



**IFC**

**International  
Finance Corporation**  
World Bank Group

**The Case For Emerging Market Private Equity**  
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### Emerging Market Private Equity

Emerging markets continue to attract an increasing level of investment by institutional investors. Against a backdrop of reduced performance from traditional markets, the higher returns available in emerging markets provide an attractive investment opportunity in which to deploy capital. However, challenges remain in determining where, how, and with whom to invest. This paper draws upon the extensive experience of the International Finance Corporation (IFC) to dispel myths and to highlight the realities of fund investment in the emerging markets. IFC, the private sector arm of the World Bank Group, is widely acknowledged as the pioneer and market leader in emerging market investment, with an unparalleled track record of consistent annual profitability for over 55 years. IFC accesses the emerging markets through a number of different strategies, including - for over two decades - investment through private equity funds. In the period 2000-2010 IFC invested an aggregate \$2 billion into 124 emerging market private equity funds giving it exposure to ~1,000 underlying portfolio companies. The success of the IFC's approach is reflected in a maturing portfolio with over 300 underlying exits, resulting in a portfolio IRR of 20%, substantially outperforming the relevant benchmarks and with reduced volatility of returns.

The key lessons IFC has drawn from investment in emerging market private equity funds are that:

- returns outperform both developed market private equity and emerging market listed stocks, while exhibiting low correlation with developed market investment strategies;
- diversification provides an attractive risk-return profile, through a broad and growing opportunity set well beyond the perceived domination of Asia-focused funds; and
- risk is lower than commonly perceived and can be appropriately managed with sufficient resources and commitment.

### Returns Opportunity and Diversification

Emerging market exposure is an increasingly critical part of any forward-looking investment portfolio. Available returns have caught up and now exceed those in developed markets.

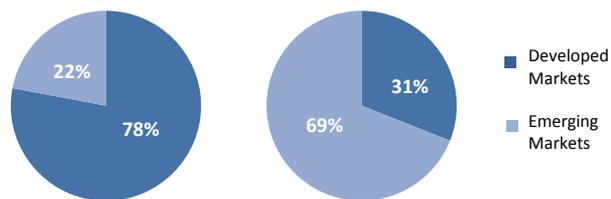
**Comparative PE & VC End-to-End Returns (Q2 2012)**

	US	W. Europe	Global EM
3 Year	15.9%	13.6%	15.5%
5 Year	5.8%	1.6%	7.8%
10 Year	10.9%	15.4%	11.4%
15 Year	13.6%	15.1%	7.9%

Source: Cambridge Associates

Emerging markets private equity returns are intrinsically linked with the accelerating growth of household incomes in those markets. Continued rapid growth in the emerging market middle class means that more than half of the world's population will have joined the consuming classes by 2025, leading to an unprecedented shift in global GDP distribution (ref. McKinsey & Company, August 2012).

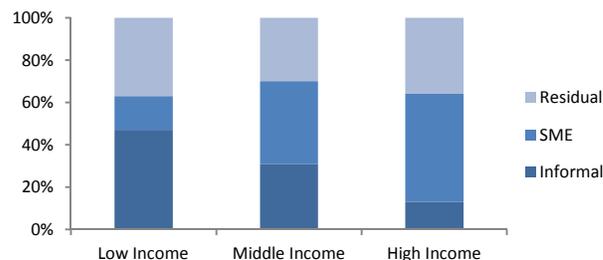
**Projected Share of Nominal GDP 2010-2030**



Source: World Bank

By 2025, annual consumption in emerging markets is expected to reach \$30 trillion, driving demand for natural resources, energy supply, consumer goods, and infrastructure (ref. McKinsey and Company, August 2012). To satisfy this increased demand, small and medium-sized enterprises (SMEs) will develop and grow into a substantial market segment. In low-income markets, SMEs represent a relatively low proportion of businesses (16%), but this proportion increases rapidly with income growth, suggesting a dynamic entrepreneurial class looking for capital and in need of expertise to help grow their businesses.

**Firm Size and GDP Correlation**



Source: Cambridge Associates, MSCI and IFC

While public markets exist in many of these countries, IFC's analysis and experience finds that generating sustained returns in growth markets is best achieved through private equity. A comparison of relevant indices broadly supports this.

**Public vs. Private Equity Comparison: End-to-End Pooled Returns (Q2 2012)**

	3-Yr	5-Yr	10-Yr	15-Yr
CA Global EM PE&VC Index*	15.5%	7.8%	11.4%	7.9%
MSCI EM Index**	10.1%	0.2%	14.4%	6.3%
CA Asia EM PE&VC Index*	17.0%	9.0%	11.4%	8.4%
MSCI EM Asia Index**	10.0%	0.4%	12.1%	3.2%

Source: Cambridge Associates (CA) and MSCI

\* Private equity indices  
\*\* Public equity indices



IFC believes that this outperformance is based on the ability to access dynamic and rapidly growing sectors such as consumer discretionary, industrials, IT, and healthcare. These sectors are more closely linked with burgeoning domestic, middle-class demand, while emerging market listed indices are generally dominated by the financial, materials and utility sectors.

