

Opportunities for Pacific Alliance grow from China's mispricings

Focusing on the benefits to be had from the rapid transformation of China's markets, Gradel and Geicke have launched the Pacific Alliance Asia Opportunity Fund

On 21 September, a low profile Asia-based investment group launched its flagship product, Pacific Alliance Asia Opportunity Fund, on London's AIM market. The fund began trading with \$275 million and immediately shot up to a 10% premium.

Those close to the market would have recognised Pacific Alliance Group as the name behind two other AIM closed-end fund launches earlier this year: VinaLand, which invests in Vietnamese property, and ARC Capital Holdings, which does private equity deals in China's booming retail and consumer sector.



Chris Gradel and Horst Geicke

The group's first AIM-listed fund, the Vietnam Opportunity Fund, has returned about 30% a year since inception in September 2003, according to Pacific Alliance managing director Chris Gradel.

The choice to use a listed vehicle was driven by the group's investors - mainly hedge funds, funds of hedge funds and high-net-worth individuals. AIM was chosen rather than Ireland or Luxembourg mainly because of the market's higher liquidity. Until recently, the Vietnam Opportunity Fund was more liquid than the entire Vietnam stock market, Gradel notes.

As well as choosing a market for liquidity, the funds have built-in discount protection measures, such as share buyback programmes and attractive distribution policies (the Pacific Alliance Asia Opportunity Fund will pay an 8% dividend).

Overall, Pacific Alliance manages \$1.2 billion, primarily in private deals in the growing markets of China and Vietnam. The group has some 30 staff across offices in Hong Kong, Shanghai and Shenzhen, and 70 more in Ho Chi Minh City and Hanoi (30 of whom work on real estate) to manage its \$500 million Vietnamese portfolios.

The group's core philosophy is to buy assets at a discount, largely in the private arena, although it also targets deep value and activist opportunities in listed stocks. The new Asia Opportunity fund follows this value-driven approach, but with a hybrid focus on private equity and opportunities that arise from mispricings in China's fast-developing and inefficient markets. "It is more of a hedge fund mentality," Gradel says. "However, most of the deals will still be off-market."

The new fund has a target IRR of more than 25% and is launched on the back of strong returns for two private vehicles with similar strategies. Pacific Alliance I was invested between August 2002 and September 2004 and generated a net IRR after all fees of more than 60%. Pacific Alliance II, launched in August 2005, has returned more than 35% on \$185 million of invested capital in its first year.

Another attraction for investors is that returns are uncorrelated with global markets. Pacific Alliance II rose 14% in May and 10% in June, when most Asia funds struggled in difficult markets.

Pacific Alliance Group was founded in 2002 by Gradel and Horst Geicke, an entrepreneur who has 22 years' experience in the Asia-Pacific and a string of high-level appointments, including president of the European Chamber of Commerce in Hong Kong, a director of the German Chamber of Commerce in Vietnam, and adviser to the Hong Kong Government.

Gradel began his career with the Pritzker family (who own the Hyatt hotel chain) after graduating from Oxford University with a joint masters in engineering, economics and management. The Pritzkers sent him to China, where he made several investments for their Marmon Group holding company in the mid-1990s, including a buyout of a state-owned company. Gradel says the experience gave him "lots of headaches" but was very influential in teaching him how to do business in China, especially in working with the Chinese authorities.

Gradel then went to work with multi-strategy fund Millennium Partners in New York, and then joined McKinsey in Hong Kong for three years.

This was when he met Geicke. He was keen to get back into investing. "We shared some ideas and decided to join forces," he says. Pacific Alliance began by investing Geicke's private capital, along with some capital provided by Millennium.

Their initial focus was restructuring underperforming closed-end funds in Asia, which was Millennium's strategy at the time. "Then we became more active and got into stickier situations where on-the-ground knowledge was more valuable," Gradel says.

"Our core strategy has not changed since then," he notes. "We are looking at where we can buy assets at a discount because of factors such as distress, liquidity constraints, regulatory change or poor governance. We see these drivers of discounts in abundance in the region."

They soon began to look at Vietnam, where Geicke has a factory and close relationships in the business community. Vietnam was very similar to China in the mid-1990s in terms of GDP per head, retail opportunities, capital markets, a fledgling mortgage market and state-industry privatisations, Gradel notes. They also found "incredibly low valuations because absolutely nobody was interested in the country".

