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Business Services

Take Private Opportunity in Asia?

By Michel Brekelmans

PE and corporate investors have been significantly impacted by travel restrictions imposed by governments round the world. Critical on-site and face-to-face due diligence has been hindered and many investors have hunkered down focussing on their existing portfolio or closing only those deals that were already in advanced staged at the time the lockdowns hit Asia.

But with $400bn in dry powder targeting PE investment across Asia, many players are eager to get back into deal making mode. Take privates and private investments in public entities ('PIPE') have become a viable source of potential deal flow since much of the DD can be done based on public data without direct access to the target.

Business Services amongst favoured investment theme for PE investors in Asia

In a previous paper, we explored the opportunity for take privates and PIPE's across the consumer sector (click here). In this new paper we repeat the exercise but look at the business services sector which consist of a wide range of subsectors, including commercial, industrial and technology services.

Many PE and corporate investors are attracted to business service companies given several favourable industry and market trends and attractive features of their business model:

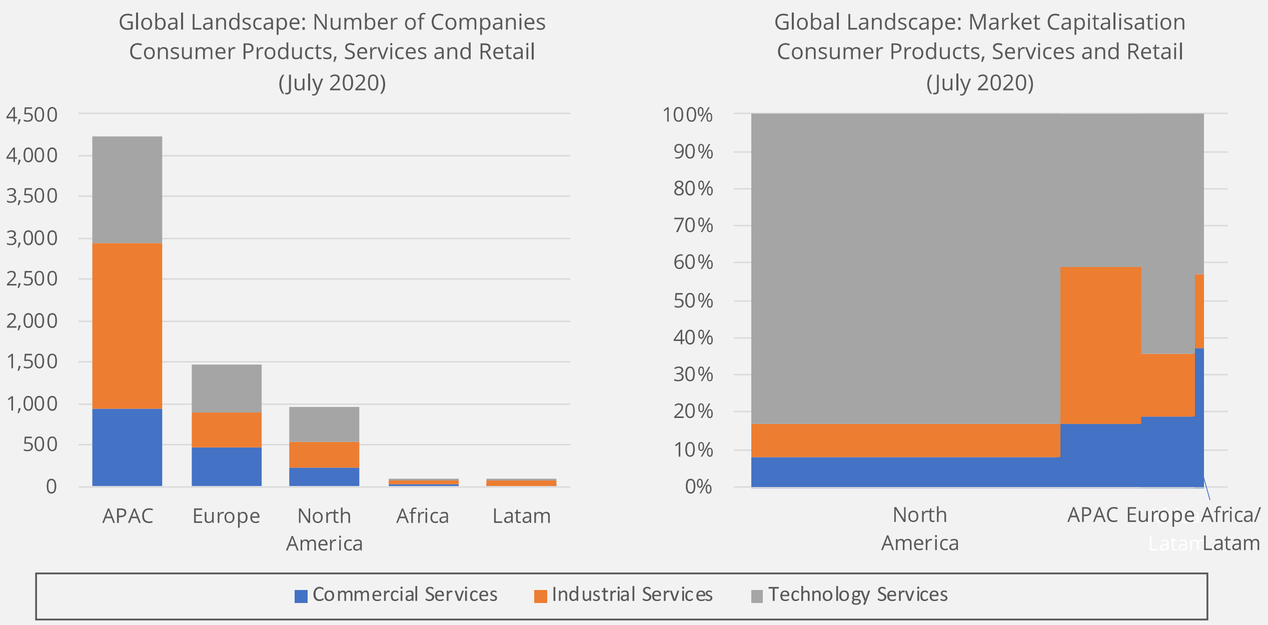
- Continued trend towards outsourcing of non-core services and functions;
- Strong margins resulting from efficient service delivery driven by benefits from scale, focus and technology;
- Long-term customer relationships with recurring revenue base;
- Attractive growth prospects, both organic and via acquisition;

- Benefit from tailwinds in regulatory complexity and/or advancements in sustainability and efficiency

The fortunes of different business service players has varied markedly throughout the COVID-crisis with some players being impacted severely as services delivery become impaired by lockdowns and budget pruning and others benefitting strongly from changes in customer behaviour and channel dynamics caused by the pandemic.

