

# VANCOUVER 2011

## Due Diligence in Emerging Markets

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# Structure of the Presentation

- Introduction to IFC & OPIC
- Macro Opportunities and Managing Risk in EM PE
- IFC Approach to Due Diligence
- OPIC Approach to Manager Selection

# Introduction to IFC and OPIC



# Introduction

- IFC & OPIC invest only in emerging markets and have been investing in emerging market private equity for over a decade.
- Both organizations have development mandates which require them to invest 'ahead of the pack' in both new countries and new GPs.
- Not everything about our investment approach will suit institutional investors. We will explain what we do and why we do it with enough clarity for you to select which parts work for you and which do not.

# IFC – Brief Overview

- 180 funds in portfolio, all in Emerging Markets
- \$3 billion of commitments, \$1.5 billion called and outstanding
- Annually commit around \$400 million to 20 funds
- 70%+ 1<sup>st</sup> time funds
- Geographic exposure very different to Cambridge Index. e.g. Asia 35% vs 70%, Africa 16% vs 3%
- Early entrant to markets and leave as supply of commercial capital rises

## Performance:

IRR from 2000 to...	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10
<b>IFC: Private Equity Funds*</b>	22.9%	15.6%	14.4%	15.3%	17.0%	18.1%	20.1%	19.5%	18.8%
<b>IFC: All Funds (includes debt, real estate, etc)</b>	19.8%	12.3%	11.4%	13.0%	14.1%	15.0%	15.7%	15.3%	14.9%
<b>Cambridge EM Top Quartile</b>	16.9%	10.7%	9.4%	10.3%	12.7%	16.2%	16.8%	14.1%	17.0%
<b>Cambridge Asia ex-Japan Top Quartile</b>	14.9%	10.6%	6.6%	8.5%	9.0%	14.5%	15.5%	13.7%	17.0%
<b>Cambridge US PE Top Quartile</b>	19.5%	14.2%	12.0%	12.2%	16.0%	14.1%	13.9%	14.1%	15.5%
<b>MSCI (IFC PE Fund cash flows) **</b>	8.8%	1.8%	-1.1%	7.7%	12.1%	13.4%	13.1%	9.6%	13.3%

Source: \* All *Private Equity* funds invested by IFC since 2000, calendar year. Excludes debt, infrastructure & real estate funds.

\*\* Matching cash flows to IFC Private Equity Funds invested/divested from MSCI.

Cambridge Numbers from Cambridge Associates.

# OPIC: Introduction

As the U.S. Government's development finance institution, OPIC mobilizes U. S. private capital to help solve critical development challenges and in doing so, advances U.S. foreign policy..

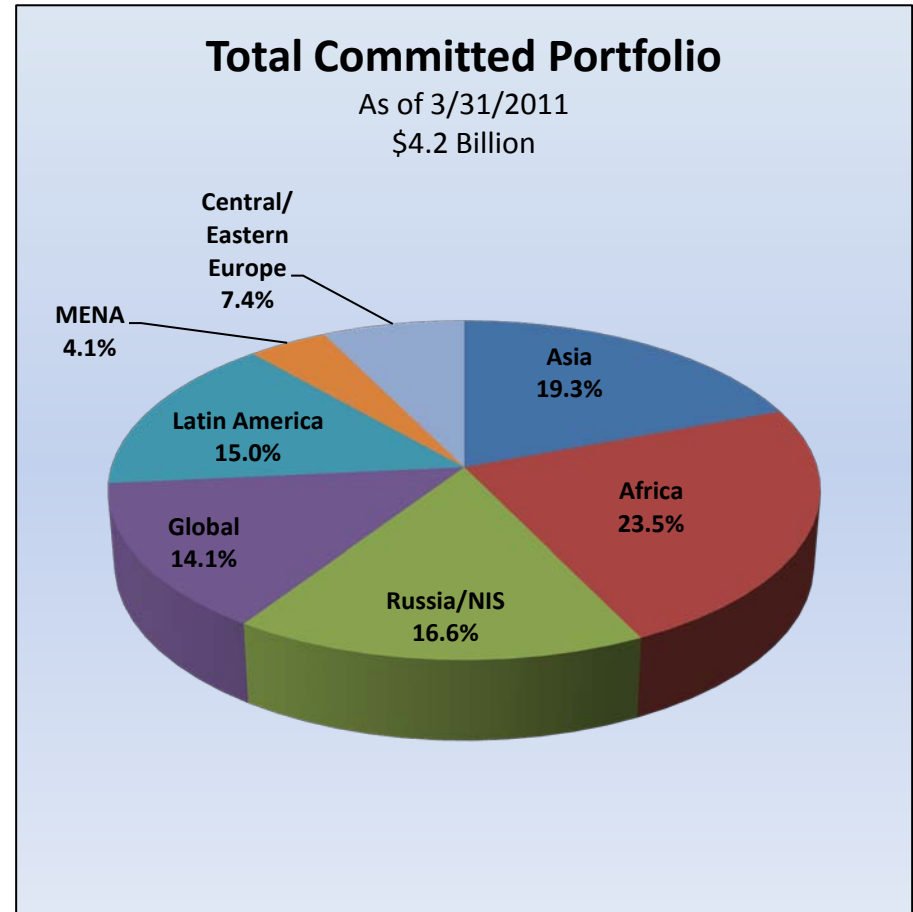


- Shading denotes
- OPIC-eligible countries

*OPIC currently manages a \$13.4B portfolio of projects in over 150 countries and operates on a self-sustaining basis at no net cost to the American taxpayer.*

# OPIC Funds Program- Brief Overview

- One of first and largest emerging markets PE sponsors
  - Committed to first fund in 1987 (Africa Growth Fund)
- Since 1987, OPIC committed \$4.2B+ to 57 funds which provided capital to 450+ companies
- Helped mobilize \$10B+ of equity capital in emerging markets
- ~1/3 of OPIC commitments were made to first-time fund managers
  - Bedminster
  - Global Environment Fund
  - Helios
  - Siguler Guff
- Leader in developing ESG best practices

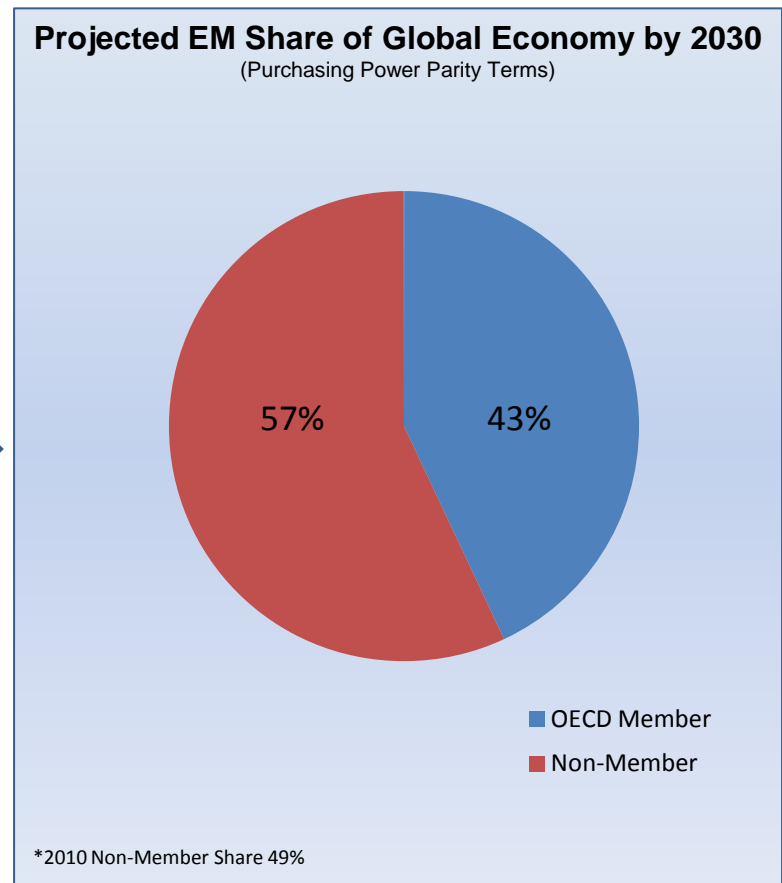
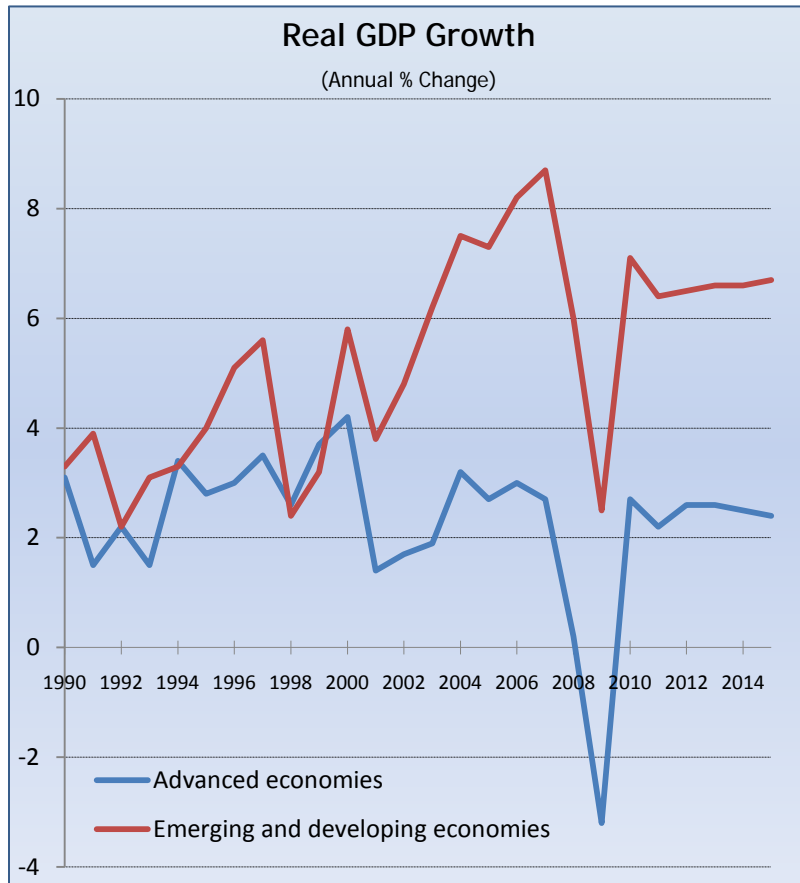


