THE CHANGING ASIAN LANDSCAPE – PART 4
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Asia Private Equity: Riding the 'Three Locomotives'

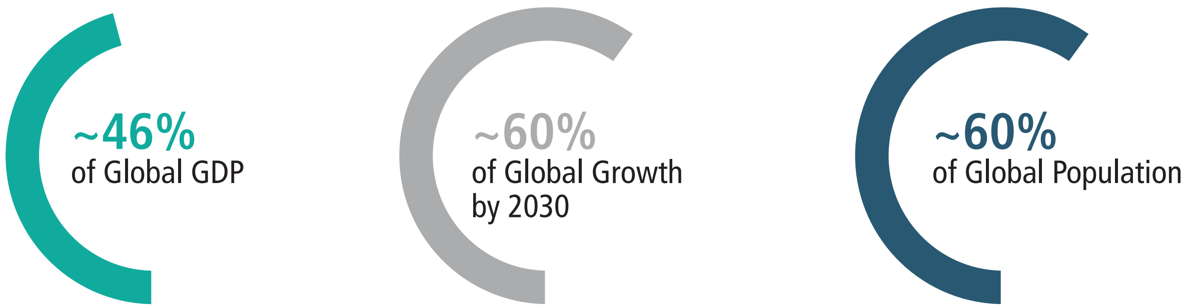
Private equity is enjoying increased attention in Asia, where global investors are looking for exposure offering diversification from more established U.S. and European markets. In the latest of our interview series on *The Changing Asian Landscape*, Kent Chen, Head of Asia Private Equity, describes some of the virtues of investing in the "three locomotives" of Japan, China and India, and how Neuberger Berman's broad Asia platform has enhanced our efforts to provide investors effective access to these opportunities.

Why consider exposure to Asian private equity markets?

Let's first look at the big picture. Asia accounts for about 46% of global GDP, 60% of the world's population and 60% of expected global growth through 2030. Its current 5% growth rate is less than historical levels, but still respectable. In short, we believe Asia represents a substantial and attractive opportunity that merits portfolio exposure.

What's more interesting from our perspective, however, is that private equity penetration across Asia is still lower than in the U.S. or Europe—creating ample opportunities for investors. Lower penetration means that competition is generally less intense. The U.S. and Europe are fairly mature markets with many well-established general partners. In Asia, there are fewer well-established GPs. As a result, the private market is less efficient and thus provides more openings for seasoned investors.

ASIAN MACRO SNAPSHOT



Source: IMF and World Bank, data as of 2023.

Why think about Asian private equity as multiple markets?

Within Asia, we are fortunate to have three of the largest economies in the world: China, Japan and India. Each of them is in a different stage of economic development. Japan used to be the powerhouse of global manufacturing and exports, but fell into an extended period of stagnation. Then, China's reforms and open-door policy helped it become a driver of global growth—a role that lasted for two decades. Now that China is slowing down, India is growing rapidly, replacing China as the region's growth engine.

I like to think of these economies as three locomotives. Each of them may be moving at high speed for some time, but at some point may need to go back to the workshop for repairs, and eventually come out better and stronger than before.

That's what makes Asia interesting as an investment destination—it's not synchronized with the U.S. or Europe, but it is also not synchronized internally, and can thus offer meaningful diversification.

What are the impacts of China's economic downshift?

There are two sides to the China slowdown story: On one side, some of the capital originally going to China will be diverted to other parts of Asia. That is what we are seeing today. On the other side, the slowdown in China is filtering through to economic activity in neighboring countries. Chinese imports and tourism used to be a key theme in Asia. That spending has declined. And given challenges in China's corporate sector, investment flows to other countries have also fallen, including those for mergers and acquisitions and direct investment. In short, deceleration in China is a double-edged sword for the rest of Asia, where they receive more capital, but also see repercussions from the slowdown.

How long will it take for China to see meaningful improvement?