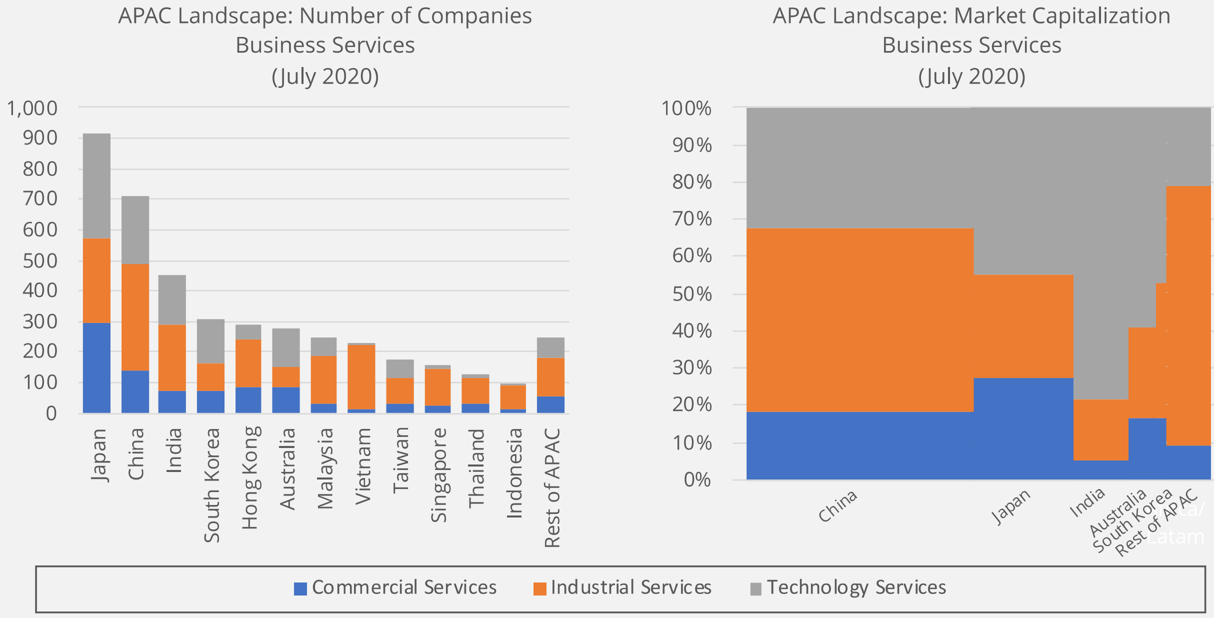
Asia’s Business Services Landscape

Asia is home to over 4,000 public companies across the business services sectors. This represents over 60% of all listed companies globally in the business services space. In terms of market capitalisation, Asian companies represent only 29% of the global total behind North America whose companies represent around 56% of the global total pushed by several tech behemoths such as Microsoft, Adobe, Paypal and Cisco.



