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SOUTH AND SOUTHEAST ASIA PRIVATE EQUITY REVIEW

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AUTUMN 2017

INDIA PRIVATE EQUITY ACTIVITY CONTINUES TO SURGE

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State of the market

India is steadily emerging as a sweet spot for private equity investors in the Asia-Pacific region. Between 2014 and 2017, the Indian PE market has maintained a significant market share of 24.3% (buyouts) and 19.3% (exits), by deal count in the region.

"Its long term investment and commitment to the Indian legal market means many Indian law firms, in particular, name it as the foreign firm with the best reputation in India'"

RSG CONSULTING 2016

Although the Indian PE market declined after the 2007-08 downturn, there has been a significant increase in activity in recent years with foreign PE investors demonstrating a healthy enthusiasm for this rapidly maturing market.

Market commentators anticipate that 2017-18 could be very strong years for the industry, provided that the policymakers (and implementers) continue the progress recently demonstrated.

Prime Minister Modi's government has made a number of structural changes to the legal and regulatory landscape since being elected, which have helped India maintain its attractive investment environment for both domestic and foreign investors.

PE ACTIVITY IN INDIA
Snapshot of the last three years

2014	2015	2016
After a couple of difficult years, 2014 saw an increase in PE activity (in line with the Asia-Pacific-wide boost) with exit (US $1.8b) and buyout (US $5.8b) deal values increasing when compared with 2013.	2015 saw a sharp increase in PE activity, with exit (US $7.2b) and buyout (US $9.3b) deal values eclipsing 2014 annual totals by 229.7% and 43.3% respectively.	After a record breaking 2015, there was a relative slowing down of PE exits in 2016, with PE exits dropping by 22% to US $6.3b. However, buyouts increased by 40% to US $12.6b.
Most of it was concentrated in the technology sector with Flipkart and Snapdeal raising US $1.7b and US $627m respectively from PE houses.	Most of it was concentrated in the technology, financial services and pharma sectors.	Most of it was concentrated in the consumer services sector.
This was the first year since the 2008 downturn which showed signs of recovery bringing the overall deal value to similar levels.	More than one-fourth of India's M&A activity was sourced from a PE buyer, reaching the highest proportion on record (117 deals).	Unlike the last few years where Indian PE houses were dominant, foreign PE houses played an important role in 2016 with seven in every ten deals involving a foreign PE house.

Key highlights from 2017 so far have been as follows.

- **Consumer services:** 30% of all PE investments have been in the consumer services sector, with 17% in financials and 15% in technology and industrials respectively.
- **Exits:** Whilst secondary and strategic sales increased in the last two years, IPO exits have been less popular primarily because of the onerous listing requirements applicable to certain PE owned companies (see below). The increase in exits is an important indication of confidence in the market, although the overall market share of exits in India in the Asia-Pacific region is still relatively low at 19.3% (as compared to China's 31%).
- **Increase in VC investment:** Although there has been a decrease in the number of investments in the market, 65% of all private equity and venture capital sector investments by deal count have been in venture capital (despite speculation that venture capital firms would face a difficult year for fundraising). In 2016, there was a steady increase in this number with venture capital funds dedicating a total of US $2.2 billion (as compared to US $1.5 billion in the previous year).

Recent Developments

- **Ease of listing norms for PE investors**

  The Indian securities regulator (**"SEBI"**) has recently eased norms for PE investors looking to use the IPO exit route by relaxing the one year lock-in requirement. This relaxation was made by the SEBI following its 21 June 2017 board meeting but the details of the relaxation have not yet been made public.

  Earlier, the entire pre-IPO shareholding of PE investors used to get 'locked-in' and investors had to wait at least one year after the listing to exit their investment. This had made IPO exits extremely unpopular amongst PE houses, as this requirement did not quite align with the exit strategies.

  This new relaxation will only apply to a category of AIFs (see below).

- **Distressed assets**

  Distressed assets (particularly real estate assets) have also become a focus area for PE houses. Many PE houses have established, or are in the process of establishing, specific funds or asset reconstruction companies (**"ARCs"**) to invest in such assets, with the aim to put in place an arrangement. This is similar to the arrangements that have been successfully adopted in a number of European countries.

  The recently enacted Insolvency and Bankruptcy Code 2016, which is expected to improve the speed and transparency of the insolvency system and debt recovery in India, is also expected to help improve investor confidence in seeking such distressed assets.

  The recent relaxation by the SEBI in relation to mandatory tender offers in the case of distressed acquisitions is another welcome change which will boost investments in this area.

- **Goods and Services Tax ("GST")**

  The much debated single harmonised indirect tax regime was eventually approved by Parliament last year and came into effect earlier this month. It is expected to be generally positive for investment and growth, and is likely to provide further impetus for continued PE investments.

- **Foreign Direct Investment ("FDI")**

  The Indian government relaxed foreign direct investment limits across a broad spectrum of sectors and abolished the Foreign Investment Promotion Board (**"FIPB"**). Most sectors now allow full foreign ownership without any restrictions, which is likely to boost investment from foreign PE houses.

- **Corporate governance**

  Improvement in Indian corporate governance over the last few years (in particular, since the enactment of the new Companies Act in 2013) has bolstered new foreign players entering the market. We expect to see further improvements in this area. In fact SEBI has recently established a committee which will be making recommendations to improve the standards of corporate governance in listed companies in India.

  India is also seeing a change in culture, with shareholder activism gaining more prominence which has built confidence amongst foreign PE houses and helped ensure that they will not be side-lined by strong promoter groups.