# Macro Opportunities and Managing Risk in Emerging Markets PE



# The Growing Significance of Emerging Markets

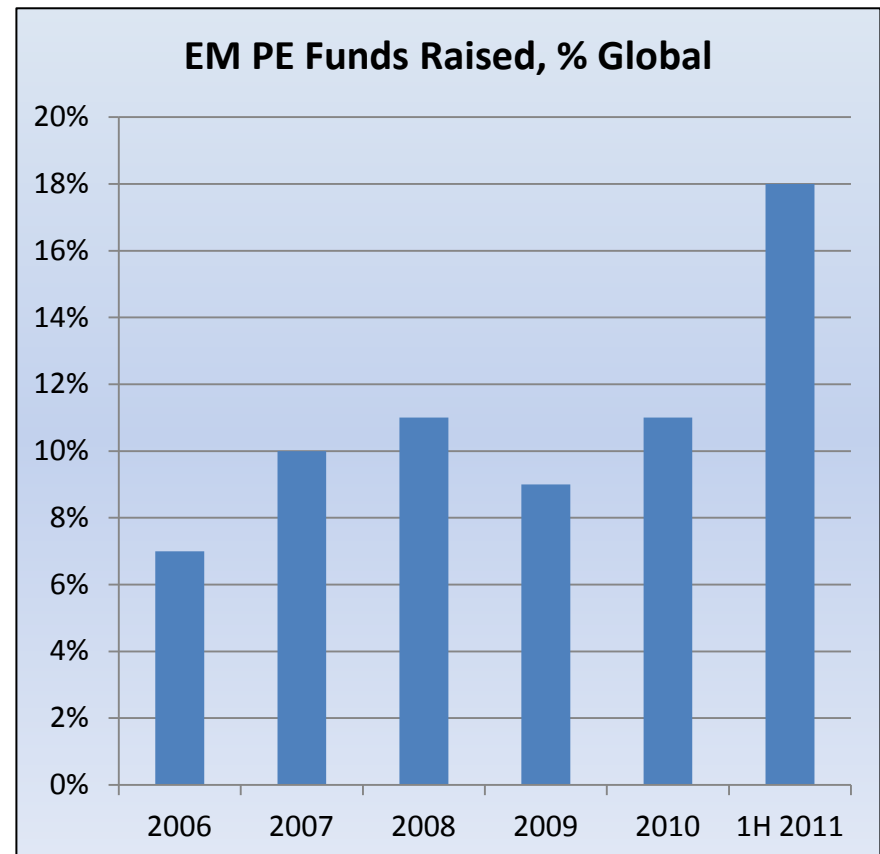
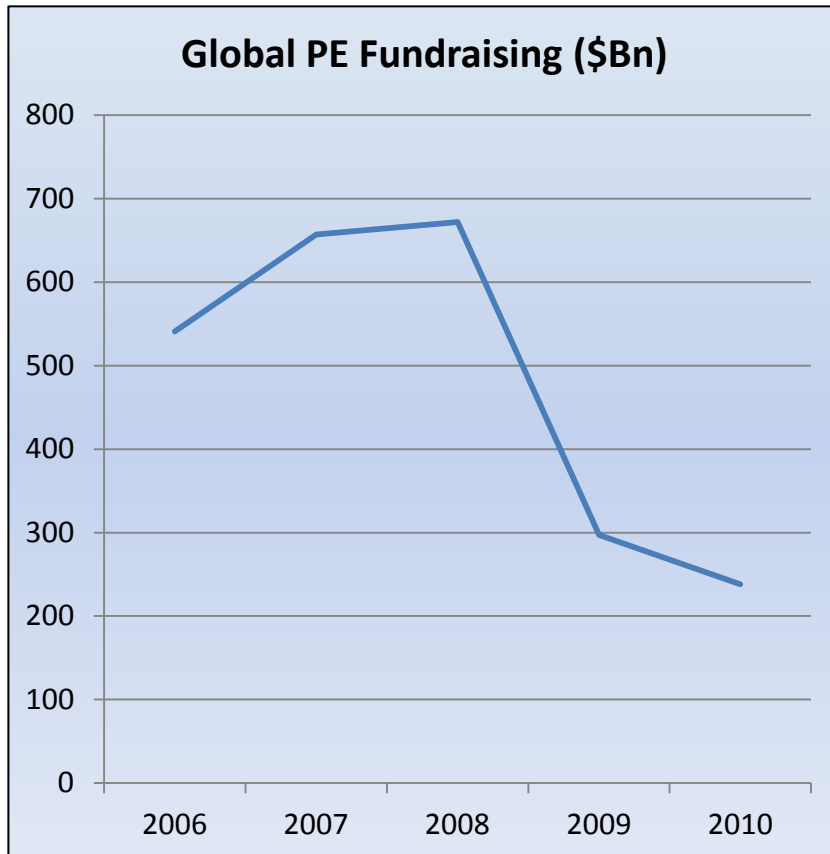
Continued Growth Outperformance to Translate to Larger Slice of Global Pie



# EM Private Equity Has Been Big Recipient of Growth

While PE Fundraising Has Slowed Globally....

EM Funds Raised as % of Global Total Continues to Grow



Source: EMPEA & Preqin

In 2010, China and India accounted for 26% & 11% of EM PE fundraising, respectively

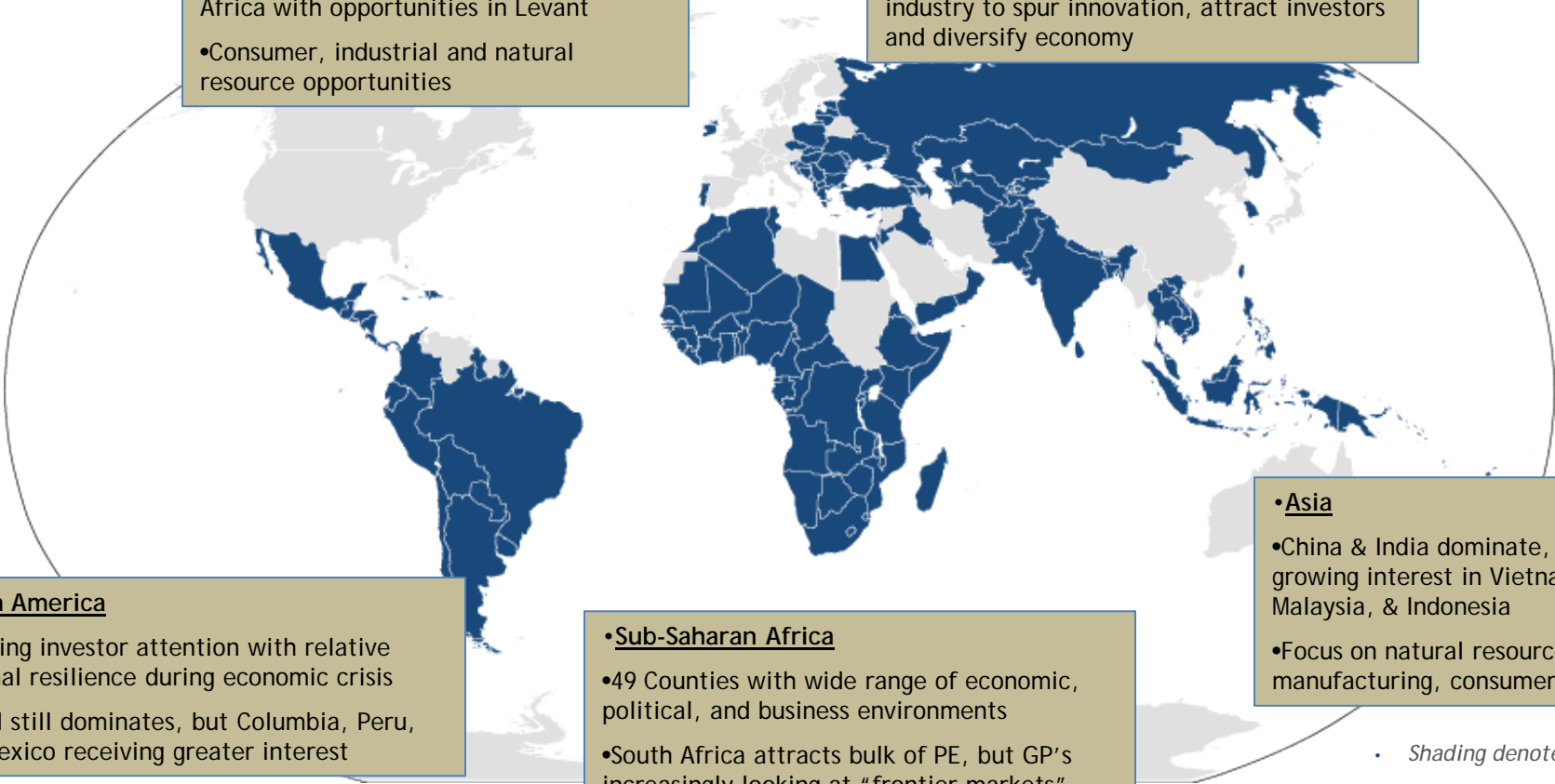
# Unique Opportunities

• MENA

- Activity centered around GCC and North Africa with opportunities in Levant
- Consumer, industrial and natural resource opportunities

• Eastern Europe

- Transitioning from planned to market economies
- Close links to EU is both opportunity & challenge
- Russia taking steps to develop VC/PE industry to spur innovation, attract investors and diversify economy



