Raising Capital. Capital Raising for Hedge Funds and Private Equity in Asia.

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After the financial crisis of 2008 the only investors in either hedge funds or private equity to resume investing with any significant appetite have been US pensions and endowments. In Europe, the appetite for hedge funds has fundamentally changed in favour of greater regulation, liquidity and transparency, which, at least in part, was thought to be addressed by the application of UCITS III. For private equity, some appetite has returned, certainly more so than for hedge funds, where the investor appetite for offshore, limited liquidity, unregulated funds haves been decimated.

In Asia, the appetite for hedge funds was similarly decimated after 2008 and has remained moribund ever since. The number of Asia ex-Japan ex-Australia institutional investors is sparse. Most of the investable wealth lies in the hands of the first or second generation of families where the operating business remains in full force and continues to generate high returns on equity in the 20% – 30% range, making low volatility and low return investments relatively unattractive. Diversification and risk mitigation are concepts not yet fully developed in the strategies of these investors. When hedge funds were sold to these investors pre 2008, they were largely, either intentionally or accidentally, mis-sold as a capital protection strategy. When liquidity was denied in the depths of the crisis through the invocation of redemption gates and suspensions of NAV, the trust between fund managers and investors was irreparably broken.

Private equity investments, whether in venture or growth are more in line with the culture of enterprise and returns expectations of LPs in Asia. Whereas Asian LPs are intolerant of illiquidity in hedge funds, they are more receptive of long gestation investments in private equity.

Traditionally, the wealth management industry in Asia has been dominated, almost to exclusion, by private banks. This is natural given the shape of the investor base, comprising mostly high net worth individuals and families and only a small collection of institutions. Institutional investors, including sovereign wealth funds, endowments, corporate pensions, often have professional investment management resources, whereas high net worth individuals and families often do not. This is changing as some of the trust between private clients and private banks has been eroded following the poor quality of investment advice which became apparent in 2008. As a reaction, more family offices are being established to perform due diligence on investments offered by private banks. Unfortunately, there remains a distinct dearth of experienced investment professionals and thus many family offices end up turning to the same private banks for advice and investment products.

While the appetite for hedge funds has not and is not expected to recover anytime soon, the appetite for private equity has recovered albeit in a slightly different shape. Investors have more appetite for direct deals while remaining cautious of blind pool funds. While trust has yet to be rebuilt, investors are happy to invest where they have greater visibility and control and where their experience in their own operating businesses gives them either comfort or finds them strategic opportunities.

Private equity funds, for principal-agency reasons, have never been significantly distributed to Asian LPs. Private banking marketer compensation and incentives are responsible for this. The average tenure of a private banker in Asia is relatively short with the vast majority of bankers never surviving a single private equity fund's life in a given bank. Average tenures have fallen from 5 years to under 3 years in recent times. This makes private equity unattractive to private bankers even if they are attractive to their underlying investors. As a result, less private equity capital is raised than could potentially be raised. In a word, private clients are under-served in private equity products.

Another problem is that the quality of due diligence and origination staff can be poor. The corporate environment and bureaucracy inherent in multi business line banks naturally discourages relevant entrepreneurial talent. Staff turnover is high, which in the hedge fund and private equity industry is highly disruptive and undesirable.

Investors also extrapolate from their mostly poor experience with structured products where high fee and high margin products with often complicated payoff designs are pushed onto clients. There is but one single significant distribution channel for structured products.

Private equity is by its very nature a long gestation strategy and investors require a high level of comfort that they are offered the best opportunities, subjected to deep scrutiny and due diligence and that their agents' interests are aligned with theirs. In Asia today few, if any, such agency businesses exist to fill this need.

Until a more efficient placement agency model arises, private equity GPs and hedge fund managers have few options, and private banks, for all their agency issues, remain the primary channel for capital raising.