- **Alternative Investment Funds ("AIFs")**

  The Indian PE market has recently seen the emergence of a new structure for investments, alternative investment funds (also known as AIFs). These are basically privately pooled investment vehicles which must register with SEBI. The regulations relating to AIFs provide regulatory clarity on the operation of private equity and other funds, making them popular amongst sophisticated investors.

SUMMARY OF KEY PITFALLS IN INDIAN PE DEALS

- Lack of rigorous due diligence on the target.
- Nonalignment of incentives of the promoter/management of the target.
- Poor/ineffective corporate governance structures of the target.
- Failure by the PE houses to track the covenants and undertakings in effect during the life cycle of the investment.
- Lack of careful consideration to:
  - structuring issues, in particular in relation to debt;
  - the evolving tax aspects (eg Minimumum Alternate Tax (**"MAT"**), pass through for AIFs and implementation of General Anti-Avoidance Rule (**"GAAR"**), in particular tax treatment on exits.
- Governing law and dispute resolution.

Last year the Indian government allowed foreign investments into AIFs, which has resulted in AIFs having raised significant commitments of about US $11 billion as at the end of 2016.

- **Foreign investor and enforcement issues**

  Foreign investors in the past have faced serious issues in ensuring that their Indian counterparty complied with the contractual obligations and in enforcing awards in India in the case of any breach. However, a recent high court ruling is a positive indication of things to come.

  In April 2017, the Delhi High Court handed down a landmark ruling (in the case of *Cruz City 1 Mauritius Holdings v Unitech Limited*) rejecting objections to the enforcement of a US $300 million LCIA award. This decision is not only a clear indication that Indian courts are now taking a more commercial approach to uphold the sanctity of contractual arrangements between parties but also an endorsement to the Indian government's pro-investor and non-interventionist approach.

Predictions

Our key predictions for PE in India for the short term are below.

- **Deal activity and top sectors**

  Overall, we are optimistic about stronger deal activity as there has been a significant build-up of dry powder in the recent years.

  We anticipate continued focus on consumer services (as well as consumer discretionary) this year. PE funds are also showing an increased interest in retail real estate assets.

  Banking, financial services and insurance are also areas to watch, with growth expected to be bolstered by strong macroeconomic progress, rising incomes and a growing middle class.

  The increased deal activity in the healthcare sector in 2016 is also likely to carry through into 2017.

- **Fund raising**

  Fund raising is expected to continue to be challenging this year. Evidence suggests that the amount raised in the first quarter of 2017 was significantly lower than the amount raised for the same period in 2016.

- **Increased protectionism**

  The Indian government recently red-flagged last year's biggest M&A deal (Rosneft's acquisition of Essar Oil) on grounds of national security concerns. This is perhaps the first significant indication by the Indian government of increased protectionism of high profile assets (which appears to be a global trend at the moment).

  With constant threat from neighbouring countries and emerging global consensus against terrorism, India is likely to increase monitoring big ticket M&A and PE deals. Whilst it may be important for the Indian government to track deals from an internal security perspective, it will have to ensure that any CFIUS-style intervention is supported by clear guidelines and must not be implemented in an unpredictable manner.

- **Over-leveraged business**

  We expect to continue to see the sale by promoters of non-core assets and of strategic stakes to raise funds to reduce borrowings and invest in core assets. This will be an important deal driver for the PE industry, alongside investment in distressed assets.

- **Hands-on approach and alignment with promoters/management**

  PE has traditionally been a minority equity story in India. However, this seems to be changing. PE houses in India are increasingly seeking either significant minority or controlling stakes in order to exert greater influence rather than becoming a passive investor or merely relying on the growth wave.

  Such an approach has been coupled with an increased focus on due diligence of founding shareholders/promoters and management. The alignment between the promoter and the investor is absolutely key to running a successful operation.

- **Innovative investment strategies**

  We anticipate that investors will become increasingly creative with their investment strategies. For example, Goldman Sachs has recently executed its Indian investments through a 'buy and build' investment strategy, whereby it either acquires a large stake in a small business, or sets up a business from scratch, and brings in a professional team to scale up the business.

- **Venture debt**

  An increase in the cost of equity investment has contributed to a new trend for venture debt structures in the Indian market. Venture debt is used to fund capital expenditure, finance working capital requirements, fund mergers and acquisitions, or finance specific projects.

  Venture debt is likely to grow in popularity and we anticipate that venture debt investors will focus on established internet companies that are in need of additional cash.

RECENT KEY DEALS

Brookfield/Reliance Communications – Brookfield Infrastructure's acquisition of Reliance Communications' telecommunications towers business for US $1.6 billion (the largest investment by a foreign financial investor in the infrastructure sector in India).