• Latin America

- Growing investor attention with relative regional resilience during economic crisis
- Brazil still dominates, but Columbia, Peru, and Mexico receiving greater interest

• Sub-Saharan Africa

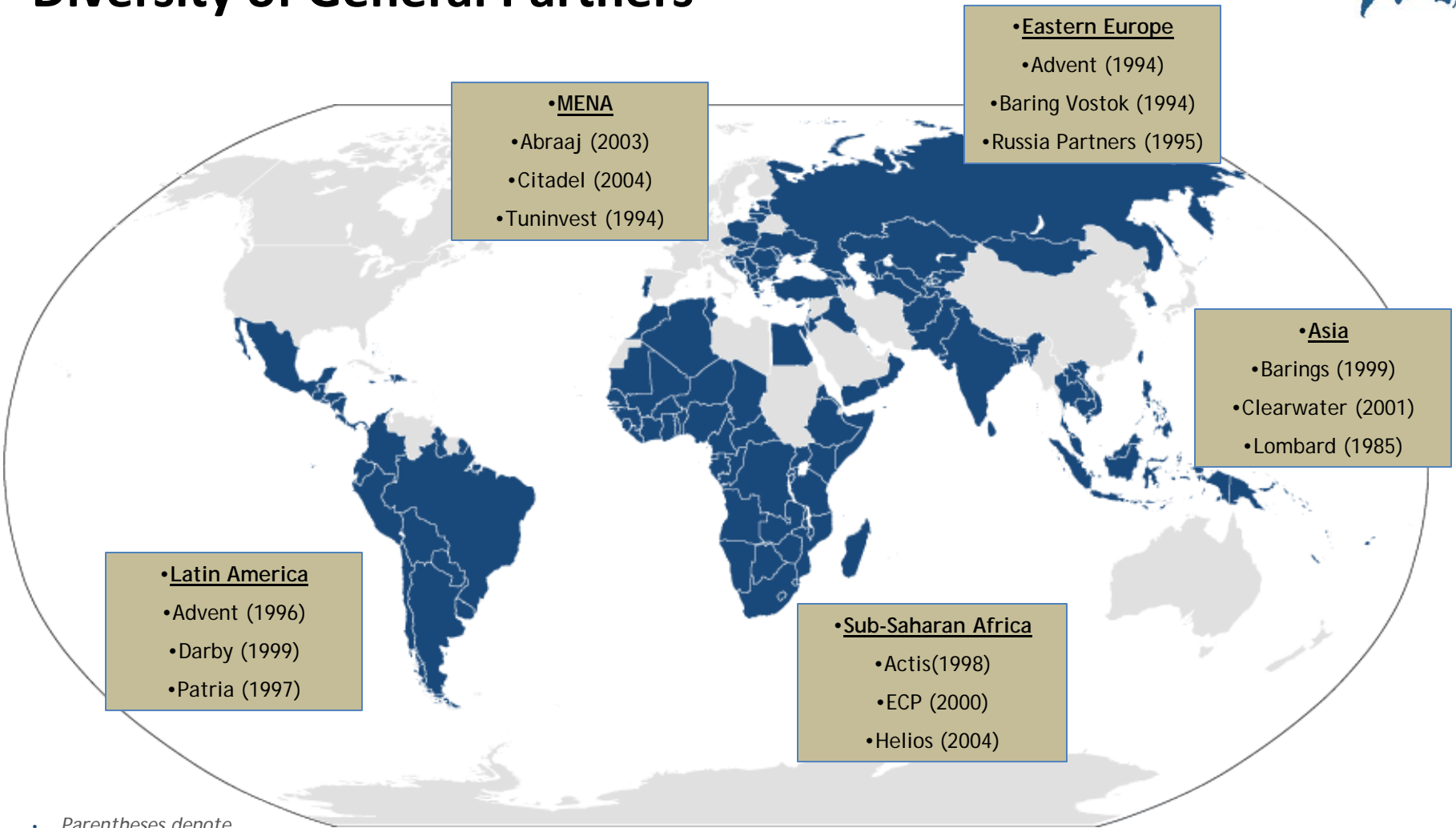
- 49 Countries with wide range of economic, political, and business environments
- South Africa attracts bulk of PE, but GP's increasingly looking at "frontier markets" such as Kenya and Nigeria

• Asia

- China & India dominate, but growing interest in Vietnam, Malaysia, & Indonesia
- Focus on natural resources, manufacturing, consumer, TMT

- *Shading denotes*
- *OPIC-eligible countries*

# Diversity of General Partners



• Parentheses denote first local investment vehicle

# EM PE Funds Have Performed Strongly

## Private Equity Performance (End to End Returns)

(Periods Ended September 30, 2010)

	EM PE/VC	US PE	US VC	W. Europe PE	MSCI EM Index	S&P 500
One Quarter	9.3	5.1	3.8	11.9	18.2	11.3
One Year	25.0	17.7	8.2	16.0	20.5	10.2
Three Years	6.5	1.3	-2.1	-5.8	-1.2	-7.2
Five Years	14.1	9.1	4.3	13.9	13.1	0.6
Ten Years	9.1	8.1	-4.6	16.4	13.8	-0.4

- Source: Cambridge Associates LLC Proprietary Indices: pooled end-to-end returns, net of fees, expenses and carried interest.
- Data provided on an as-is basis and is based on a limited pool of emerging markets private equity fund managers

# With Opportunity Comes Risks

Macro/Political

Manager Selection

Legal

Asset Management

# IFC's Approach to Due Diligence in Emerging Markets

# Top-Down or Bottom-Up?

- We build our portfolio bottom-up, not top-down
- For each country we ask:
  - Is there enough deal flow for a country-dedicated fund?
  - What is the most relevant skill set for PE in this market?
  - Can we find a GP with the right skill set to capitalize on the opportunity?

If we get positive answers to these questions, we invest.

- Our geographic allocation is:
  - Across all regions in Emerging Markets
  - Weighted towards IDA countries (less than \$1000 per capital GDP)
  - Weighted away from countries already attracting a lot of commercial capital
  - Continuously looking to see if exposure to new countries is possible



# Why Not Top Down?

Our development mandate does not allow for a top-down macro approach.

However, even if it did, I personally do not believe that a top-down approach is the most appropriate for a long-term and illiquid asset class such as private equity.

The investment period is 5 years. The exit period is a further five. That is too long a period over which to take a macro view.

# If Not Top-Down, How do we Manage the Risks?

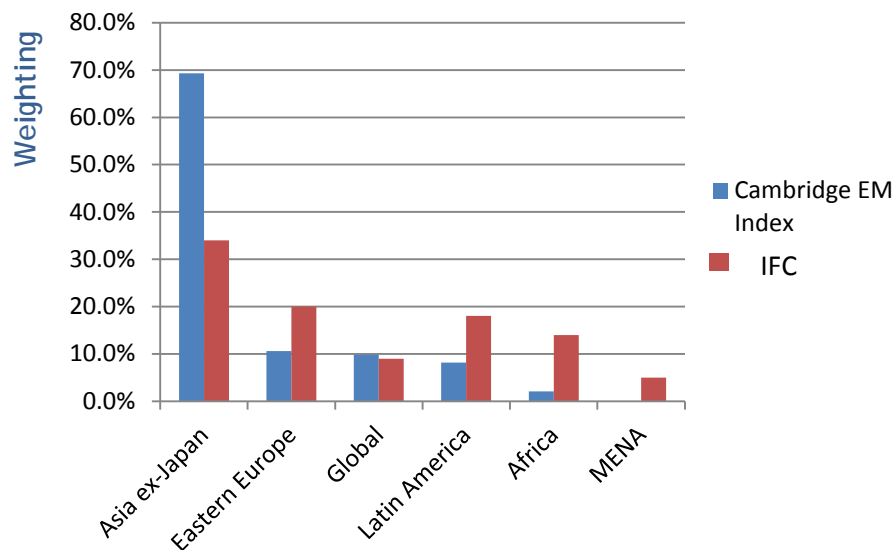
## Macro & Political Risk

We use geographic diversification to manage macro and political risk.

Our geographic exposure is much broader than the Cambridge EM Index.

The EM PE opportunity is broad enough to allow this at our bite size of \$10-30 million.

We think diversification has contributed to our out-performance.



# If Not Top-Down, How do we Manage the Risks?

## Macro & Political Risk II

Growth strategies are much less exposed to cyclical and macro risk than leverage or momentum strategies.

Model the strategies and shock them and you will see this.

This is especially the case in EMs which continue to have a base of domestic growth resulting from the shift to market-based economies.

PE returns in most EMs are driven by growth. The average debt/equity ratio of companies within IFC-invested funds is 0.74.

We specifically focus on growth-based strategies.

We do not try to pick vintage years.

However, as we invest in many markets, we do tilt away from markets which have a combination of (i) existing high valuations, (ii) a significant overhang of dry powder likely to last 2.5 to 3 years or more and (iii) no obvious driver of increased deal flow.

# If Not Top-Down, How do we Manage the Risks?

## Micro Risks

*Our Due Diligence seeks GPs who can manage the Micro risks*

- (a) We seek GPs with the operating experience to manage operating and execution risk, which are larger in growth strategies than leverage or momentum strategies.
- (b) Most transactions in EM are minority. Many EM legal systems work too slowly to make enforcing shareholder agreements an attractive option. GPs with the right skill set can successfully manage minority positions.

We seek GPs who are (i) sufficiently local and (ii) add enough value to for effective partnerships with the entrepreneur to manage the risks of weak legal systems.