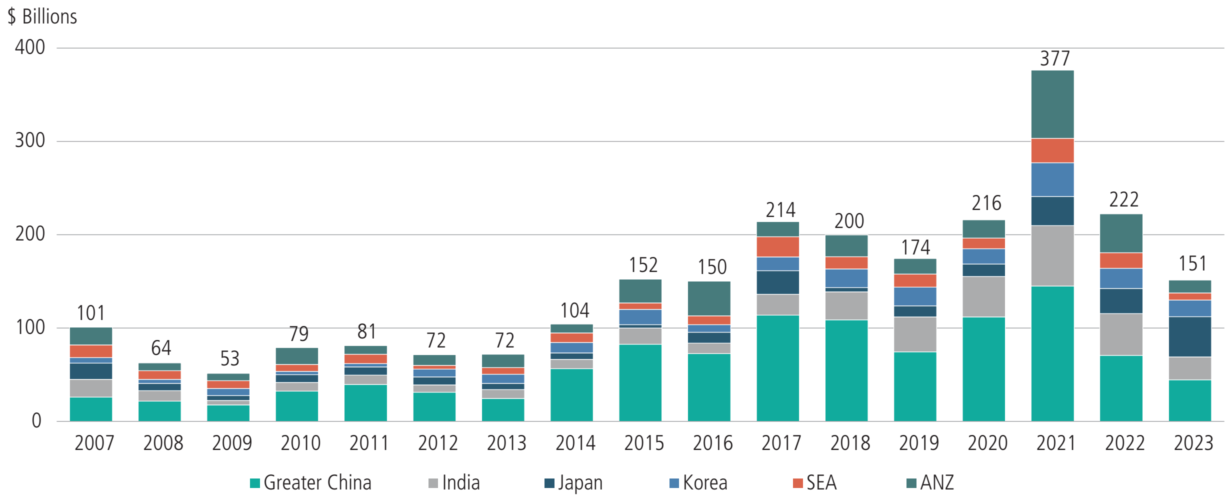
We are not talking about a one-year or two-year correction; it is more long term in nature and may take three to five years.

Right after the reopening from COVID lockdowns, many thought the Chinese economy would rebound quickly, and that consumers would start spending as before the pandemic. But that did not happen, and the property market downturn has made things worse. With the overhang now affecting other segments of the economy, recovery will probably take a bit longer than many people would expect.

That said, we are seeing some green shoots. Despite weak consumer confidence, domestic consumption is holding up reasonably well, and intra-Asia trade continues to grow in spite of the ongoing trade tensions. Instead of relying on fixed asset investments, the green economy, digital economy and services sector will be new growth drivers for China in its next stage of development, which could help to make it more resilient in the long run.

ASIAN PRIVATE EQUITY INVESTMENT

Greater China remains the largest Asian private equity market, but Japan is gaining traction quickly.



Past performance is no guarantee of future results.

Source: AVCJ, as of December 31, 2023. Greater China includes China, Hong Kong, Macau and Taiwan; SEA (Southeast Asia) includes Indonesia, Malaysia, Philippines, Singapore, Thailand, Vietnam, Laos, Brunei, Myanmar and Cambodia; ANZ includes Australia and New Zealand. Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal.

Let's talk about private equity market dynamics in key Asian countries, starting with Japan.

Despite its status as a leading economy, Japan's private equity market is small in size relative to that economy. As such, valuations remain attractive, in our view.

This is particularly the case among midsize and small companies. At the larger end, there are many global private equity players; among smaller caps, however, local general partners tend to focus on privately owned businesses looking for succession solutions or carve-outs of non-core assets by major corporations.

We are seeing an increasing number of opportunities to buy out high-quality businesses, many of which are market leaders in growing sectors. This increase is primarily due to wider acceptance and an improving perception of private equity sponsors among corporate managements and business owners. This, in our view, has resulted from sponsors' decades-long diligent and prudent effort to add value to their portfolio companies. Unlike many other parts of the world, sponsors in Japan also benefit from still-abundant leverage financing, with cost typically as low as 2 – 3%, in our experience.

Are Japan's public market reforms helping private markets?

Public market reforms have greatly assisted private markets in Japan. Pressure on public companies to focus on core businesses has prompted many to carve out non-core businesses. And the increasing influence of activist shareholders is making public company managers seriously consider privatization with the help of private equity sponsors. Meanwhile, pressure to increase returns on equity is pushing public companies to spend excess cash on growth initiatives, including M&A. In our view, this creates attractive exit opportunities for private equity sponsors.

Even with its macro issues, do you continue to find opportunities in China?