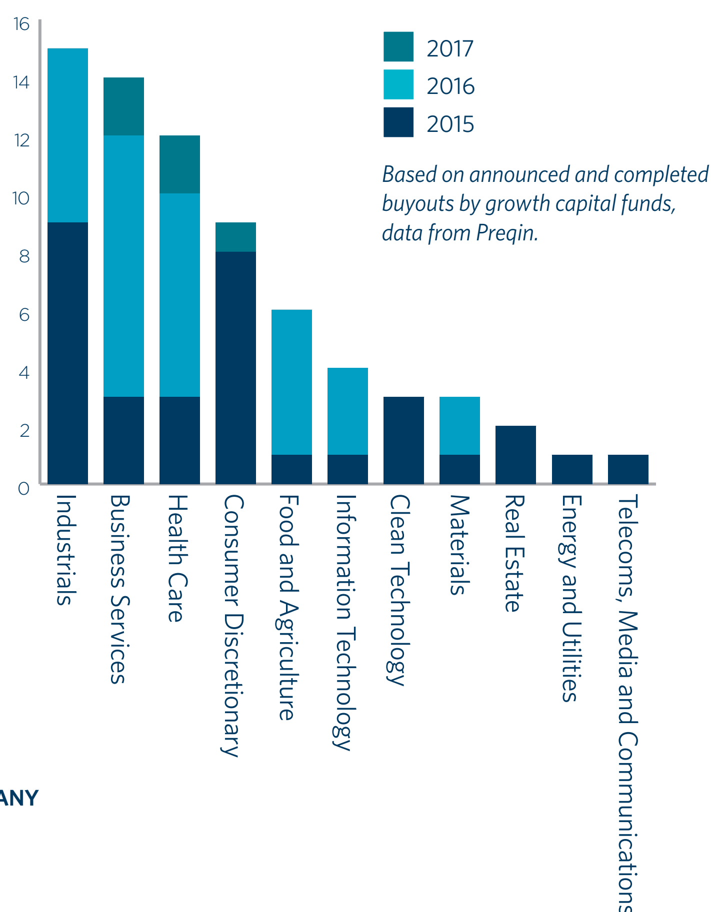
KKR/Alliance Tire Group – KKR's sale of Alliance Tire Group for US $1.2 billion (one of the largest exits of 2016).

Blackstone/Mphasis – Blackstone's acquisition of Mphasis for US $1 billion (the largest PE investment in India's outsourcing sector and Blackstone's largest acquisition in India).

MOST ACTIVE FUND MANAGERS

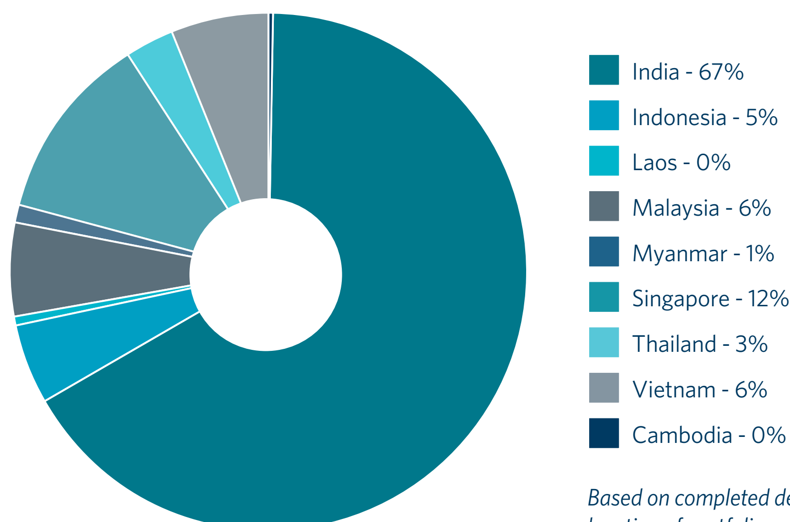
NAME	NO. OF DEALS
KKR	9
CARLYLE GROUP	6
CREADOR MANAGEMENT COMPANY	5
STANDARD CHARTERED PRIVATE EQUITY	4
ADVENT INTERNATIONAL	4
TA ASSOCIATES	4
WARBURG PINCUS	4
IFC ASSET MANAGEMENT COMPANY	4
TPG	3
NEWQUEST CAPITAL PARTNERS	3
VERLINVEST	3
APAX PARTNERS	3
BLACKSTONE GROUP	3
GOLDMAN SACHS MERCHANT BANKING DIVISION	3

SECTOR ACTIVITY BY NUMBER OF DEALS (70 DEALS) 1 JAN 2015 – 31 MAR 2017



Based on announced and completed buyouts by growth capital funds, data from Preqin.

GLOBAL FUND MANAGER ACTIVITY BY LOCATION OF PORTFOLIO COMPANY 1 JAN 2015 – 31 MAR 2017 (297 DEALS)



Based on completed deals and location of portfolio company, data from Preqin.

INDIA EXITS MARKET TRENDS

FROM TOP
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Market Trends

2016 saw private equity and venture capital firms exits totalling US $7 billion across multiple sectors. While the number of exits was less than in preceding years, deal value increased reflecting the growing sophistication of the Indian market as well as the maturing of sizeable investments. This can be attributed to the wider process of macroeconomic reforms and growth opportunities available both domestically and internationally to Indian companies.

Capital Markets and M&A Exits

Across sectors, financial services, information technology, consumer, industrials and healthcare accounted for the majority of the deals completed in 2016. Healthcare showed the most deal growth relative to the other sectors. Interestingly, M&A exits were most popular in the IT and TMT sector – although M&A as a preferred exit route was sectorally less popular compared to the public market exits.

This may be attributed to overall public market conditions rather than structural changes as M&A exits have otherwise increased in volume and value over the last three years. As buyers look to inorganic growth opportunities (and as public market exits can be challenging to execute in volatile conditions), it is reasonable to project that M&A will continue to grow steadily as private equity investors look for the better pricing and execution certainty that M&A can provide.

Public market exits reflect a more complex picture. While buoyant stock markets can offer private equity investors attractive pricing, private equity exits also have had to compete with 'new money' companies for investor interest in the IPO space.