IFC's private equity funds portfolio also has significantly greater geographic diversity than comparable indices and this has proven to be an important factor for sustained performance and low volatility of returns. IFC's global network enables it to access and invest in a diverse set of local private equity funds, gaining exposure to less competitive economies and opportunities. Listed indices tend to provide a narrow concentration in the largest emerging markets with higher valuations and where growth may be abating. The benefits of this diversification are demonstrated through both increased returns and reduced portfolio volatility.

**IFC Return Comparison Against Relevant Benchmarks**

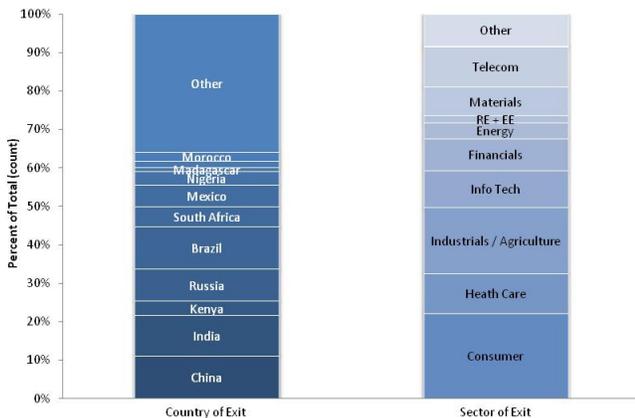
IRR from 2000 to...	Jun-11	Dec-11	Jun-12
IFC Private Equity Funds	22.2%	20.2%	19.7%
Cambridge Global EM Top Quartile	19.8%	14.6%	14.2%
Cambridge Asia EM Top Quartile	21.7%	14.4%	14.3%

Source: Cambridge Associates and IFC

As a comparison, 27% of the IFC's private equity funds portfolio are Africa-focused compared to 4% for the Cambridge Associates (CA) index while 55% of funds in the CA index are Asia-focused compared to only 24% of IFC's investee funds.

The profile of exits for IFC's private equity funds portfolio further reflects the global nature of the emerging market opportunity. The portfolio's 325 company realizations to date have a broad geographic spread across multiple regions. It also serves to substantiate the return profile, with proven returns, predominantly realized through trade sales, MBOs, and IPOs.

**IFC Portfolio Exits by Geography and Sector**

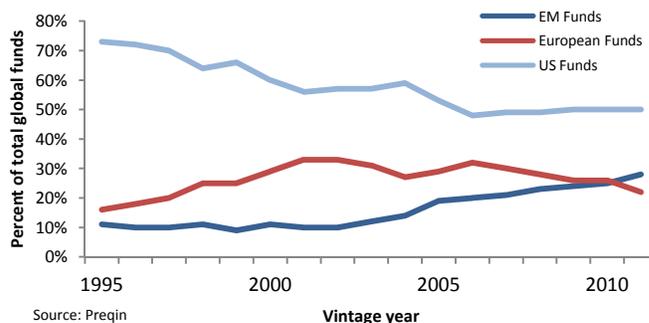


Source: IFC analysis

**Opportunity Set is Broad and Growing**

Despite strong growth, private equity penetration in emerging markets remains relatively low. In 2011, private equity investment as a share of GDP was ~1% for the US. Even in larger emerging markets like China and India, penetration remains an order of magnitude lower. This disparity is expected to be reduced as emerging markets attract more capital seeking the attractive returns available. The emerging market private equity opportunity is also fueled by rapidly growing companies in emerging markets, which recognize the benefits of external advice and seek guidance as they expand. Emerging market-focused funds represented 15% of all private equity fund capital raised in 2011 and their share, both in terms of capital and number of funds, is expected to continue to grow relative to those in other regions.

**Growth in Number of Emerging Market Funds 1995 - 2011**



Source: Preqin

Many fund managers in the emerging markets are at an early stage in their development and have established funds to benefit from untapped and often nascent markets. A key advantage that such early-mover funds enjoy is reduced competition for deals, allowing the teams additional time in considering transactions and ultimately achieving more appropriate valuations.

These funds are managed by individuals with prior experience in consulting, private equity, or the corporate world, who are utilizing their skill sets and experience in previous roles to develop opportunities.

IFC's investment track record mirrors these facts, with over 50% of funds invested in since 2000 falling into the early-mover category. These funds have provided strong returns, collectively outperforming IFC's portfolio as a whole, achieving a pooled IRR of 26% (vs. 20% for the portfolio). This suggests that early-mover funds represent an important return component in an emerging markets private equity funds portfolio.