Source: SCP/Asia Research & Analysis

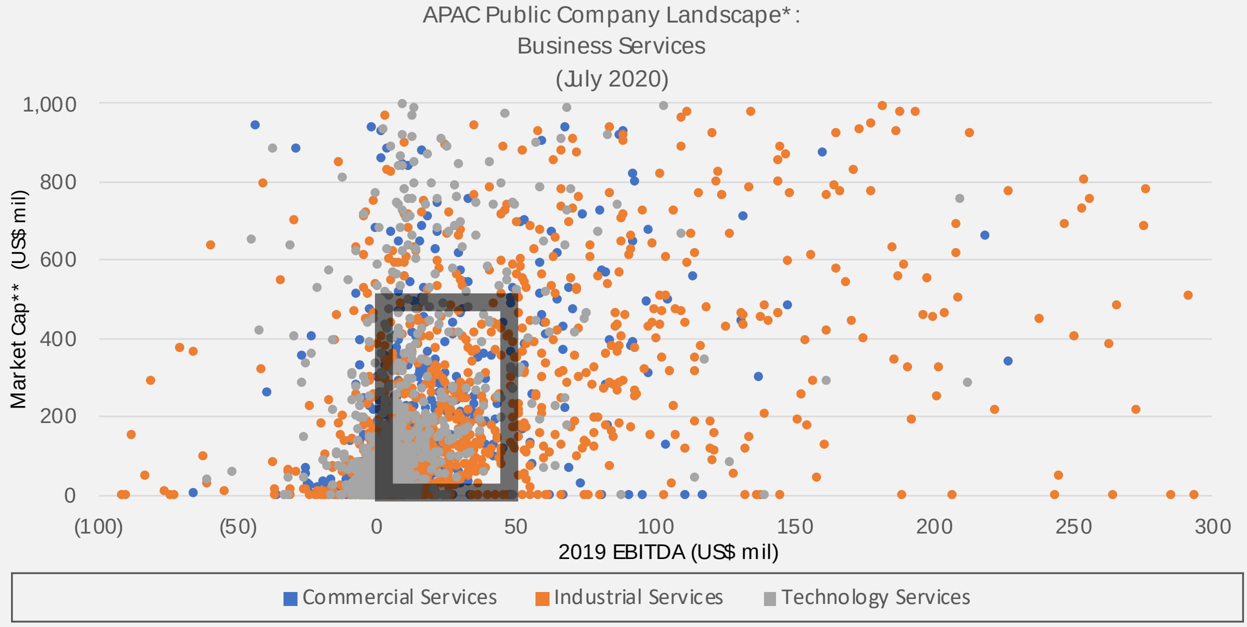
Within Asia, Japan has the most listed companies in the business services space, followed by China, India and South Korea. In terms of market cap, China represents almost half of all public consumer company value in Asia, followed by Japan with around 20% share.



Source: SCP/Asia Research & Analysis

Size matters: addressable target pool

Not all listed companies are suitable candidates for take privates. PE firms have capital to deploy and a minimum deal size is required to make the effort worth their while. At the same time, some of the largest players are out of reach of even the biggest funds.We have banded the players in terms of 2019 EBIDA excluding al players with EBIDTA below US$1m and greater than US$50m. Likewise we have also excluded players with a market cap below US$10m or greater than US$500m.