# Emerging Market Due Diligence

- **Comparison with Developed Market Diligence**
- **Points of Difference in EM Diligence**
  - Deal Flow
  - What are the drivers of returns?
  - Matching the GP skill set to the drivers of returns
  - How local is the GP?
  - Reputation – Politically Connected Persons
  - Environmental & Social Sustainability
  - Legal Environment
  - Exits

# Not Your Standard Diligence Framework

Diligence Point	Developed Market	Emerging Market
Verify track record	Core	Often no full exit track record
Verify attribution of track record to current team	Core	Often no full exit track record
Team Stability	Core	Core, but often short history together
Is there sufficient deal flow?	No need to ask	Often need to ask
How are returns made in this market?	Usually not asked	Need to ask
How Local is the Team?	Usually not asked	Need to ask
Are there exits?	No need to ask	Need to ask
Are contracts enforceable?	No need to ask	Need to ask
What are the macro and political risks?	No need to ask	Need to ask



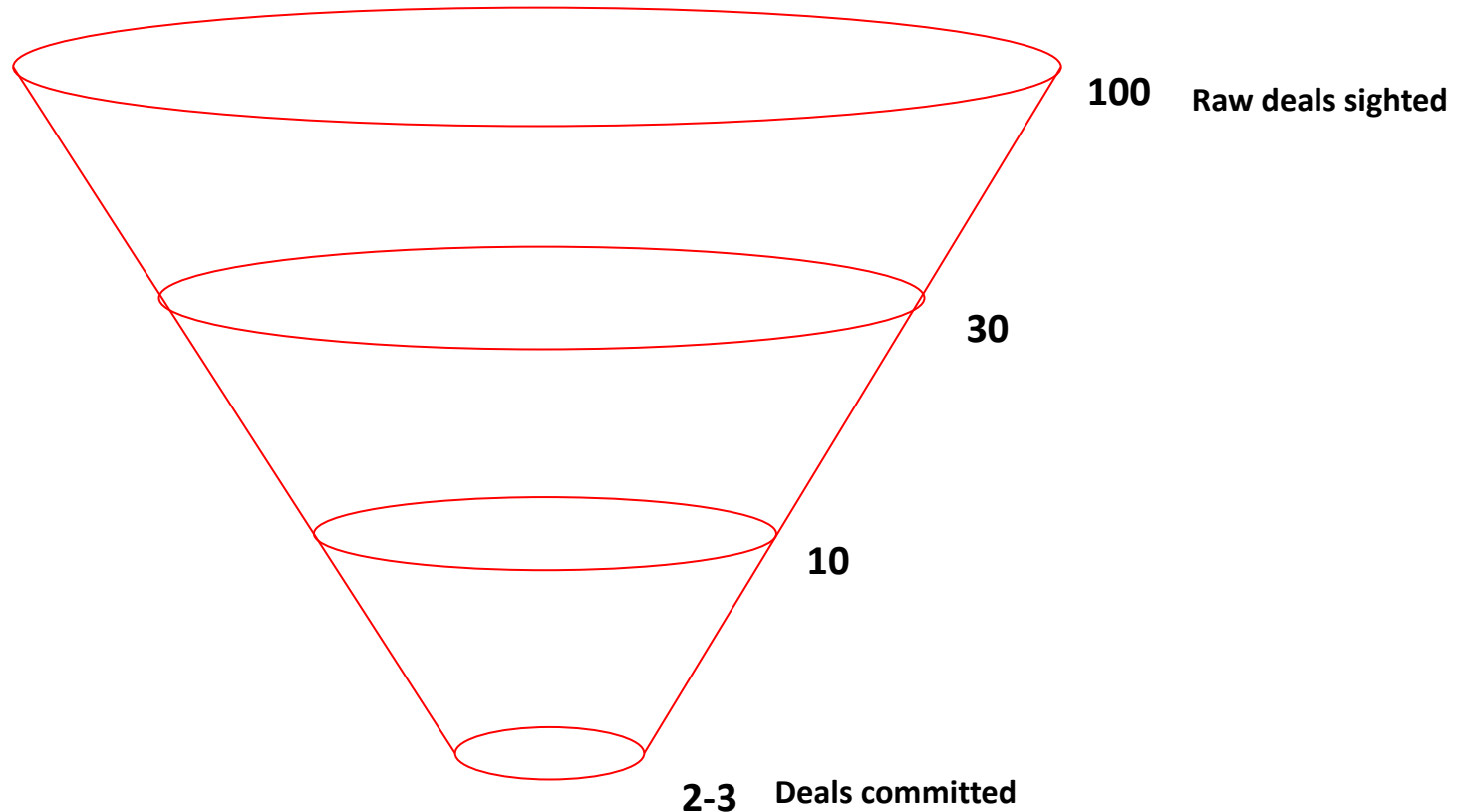
**I will concentrate on those aspects of diligence which differ in Emerging Markets**

# What We Have Not Looked For

- Well known brand
- Top Quartile Record Outside the Target Market  
*We do not think track record travels without the right local capacity*
- Fund III+ with full-exit track record  
*Policy driven, we usually have no role by then*

# Is there Adequate Deal Flow to Support the Fund?

## Where Can We Find Adequate Selectivity?





# Is There Enough Deal Flow?

Deal flow has grown hugely in EM in the last ten years and continues to grow and evolve.

As it is not 'steady state', it is wise to understand it.

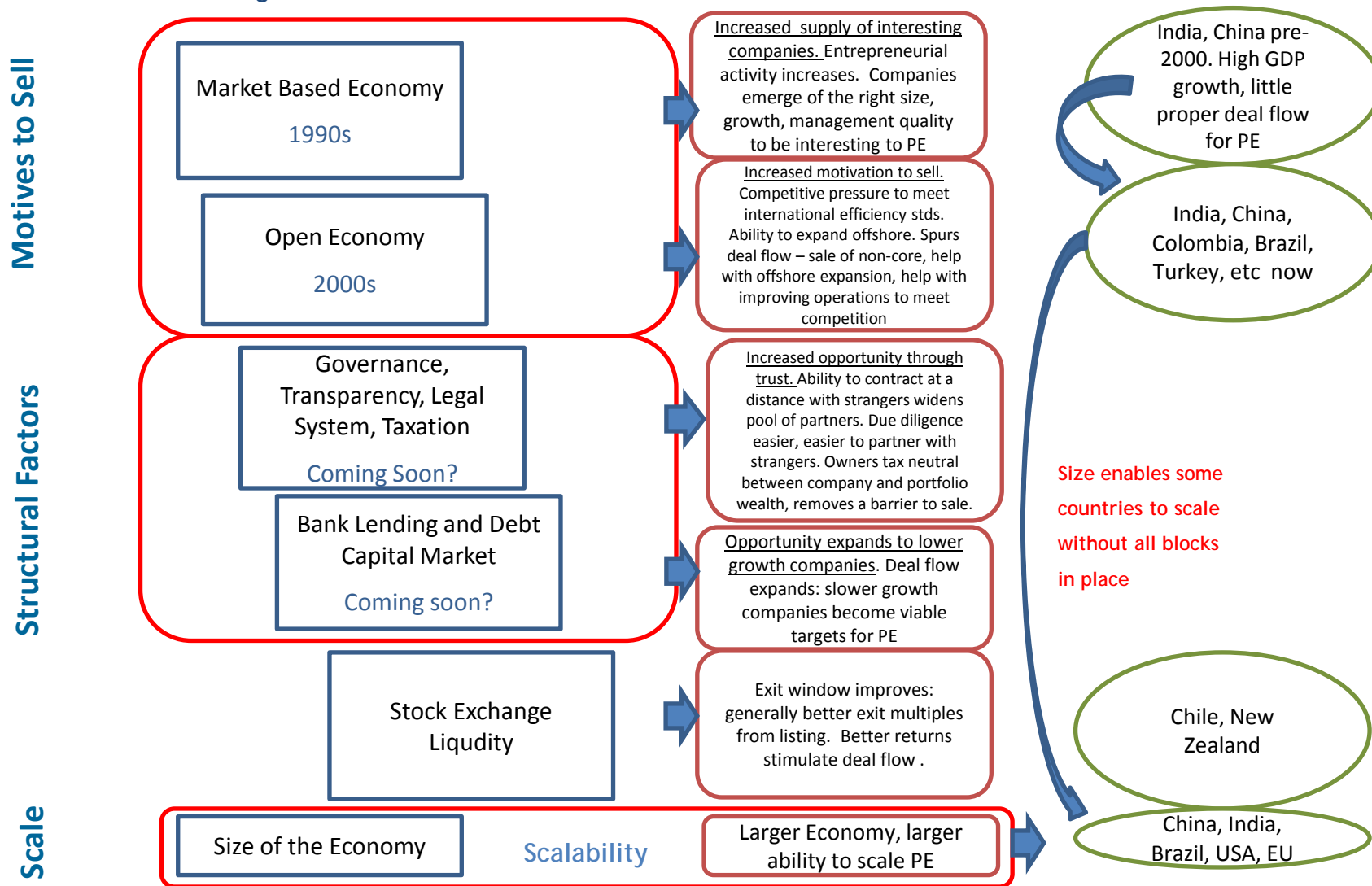
e.g. Vietnam and Mexico have relatively low PE activity for their size.  
Why?