The result was the Vietnam Opportunity Fund, which was seeded in September 2003 with \$9.5 million by Pacific Alliance, Millennium, Hong Kong-based Sun Wah Group and Deutsche Securities, and has since grown to \$312 million.

The fund is managed by affiliate company VinaCapital Group, founded by Geicke, Gradel and Don Lam, its managing partner, who has day-to-day management responsibility. It invests in pre-IPOs, privatisations and listed companies, as well as private equity and real estate.

Property became such a large part of the fund that in March 2006 the group launched an AIM-listed dedicated real-estate fund, VinaLand, which now has \$217 million in assets and is also managed by VinaCapital.

The fund invests mainly in city centre developments in Vietnam. "We are buying existing buildings where they are available, but there is little stock, so we also have to take development risk," Gradel says. The group's flagship development to date has been a mixed-use building containing Vietnam's first shopping mall, whose anchor tenant is a major department store. "With the possible exception of India, there is probably no market with such an imbalance of supply and demand for real estate," Gradel notes.

Geicke's contacts are key to developing these opportunities. The fund's directors include Nicholas Brooke, former head of Swire Properties, who also advises the Hong Kong government, and NK Tong, son of Malaysia's 'condo king', who also runs his own property company.

"We have tried to bring in as much experience as possible," Gradel says.

In contrast with the Vietnam funds, where returns are driven by the country's economic growth, the Pacific Alliance Asia Opportunity Fund is looking for asset mispricings caused by China's rapid transformation. Gradel is reluctant to disclose details of deals, but says that the average deal size is \$10-\$20 million. "That's our sweet spot," he says.

He sees no reason why the window of opportunity for Pacific Alliance should close in the foreseeable future. As long as the drivers behind asset mispricings remain in place, so will the opportunities, he says. And although competition for deals will inevitably increase, the market is large enough to absorb it. "The amount of capital we are putting to work is a drop in the ocean," he says.

In any case, hedge funds are more likely to invest with Pacific Alliance than compete for deals given that the opportunities require intensive work to execute. Hedge funds, mainly US-based, and funds of funds, mainly European and Asian, account for roughly 40% of group assets. High-net-worth individuals (mainly private banks and family offices) account for the rest.

A potential cloud on the horizon could be the hardening attitude of the Chinese authorities. "The government is making it harder to invest in the country. Well-publicised groups are having difficulty getting government approval," Gradel says.

Pacific Alliance affiliate ARC Capital Partners, headed by Rachel Chiang, focuses on private equity in China's fast-growing retail sector. ARC Capital Holdings, with \$120 million in assets, was listed on AIM in June 2006.

Earlier this year, Pacific Alliance acquired Chinese baby product manufacturer Goodbaby for \$122.5 million. The deal received broad press coverage for being the first 'classic' LBO deal in mainland China, following a change in the regulations. ARC and Pacific Alliance II were co-investors.

But Gradel says that China is "nervous about selling off the family silver too cheaply and losing control". In the retail sector, local operators have lobbied against the arrival of Wal-Mart, and the local authorities' tendency to give preferential treatment to brand-name companies.

Pacific Alliance's answer is to keep a low profile, avoid anything politically sensitive and, where possible, work with local authorities. "That has been my biggest lesson from the mid-1990s," Gradel says. "Alignment of interest with stakeholders is absolutely key in an environment where regulations are changing constantly and the courts can't always protect you."

CHRIS GRADEL: CV

Title: Co-founder, managing partner and group chief investment officer

Education: Joint Master in engineering, economics and management, Oxford University.

Career: Co-founder of Pacific Alliance, VinaCapital and ARC Capital China.

Former engagement manager with McKinsey in Hong Kong.

Broad M&A experience, including transactions in Hong Kong, China, Taiwan, Singapore, Indonesia, Germany and the US.

Invested/managed three firms in China for Pritzker family including set-up of green-field manufacturing plant and take-over and re-organising of an SOE.

HORST GEICKE: CV

Title: Co-founder and chairman

Education: MA in economics and business law, University of Hamburg.

Career: Co-founder of Pacific Alliance, VinaCapital and ARC Capital China. Built up own manufacturing and trading business with factories in China and Vietnam.

Former president, German Chamber of Commerce, Hong Kong.

Past chairman, European Chamber of Commerce, Hong Kong.

Founding member and director of Hong Kong - Thailand and Hong Kong - Vietnam Business Councils.