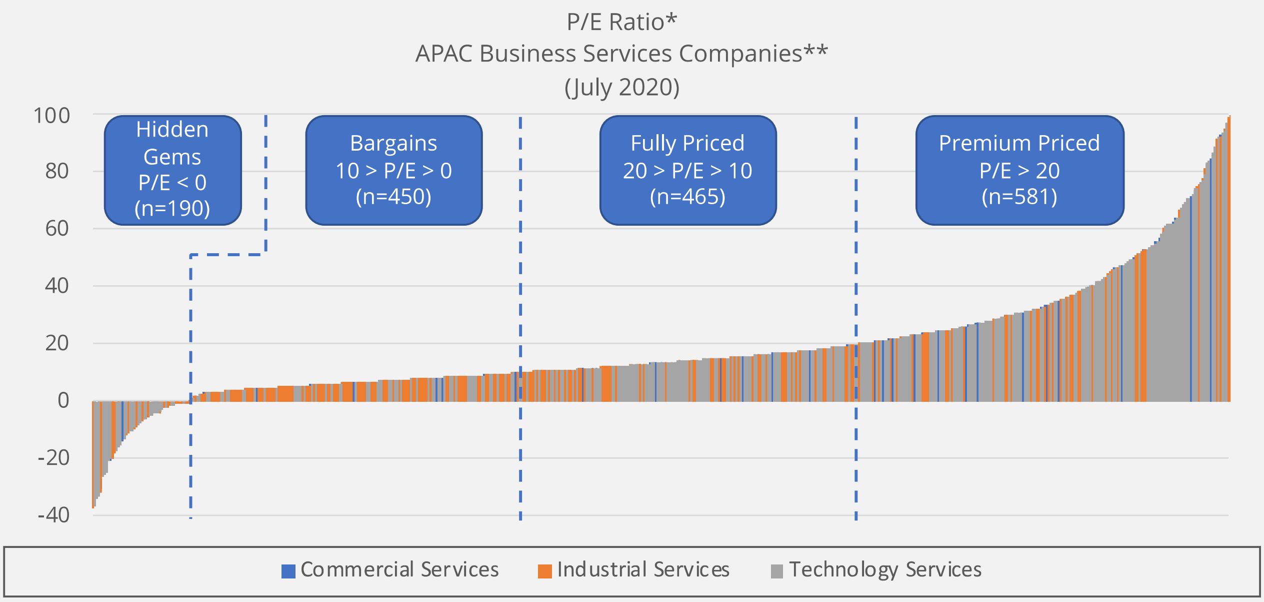
Note * outliers not shown in chart; ** per 18 July 2020
Source: SCP/Asia Research & Analysis

By applying the filters above, we remain with ~1,700 companies that could be potential targets for PIPE or take private deals in Asia; this is around 40% of the total listed consumer companies in Asia. Roughly a third of these has an EBITDA of US$1-5m, which could be a suitable for smaller funds; ~50% of the addressable set has an EBITDA of US$5-20m which puts them in the sweet-spot for a typical mid-cap transaction; the remainder consist of companies with an EBITDA of US$20-50m which takes it into the territory of the larger regional or global funds.

Valuation Rationalisation

With 1,700 companies in the pool, how do we narrow down to a more manageable set? PE's, like most investors, don't like to pay more than the prevailing market rate. Better still, they are looking for value creation opportunities that result in significant exit multiples down the line.

One way to identify candidates for take-privates and PIPE's is to look at the P/E ratio and categorise and filter out players with premium pricing or, potentially, negative P/E rations. We have segmented the pool of companies in four categories based on their P/E ratio.



Note * per 18 July 2020 ** Only shows companies prioritized for take private and PIPE potential based on EBITDA and Market Cap; outliers not shown in chart (P/E > 100 or P/E < -40)

Source: SCP/Asia Research & Analysis

There are 190 companies with negative P/E ratios, meaning negative PAT (but positive at the EBITDA level to be included in our set).

Amongst this group there could be some bargains, companies that are on a path to profitability that is yet to be recognised by the market.

There are 450 companies with a P/E ratio up to 10x. This would be a valuation level that most PE firms would be comfortable with. By paying a 20-30% premium above the market rate, PE's may be able to take private a business and help management focus on managing through the current COVID turbulence and work on a number of strategic initiatives before exiting down the line, hopefully with improved profitability and at a higher rating.

