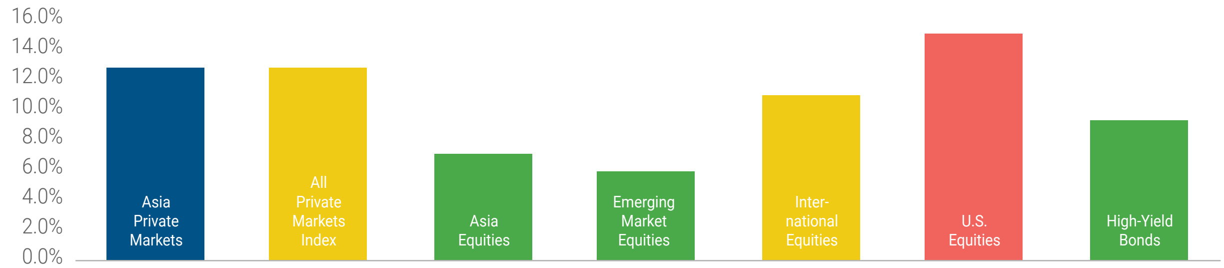
Japan, the third largest economy in the world by GDP, despite experiencing stagnant macroeconomic growth, offers attractive opportunities for private investors.[7] As discussed in our previous paper, Japan's fading conglomerates house a number of non-core assets that are often under-managed. Founders of many small and medium-sized companies face retirement without a successor, so private capital can often play a pivotal role in improving corporate productivity and facilitating business succession in Japan.

Performance

Performance, performance, performance. This is arguably the most important factor for investors who are considering increasing or adding exposure to Asia in their private markets portfolios - and rightfully so. After all, it's not ideal to shift asset allocations from the more developed markets to developing/emerging markets if they don't deliver justified performance.

10-Year Asset Class Risk-Adjusted Performance

Annualized Time-Weighted Return as of 6/30/2019



	Asia Private Markets	All Private Markets Index	Asia Equities	Emerging Market Equities	International Equities	U.S. Equities	High-Yield Bonds
Sharpe Ratio	1.06	1.07	0.33	0.20	0.60	0.88	0.92

■ Asia Private Markets Outperforming by 300+ bps ■ Asia Private Markets Outperforming by 0-300 bps ■ Asia Private Markets Underperforms

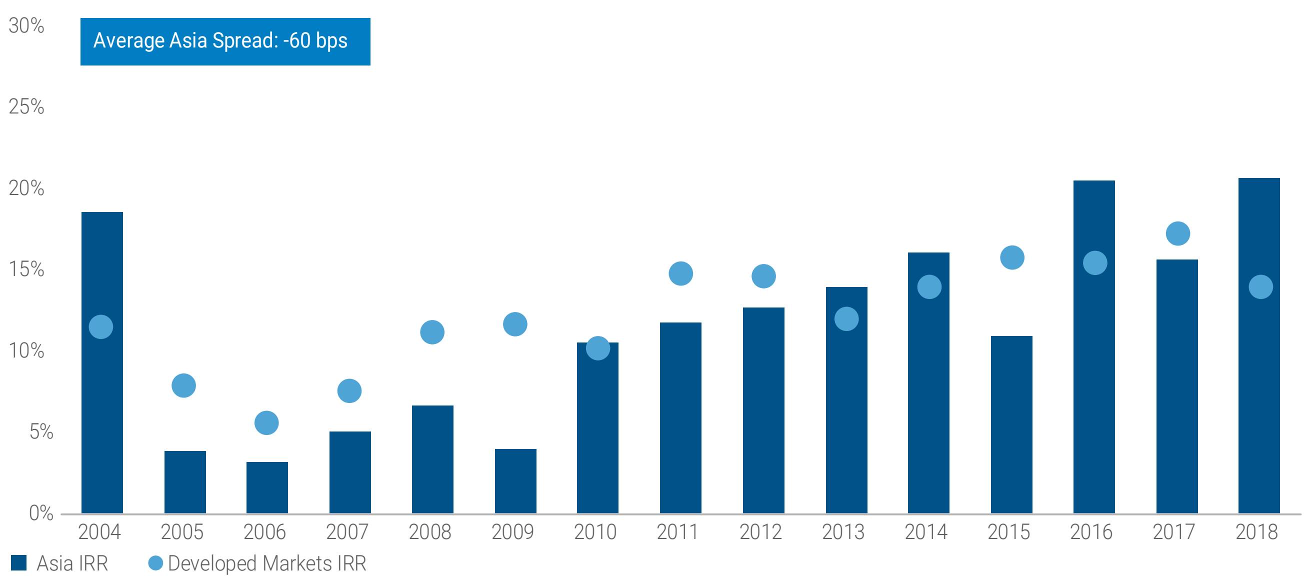
Indices used: Hamilton Lane Asia Private Equity with volatility de-smoothed; Hamilton Lane All Private Equity with volatility de-smoothed; Russell 3000 Index; Credit Suisse High Yield Index; MSCI Asia Pacific Index; MSCI Emerging Markets Index; MSCI World Index. Geometric mean returns in USD. Assumes risk free rate of 2.4%, representing the average yield of the ten-year treasury over the last ten years. Source: Hamilton Lane Data via Cobalt, Bloomberg (November 2019).

