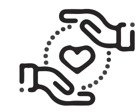
PE impact investors should target SMEs

BY **TAN ZHAI YUN**

The firm's five focus areas

Agri-food	Climate change	Water and circular economy	Affordable healthcare	Affordable education
				
Food safety and traceability, organic food, plant-based diet, sustainable farming and aquaculture	Access to clean energy, energy efficiency, emission reduction solutions for industries and transport, sustainable buildings and climate resilience	Access to clean water and sanitation, water and material recycling, waste management, waste-to-energy, biomass and bio-gas solutions and innovation in material and packaging	Access to affordable healthcare, preventive healthcare, innovation in clinical trials and homecare monitoring platforms	Access to affordable education, education technology, mobile learning and inquiry-based learning

Private equity (PE) impact investors should look at small and medium enterprises (SMEs) in Southeast Asia as these companies are ready to embrace sustainability practices and are able to have a direct impact on society, according to Jupiter Impact Partners Pte Ltd.

The impact investing landscape in Southeast Asia is currently dominated by development financial institutions (DFI) such as the International Finance Corporation (IFC) and Asian Development Bank. Although they also invest in the SME segment, they tend to invest in less-developed markets, fewer sectors and have bigger deal sizes. At the other end are angel investors and venture capital funds that invest in start-ups.

"The other investors are taking a sector-based approach by looking at the microfinance or technology sectors. They are looking for the next unicorn. A lot of funding is skewed towards those sectors and big deal sizes. So, that leaves a funding gap for SMEs [companies with sales of between US$5 million and US$40 million]," Han Wan Hoon, head of research at the Singapore-based impact investing PE firm, tells *Personal Wealth*.

Han and co-founder Yap Kian Woon recently spoke at an event organised by Malayan Banking Bhd and Bursa Malaysia called "The evolution of ESG investing".

A 2018 report by the Global Impact Investing Network had similar findings. From 2007 to 2017, impact capital deployed by DFIs stood at US$11.2 billion, compared with US$904 million by private impact investors (PII). The average deal size by PIIs in the eight major markets in Southeast Asia was US$6.9 million while that of most DFI deals was more than US$100 million.

There is a concentration of investments in a few sectors such as financial services and energy. Agriculture and micro-SMEs are two areas with high potential in the region.

"We looked at the whole industry and found pockets of small funds [typically with assets under management of less than US$30 million] that started as non-governmental organisations before becoming impact funds. Then, you have the very big PE firms such as KKR and TPG Capital, which cover the globe and may not have a local team. We are right in the middle, targeting mid-sized impact investing deals of between US$10 million and US$20 million, in a few sectors," says Yap.

Jupiter Impact Partners focuses on four areas — agribusiness and food, circular economy and water, climate change mitigation, and healthcare and education. Its investments in the last two areas are targeted at companies that make their services affordable and accessible. Interestingly, many start-ups are emerging in these four sectors.

"Investing in start-ups may sound more interesting, but the failure rate is very high. It is not organic growth because they do not have a core business yet. We like companies that have been around for some time," says Yap.

"An example of a deal in our pipeline is a vertically integrated poultry farm-to-table business in Vietnam. The CEO can run the business successfully because he had worked in the industry as a senior professional for multinational corporations for many years before starting his own business. He can identify market trends and gaps."

The farmer also knew about the demand for traceability in the meat industry, so consumers can be assured of the quality of their food, says Han. "He knew about the need to reduce [the use of] growth hormones and antibiotics [so he decided to change the way he was doing things]. We like these companies that have deep knowledge of their core business and are adapting to the new economy, which give them a higher chance of success."

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> > ***Han***

These SMEs want to change because they realise consumers are demanding sustainable practices. The impact of climate change is also felt by all parties in the form of unpredictable weather changes, for instance.

Han — who has more than 20 years of investing experience, having worked at a brokerage, asset management and hedge fund management company — points out that this investment thesis could not have worked five years ago due to a lack of awareness among consumers.

Meanwhile, some may say SMEs in Asia have traditional business models and are averse to change. That may have been true in the past, but the new generation of entrepreneurs is different, says Yap, who has a background in venture capital and PE.

"A sufficient number of businesses have been built in the region. So now, we have a batch of entrepreneurs in their late thirties to fifties. They have been trained by multinational corporations, are knowledgeable and are educated. We are looking for such people — professionals turned entrepreneurs," he adds.