IPO investors also generally expect to see private equity investors retaining a stake in the company post-listing and therefore full exits are usually only available after the expiry of a lockup period. This has meant that private equity exits in 2017 have frequently been in the form of on market secondary sales, which in turn have had to comply with pricing guidelines (which involves tracking the stock closing price over a fixed period in order to arrive at a regulatory floor price) leading to less room for commercial maneuver and execution certainty than private equity investors ideally would prefer.

Regulatory Changes

In order to address some of these structural and regulatory issues, certain reforms introduced by the Indian securities regulator should be helpful.

First, the lockup requirement previously applicable to private equity investors in an IPO company has been amended so that these investors can exit within one year of the date of their investment rather than one year from the date of listing.

Secondly, the listing requirements applicable to companies with majority private equity and venture capital ownership are likely to be eased, enabling these companies to come to market more quickly, facilitating sellers' objectives of greater execution efficiency.

In addition, there have been continued changes and clarifications to the foreign investment regime in general to encourage foreign direct investment.

Outlook

In the coming year, investments of around US $20 billion that were made between 2012 and 2014 are expected to start positioning for exit. These include investments in the IT, resources, financial and consumer sectors with resources opportunities being in the older vintage along with financials, while more recent investments were made in the IT and healthcare sectors.

The steady growth in M&A exits is expected to continue. At the same time inward investments is expected to continue to be strong, particularly in specialised sectors, suggesting that the positive investments and exit cycle that has been put in place in recent years should continue in the short to medium term.

INDIA INTERNATIONAL FIRM OF THE YEAR

CHAMBERS ASIA PACIFIC AWARDS 2016

ASEAN OVERVIEW

With 2017 marking the 50th anniversary of ASEAN, it is timely that we discuss the investment trends across Southeast Asia in the private equity sector.

Southeast Asia has 10 diverse markets each presenting different opportunities and challenges. So who are the largest investors? Between 2010 and 2016, of the completed M&A deals in ASEAN by member countries:

- 41% of acquisitions were by Asia-Pacific investors (being US $73 billion);
- 25% of acquisitions were intra-ASEAN investors (being US $44 billion); and
- 34% of acquisitions were by other international investors (being US $61 billion).

The region is experiencing increasingly more stable deal activity with an average annual deal value of US $87 billion between 2011 and 2016.[1] Since 2015, US $53 billion[2] has been invested by entities operating within the financial sector. By 2050, ASEAN is predicted to be the fourth-largest economy globally[3] and is the third-largest emerging market bloc after China and India[4].

China and India, as two of the world's strongest economies and the world's largest populations, are integral to the broader Southeast Asian investment landscape. The Southeast Asia region is now China's third-largest trading partner[5], and since January 2015 US $2.8 billion[6] worth of buyouts by venture capital funds have been announced and completed in India.

Malaysia in particular has been a hotspot for foreign investors. 10% of fund investments in Southeast Asia have been into Malaysia and we expect this trend to continue. Between 1 January 2015 and 31 May 2017, a total of 394 deals[7] involved a Malaysian target and a financial buyer acquirer, most of which were in the financial, industrial, consumer, TMT and real estate sectors. Malaysian financial buyer acquirers make up the lion's share at 61%, with Chinese buyers investing 15%, and Japanese buyers investing 10%.

Indonesia is also back in vogue, leading KKR to "upgrade [its] investment outlook for Indonesia".[8]

"Our recent trip to Southeast Asia leads us to upgrade our investment outlook for Indonesia. The country has one of the most compelling demographic stories. Indonesia in particular, may be one of the areas where investors are not fully up to speed on the compelling macro backdrop. In our view, therein lies the opportunity."[9]

Large scale investment in technology is also essential to the ASEAN members. As Southeast Asia rapidly develops, the leapfrog effect means technology is becoming more and more embedded in society. We are witnessing greater investment into the TMT sector particularly into online payment platforms and rideshare apps.

Between January 2015 and March 2017, more than US $600 million was invested in the telecoms, media and communications sector in Southeast Asia.[10]

We recently advised global TMT investor Softbank on its investment in a new equity funding round for Southeast Asia's GrabTaxi, a Singapore incorporated company and the region's leading online transportation and payments platform. Softbank and China's Didi Chuxing (the world's leading one-stop mobile transportation platform) were the lead investors in the US $2.5 billion funding round, the largest single financing in Southeast Asia.

FROM TOP
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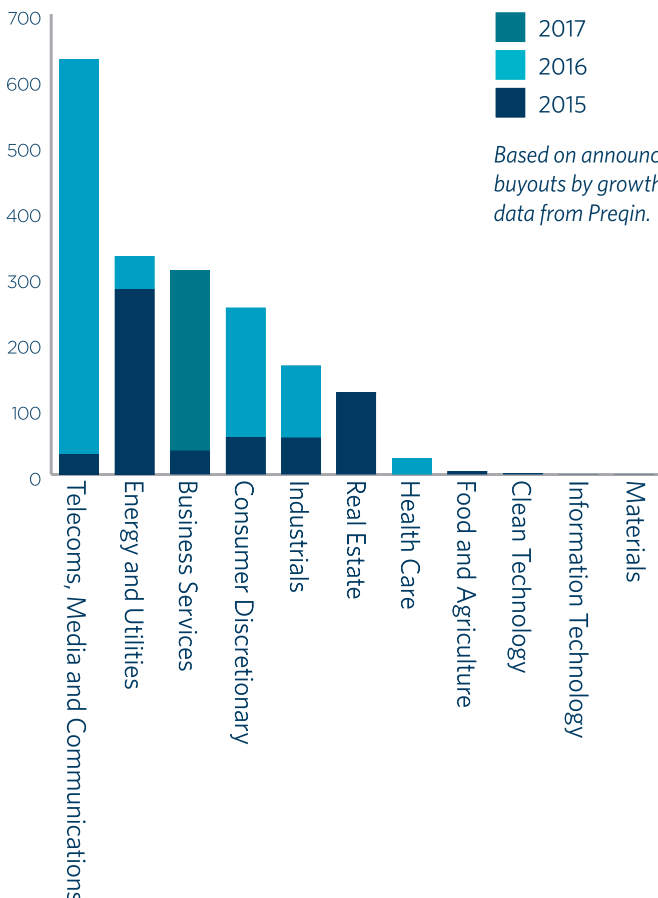
In January 2017, Innovation Network Corporation of Japan and Khazanah invested US $400 million and US $200 million respectively in edotco Group. In April 2017, Axiata announced that Malaysia's state-owned pension fund, KWAP, would also be investing US $100 million into edotco Group.