Over the past decade, the Asian private markets have delivered performance comparable to the broader private markets universe. When comparing the annualized time-weighted return, the Asian private markets may have underperformed the U.S. listed equities due to the prolonged period of expansion in the U.S., but significantly outperformed Asian equities and emerging-market equities (by more than 300 bps).

In the chart below, prior to 2012, the Asian private markets had underperformed the developed markets across most vintages. However, the Asian private markets have delivered a higher IRR than developed markets in four of the last six years. While the recent vintages remain relatively new, the data shows that the Asian private markets' performance has been catching up to its developed counterpart.

Asia IRR vs. Developed Markets IRR

By Vintage Year



Source: Hamilton Lane Data via Cobalt (November 2019)
Past performance is not indicative of future results.

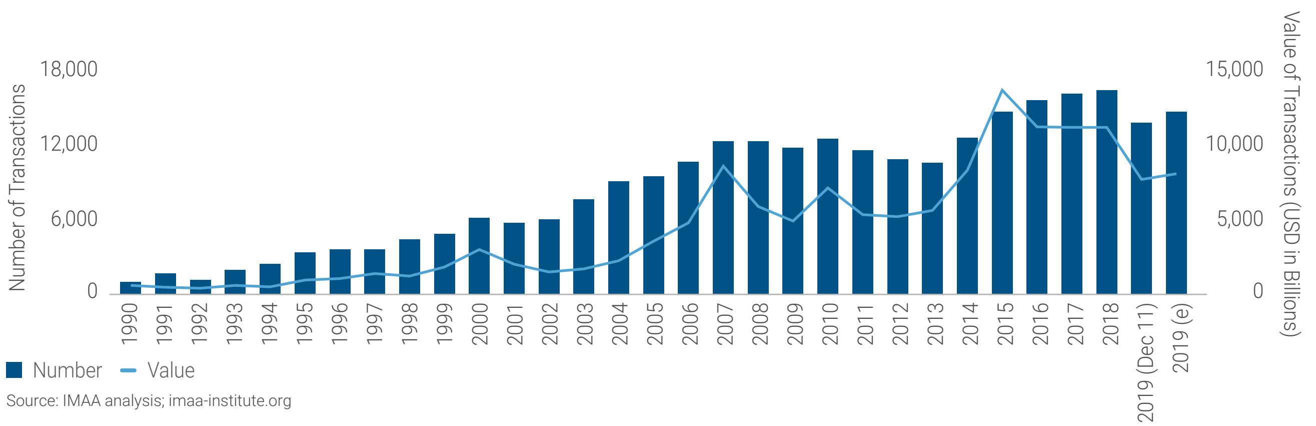
We believe the performance improvement we've seen in recent years may be largely driven by the maturity of general partners. In the late 1990s and early 2000s, the first generation of Asian general partners tended to be professionals with a background in investment banking, consulting or public equity investing and who were less experienced in private markets investing. Many of those managers have since adapted to the new wave of investing, leaving those unchanged GPs in the dust. Since the mid-2000s, many globally-established GPs have entered the market and begun building their Asia-focused funds, and more recently, a newer generation of local managers has emerged, many of which are spinouts founded by successful senior professionals from global blue-chip GPs. These managers bring to bear a better skillset and greater experience across multiple market cycles. We believe these improvements in the pool of general partners entering the Asian private markets have arguably contributed to the stronger performance in recent years.