The amount of deal flow in a market suitable for PE reflects:

- \* The # of existing motives to sell equity to 3rd parties
- \* Access to leverage
- \* Functionality of the legal system
- \* Size of the economy

# Deal Flow = Supply of Control/Influence + Legal & Debt Structures + Scale of Economy

## Building Blocks to Achieve Maximum Potential in PE



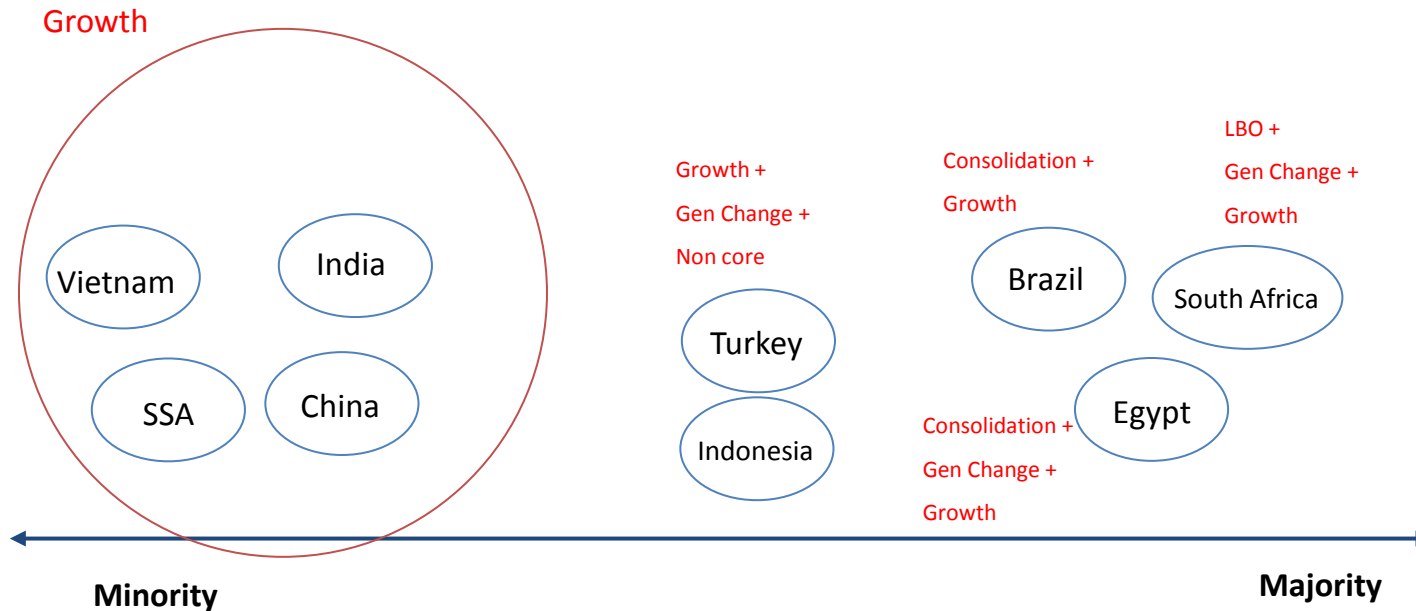
# What Creates the Supply of Control/Influence Transactions?

<p><b>Positive Motivation to Sell</b></p>	<ul style="list-style-type: none"> <li>- Strong growth situation</li> <li>- Pre-Listing Clean-Up</li> <li>- Geographic Expansion</li> </ul>	<p>Minority Minority Minority</p>
<p><b>Neutral Motivation to Sell</b></p>	<ul style="list-style-type: none"> <li>- Generational Change</li> <li>- Conglomerate focusing on Core Business selling non-Core</li> <li>- Privatization</li> </ul>	<p>Majority Majority  Majority</p>
<p><b>Negative Motivation to Sell</b></p>	<ul style="list-style-type: none"> <li>- Distressed business</li> <li>- Distressed owners</li> </ul>	<p>Majority Majority</p>

The more motivations to sell, the greater the deal flow suited to Private Equity.

Find out which motives are operating.

# Motivation of Sellers Differs Across Countries



- These are generalizations – exceptions exist
- The deal flow picture evolves rapidly

# How do we Assess Deal Flow?

- Go to the country and ask a selection of locals what motivates owners of businesses to sell control/influence
- Trend in local deregulation
- Indicators of how open the economy is – capital and trade flows – in law and in practice

# It is Important to Understand How the Returns will be Made

There are four basic drivers of return in PE:

- Leverage
- Valuation Multiple Expansion
- Revenue Growth
- Improved Efficiency

Implementing each of these strategies requires a different skill set in the GP.

To invest in EM PE successfully you need to understand the strategies which are possible in the Market and ensure the GPs you back have the skills to implement those strategies.

# How the Return will be Made is Important to GP Selection

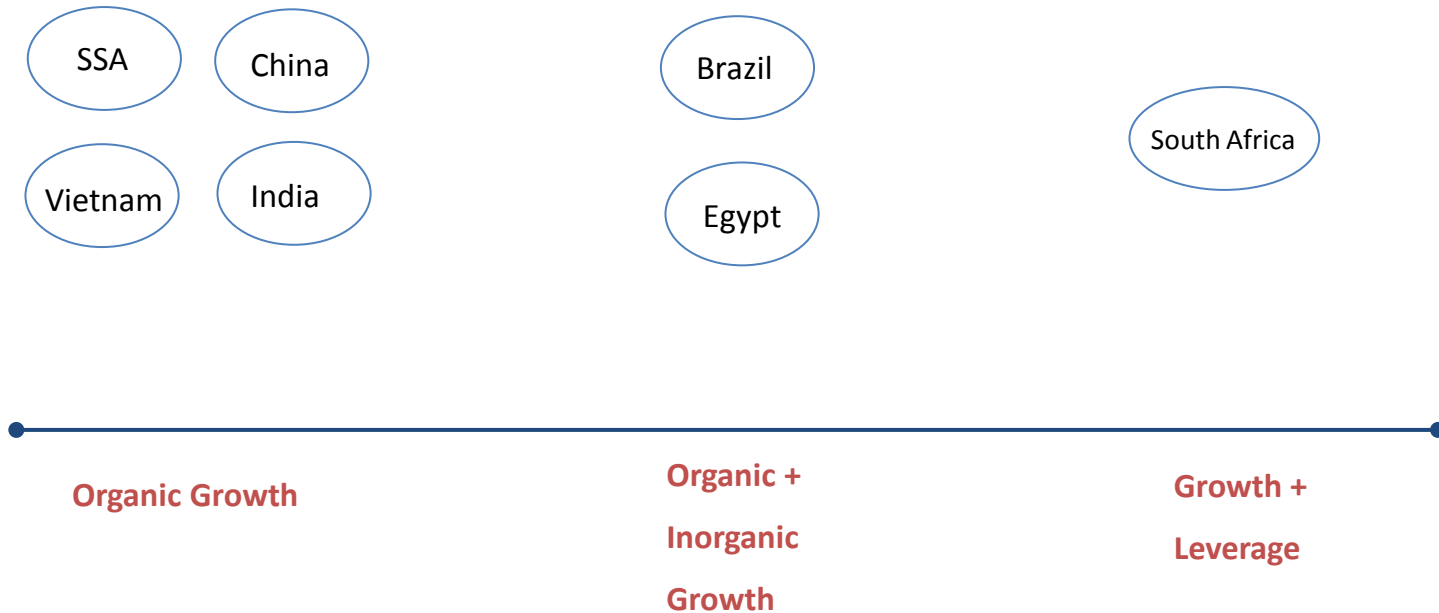
The Table shows pure plays in each of the basic strategies

Even in EM most transactions are a blend

However, usually one or two strategies dominate

	IRR	Equity	Cash out by Dividend , Stock Purchase etc	P/E at Entry	P/E at Exit	Revenue Growth p.a	Margin Improves from 5% to x%	Holding Period Years
Leverage	25%	30%	55%	6	6	0%	5%	5
Multiple Expansion	25%	75%	10%	6	14	0%	5%	5
Growth	25%	75%	10%	6	6	20%	5%	5
Efficiency	25%	75%	85%	6	6	0%	30%	5