Overall, the steady growth in M&A is expected to continue across the region, particularly as the competition in deals rises, with Malaysia and Indonesia as obvious hotspots. At the same time, we expect the TMT sector to remain of primary interest to inbound investors as ride-share and online payment platforms expand their number of users and continue to disrupt the market.

ACTIVITY BY VALUE OF DEALS (US$1.8BN) 1 JAN 2015 – 31 MAR 2017



Based on announced and completed buyouts by growth capital funds, data from Preqin.

FOOTNOTE

1. Rediscover ASEAN A growth story of 10 countries.
2. Value based on transactions where target location is Southeast Asia and the acquirer's ultimate parent operates in the financial sector, data sourced from Thomson Reuters.
3. Keith Breene, 'What is ASEAN?' (World Economic Forum, 9 May 2017) https://www.weforum.org/agenda/2017/05/what-is-asean-explainer/
4. The Boston Consulting Group 'Private Equity in Southeast Asia'(2012) page 4.
5. Breene, 'What is ASEAN?', 2017.
6. Value based on announced and completed buyouts by growth capital funds, data sourced from Preqin.
7. Reported deals with an aggregate value of US $6.6 billion.
8. Henry H Mcvey, 'Indonesia: Harnessing its Potential' (KKR, 7 June 2017) http://www.kkr.com/global-perspectives/publications/indonesia-harnessing-its-potential
9. Mcvey, 'Indonesia: Harnessing its Potential', 2017.
10. Value based on announced and completed buyouts by growth capital funds, data sourced from Preqin.

SPOTLIGHT ON MALAYSIA

Malaysia has seen healthy levels of investment from financial buyers amidst the backdrop of a fluctuating but still relatively weak ringgit, a consumer-driven economy that remains robust despite recent challenges, and an ongoing liberalisation of foreign investment restrictions. Malaysia offers quality assets at attractive valuations across a variety of sectors, leading many financial buyers to view Malaysia as a gateway to the growing ASEAN economies and an ideal means of establishing a footprint in the region.

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Associate

Overview of deal activity

The period from 1 January 2015 to 31 May 2017 saw a total of 394 reported deals (valued at an aggregate of US $6.6 billion) involving a Malaysian target and a financial buyer acquirer. Most of these reported deals were in the financial, industrial, consumer, TMT and real estate sectors. Malaysian financial buyer acquirers invested the lion's share of the aggregate deal value at 61%, with Chinese buyers investing 15%, and Japanese buyers investing 10%. Despite the strong availability of capital locally, it is clear that China and Japan remain important sources of foreign investment for financial buyers.

Notable inbound transactions

Major private equity firms, such as CVC, have been interested in Malaysian assets for several years. Particularly notable deals include CVC's acquisition of gaming company Magnum Corporation in 2008, and the privatisation of fast food operators QSR Brands and KFC Holdings in 2013 in a consortium that CVC co-led with EPF. There has been recent speculation that QSR will undergo a listing in the near future.

Recently, CVC completed its privatisation of Malaysia-based Nirvana Asia at a deal valuation of US $1.1 billion, marking the first time a Hong Kong listed company had been taken private by a private equity firm.

In March 2017, Actis announced that it had acquired 44.4% of listed payment services provider GHL Systems from Creador, a Malaysian private equity firm, in a deal which reportedly gave Creador a 2.8x return on its initial investment in GHL Systems.

Retail focus

The retail sector has been particularly active in recent years, with investments by AIGF (a fund managed by CIMB Private Equity and Mitsubishi Corporation) in supermarket chain Jaya Grocer, by CMS Opus (as part of Ekuinas' outsourced funds programme) in MBG Fruits, by Singapore-based KV Asia in TF Valu-Mart, and by Creador in home improvement retailer Mr. DIY.

More recently, Village Grocer, majority owned by Malaysian fund Navis Capital, announced that it had acquired competitor Ben's Independent Grocer, strengthening its position in the premium groceries sector. State-owned fund Ekuinas also completed a US $17 million minority acquisition in a privately owned Malaysian sports retailer Al-Ikhsan earlier this year.

Other current year highlights

In the current year alone, Malaysia has seen several acquisitions by financial buyers in the TMT, materials, business services and healthcare sectors.

The largest amongst these was the investment in January 2017 by the Innovation Network Corporation of Japan and Khazanah of US $400 million and US $200 million respectively in edotco Group, the telecommunications infrastructure services subsidiary of Malaysian mobile network operator Axiata. In April of this year, Axiata announced that Malaysia's state-owned pension fund, KWAP, would also be investing US $100 million into edotco Group.