Asia's maturing capital markets also have been helpful in boosting the region's position in the global economy. In the last decade, Asian capital markets have grown at a faster pace than that of the global market. The region's IPO market has been very active, particularly within the Hong Kong and Chinese domestic stock exchanges, and the volume of M&A has increased.8 The growth in third-party service providers, including financial advisors and placement agents, also has contributed to the spike in activity.

M&A and Venture Activity

Number & Value of M&A Asia-Pacific

Mergers & Acquisitions Asia Pacific



Source: IMAA analysis; imaa-institute.org

In addition to the growth in Asian capital markets in the last decade or so, the quality of entrepreneurs and management teams also has improved. More Asian professionals who have studied and worked overseas, especially those with management experience, have returned to launch their own start-ups or further develop their careers within Asia. Historically, Asia GPs found it difficult to source the appropriate talent to manage their portfolio companies. But, with an influx of newly-seasoned professionals returning to Asia, the talent pool has deepened, allowing GPs to form stronger teams with more relevant experience.

Despite strong historical performance in the Asian private markets, DPIs in this region have historically trailed those in the developed markets. This is largely because the Asian GPs still rely heavily on IPO exits and thus Asian funds generate cash flows that can be less stable and more prone to suffer in an economic downturn. Prior to 2015, DPIs in Asian private markets were lower than DPIs in developed private markets. However, since 2015, DPIs in Asia have gradually improved, catching up to the developed markets. We have observed more buyout deals in Asian markets and Asian GPs have demonstrated a better control of deal exit strategy. All of these have contributed to the improvement of DPIs and liquidity. In China, some partial sales for unicorns happened pre-IPO, so the gains could be distributed to LPs earlier. With further development in the Asian capital markets and banks' increasing familiarity with dividend recapitalization and LBO finance, DPIs of Asian funds could continue to improve.

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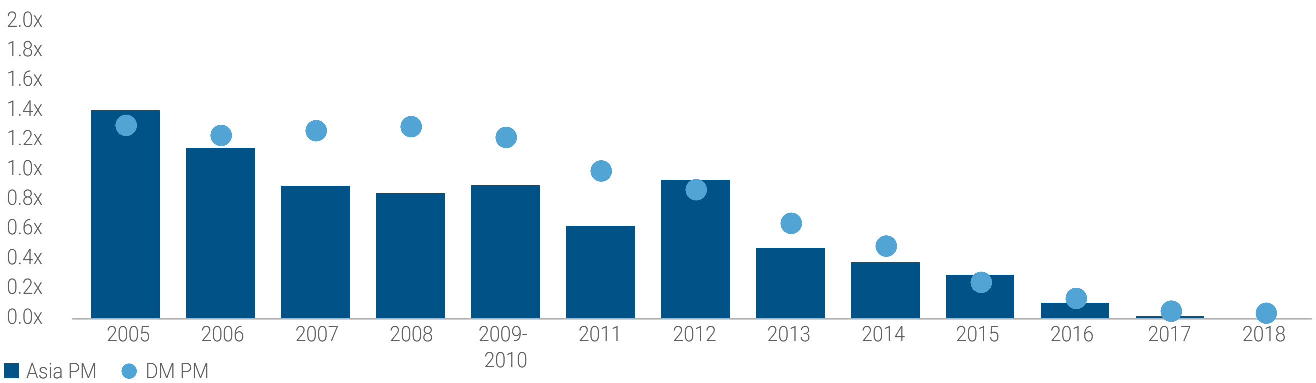
Asia & Developed Markets All Private Markets Median DPI