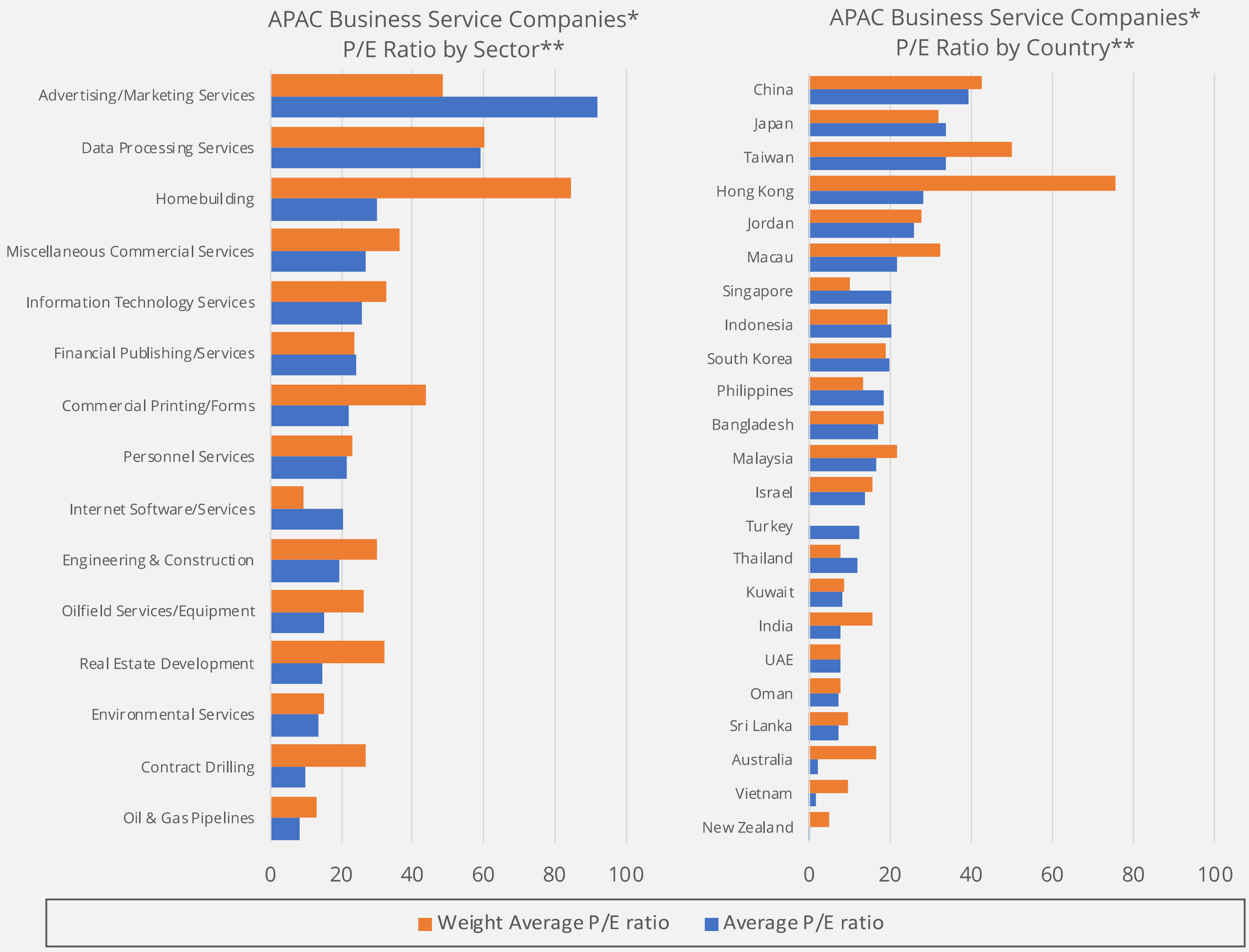
Beyond that, there are 465 companies in the 10-20 P/E range and a further 581 companies with P/E multiples above 20x. The latter group would represent many companies from China and tech oriented businesses with high growth prospects. Not all PE firms will be comfortable backing companies at those valuation levels, but several large players have pivoted their investment focus towards these types of businesses in search for higher returns compared to typical mid-market MBO's in more traditional sectors.

Sector or Country Themes

Many PE investors have clear sector or country mandates for investment. Looking across the landscape we can see clear differences in valuation levels by consumer sub-sector and country.