# The Predominant Strategy Differs Across Markets

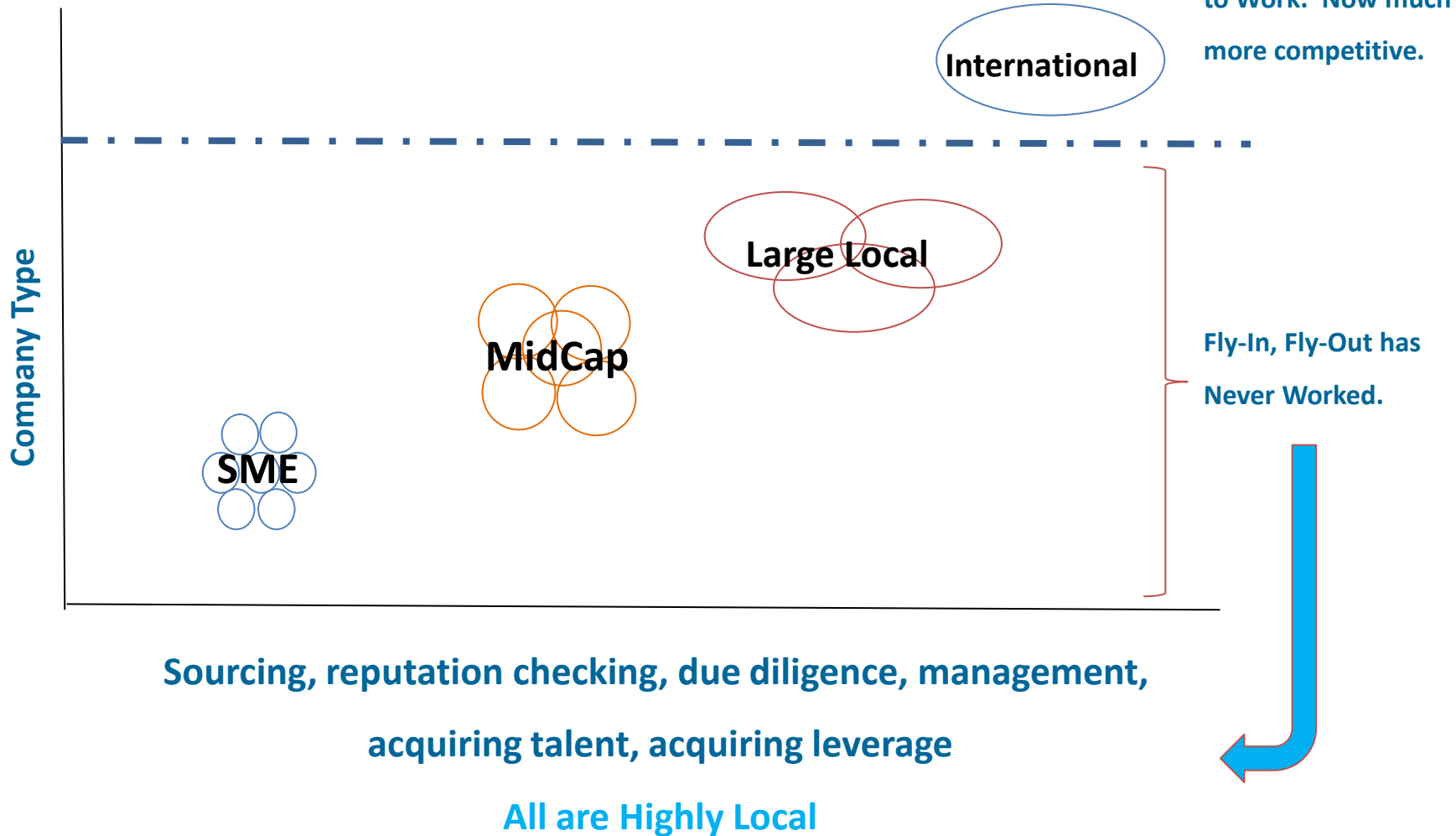




# Manager's Skill Set Needs to Match the Way the Return will be Made

<b>Return Driver</b>	<b>Source of profit</b>	<b>Skill Required</b>
<b>Arbitrage</b>	Pricing multiple differential between private market and public/M&A markets	Investment or Merchant Banking Consultancy
<b>Leverage</b>	Leverage a company with stable earnings	Investment Banking
<b>Earnings growth</b>	Increase earnings through expansion or acquisition.	Corporate Operations, Entrepreneurial, Consulting
<b>Margin expansion</b>	Increased profits via improved efficiency or shifting product to higher margin niche.	Corporate Operations, Entrepreneurial, Consulting
<b>Improved transparency and governance</b>	Earnings attract a higher price, as buyers feel more informed and protected.	Corporate Operations, Entrepreneurial, Consulting
<b>Multiple expansion due to growth or profits</b>	Earnings of company attract a higher price / earnings multiple	Private Equity – acquire based on what you can sell

# Being Local is Very Important



# IFC's Experience is that Being Local is Important



Sample: Mature and failed funds invested post-2000 in IFC portfolio pre-crisis 2008

# Ways of Being Local

GP Type	How Become Local?	Issues
Local GP	Fully local operation	Good access to transactions, talent, due diligence. Funding typically limits access to largest deals – need to syndicate. (This is slowly changing)
Foreign GP	Affiliation with local GP	Access to largest deals with full local skill set. Not access deals local affiliate can do for itself.
Foreign GP	Local office	Local skills + broader deal access. Expensive. Need to ensure alignment and influence with HQ.

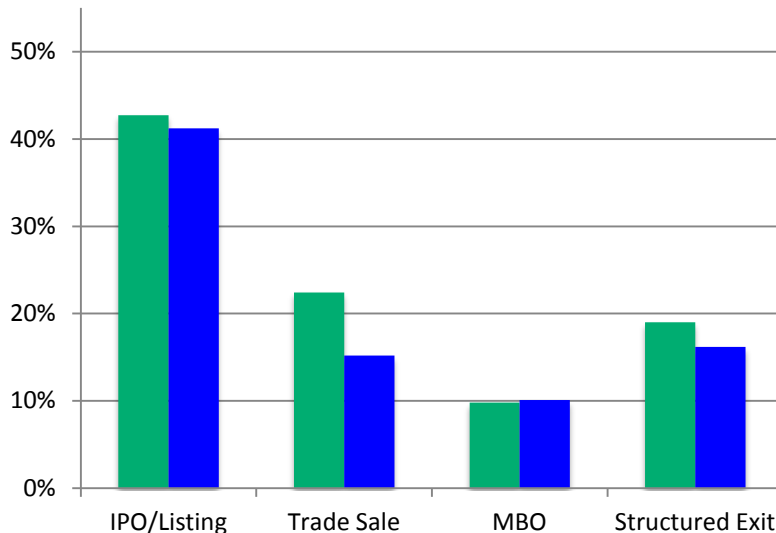
# Legal Enforcement

- Most investments in EM PE are minority positions, relying on shareholders agreements.
- Yet most EM legal systems move too slowly for enforcement to be an attractive option.
- In our experience GPs who are both (i) local and (ii) have the experience to be able to add value to companies such that they are seen as partners by GPs, can successfully manage the relationship from entry to exit.
- In this context, weak legal systems reduce deal flow rather than increase risk.

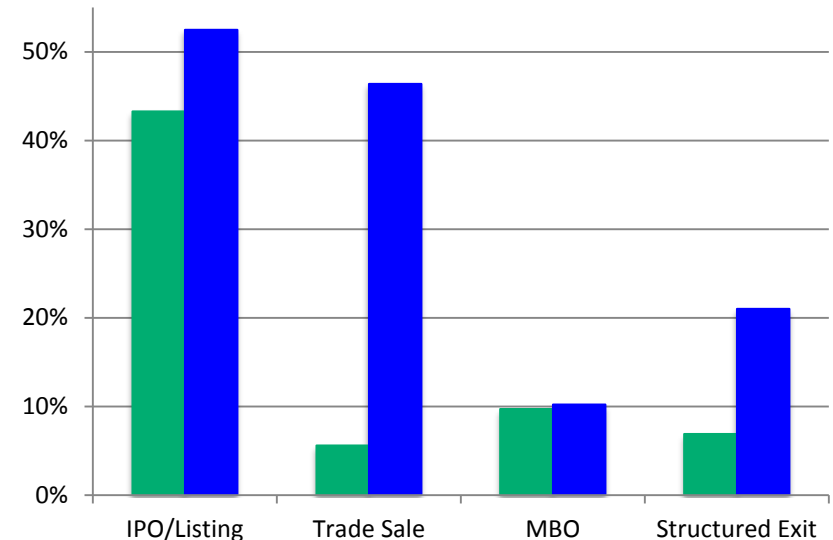
# GPs with the Right Skill Set Can Manage Minority Risk

Minority positions (blue) have performed well in all forms of exit, indicating that the risks associated with minority positions can be managed effectively.

**Median IRR**



**Average IRR**



Sample: Exits of 61 majority positions and 251 minority positions from IFC invested funds

# Reputation and Politically Connected Persons

Backing first time teams it is very important to be certain of each team member's reputation.

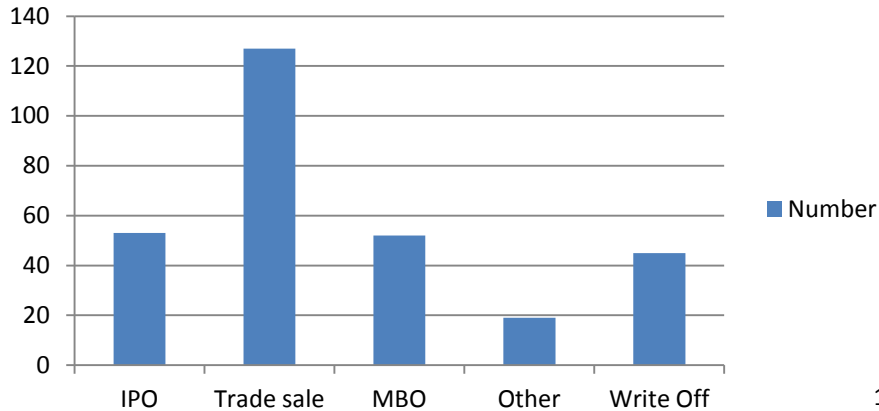
Also, in EM, the risk of political connection is elevated.

Politically sourced transactions are risky.

We use our local offices to run background checks on reputation and political exposure.