By Vintage Year



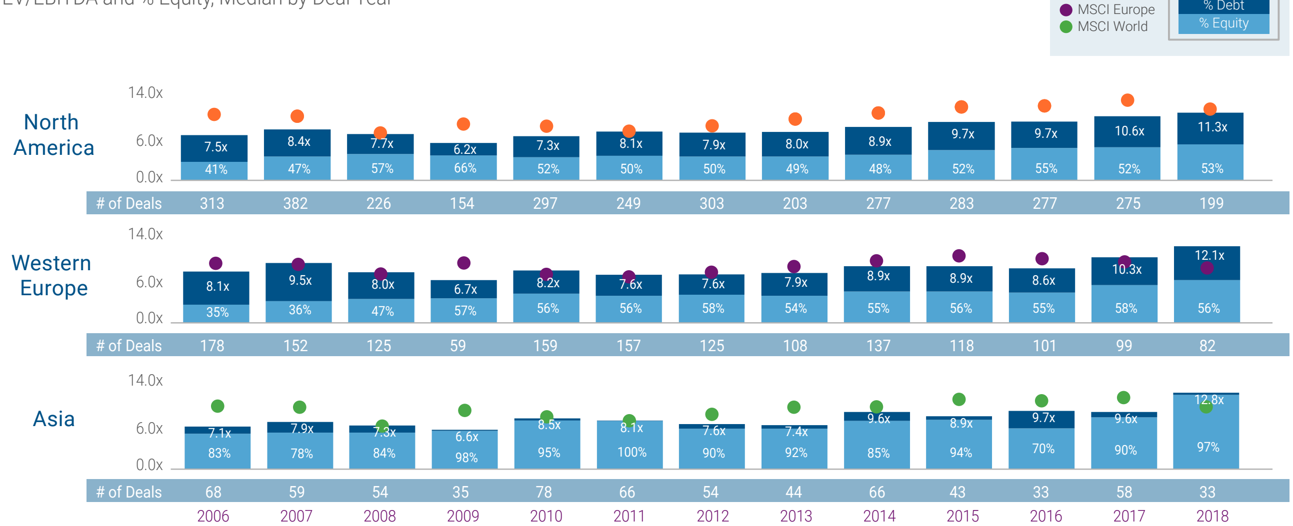
Source: Hamilton Lane Data (November 2019)

Market Risk

It's time to dive into what we know is on every investor's mind when considering a new or increased allocation to the Asian private markets: is investing in this region too risky? We won't deny that there are many risk factors to consider: high purchase prices, fewer notable large market players, difficulty in exiting, the tensions of U.S.-China trade situation, and the political risks across different countries. All of these factors contribute to a common mindset that private markets investing in Asia could be fragile and risky. So, let's turn to the data.

Purchase Prices

EV/EBITDA and % Equity, Median by Deal Year



Source: Hamilton Lane Data, Bloomberg (November 2019)