The current year also saw Creador acquire a minority stake in Indonesia-based Hermina Hospital Group, and the merger of Navis' Celebrity Fitness with Fitness First Asia.

Regulatory considerations

The strong Malaysian inbound activity demonstrates the confidence that financial buyers have in Malaysia's foreign investment regime. Nonetheless, the regulatory regime applicable to foreign investment is constantly developing and requires careful consideration by investors eyeing Malaysian targets.

Up until 2009, all foreign investments, including mergers and takeovers, and acquisitions of equity interests and real property, fell under the purview of the now disbanded Foreign Investment Committee (**"FIC"**) and repealed FIC Guidelines.

Notwithstanding the disbanding of the FIC and repeal of the FIC Guidelines, foreign investment restrictions continue to apply and are enforced by sector-specific regulators. Such restrictions may be expressed as a cap on foreign shareholding, a minimum level of Malaysian and/or Bumiputera shareholding, or a combination of these approaches.

Foreign investment restrictions in Malaysia generally take the form of policy requirements which must be satisfied prior to the issuance of the required licence by the regulator. While certain regulators have made equity requirements publicly available (for instance the banking, insurance, upstream oil and gas, construction, distributive trade and healthcare sectors), this is not the case for all sectors. Given the policy (non-statutory) nature of these restrictions, some uncertainty inevitably arises where there is a change in policies.

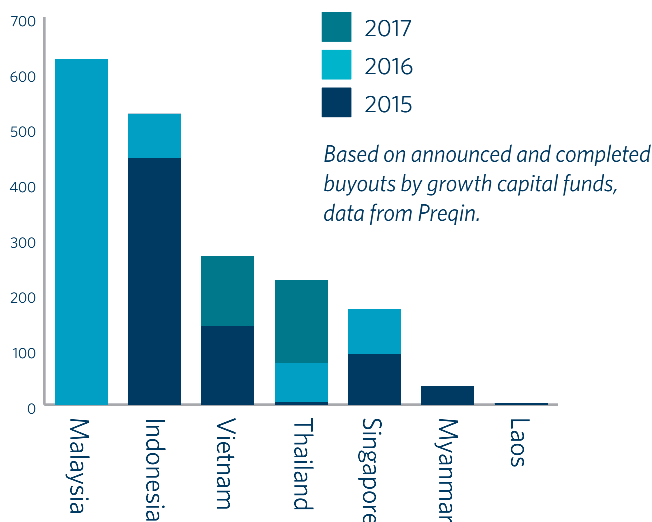
One example is in the retail sector. The *Guidelines for Foreign Participation in the Distributive Trade Services Malaysia* issued by the Ministry of Domestic Trade, Co-operatives and Consumerism which sets out equity requirements in respect of different retail formats is made public, but specific guidelines amending and liberalising the requirements for convenience stores, although implemented, have not been made publicly available.

In the education sector, equity requirements applicable to different types of private education and private higher education institutions are only partially publicly available. Foreign investors may therefore be required to engage with the Ministry of Education and Ministry of Higher Education respectively to conclusively ascertain the policy of the day.

Conclusion

In spite of the complex regulatory landscape, Malaysia is, and is likely to remain, a hot spot for foreign investors. However, those wishing to execute a well informed and smooth transaction need to be aware of the regulatory environment. Foreign financial buyers and their advisors should be prepared to engage with the relevant authority in order to understand the applicable investment requirements, and how these requirements are implemented, when considering the legal feasibility and structure of a transaction.

ACTIVITY BY VALUE OF DEALS (US$1.8BN) 1 JAN 2015 – 31 MAR 2017



MOST ACTIVE FUND MANAGERS

NAME	NO. OF DEALS
NAVIS CAPITAL PARTNERS	5
STANDARD CHARTERED PRIVATE EQUITY	5
CREADOR MANAGEMENT COMPANY	5
MEKONG CAPITAL	3
EKUITI NASIONAL BERHAD	3

SPOTLIGHT ON INDONESIA

State of the market

The expansion of PE activity across all sectors in recent times mirrors the broader macro trends in play in the Indonesian economy. The steady expansion and deepening of the Indonesian middle class, creates opportunities for rapid growth in these consumption related sectors. In particular, technology-related start-ups are making increasing headway in a variety of sectors (driven in particular by Indonesia's high mobile phone usage), including in the transportation and fintech sectors. Although many of these companies remain small, a number of them have begun to attract significant foreign investment from financial investors e.g. Go-jek and Tokopedia.

This long term trend has been further bolstered by improvement in government funding for infrastructure projects, the government's efforts to broaden the tax base and the attainment by Indonesia of investment grade status by all three major rating agencies, having weathered the negative effects of the "Taper Tantrum" and the slowdown caused by China's commodity readjustments in recent years.

Overall, the long term demographic trends are favourable for Indonesia, and the shorter term economic indicators are increasingly positive, creating a steadily improving investment climate for PEs in Indonesia.

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Senior Associate

PE deal execution in Indonesia

We set out below a number of key challenges facing PE investors in Indonesia:

1 Foreign ownership restrictions

Many key sectors remain either closed or partially closed to foreign investment (for example, retail and towers). This is driven by a very deeply held view that certain sectors ought to be reserved exclusively for local investors only. This protectionist mind-set has inevitably given rise to a very large number of (often vague) ownership related regulations which seek to directly or indirectly limit the ability of foreign capital to invest in these closed or partially closed sectors. Whilst this has not prevented determined and experienced PE investors from participating in these sectors in Indonesia, for example via convertible or exchangeable bond structures, it does deter less experienced investors given the complexities and risks involved in these structures.