Advertising and marketing agencies, data processing firms and home builders command the highest valuations. Japanese players like Eole, Kufu, Ceres, Genday, Adways and many others are amongst the highest valued companies in the advertising and marketing services category. Many of these companies have revenues in the US$50-150m and many have seen performance deteriorate over the past year with reporting significant decline in earnings. Valuation have however remained relatively high suggestion optimism for business recovery post-pandemic.

At the lower end of the spectrum we see many oil and gas related businesses including oilfield service providers, contract drilling and oil and gas pipeline operators. The reduction in oil demand as a result of the economic slowdown and the increasing trend toward renewables has put significant pressure on these business and valuations have declined as a result.



Note * Only shows companies prioritized for take private and PIPE potential based on EBITDA and Market Cap; outliers not shown in chart (P/E < 0); ** per 18 July 2020

*Source: SCP/Asia Research & Analysis

China premium less pronounced in business service sectors

The highest valuations are found in China, reflecting the large addressable market and relatively strong growth prospects. But compared to other sectors, the differences in valuations across Asian markets are less pronounced in business services with Japanese and Taiwanese players recording similar valuation levels compared to their Chinese peers. Partly this reflects that many business service players are less easily scalable without adding human resources for service delivery or asset investments. Hence the big China premium that we can see in the China's tech or consumer sectors is less pronounced when we look at business services companies.

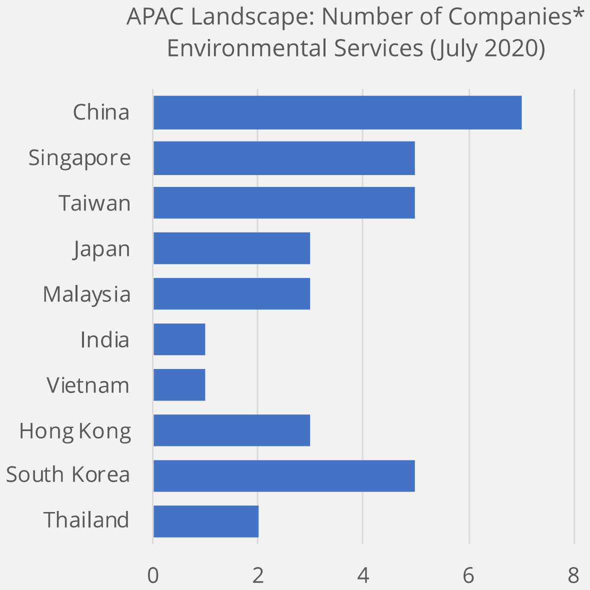
Valuations for business services companies in ANZ, Vietnam and niche market like UAE, Oman and Sri Lanka are relatively low. Vietnam and Australia both have a significant number of listed business service players within the size thresholds for take privates and PIPE's (72 and 64 respectively).

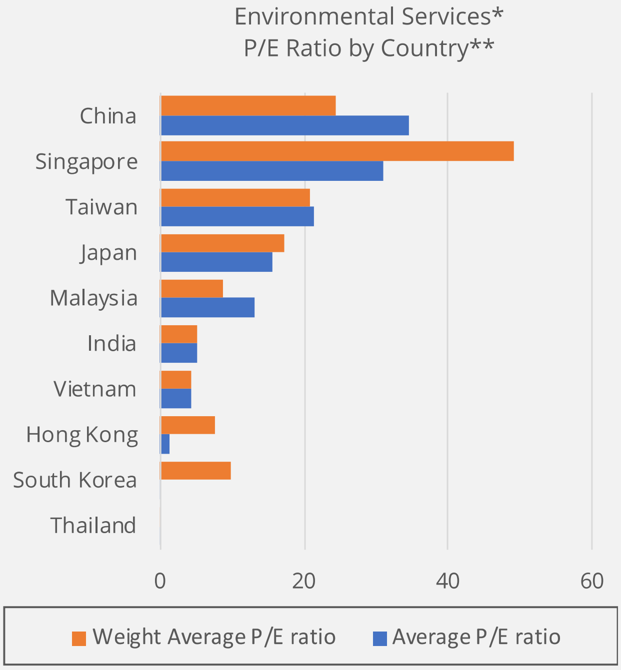
Many of Vietnam's low valuation business service players are in the areas of real estate development and engineering and construction services. Most of the players are relatively small, typically with less than $50m in revenues, and not on the radar screen of many investors. However, recent performance of these companies is often quite good in terms of profitability on profit growth. Investors should consider a look at these payers and the sector is clearly attracting interest with KKR and Temasek leading a $650m deal for a stake in Vinhomes in June this year.