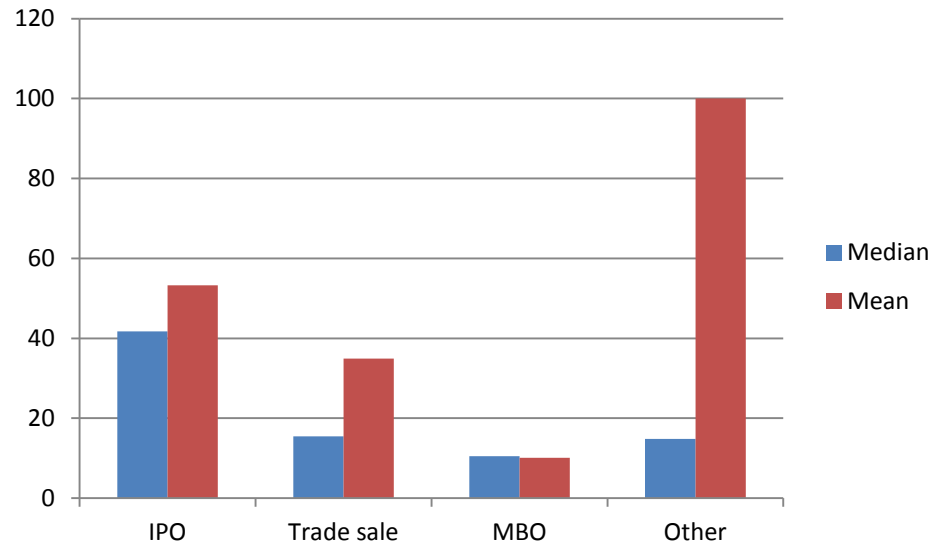
# Attractive Exits are Available

## Number of Exits



Average Holding Period = 4.8 years

## IRR on Exits



Sample: 296 exits from IFC invested Funds



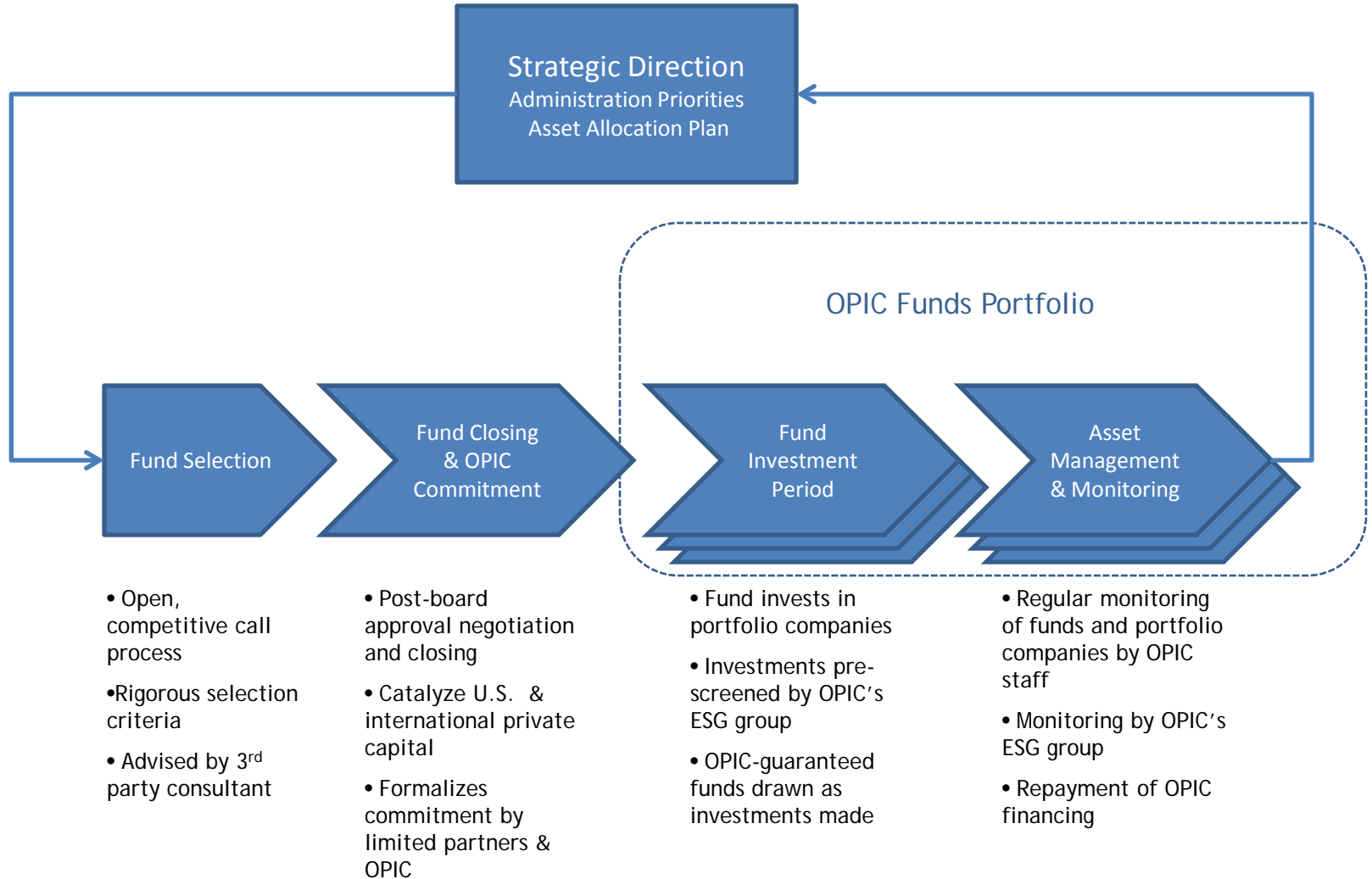
# Environmental & Social Sustainability

We think there are both commercial and reputational benefits in ensuring that GPs in EM have Environmental & Social Risk Management Systems and are properly resourced to implement them.

We insist on any fund to which we commit having such a system and we actively monitor its performance.

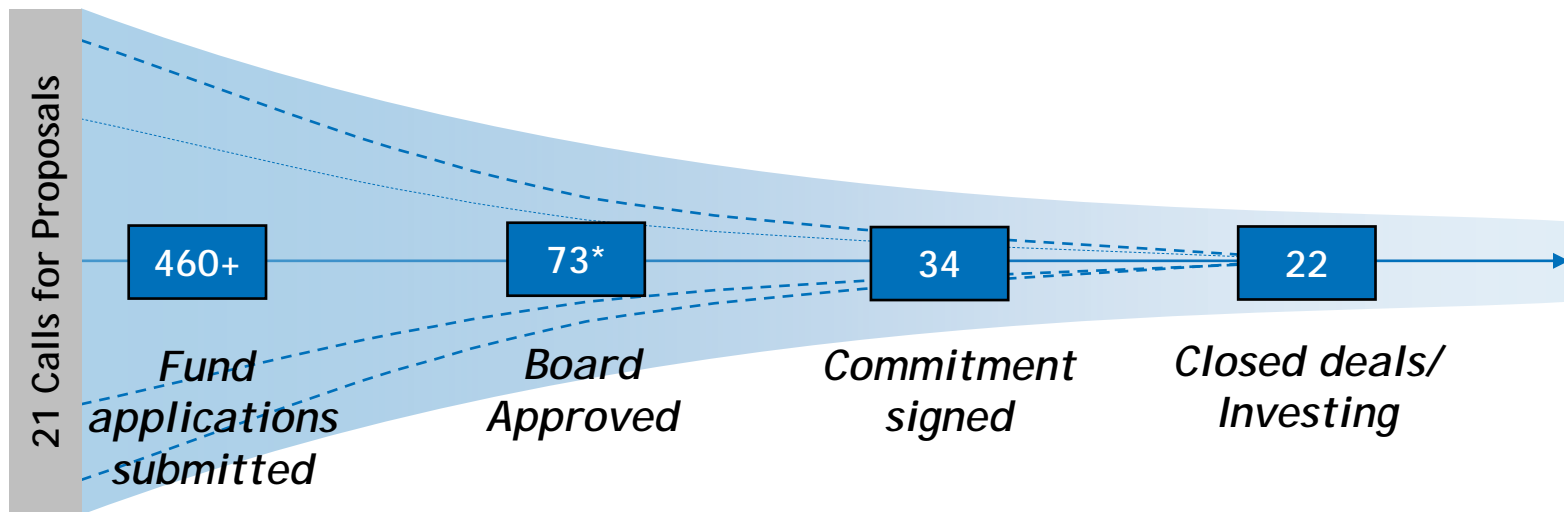
# OPIC's Approach to Manager Selection

# OPIC: Funds Program Design



# OPIC Investment Funds Selection Process

A Rigorous Selection Process Implemented in 2002



## OPIC's competitive selection process

- Private equity track record in emerging markets
- Experience, depth, and credibility of management team
- Credibility and thoughtfulness of proposal
- Ability to meet goals of given Call for Proposals
- Ability to raise equity capital
- While OPIC has backed first time funds, prior track record & experience rigorously assessed

# Active Selection: OPIC's Fund Screening Template

<b>Firm Name</b>	
<b>Fund Name</b>	
<b>Date of Launch</b>	
<b>Target Size</b>	
<b>Proposed OPIC Funding</b>	
<b>Leverage Level (%)</b>	
<b>Deal Size</b>	
<b>Assets under Management</b>	
<b>Strategy</b>	
<b>Geographic Focus</b>	
<b>Industry Focus</b>	
<b>Contact Details</b>	
<b>Year Founded</b>	
<b>Prior Funds</b>	
<b>Organization Structure and Sponsors</b>	
<b>Jurisdiction</b>	
<b>Key LPs</b>	
<b>GP Commitment</b>	
<b>Office Locations</b>	
<b>U.S. Nexus Issues?</b>	

<b>Management</b>	<b>Strategy</b>	<b>Track Record</b>	<b>Fundraising</b>	<b>Development Impact</b>
L/M/H	L/M/H	L/M/H	L/M/H	L/M/H

**Main issues addressed in memo:**

- Strategy
- Management team and organization
- Key investment professionals
- Track record
- Pipeline
- Fundraising ability
- Investment strategy
- Legal and terms
- References
- Development/ESG impact
- Fit with OPIC priorities and objectives

# Active Selection: Addressing Risk in Emerging Markets

## Special Due Diligence Considerations



Strategy	Management Team	Investment Professionals	Track Record	Pipeline
<ul style="list-style-type: none"><li>• Country specific or regional?</li><li>• Sector specific or sector agnostic?</li></ul>	<ul style="list-style-type: none"><li>• <b>Abundance of 1<sup>st</sup> time managers</b> adds importance to prior fund management roles</li></ul>	<ul style="list-style-type: none"><li>• Cohesiveness issues with <b>newly formed teams</b></li><li>• Are <b>larger teams</b> warranted in these markets with greater risk?</li></ul>	<ul style="list-style-type: none"><li>• Importance of audited returns</li><li>• <b>Reference checks</b> take on added importance to verify members deal involvement</li></ul>	<ul style="list-style-type: none"><li>• Is there enough deal flow to support proposed fund size?</li><li>• <b>How real is the pipeline?</b> 3<sup>rd</sup> party verification critical</li></ul>

Fundraising	Legal & Terms	ESG	References
<ul style="list-style-type: none"><li>• Expect longer fundraising periods</li><li>• Placement agents may plan a more important role</li></ul>	<ul style="list-style-type: none"><li>• Importance of <b>international counsel</b></li><li>• Are interests appropriately aligned?</li></ul>	<ul style="list-style-type: none"><li>• Failure to follow <b>international best practices</b> can translate to significant headline risk</li></ul>	<ul style="list-style-type: none"><li>• Diversity of checks across previous funds and other market participants</li></ul>