If you had asked me five years ago, I would have said that China is "a bit too hot," with too much capital chasing a limited number of deals, leading to high prices. Now, given the ongoing challenges of the macro environment, geopolitics and domestic structural issues, valuations in the public and private markets have come down substantially. In the private market, we've found that many deals are at 50% of previous levels, which creates appealing special situations.

Let's take the property market, for example. Some liquidity-constrained property developers, in order to service their debt, are selling high-quality, non-property assets at attractive valuations. And due to the poor market sentiment, a lot of operationally sound, profitable companies with solid fundamentals listed on various stock exchanges are trading at deep discounts to their IPO prices. It's possible to take those companies private and "warehouse" them for a few years before taking them public again in Hong Kong or Shanghai.

The environment in India is quite different, obviously.

India has received a lot of attention in the last several years, but rightly so, because of its strong growth momentum. In contrast to China, many people worry about valuations in India. But in our view, the high secular GDP growth may justify some of those valuations, particularly for fast-growing, market-leading companies. At the same time, we are very selective and disciplined; if we think a deal is too expensive, we will not hesitate to walk away, but we aren't fazed if a good business with strong growth potential is trading a little higher than it otherwise might be.

So that's the diversified opportunity set of Asia in a nutshell. You have value in Japan, special situations in China and growth in India—with all three locomotives operating at different speeds and providing different opportunities.

How do you see those opportunities by industrial sector?

Manufacturing is a key part of the picture, whether in Japan, China or India. Japan is more on the high end, involving higher value-add segments. China has been undergoing an industrial upgrade, transitioning from low-cost manufacturing to higher value-added products. India and Southeast Asia are taking up opportunities where companies are relocating to lower costs and diversify supply chain risk.

The consumer sector is also key in the region—with opportunities varying depending on demographics and wealth levels. In Japan, a growth area of consumption is about catering to the elderly. Even with slower growth, China is in the midst of a consumption upgrade for its middle class. In India and Southeast Asia, a large and young population appears poised to create major consumer markets.

Health care is another big theme in the region, but with different focuses—eldercare in Japan, med-tech and biotech innovation in China, and demand for high-quality health care in India and Southeast Asia.

Tell us about the structure of Neuberger Berman's Asia private equity team.

We are very fortunate to be part of a global, multi-asset platform with a significant presence across Asia. As I've mentioned, Asia is one region, but is composed of multiple markets—not just in economic terms, but in relation to culture, political, legal and regulatory systems, and currency. To capitalize on opportunities, we believe we should have a local team with local expertise across multiple countries. So, we have people in Tokyo, Singapore, Shanghai and Hong Kong who speak the local languages and understand the culture and business environment. With just seven professionals, our team may be smaller in number than our peers, but it is larger than most when it comes to its geographic footprint.

This setup enables us to cover Asia differently—and I would say more effectively—as well. Most of our peers are siloed by strategy—primary funds, co-investments, secondaries, etc. In our case, each locally focused team can work across all of these areas, which means that we can easily generate multiple opportunity types from the same general partners, which has helped foster closer strategic ties with our GP partners.

These relationships, in turn, create a deep familiarity with the GPs, so we know their strengths and weaknesses, which enables us to see almost immediately whether a given deal is worth pursuing. That facilitates our decision-making speed, which has helped us participate in a disproportionate number of deals in the region, even as overall transaction volume in the market has declined. This was even more true during the pandemic, when we found our structure to be particularly advantageous. If you recall, almost all the countries in Asia engaged in travel lockdowns. So, while our peers were generally isolated in their regional headquarters, we had our local teams meeting GPs on the ground nonstop.

How does your approach help with risk?

It's important to remember that Asia's private equity market is not mature, and still evolving. Despite the recent increase in investor interest in the Asia PE market, you would expect ups and downs in the investment environment for different markets.

Within each country, it therefore makes sense to work with experienced local general partners. With traditional foreign direct investment, companies may go into a new market and do nearly everything on their own, which subjects them to considerable risks. In contrast, we usually partner with GPs with proven expertise and experience to navigate regulatory, macroeconomic and business challenges unique to that market. That, along with Neuberger Berman's global investment expertise and due diligence capabilities, provides a meaningful safeguard for our clients as we look for private equity opportunities in Asia.

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