Deep Dive into a Sector

Taking a broad sweep across a sector or country theme is quite meaningless in identifying the right opportunities due to skewed results from outliers. We'd have to deep dive into a specific subsector to get more meaningful results and identify the companies that could potentially be interesting take private targets.

We picked the environmental services category to illustrate a deep dive:





Note * Only shows companies prioritized for take private and PIPE potential based on EBITDA and Market Cap;
** per 18 July 2020; Outliers not shown in chart (P/E < 0)

Source: SCP/Asia Research & Analysis

There are 35 public companies in the environmental services space in APAC suitable for take private or PIPE investment (based on our EBITDA and market cap criteria). Most companies are listed in China, followed by Singapore, Taiwan and South Korea with 5 companies each.

The highest valued companies are in China. Valuations in Malaysia are more reasonable whilst the sole player from Vietnam is valued relatively low.

Let's take a look at the companies in these countries to develop a better understanding of their relative performance and home in on what might be good targets for a take private or PIPE deal. The table below lists a select number of business services companies and summarises several key indicators for each player.

Table: Business Services companies in select APAC countries

			Scale			Performance		Profitability					Valuation		
Company	Country	Latest Reported Year	Sales (USD Mil.)	Mcap. (USD Mil.)	EV (USD Mil.)	Revenue Growth (%)	PAT Growth (%)	GP (%)	EBITDA (%)	EBIT (%)	PBT (%)	RoCE (%)	EV/EBITDA (x)	MarCap/EBITDA (x)	P/E (x)
Zhejiang Feida	China	2019-12-31	490.8	415.9	608.7	(6.8)	3.1	14.6	4.7	8.5	3.1	6.4	14.6	21.3	31.7
Wuxi Xuelang	China	2019-12-31	178.8	325.6	445.5	24.1	7.4	22.8	8.9	12.5	7.4	6.0	19.9	11.2	25.0
Weigang Environmental	China	2019-12-31	77.8	59.3	47.9	7.2	17.0	27.2	15.0	16.2	17.0	14.1	3.8	6.7	6.1
TIL Enviro Ltd.	China	2019-12-31	65.8	63.9	141.9	4.7	26.3	33.2	29.5	30.2	26.3	8.0	7.1	3.4	4.6
ELL Environmental Holdings Ltd.	China	2019-12-31	9.9	16.3	12.8	(2.0)	22.0	42.9	14.2	20.1	22.0	2.6	6.5	7.1	131.5
Cscec Scimee Sci. & Tech. Co., Ltd	China	2019-12-31	176.4	439.0	508.0	(0.4)	15.2	39.3	15.5	24.0	15.2	9.0	12.0	6.5	19.4
Anhui Zhonghuan	China	2019-12-31	93.6	330.0	480.3	60.4	18.5	28.9	21.8	23.1	18.5	7.8	22.2	4.6	23.5
Tex Cycle Technology (M) Bhd.	Malaysia	2019-12-31	7.4	23.8	19.4	(19.7)	24.2	59.1	15.5	26.7	24.2	4.0	9.8	6.5	19.8
Cypark Resources Bhd.	Malaysia	2019-10-31	90.9	110.8	267.5	8.2	31.5	36.0	33.5	38.0	31.5	7.1	7.7	3.0	5.0
Brite-Tech Bhd.	Malaysia	2019-12-31	6.7	21.0	22.6	1.9	25.7	45.9	22.9	28.5	25.7	7.4	11.8	4.4	14.9
Thong Nhat JSC	Vietnam	2019-12-31	7.9	15.0	0.7	166.4	56.0	57.4	47.1	53.3	56.0	13.9	0.2	2.1	4.3