2 Sector specific restrictions

On top of the ownership restrictions outlined above, there are further sector specific rules which may impede investments in certain sectors. For example, in the insurance sector there is a requirement that a foreign investor investing in an insurance company must itself be an insurance company or a holding company which has as one of its subsidiary an insurance company in the same line of business as the target. The underlying rationale is that a foreign investor in this sector has the required knowledge to help the target insurance company to develop its business, but one of its potential effects is that it may deter financial investors who operate using a funds structure, and which has a shorter investment horizon compared to strategic investors. It is critical when investing in Indonesia to identify such issues at an early stage and to deal with these issues upfront with the regulator.

3 Restrictive operational rules

The protectionist mind-set gives rise not only to complex ownership limitations, but also a variety of other rules regarding the operations of certain business models. For example, there are complex rules under the franchise regulations which seek to limit the number of outlets a restaurant business may have without involving SME franchisees. The underlying policy of the rule is purportedly to promote SME participation in franchised businesses, but its effect is to potentially limit the growth potential of certain highly effective franchise businesses. These types of restrictions often give rise to elaborate schemes to either comply and/or work around these rules, which can be unattractive for less experienced PE investors in Indonesia.

4 Multiple regulators

With complex regulations administered by a vast bureaucracy, it is inevitable that this will give rise to multiple regulators whose mandate often overlap, and where it cannot be assumed that a coordinated response is adopted. This is currently most acute in the 'fintech' / payment sector where there are at least 3 different regulators – BKPM (the foreign investment coordinating board), OJK (financial services authority) and BI (central bank) – with overlapping jurisdictions. The amount of time and effort it requires to carefully navigate these institutions can slow down deal execution in a very real way. With careful planning – and creative structuring – this regulatory issues can often be overcome, but it does take more time.

5 Corporate governance

Although the corporate governance landscape in Indonesia has improved significantly since the Asian financial crisis of the late 1990s, there remains acute challenges faced by foreign investors, in certain circumstances, in ensuring that the target companies adhere to a high standard of corporate governance, including in relation to anti-corruption and related party transactions.

6 Less flexible corporate structure

It is generally the case that the Indonesian regulatory environment and company law are less flexible when it comes to structuring complex share capital structures, for example, redeemable/convertible preference shares and/or shares with 'tracking' rights. Changing the share capital structure of an Indonesian company also normally involves obtaining prior regulatory approval, which makes complex share capital structures cumbersome in practice. A forward thinking Indonesian controller often plans years in advance of these potential issues by structuring their investment vehicles outside Indonesia in Singapore or Hong Kong, for example.

7 Tax leakage

In general, Indonesia is not the most tax efficient jurisdiction when compared to jurisdictions like Singapore and Hong Kong. If not structured properly, Indonesian investment can suffer from significant tax leakages. A lot of Indonesian PE investments are highly structured in part due to tax considerations.

8 Uncertain enforcement of contracts

Enforcement of contracts in the local courts remain uneven at best, and in the worst cases, can become subject to unethical influences. Hence, both the choice of jurisdiction for dispute resolution and the choice of governing law for key transaction documents are key considerations which will need to be considered carefully. Arbitration for dispute resolution is a key mechanism to protect investments.

9 Exits from complex structures

It is an inevitable consequence of highly structured transactions that an exit by way of sale to a third party will entail the new incoming buyer getting comfortable with the (often complex) inherited structures. As these structures are often bespoke and designed specifically for the relevant situations, it is often not easy to convince new strategic or other financial investors to adopt the same structures, as their appetite for (and perception of) the relevant regulatory risks such complex structures entail are often different. In some cases, the more viable exit route is through an IPO or re-IPO (in stages) of the target.

10 Finding reliable local partners

A lot of the challenges identified above may be mitigated by finding a reliable local partner who has the capacity to deal with these issues. It goes without saying that such partners (who are willing to do a deal at a reasonable price) are in short supply, in an environment where there is a high level of competition among both local and foreign PEs looking for good assets which are scarce.

Typical solutions or work arounds

PITFALLS	TYPICAL SOLUTIONS OR WORK AROUNDS
1 Foreign ownership restrictions	Adopting a convertible or exchangeable bond structure, whereby foreign investors invest in bonds pre-IPO, and where bonds will only convert into shares of the target on IPO (taking advantage of the 'portfolio investment' in listed shares exemption from the foreign ownership restriction). The features of the bonds will to the extent possible seek to replicate the features of an equity investment.
2 Sector specific rules e.g. requirement in insurance sector for foreign investor to be in the same line of business as the target	Deep sector knowledge is a must when investing in complex sectors in Indonesia e.g. financial services. Given the multitude of rules and their often opaque nature, the only real way of accessing how a rule will be applied in practice will be to test the relevant rules with the regulator in real life situations. Early engagement with regulators on complex regulatory issues will often determine whether the deal can go through.
3 Restrictive operational rules e.g. restrictions on outlet for certain franchise businesses	It is not unusual to find fairly aggressive recharacterisation techniques being used in the Indonesian context as work arounds for restrictive rules. For example, we have seen cases where franchise structures are being recharacerised as licences instead, in order to avoid restrictive requirements applicable to franchises. The key skill here is to understand the extent to which an underlying policy is being applied by the relevant ministry in order to assess the real risks involved in such recharacterisation techniques.
4 Multiple regulators. e.g. currently, in the fintech sector, the regulators involved could include BKPM, OJK and BI.	It is vital to understand the basic philosophy of each of the regulators and the limits of their respective jurisdictions (both in theory and in practice). This basic understanding will often help shape a strategy on how to navigate these different institutions in a way which result in a positive outcome. It is often essential for a foreign PE investor to partner with a skilful local partner who can handle such complexities arising from overlapping government agencies. Directed and targeted consultations with the relevant government agencies are key to successful deal execution.
5 Corporate governance, e.g. corruption and related parties issues	It is important for PE investors to conduct vigorous due diligence on Indonesia related transactions, both legal and financial. Given the continuing dominance of family or family groups within the largest and most sophisticated Indonesian groups (who are likely counterparts to foreign PE investors), it is important to be vigilant in particular on related party transaction issues. Even if the target is a listed entity where OJK capital markets rules on affiliated party transaction apply, such rules are often not rigorously applied and independent appraisal mechanisms prescribed by the rules are often not robust (in practice).