"We prefer to partner them than family-owned businesses that are usually controlled by one person. Typically, this group of people come together to do something different. They are more open and transparent. Based on a lot of the deals that we look at, SMEs are not necessarily the creator of technology but they know how to tweak and apply the technology."

Yap and Han believe that SMEs can play a huge part in impact investing because they are able to create more jobs than a typical start-up. "SME businesses are expanding and are able to hire more people. So, the dollar per impact

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ple do not do this. We do not know the core of the business when we invest in its shares."

Chang provides another example. Last year, he bought Facebook shares at the height of the company's data privacy scandal and the investment gave him a good return. "I bought the shares when the price went down because of the scandal. I knew that it would be a temporary situation because in the end, the company's value and business remained intact," he says.

"The market almost always overreacts when there is bad news. So, I tend to buy shares at such times."

Chang describes himself as a value investor with a relatively conservative risk profile. He avoids alternative investments such as cryptocurrencies. But when he does take risks, it is often in a calculated manner.

"If I understand something really well, I will invest quite a lot of money in it. But if I do not, then I will stay away. I am already taking risks by being a start-up founder," Chang laughs.

MANAGING WEALTH AS A START-UP FOUNDER

After excelling in his A-Levels, Chang received a full scholarship to pursue an integrated master's degree in engineering, which takes four years at the University of Oxford, three of which are for a bachelor's degree. He was given £10,000 a year for expenses.

During his second year, at end-2017, he was inspired by the popular augmented reality mobile game Pokémon Go to create JomRun. Both are mobile applications that incentivise their users to go out and be less sedentary.

While Chang understands the transient nature of app or gaming trends, he had conviction in JomRun's sustainability because of his passion for sports. As a regular runner and former windsurfing representative of the University of Oxford, he aspired to build a tech business that encouraged people to be more active and healthy.

To pursue this dream, however, Chang had to choose between completing his master's degree and developing an app because the university prohibits students from managing a business while pursuing their studies. "I had already received an undergraduate degree after my third year and I was not bound by the scholarship to complete the whole course, unlike students under other scholarships," he says.

"I did not use a single sen from my parents. Even though they would have preferred that I finished my master's degree, I was not pressured into doing that. I told them I no longer liked what I was studying. In the end, they were quite supportive of my decision to start a company."

Chang needed capital to get JomRun off the ground. So, he developed what he describes as a "hardcore saving habit". "I lived in a store room and spent less than 30% of my total scholarship every year. By the second year, I had about £14,000 in savings, as well as some income from my part-time job," he says.

"I used the money to invest in stocks. I am an aggressive investor when I understand what I am investing in. So, I put everything into stocks.

"At the time, I knew that I could live my life like the other students on scholarships. But seeing as I had saved up all that money, the worst thing that could happen was to lose all of it.

"But even then, I could still get a job and earn more. Thankfully, most of my investments did quite well. In fact, some of these gave me great returns and helped me fund my start-up journey."

After developing the proof-of-concept for JomRun, Chang had to close deals with potential collaborators. He found it challenging to make successful pitches because not only did the company owners not take him seriously due to his age but also the app was not live on any mobile app store yet.

"Before I moved back to Malaysia, I had to make cold calls starting at 3am everyday in the UK due to the time difference. But it was difficult to close a deal because the app had no traction yet. I had to do this for two months before I closed my first deal," he recalls.

Chang says if he had not decided to build JomRun, he would still have been an active stock investor. "But it is a bit difficult at the moment because it feels like I am investing in something bigger because it is my own company."

While Chang thinks that investing early on in life is all well and good, he emphasises the importance of managing one's personal finances, especially when it comes to growing one's savings. He has his parents — both accountants — to thank for instilling in him the importance of budgeting. When he was a primary school pupil, his parents would only give him pocket money if he tracked his spending at school.

"They told me to jot down each transaction. But at the time, I disagreed with them and was lazy so I did not do it properly. But growing up, I realised the importance of that habit. I started to cultivate it during my university years because I was receiving scholarship money, which meant I had to be more careful with my expenditures," says Chang.

He says being a start-up founder — especially one who is currently scaling up — has changed the way he looks at money and expenditure. Previously, he would choose a more cost-efficient way of doing things even if it meant taking more time. But now, he is willing to fork out more money in exchange for time to do more important things.