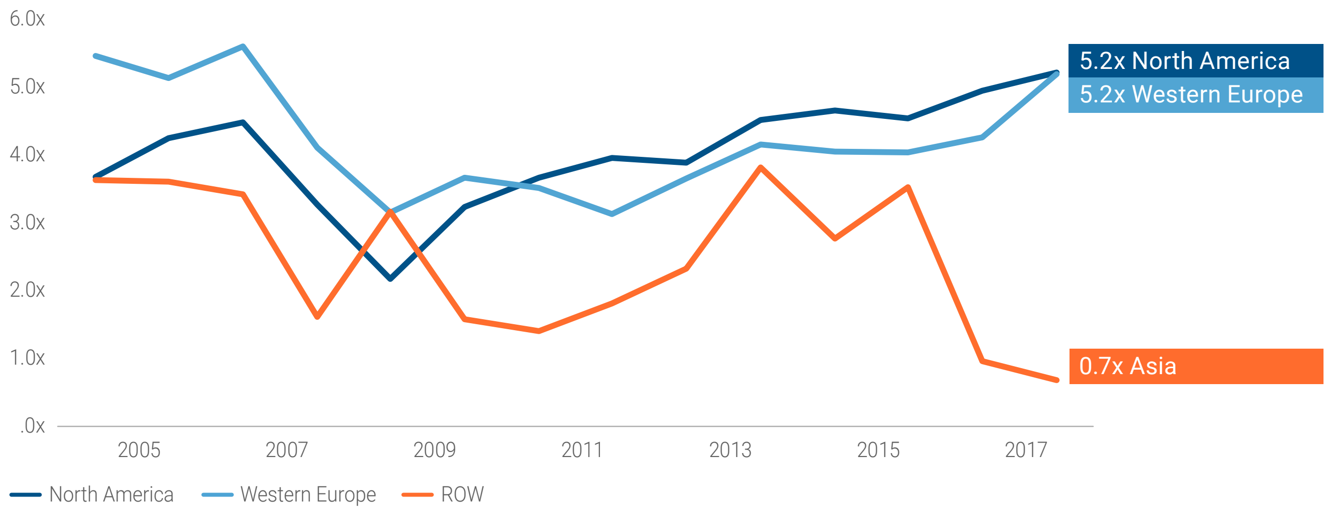
The above chart reveals an interesting takeaway: historically, the purchase multiples of the Asian private markets have been comparable to or higher than in North America and Western Europe in some vintages. However, take a closer look at the debt to equity ratio and you'll see that Asia is much less levered comparatively. So unlevered, in fact, that a median equity portion could reach 70%, or even 100%, of the deal's purchase price. With nearly no debt position and historical comparable performance, financial risk in the Asian private markets might actually be misunderstood and overstated.

If we look even further at the leverage multiples at acquisition, the chart below would appear to show the differences more easily: 0.7x in Asia vs. 5.2x in North America and Western Europe. In this instance, would

North America or Western Europe actually be the riskier and more worrisome option? We know it may be hard to believe, but when a financial downturn truly comes, Asia could be viewed as a safer choice given the good equity cushion.