PITFALLS	TYPICAL SOLUTIONS OR WORK AROUNDS
6 Less flexible corporate structures	This is often dealt with by having the immediate target entity incorporate outside Indonesia. This will often be beneficial to the seller from a tax perspective as well. From the PE investor's perspective, such structures are likely to increase the flexibility in terms of adopting more complex capital structures such as redeemable / convertible preference shares.
7 Tax leakage	Common techniques in Indonesia to minimise capital gains tax include structuring the target company as an off-shore entity, and selling shares in listed companies rather than private entities. Choice of jurisdiction of bidco to be used by the PE fund will often be important as well in order to extract profits efficiently, depending on the double tax treaty between Indonesia and the country in which bidco is incorporated.
8 Uncertain enforcement of contracts	It is almost routine now for high value investment / acquisition contracts involving foreign investors investing in Indonesia to be subject to arbitration as the dispute resolution mechanism, and where possible for the choice of law to be that of a stable common law country (Singapore being a clear favourite in recent years). Whilst necessary, these measures alone are often inadequate, and in practice, we see PE investors adopt other practical measures to ensure compliance with contracts e.g. price retention, staged payment and/or escrow account arrangements.
9 Exits from complex structures	For highly structured investment structures, a high degree of 'education' time will need to be invested in potential buyers in an exit, to help such buyers access the risk inherent in complex structures. Having credible advisors (experienced in such structures in Indonesia) on both the sell and buy sides are often important.
10 Finding reliable local partners	This may seem obvious, but it is key to operating successfully in Indonesia for PEs to have team members who have the right language skills, as this accelerates the ability to build trust quickly with potential local partners. We have seen time and again, teams who have an appropriate mix of local and international deal execution skills performing well in the Indonesian context.

Looking ahead to 2018

Looking ahead, our key predictions for PE investors in Indonesia in the next 12 months are as follows:

1 Sustained private equity and venture capital investment

We expect foreign private equity and venture capital to continue to seek out investments in Indonesia in selected sectors. Over the last 5 years or so we have seen the sectors in which foreign private equity and venture capital funds invest in becoming increasingly diverse as more foreign funds begin to invest in Indonesia. This ranges for example from, food and beverage, health care, real estate to TMT (including e-commerce and fintech). We expect this trend to continue in the next 12 months.

2 Financial services sector (including fintech)

We expect continued foreign interest in the Indonesian financial services sector, including in the insurance sector and the new (but fast growing) fintech sector in Indonesia. M&A activity in the financial services sector is likely to be driven by regulatory requirements (e.g. single presence policy and local ownership requirements in the insurance sector) and also fast growing new opportunities in emerging sectors (e.g. peer to peer lending and payments). The Indonesian Government is strongly supportive of a 'financial inclusion' agenda and is encouraging the use of technology in this area – as the regulations become clearer, there is a higher likelihood that foreign investment in this sector (including from PE investors) will increase. We also expect to see PE investors exiting mature investment in the financial services sector.

3 Consumer sector and Impact of technology

The impact of technology on the consumer related sectors in Indonesia is increasingly felt and we expect the pace to accelerate in the next 12 months. This opens up opportunity in a number of related sectors, including for example e-commerce, payments and transportation. The fund raising requirements of these fast growing companies are likely to attract foreign venture capital, private equity and also strategic investors looking to get in early into this new emerging areas for investment in Indonesia.

We also expect the longer term trend of companies involved in providing goods and services to the Indonesian middle class to continue to attract foreign investment (including from PE investors), in particular in the following sectors: food and beverage, healthcare, leisure and logistic / distributions sectors.

4 Increase in company insolvencies and distressed scenarios

Much of Indonesian corporate borrowing is dollar-denominated and we expect to see the trend of increasing company insolvencies (or at least distressed situations) continue in the next 12 months, as certain Indonesian companies (particularly those exposed to the natural resource sector) to continue to struggle with sluggish revenues and rising cost of foreign debt service. This will likely result in higher numbers of distressed asset sales and corporate restructures, even if formal bankruptcies do not eventuate. We are aware of specialist funds who focus on complex or distressed situations to be looking at Indonesia in recent months, and we expect this to continue.

5 Entertainment and the creative industry

Both entertainment and creative economy sectors have opened up to increased foreign ownership levels signalling the Indonesian Government's renewed commitment to welcoming overseas investment in these areas. In particular, foreign ownership limitations have been relaxed in the food and beverage, accommodation (e.g. one and two-starred hotels), film (e.g. distribution, production, cinema operation) and sports and recreation sectors. As a result, we expect to see increased interest from foreign investors in these sectors, particularly where businesses in these sectors have an e-commerce dimension. We expect to see financial investors increasingly active in this space in the future.

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