Assessing Private Equity Trends Worldwide

Private equity remains bullish about China in the face of its slowing economy, as firms spot opportunities in the nation's transition to a consumer-driven market from an export-driven one. But they are picking their investments more carefully, making sure they are aligned with long-term trends such as shifting demographics. Moreover, changes in China's IPO rules are welcomed by PE firms because going public is an increasingly important exit strategy. Southeast Asia is also strong as a PE target; there has been a rebalancing towards developed economies of late. Michael Rogers, EY's global deputy private equity leader, and Stephen M. Sammut, a senior fellow and lecturer at Wharton, discussed PE trends globally with Knowledge@Wharton.

An edited transcript of Part 1 of the conversation follows.

Knowledge@Wharton: Steve, could you give a brief overview of the worldwide trends in private equity?

Stephen M. Sammut: That's a tall order but I'll try to be brief. The thing to bear in mind most importantly … is that it is very heavily driven by the performance of public equities, in the sense that money managers of the funds have to balance their commitments to alternative assets, including private equity, typically against the overall assets under management that they have. And those tend to be very sensitive to publicly traded securities.

At the moment, the stock markets are looking fairly robust, and there are a lot of questions as to whether that is sustainable given so many other questions [about what's going on] in the world. I suspect that pension fund managers and their counterparts at other financial institutions are being somewhat cautious about what they are going to commit for fear that if public markets do drop, they are going to be overweighted in private equity.

But having said that, [there are some] interesting transitions in the Chinese economy and [its movement] towards a consumer[-driven market], which is something that will play out in a generation but especially over the next 10 years. That happens to coincide with the life cycle of a private equity fund. [Meanwhile,] India's reform measure seems to be taking hold. There probably will be an influx of capital there and certainly an increase in the number of transactions.

I also think Southeast Asia is looking fairly strong overall. That is probably the region that is going to be most sensitive as to whether or not the Trans-Pacific Partnership (trade deal signed in February 2016) becomes reality because they may be the principal beneficiaries.

I would say with Africa, there is very robust activity, perhaps maybe a little over-commitment in the last two years of new capital into the region. Not that Africa cannot absorb it, it's just that there may not be enough evidence yet that the number of bankable or fundable transactions are there. But it is materializing.

Knowledge@Wharton: Mike, your sweeping view, please.

Michael Rogers: It's certainly an interesting time for private equity around the world. Our biggest clients, the folks we visit with around the world, look at the markets very independently. If you go back a couple of years ago, you might have lumped a number of different countries into the emerging markets bucket. Now, I think people are very clear, as Steve just laid out, there are delineations between each market, and it's quite different these days when people talk about Asia-Pacific or Africa or Eastern Europe and Latin America. They are different markets completely. When you drill in to each market, you get a much different response in terms of what's attractive.

A couple of years ago, everybody just thought that growth was going to be slow in the developed, larger markets in the United States and Europe, and that we would have to go to emerging markets. I don't want to say that has scaled back, but there's certainly been a little pressure taken off the gas in terms of the emerging markets. There's been a little bit of a rebalancing back to the developed markets in the U.K., Germany and also in the U.S. But we still see an interest because of that long-term growth consumerism [trend] that is out there. Some of those themes are still in place and will be for a long time.

Knowledge@Wharton: Let's jump right into China, where … the economy seems to be growing faster than in most developed markets, even though it is slowing down in general. China has a population of 1.3 billion, and many of them are entering the middle class. These are the fundamental growth drivers that get talked about a lot. But this slowdown has also caused havoc for many of China's suppliers outside the country and at times for the currency and equity markets. … How would you characterize the kinds of deals being done and their size over the last year or two?

Rogers: As you point out, I think the investment activity in China is off considerably so far this year. One of the statistics we look at pretty closely is the analysis done by the EMPEA (Emerging Markets Private Equity Association), and they thought that total investment was just about $1.5 billion in the first quarter. That's well off last year's pace of almost $12 billion. Sometimes these numbers can get bucketed based on size and deals and things that occur, but that's a pretty significant trend down for the first quarter. Valuations, though, continue to be relatively high, particularly for strong assets.

So, I think we're going to see a little more picking and choosing with folks being a little bit wiser about how they invest and look for situations where they can make operational improvement. That's a big component here because if you think that the Chinese economy will slow a little bit, then you have to make sure that you're making the types of investments that make sense from [the viewpoint of] long-term sector trends. One of the things we continue to see from our clients and folks in the marketplace is a focus on the demographics — the growth of the middle class, telecommunications, consumer products, retail, education, travel, things of that nature — as the economy turns itself to more a consumer-driven [market] as opposed to export-driven.

I'll leave it to Steve to fill in some of the gaps on this locally, because I know he spends a lot of time there, but I think one thing that does concern folks on the macro side is the amount of debt that is being accumulated and the pace at which the government is accumulating debt and putting it into infrastructure products. There's a lot of money that is being spent trying to keep the economy going, so folks are watching with a careful eye. Those trends still are there, and a lot of folks would like to have access to those consumers. But I think people are very conscious about some of the macro issues there.

Knowledge@Wharton: Steve, what is your view on China overall?

