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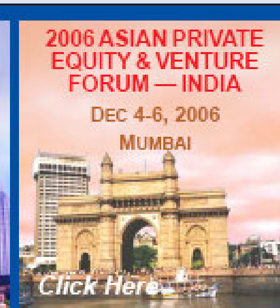

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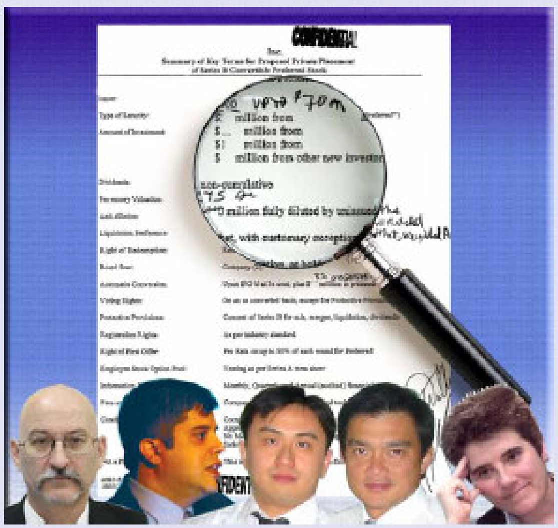

MANAGING RISK IN ASIAN PRIVATE EQUITY

Risk is held up as an unavoidable concomitant of investing in Asia – the extra market risk, regulatory risk, transactional risk, and even fund risk of a rapidly evolving market. Risk management specialists are the ones most directly involved in this aspect of the business, and the ones most likely to be tapped by private equity firms needing external support for it. *AVCJ* spoke to some of the leaders in the field in Asia for their assessment of the critical issues in risk management.

Frank Hawke

Private equity firms and risk management

There is no question that private equity firms in Asia are heavy users of risk management services. "The driving feature of our business in the region right now is coming from the private equity firms and the banks," says Anne Tiedemann, Regional Managing Director, Greater China & South East Asia at Kroll Inc. "The very basic due diligence for those firms is really what put Kroll on the map."

However, private equity firms can be the objects as well as the users of risk management techniques. Protecting against risk by insuring can expose a private equity firm to the same kind of scrutiny that a limited partner investor would make. "We do our own due diligence to decide on the insurability of the risk," says Chin T. Feng, Assistant VP and Regional Manager at Chubb Specialty Insurance. "We look at various aspects: Number One is the quality of the management team. We look closely at the portfolio companies they invest in and manage. We look at their track record in detail. We look at their financial performance: the internal rate of return they have delivered in the past , and their disclosure practices."

The presentations received are often "the same confidential information that a VC firm would normally send to investors when analyzing a new business prospect, such as their private placement memoranda," adds Simon Moi, Senior Underwriter for Executive and Financial Risk at Chubb.

Likewise, funds may need to do due diligence on their prospective LPs, especially in a region like Asia where many of these may be high-net-worth individuals or family offices. "Generally, private equity firms know their investors for a long time," declares Rohan Bedi, author of the PricewaterhouseCoopers Singapore publication *Money Laundering Controls and Prevention*, and senior anti-money laundering implementation manager at a major international bank. "Where investors are new and are HNW individuals, proper due diligence is required, covering country, business, entity, and transaction risks. Money laundering risks are mitigated by the fact that lock-ups exist, and typically integration-stage monies only will be laundered, where it happens."

Rohan Bedi

Risk and the Asian environment

Along with Asia's unique peculiarities as an investing environment, another factor multiplying risk is the relative inexperience of some new funds that have been set up in the recent rush to invest in the region. This can increase the value of the risk management specialists.

"Some firms are more entrenched in the environment than others. Those that aren't entrenched have benefited greatly from our skills," remarks Frank Hawke, Chairman, Greater China at Kroll. "For some private equity firms, we're pretty much part of their SOP."

Risk management in Asia is handicapped by a constraint that is also impacting investments overall – the relatively slow pace of business here. "The challenge for us is timing, the time it takes to do these projects in the region," Tiedemann admits. "The big challenge for Asia is it takes longer to get things done, longer to corroborate this information."

China is already emerging as a jurisdiction where deals move slow, but it has other special issues as well. "It's pretty self-evident to anybody who looks at this for a few minutes that the money coming into China is pretty large and growing," says Hawke. "China is an environment where there are a lot of risks, and where business is done differently from where the private equity firms come from."

Tiedemann does feel, however, that the competence of the funds as risk managers has improved overall. "There's a level of sophistication that's been applied to transactions that I didn't experience when I first joined the company 18 years ago. There is a lot more work done by the funds themselves and a lot deeper, keener understanding of what the issues are."

Anne Tiedemann

Risks along the investment life cycle

Going into deals is obviously one of the key points in risk control. "Obviously you have risks that you want to mitigate or look into before you go into a deal, and any deal has risks," as Hawke puts it. Bedi points out that, "for the company being invested in, a review of the ownership structure and business arrangements is required, including interrogation against lists of known or suspect bad guys."

"In general, these firms are looking at projects where the individual they're going to partner with is already well to do or has made some money and is reasonably high profile, and it's important to know how that individual got that way," Hawke continues.

Simon Moi

"The consequences of improper risk management are that the private equity firm could be accepting monies from bad guys or could be facilitating the operations of bad guys by injecting capital in the company," Bedi warns. "This has clear consequences in terms of fines – a key financial institution was fined $100 million by US authorities – and regulatory actions."

"We've seen claims brought by the portfolio companies well after the exit or the termination date of the fund," remarks Feng. "The VC normally appoints an outside director to sit on the board and manage the operation for a long period. They're responsible for everything from financing to supervising the staff. If something goes wrong or if the employees of the portfolio company, or the founders, are dissatisfied with the way the company has been managed - especially if they're preparing to go IPO or sell the company - there could be conflict-of-interest situations resulting in ugly legal disputes."

Having a controlling shareholder position can paradoxically increase risk exposure if something does go wrong. "If a VC's strategy is to invest in small-caps and private companies, it is usually viewed as positive to have majority control of greater than 50%," notes Moi, but adds, "If you're talking about a blue-chip listed company, then the outside directorship risk exposure can be quite high."

Exiting an investment also requires stringent risk controls, especially when compliance issues arise during a listing. "We are often brought in when the red herring is being printed and something has popped," notes Tiedemann.

Trade sales may demand just as much scrutiny. "During the exit stage, due diligence from an anti-money laundering and combating financing of terrorism perspective is also required on any potential purchaser," remarks Bedi.

Risk management skill sets and functions

The skill sets and operations of risk management sit alongside legal and accounting services, but are distinctly separate. "We talk about three pillars of pre-transactional due diligence," says Hawke. "You have the legal, financial, and what we call the investigative. What we excel at is the investigative due diligence, which covers a lot of areas that the law firms and accounting firms don't. That covers reputational risk – getting involved with a certain individual."

Chin Feng

"Our value is on the human intelligence side: assessing information, interviewing all sorts of people," concurs Tiedemann, "looking at track record, previous businesses, talking to other banks and financial institutions that have been involved with the parties, government in some situations."

"The skill set required is really to get behind the corporate veil to identify the ultimate beneficial owners and to understand the business arrangements. One has to dig deep enough to get to the bottom of things," says Bedi.

For long-term private equity clients, Tiedemann stresses, "We can become part of the team and help them structure the deals. We're not deal killers: we want to facilitate these deals."

-PSM