Leverage Multiples at Acquisition

Net Debt/EBITDA

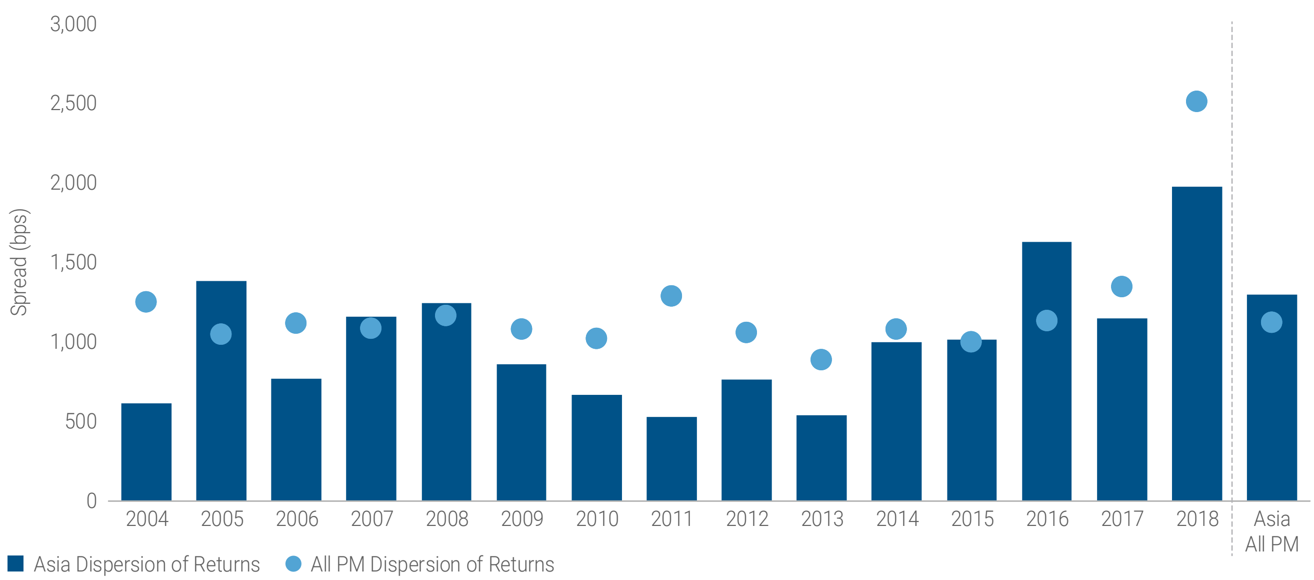


Source: Hamilton Lane Data (July 2019)

An analysis of the Asian private markets dispersion of returns gives us even more relief. We gathered the interquartile range for the Asian private markets by vintage year. The data again may surprise you. There is actually no strong pattern that the Asian private markets are more volatile or dispersed.

Asia Private Markets Dispersion of Returns

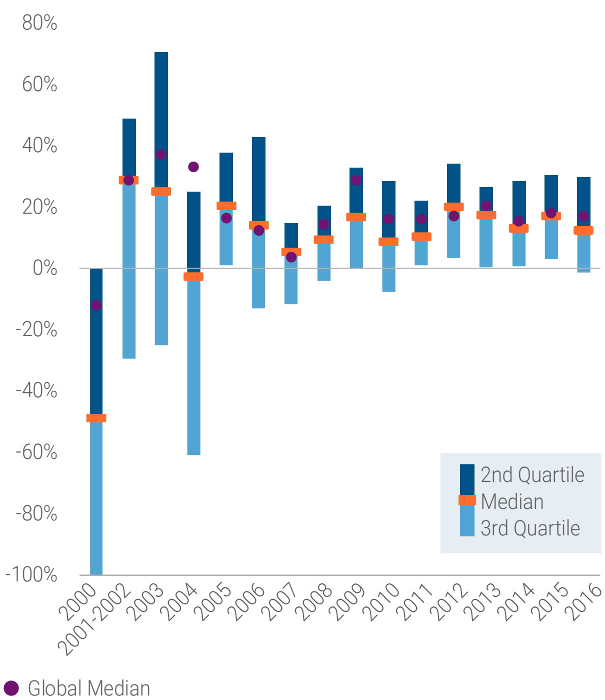
By Vintage Year



Source: Hamilton Lane Data (November 2019)
Past performance is not indicative of future results.

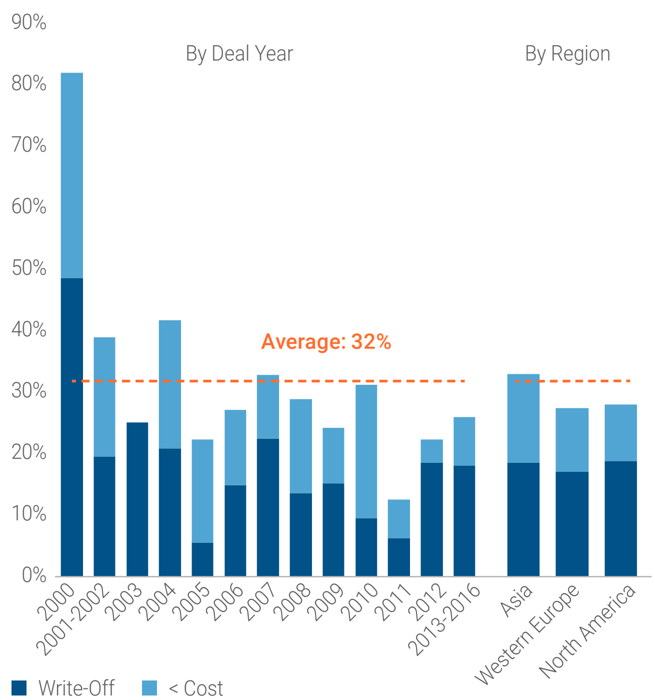
It's true that the Asia buyout deal loss ratios are still higher than the All Private Markets average; however, recent developments are encouraging. Compared to the early 2000s, the third-quartile gross deal returns from 2011 to 2016 are nearly all positive, and the loss ratios also improve the average. We believe that this trend could continue as the Asian market and its players become increasingly mature and prudent.