"I tend to link money with time — money is time and vice versa. When I was a student, I would take the bus to save money. But now, I take a taxi or Grab because attending meetings on time is more important than the RM15 I spent on the fare," says Chang

"Another thing is that I no longer actively research and look for stocks to buy like I did before I started JomRun. I focus on [building] the company instead, which means I deal with more risks now. So, I just monitor my existing investments and build up my savings."

While Chang believes in the power of compounding interest and the benefits of investing as early as possible, he says it is more important that young working professionals lead a financially sustainable lifestyle before committing to more investments. "It is good to put money in investments to learn. But if we do it thinking we can get very rich just by investing and not relying on a day job, that is not a good thing. Some people spend a lot of time reading all the books on investing, but never care to work hard in their career or studies," he says.

"What they do not realise is that stocks are essentially companies. So, if you never spend any time working at a company, how would you know how it operates? I think it is important to experience working in companies to become a better investor." E

Food security a key driver

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is higher. They accounted for about 70% of the jobs created and contributed almost 50% to GDP in Singapore [in 2018], for example," says Han.

INVESTMENT THEMES DRIVEN BY DEMAND

Of the five areas the firm targets, agribusiness and food is the one they believe has the most potential, followed by circular economy and climate change mitigation.

The number of SMEs in the agribusiness and food industry is huge. It includes food producers, agriculture technology providers, farm management tool providers and those processing and distributing food.

One of the SMEs the firm is interested in is a Malaysian organic farm that applies circular economy principles by using black soldier flies to manage industrial food waste. The flies become feed for chickens, replacing commercial grain-based feed, which has been blamed for causing deforestation globally.

"There is also a company that produces custom-made fertilisers that do not dissolve in water immediately and are, therefore, wasted. Instead, they can be slowly released, which reduces wastage and boosts the growth of crops," says Yap.

"There are people who are establishing smart farms by using the Internet of Things. Another category of companies are those creating food substitutes such as Beyond Meat in the US. But there are not many of these in Malaysia."

A major driver of innovation in this sector is food security. This is especially true in Singapore, where the government has been pushing for solutions that can reduce the country's reliance on food imports.

"The government is giving a lot of subsidies, incentives and land allocation to incentivise people to get into agriculture, such as indoor farming in a controlled environment. [By doing so,] you can reduce the carbon footprint from importing food and shorten the time from farm to table. I think that is also a big business," says Han.

Some of the companies in these areas are bound to grow. Han cites aquaculture farms in Singapore as an example. "They are small now and have no scale, so the profitability is not there. But the Singapore government is encouraging [their growth] and land is scarce. This will accelerate the consolidation of those companies. It is all about timing," she says.

Climate change mitigation solutions include companies that create micro-grids, which allow for distribution of energy independent of the main power grid. It is often used by renewable energy producers.

Some companies in this area create efficient power management systems. "One company fixed the chiller in an air-conditioning system so that it consumes 30% to 40% less energy than a typical system," says Yap.

For some of the focus areas, the investable universe is big enough, they say. But deals are harder to find in the education and healthcare space. "It is true that it is harder to find commercially high-return opportunities in those two sectors, which also provide accessibility and affordability," says Yap.

NEW FUND TO CAPTURE OPPORTUNITIES

Jupiter Impact Partners was founded earlier this year. Co-founder and managing partner Melissa Kang was previously ESG officer of Morgan Stanley's global impact fund and principal investment officer and regional lead for East Asia-Pacific at IFC.

The PE firm is currently raising money for its first fund, which it aims to close by year end. Han and Yap say the firm already has a pipeline of investors and about US$400 million worth of deals, the majority of which are in Southeast Asia. A few of the companies are in China, but they have business models that can be replicated in the region.

The top-quartile PE firms in Southeast Asia deliver a net internal rate of return (IRR) of about 15%, according to Yap, and Jupiter Impact Partners aims to achieve a similar return.

By looking at the historical data of IFC, Yap and Han are confident the firm's investments will generate good returns. According to reports by IFC and the Organisation for Economic Cooperation and Development, IFC's private equity investments saw returns of 14% to 23% from 2000 to 2011.

"A lot of these development funds actually provide very good returns. It is just about having the right timing and opportunities," says Yap. E