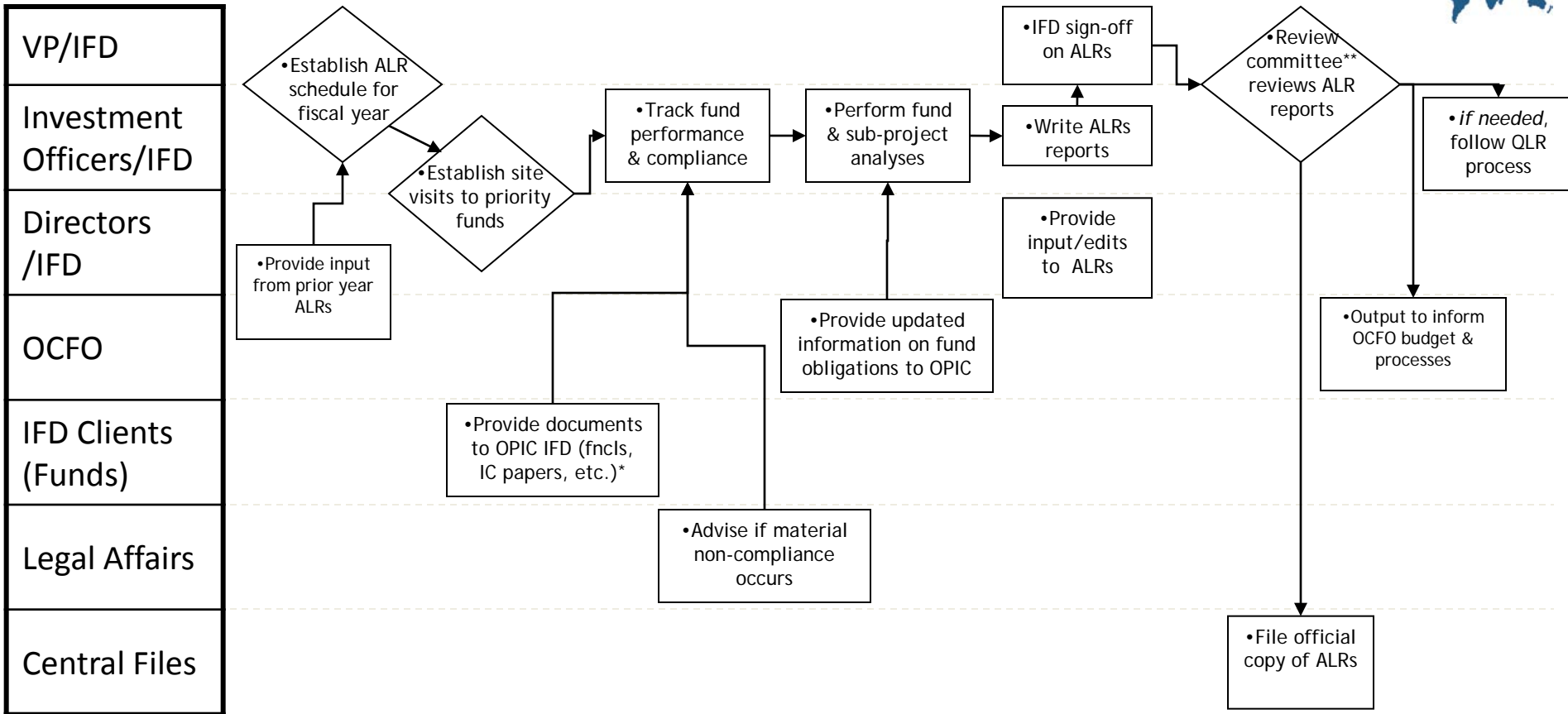
# Addressing Risk: **Environment, Social, Governance** Policies

- OPIC’s Office of Investment Policy (“OIP”) ensures that each OPIC project:
  - Has no significant adverse impact on the host country’s **environment** or affected **community** (communities)
  - Respects **human rights**, including the **rights of workers**
  - Does not cause a significant adverse effect on the **U.S. economy or U.S. employment**
  - Has a positive **developmental impact** in the host country
  - Is **complementary** (or “additional”) to private sector banks and insurers
  
- OIP provides environmental, worker rights, human rights, and economic impact clearances prior to project approval for all OPIC-supported projects and in certain cases, OPIC-supported financial intermediary sub-projects
  
- OPIC also completes **Know Your Customer, Anti-Money Laundering, and Character Reference Due Diligence** screens, including consultation with commercial and U.S. government information sources



# Active Management: OPIC's Monitoring Process

## •1 OPIC IFD Monitoring: Annual Loan Reviews (ALRs)



•Timeline:      •September/ October...

•...completed by June 30<sup>th</sup>

## •2

## •OPIC IFD Monitoring: Quarterly Loan Reviews (QLRs)

### •Criteria:

•Funds that are deemed to be a higher risk are those funds within 2 years of their final maturity, not including extensions, and funds rated at "Watch" or below through OPIC's Annual Loan Review Process.

### •Process:

•The content, distribution, format, methodology, and risk rating process of the QLR follows that of the ALR. Value is assessed on a more regular basis as either: the fund is nearing its completion with OPIC exposure, or a material weakness has been found within the collateral or management of the Fund.

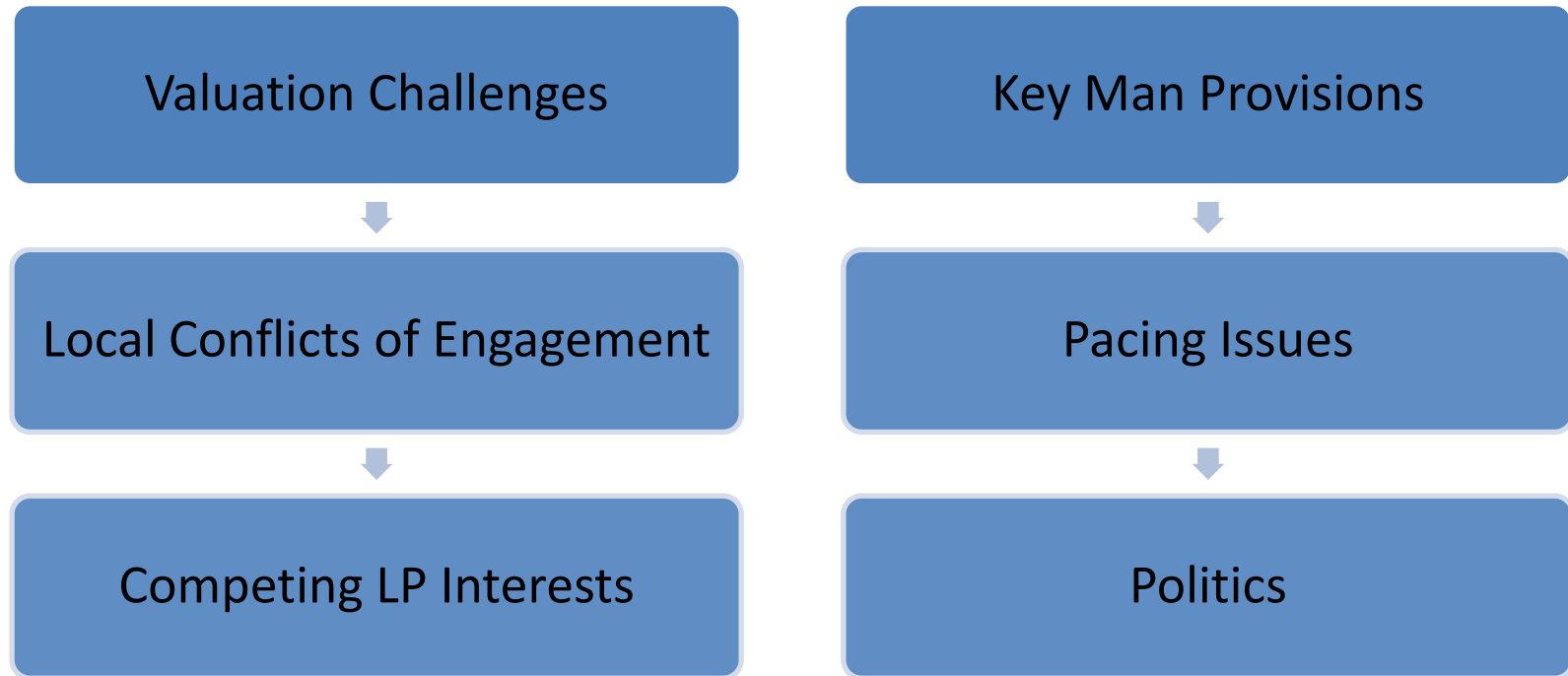
•In cases where a QLR has been completed for a fund, the annual compendium of QLRs will serve as the ALR for the given Fund.

\* Fund manager cooperates on any site visits deemed necessary by IEO/IFD

\*\* ALR review committee includes representatives from IFD, Credit Dept., OCFO, and Legal Affairs (if needed)



# Lessons Learned: Real World Manager Interactions



# Lessons Learned: Active Selection, Active Management



## Fund Manager A: First Time Manager Risk

## Fund Manager B: Performance Risk

- Active involvement helps manager get established in Turkey and become a first mover in Southeast Europe
- OPIC support helped catalyze equity funding from quality US and European investors
- Raised two funds in the 2000's, totaling ~\$470MM
- First fund performed successfully, second still investing

- 1990s' vintage African fund became distressed
- In 2000's, new fund manager competitively selected to take over management of fund
  - OPIC removed original fund manager for non-performance
  - New GP was first time fund manager
- New GP successfully restructured and exited at attractive IRR and multiple relative to audited fair market value at takeover
- Subsequently raised funds totaling \$1B+

OPIC regions	# funds total	# first time funds	% first time funds
CEE	7	4	57.1%
Asia	15	2	13.3%
Africa	17	9	52.9%
Russia/NIS	5	4	80.0%
Global	5	2	40.0%
LAC	15	2	13.3%
MENA	9	3	33.3%
<b>TOTAL</b>	<b>73</b>	<b>26</b>	<b>35.6%</b>

- OPIC is a hands-on investor:
- Active monitoring of funds and portfolio performance, including site visits
- As last resort, has replaced GP in consort with LPs

# Parting Considerations

*Patience is a Virtue*

*Expect Volatility*

*Be Proactive, Not Passive*

*Tremendous Opportunities Exist*