Sammut: Mike has summarized it quite appropriately. One sector he didn't mention is health care, and that is consistent with the consumer theme. I have seen a lot of interest and activity there, and it is going to be an area of tremendous growth, especially when you look at the population pyramids of China and see how rapidly the overall population is aging. This is a major social issue and creates interesting private equity opportunities. The debt, as Mike has pointed out, is really the case. I wonder if that is behind the motivation for the Chinese central government to liberalize the opportunity to invest private money in state-owned enterprises as a way of taking some of the pressure off of supporting those industries and converting some debt into equity for the owner, which is the Chinese government.

It's an open question as to whether the liberalization of the opportunity to invest in 150,000 or so state-owned enterprises will usher in a new wave of private equity because it raises lots of questions. But it is an interesting transformation. China merits a very close eye. But the EMPEA data that Mike alluded to does indicate a pretty significant drop-off, and that raised a lot of eyebrows at the EMPEA conference this past May.

Knowledge@Wharton: Obviously, there is a lot of uncertainty around the economic decisions still largely controlled by the government and the slowing of the economy. Where do things stand now regarding initial public offering rules, and what do you expect to see overall in the next 12 to 18 months?

Sammut: The IPO rules have been in transformation and currently are making a lot more sense for investors. But I think the activity in the IPO market now is less in response to the change in the rules and more of the process of healing and rebuilding confidence in the downturn that the market suffered not quite a year ago. I think shifting over to giving the Chinese securities and exchange commission the exclusive purview, which it formerly shared with the Central Government planning agency, was a very good move and is going to remove a lot of ambiguity from the point of view of investors.

Rogers: I think we do see a trend where the IPO is the preferred exit for a lot of business owners and private equity firms in the market. The fluid and optimal operation of the IPO market is critical to the success of China's PE.

I will add that fundraising has also dropped in the first quarter — seven firms raised only $2 billion. But the interesting component is that there's almost $60 billion of dry powder that's targeted for China. That means people are focusing on deployment and they're going to be trying to find deals; there's a lot of pent-up money that is eager [to be put to use]. We might say that maybe China is slowing or they've got some challenges, but there is still an awful lot of money that is eager to get invested in China, and I don't think that's going to go away anytime soon.

Knowledge@Wharton: Let's move on to Southeast Asia. Steve sounded very bullish and positive on it. I'll note that the value of PE deals in Southeast Asia dropped 11% in 2015 from the previous year. Some of the most popular deals involved early-stage tech companies, and that's a data point. One factor for the drop was the slowdown in China, then the slump in commodity prices and also some currency devaluations. Those factors in particular put a lot of deals on hold. But according to EY reports, the pipeline remains pretty strong. Mike, what do you see happening there in the next 18 months to two years?

Rogers: I think Southeast Asia is interesting. In some ways, it's positioning itself against the big economic impact that China has. There is obviously a significant number of people [in the region], and they are growing in the middle class quite quickly. While some of the numbers show some softness, we actually think that we could get more activity over there in the second half. Investor sentiment is probably as strong in the region as it has ever been, and really that jumps out at you when you look at some of the fundraising statistics. Asia just raised $4 billion in February — that was a new record in terms of the size of some of the deals that were done. RRJ

Capital raised $4.5 billion. These firms are focused more broadly on the Southeast Asia region. The fundraising shows a lot of appetite in that marketplace.

Steve touched on the Capital Confidence Barometer and some of the other measures that we use to judge interest and activity in a market, and there is quite a significant upswing in corporate confidence in the region. In our most recent survey, 60% of our respondents said that they were working on four or more deals, and that's from the corporate market. We see that if the corporates are quite active like that, PE often follows those trends. So, we are fairly bullish on Southeast Asia right now as we move into the second half.

Knowledge@Wharton: There have been a lot of devaluations in that region against the dollar. It seems like that would create more opportunities because suddenly dollars can buy more. It's almost as if the companies were on sale. Is that a big factor?

Sammut: One can say with confidence that currency volatility is perceived as a very significant risk factor in emerging markets, generally. And this does raise questions. While there might be an interesting time window in which to invest because the currency may work in everyone's favor, it sometimes can go the other way, and you cannot time the exits as precisely as you would like in this industry. But it is clearly on everyone's radar. I don't know how much of a driver it is to the accumulation of capital. What is interesting is the size of the funds that have been raised, and if past is prologue it would suggest that the interest is going to be more in larger transactions than in, say, middle-market transactions.

By and large, it is a very promising picture, as Mike has said. The middle class is growing in each of these countries. The same drivers that are classic in emerging markets play out in these markets as well. We are dealing with very well-educated workforces, many of which are going to be the beneficiary of some of the changes going on in China. In terms of a venue for manufacturing and exports, the overall picture is very strong. And I remain very bullish on health care in these regions as well.

Knowledge@Wharton: If China were to slow significantly, what is the ability of Southeast Asia to bounce back or find other markets?

Sammut: I think these economies have enough momentum and are independent enough of China where there is not going to be a downturn linked to China if China slips a little further. I think these can be seen as independent entities. I have another very curious barometer, and it will probably make Michael chuckle because I don't think he really tracks this. But [the number of] students from Southeast Asia who are enrolling in private equity courses are on the rise. I often find that sometimes students have a little bit better vision of what is in the offing than others, so that's one of my little private indicators that I'll share with you.