Source: SCP/Asia Research & Analysis

Zhejiang Feida Environmental Science & Technology and **Wuxi Xuelang Environmental Technology Co., Ltd.** are relatively larger players from China with P/E ratios of 31.7x and 25.0x respectively. Heritage of both companies is in equipment manufacturing (e.g. flue gas desuperization, dust collectors, etc) and both have branched into provision of environmental services benefitting from significant investment in environmental protection in China and around the world. But with still a significant share of revenue dependent on capital cycles, these business may not be in the sweets pot for companies looking for predictable cash flows from business service plays.

Cypak Resources is Malaysian based business with a good recent growth and profitability record. With EBITDA margin of 33.5% and

ROCE% of 7.1% the companies P/E appears relatively low at 5.0. The company is engaged in environmental engineering, landscaping and infrastructure, maintenance and renewable energy and the provision of management services. What explains Cypark's low valuation? The share price is down 43% in the last three years, falling well short of the market decline of around 1.8%, and despite managing to grow EPS by 15% per year in that time. This is quite a puzzle, and suggests there might be something temporarily buoying the share price. Given the healthiness of dividend payments and Cypark's ability to grow revenue over the last three years, there may be an opportunity here for investors for a take private or PIPE.

Scrolling further down the list we see **Thong Nhat** from Vietnam, with a P/E multiple of only 4.3, one of the lowest valued companies in the peer group. On first glance the performance of the company seems quite strong with good revenue and profit growth last year and high profitability. The company is engaged in the development of industrial zones infrastructure, the leasing of vacant land lots and manufacturing facilities in the Bau Xeo industrial park, as well as the provision of support activities to its tenants, such as clean water supply, waste collection and sewage treatment.

Beyond the Crunch

The examples above shows that a process of 'database screening' focussed on sector and/or country themes combined with a bottom up assessment, company by company, can yield some interesting ideas for potential take-private or PIPE opportunities. In the current environment, with travel restrictions severely hindering the due diligence process, this may well be a path to pursue for many PE's looking to deploy capital.

The search for suitable candidates can be finetuned beyond the process described above. Examples of additional analyses include:

- Looking at revenue and EBITDA growth over time to understand management track record
- Looking at P/E over time to understand sudden valuation shocks caused by the pandemic and whether this creates take-private arbitrage opportunities
- A review of analyst outlook for the company to the extend available
- Benchmarking of profitability and operational performance against peers

- Looking at the ownership structure of the business in terms of the free float and private shareholders to make an assessment of the potential complexity of a take private effort

Once a couple of take private candidates have been prioritised there is much that can be done in terms of critical due diligence without necessarily getting access to management:

- Detailed analysis of audited financial and investor presentations to understand the performance of the business;
- Map out the business strategy based on management announcements and 'facts on the ground' (i.e. products / brand launches, store openings, etc);
- Interviews with customers to understand purchasing process, key trends and perspectives on the target versus competitors in the market;
- Interviews with industry experts and stakeholders in the value chain to understand the industry dynamics and which players are the winners and losers in the industry;
- Desktop analysis and modelling of market demand outlook, potentially by relevant geography, market segment and/or channel to assess the outlook of the business based on the market outlook and economic cycle;
- Analysis of competitive landscape. Which players appear to be the winners in the industry? How is the target positioned?

Take privates and PIPE's will likely become a more regular feature in the PE deal headlines in the coming 6-12 months. With face-to-face due diligence significantly hampered due to the ongoing travel restrictions, take-privates and PIPE's can partially help fil the void for PE's eager to get back onto the deal-making track.

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