IFC's experience suggests that success is based on backing funds with investment strategies that rely on local presence and domain expertise to identify and transact the most promising deals. IFC's approach is predicated on ensuring that the team's experience matches the available opportunity set, and that they have an applicable or relevant track record.



### Due Diligence and Risk Mitigation

While broad macro and governance risks in emerging markets continue to decline, there is a substantial lag in perceptions. Emerging markets are regularly characterized as suffering from macro/political/governance issues, perpetuating a simplistic perception of actual risks. IFC’s experience suggests risks in emerging markets are frequently overstated and that although risks are present, they can be successfully mitigated through a systematic and in-depth investment process, which, due to the nature of investment in emerging markets, requires a slightly different approach from that in developed markets private equity.

For companies in emerging markets, limited leverage is available and multiple arbitrage is infrequently a key return driver. Return is instead fundamentally driven by focusing on growth and operational efficiency improvements. To be successful, private equity fund teams therefore require experience in those areas.

Sources of Returns (IRR) in Emerging Markets

Value Driver	IRR	Equity	Cash out through Div, Stock Purchase	Revenue Growth p.a.	Margin Improves from 5% to x%
Leverage	25%	30%	55%	0%	5%
Multiple expansion	25%	75%	10%	0%	5%
Growth	25%	75%	10%	20%	5%
Efficiency	25%	75%	85%	0%	30%

Source: IFC

As noted earlier, emerging markets are characterized by a higher proportion of early-mover funds which, for investors, may lead to a perception of risk. However, funds likely to be successful will have management teams able to effectively capitalize on the key return drivers in their target markets, while identifying and managing risk. In addition to selecting the most promising of these managers, by interacting with them from an early stage, IFC has normally been able to ensure that those that it selects for investment are effectively de-risked, since they adopt IFC’s approach and requirements in respect of ESG handling, back office and reporting, etc. This diminishes IFC’s overall portfolio risk.

Other misperceptions that IFC’s experience serves to dispel are that minority positions increase risk; that exit opportunities are limited, resulting in a longer J-curve, and that compounding small company and emerging markets risk is prohibitive. IFC’s experience indicates that exits from minority positions have been successful and that as of mid-2012, 2009 vintage funds had already emerged from the J-curve. Investee funds focused on deal sizes as low as US\$2 million have been successful. IFC’s experience also shows that minority positions work well when the manager is seen as a genuine “hands on” partner by the majority owner and makes valued contributions to growing and improving the business, rather than merely acting as capital source and sounding board.

This is not to say that risk is not a serious consideration in emerging market private equity fund investment, but rather that the level of risk is, in reality, the result of investors’ understanding of underlying risk factors, including the ability to mitigate risks through a proven and robust due diligence process.

### IFC’s Approach

IFC continually monitors and maps the emerging market fund universe. Dedicated staff based in each region provide local information on individual markets in real-time and in depth. This unique reach into the global emerging markets is the foundation of IFC’s due diligence and monitoring process, which has consistently translated to strong return performance.

As due diligence on private equity funds is heavily weighted toward the fund team and the track record in emerging markets is often limited, IFC’s established local presence, with offices in over 100 countries, is fundamental to its success. Such presence enables extensive diligence by seasoned, “on-the-ground” professionals with extensive local knowledge of market conditions, risks, and opportunities.

Due to the dynamic nature of emerging markets, past performance (for which data is in any case scarce) is of limited use as a predictive analysis tool. This contrasts with the importance assigned to this single factor in the diligence of managers in more stable developed markets. This further highlights the importance of identifying managers with the appropriate skill set and domain experience to manage the type of deal flow particular to a given market.

Beyond specifics around the fund management team, IFC’s experience suggests a requirement to delve into the specific management skills required for any proposed investment strategy. This involves examining specific market conditions in which success has earlier been achieved and judging whether conditions are likely to remain favorable for that strategy, including a thorough analysis of available deal flow. This contrasts with the simple, formulaic approach to verifying a manager’s track record and its attribution to the team. This “deep dive” approach into team and performance is both a key risk mitigant and a driver of returns.

### Conclusions

IFC’s experience of investing in emerging markets private equity funds confirms that attractive returns are available, which also offer low correlation with developed markets private equity. These funds offer access to a rapidly growing investment area more geographically and sectorally diverse than many investors perceive; and, crucially, that, although present, risk is far lower than commonly understood.

Due to the complex and rapidly developing nature of the market, systematic market mapping and strong local presence is essential to effectively engage and understand the dynamics of the emerging markets globally. As with all private equity fund investment, effective due diligence is critical. In emerging markets, the diligence is keenly focused on the capabilities and skill set of the team, relative to the market in which it operates, as opposed to the primary focus on track record utilized in developed market private equity.

IFC continues to invest successfully into this rapidly developing private equity market, which offers excellent risk-adjusted returns, when appropriately addressed through an effective and well resourced due diligence process.