Asia Gross Buyout Deal IRR Quartiles
By Deal Year



Source: Hamilton Lane Data (November 2019)

Loss Ratio of Realized Buyout Deals
% of Deal Count



Source: Hamilton Lane Data (November 2019)

Bearing in mind all of the above, Asia may not be as risky as we all thought. That is not to say it doesn't require a thoughtful, well-researched approach. We do think, however, that it's worth considering a new or increased allocation to the Asian private markets, with good momentum and growth and generally favorable industry trends.

Conclusion

So, have we convinced you of the potential strength lying dormant in the Asian private markets yet? At this point, we've uncovered some interesting truths about this region's private markets opportunities – its expanding scale, its historical outperformance versus Asian and emerging market equities and the positive trends we have seen in the region in recent years. While investors may worry about limited investment strategies in the Asian private markets, we'd like to think that our data brings clarity and reassurance, as we believe it's relatively easy to gain diversity in investment strategies across the various countries in the Asian private markets. But if you've just skipped to the conclusion without reading the paper… here's your takeaway: We believe, for private markets investors, Asia is simply too important a region to ignore.

As we continue our deep dive into the Asian region, we'll be serving up some insights on how to access the Asian private markets. Stay tuned for Part III of our Asia white paper series, coming soon.

Endnotes:

1 Source: https://www.cnbc.com/2019/09/10/china-emerging-asia-sustaining-global-economy-says-oxford-professor.html

2 Source: IMF 2019 GDP based on PPP, share of world (https://www.imf.org/external/datamapper/PPPSH@WEO/WEOWORLD/USA/WEQ/APQ)

3 Source: IMF World Economic Outlook (October 2019, October 2018, October 2017) - Asia's real GDP growth rate: 2016: 5.4%; 2017: 5.7%; 2018: 5.5%

4 Source: IMF World Economic Outlook (October 2019) - 2019 real GDP Growth projections: China: 6.1%; India: 6.1%

5 Source: EMPEA Industry Statistics Mid-Year 2019 (published 11 September 2019)

6 Source: Wind, data as of Oct 2019 - % market cap in CSI-300 Index: SOE: 72.6%, Private Company: 27.4%

7 Source: Source: IMF 2019 GDP, current prices (https://www.imf.org/external/datamapper/NGDPD@WEO/WEOWORLD/APQ/USA/WEQ)

8 Source: https://imaa-institute.org/mergers-and-acquisitions-statistics/

Strategy Definitions:

All Private Markets – Hamilton Lane's definition of "All Private Markets" includes all private commingled funds excluding fund-of-funds, and secondary fund-of-funds.

Credit- This strategy focuses on providing debt capital.

Infrastructure – An investment strategy that invests in physical systems involved in the distribution of people, goods, and resources.

Mega/Large Buyout – Any buyout fund larger than a certain fund size that depends on the vintage year.

Natural Resources – An investment strategy that invests in companies involved in the extraction, refinement, or distribution of natural resources.

Real Estate – Any closed-end fund that primarily invests in non-core real estate, excluding separate accounts and joint ventures.

SMID Buyout – Any buyout fund smaller than a certain fund size, dependent on vintage year.

VC/Growth – Includes all funds with a strategy of venture capital or growth equity.

Index Definitions:

MSCI Europe Index – The MSCI Europe Index tracks large and mid-cap equity performance across 15 developed market countries in Europe.

MSCI World Index – The MSCI World Index tracks large and mid-cap equity performance in developed market countries.

S&P 500 Index – The S&P 500 Index tracks 500 largest companies based on market capitalization of companies listed on NYSE or NASDAQ.

Other:

Time-weighted Return – Time-weighted return is a measure of compound rate of growth in a portfolio.

Total Exposure – Total Exposure is equal to NAV + Unfunded Commitment.

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