Private equity pioneer

By Nick Lord

The International Financing Corporation’s emerging market private equity business is a leading player in a fast growing corner of the financial markets. As well as generating strong returns, and creating private sector jobs, it is forging the development of the local capital markets.

Telecoms projects in Iraq, local currency bond deals in Latin America, or funding education projects in the Mekong delta are images that come to mind when people think about the World Bank Group or the IFC, its private sector development arm. The Group’s activities in the international financial markets, while noteworthy, are relatively minor.

There is, however, one corner of the market where IFC dominates: the fast-growing emerging markets’ private equity sector. Since 2000, IFC has built up a portfolio of limited partner positions in many of the world’s leading emerging market private equity funds. It now has US$3bn of commitments to the funds, of which US$1.5bn has been disbursed. It is invested in 180 funds, representing about 10% of all private equity funds operating in the emerging markets.

In the past few years, it has been increasing its commitment to the business: in the years 2000-06 it was looking to allocate about US$200m a year in eight to 10 funds. By 2006, its returns were coming through strongly and so it was decided to ramp up to about US$400m in 20 funds. By 2009 and 2010, with returns holding up well despite the crisis, it expanded once again, aiming to allocate up to US$900m a year in about 30 funds.

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Over the years it has backed leading funds from local markets that have gone on to deliver stellar returns, such as Baring Vostok in Central and Eastern Europe, Pan-African Investment Partners II Limited (PAIP) in Sub-Saharan Africa, GP Capital in Latin America, CDH in China and Turkven in Turkey. It is also the only limited partner among the development finance institutions that is truly global: CDC in the UK is now limited to investments in India and Africa, while EBRD, EIB and the European national development agencies are limited to Europe. It is more relevant to compare it with private sector fund of
funds such as Siguler Guff and HarbourVest.

"It would be very difficult to overstate the importance of the role played by IFC in seeding the private equity industry in emerging markets, not only as a provider of capital, but also as a leader in instituting best-practices and cultivating manager talent," says Jen Choi, head of research at the Emerging Markets Private Equity Association, a trade body, in Washington DC.

Behind this commitment to the business is a strong IRR performance. Since 2000, the private equity portfolio has generated 18%-18% returns on average a year. The total portfolio including debt funds and real estate funds is around 15.5% per year. Pre-crisis the IRR was up to around 23%, and then during the crisis it dropped to about 15%.

Swimming against the stream

According to David Wilton, CIO of Global Private Equity Funds at IFC in Washington, one of the reasons why the portfolio is performing so strongly is that it does not follow the usual benchmarks, which are heavily skewed towards Asia. Cambridge Associates for instance has a 70% weighting to Asia while IFC’s portfolio is only 35% invested there. Moreover, IFC is 18% invested in African funds, while the benchmark only allocates 2% to that continent.

“Our job is to go out and take on things that the commercial sector thinks are a bit risky," says Wilton. "So we are really at the frontier, proving that private sector investment in these places can be commercially viable and profitable. More than 50% of IFC’s investments are in the poorest countries, where we are often the first private equity investor. This focus helps us reach smaller companies and frontier countries such as Sierra Leone and Liberia – countries underserved by the existing financial systems and where impact can be greater. And when the commercial money comes in, we move on.

Wilton himself is an emerging markets veteran. Originally from New Zealand, he has been with the World Bank Group for nearly 20 years, including a stint on the ground in Egypt. He previously worked within the World Bank Group’s pension system where he brought the management of the private equity and infrastructure allocations back in-house. He was also acting CEO of the IFC Asset Management Company when it was established in 2007. Wilton began his career within the New Zealand Central Bank’s liquidity management division.

This background straddling government, development and the private sector allows Wilton to address one of the more divisive issues surrounding the business. To what extent can IFC’s private equity funds business make strong returns, while also having the required development impact that any IFC investment needs? Wilton is unequivocal: returns and impact are highly correlated. “If you look at our top 10% investments, developmentally they have been highly successful,” he says. “In terms of the impact itself, we estimate that IFC’s investments in emerging markets’ private equity alone have created about 300,000 new jobs over the past 10 years, many of which employed women.”

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Investing in funds that invest in well-run companies, especially those in emerging markets which adhere to high environmental, social and governance (ESG) standards makes investing sense. It is much easier for those companies to be sold to developed market companies if all their ESG issues are transparent. And trade sales are the main way that emerging market private equity investors can exit their investee companies, as opposed to IPOs.

IFC’s investment process is focused on finding growth, rather than just trying to ride leverage. In order to achieve that it looks for funds that are run by people with direct experience in business, as opposed to ex-bankers or consultants.

“What we try and do is find the private equity guys who have the skill sets to help fast growing companies overcome the sorts of problems they face,” says Wilton. “This could be companies who need better governance, or they need to bring in new functions, such as an independent CFO, or a marketing function, or develop their supply chain networks.”

The impact of this approach has been felt in a number of ways additional to the job growth and financial returns that IFC is seeking: it has seeded an entire industry and set the standards which have enabled it to grow. IFC has established many of the governance and reporting protocols that are standard in EM PE Limited Partner agreements today," says Choi. "IFC has also spawned many of the industry’s leading fund managers, helmed by entrepreneurial former IFC staff who have struck out on their own in their home markets.”

Backing funds vs direct investment

http://www.ifre.com/private-equity-pioneer/1519196.article
Wilton says that unlike other large LPs, IFC invests about 70% of its portfolio in first-time funds. This allows it to set the terms and benchmarks for all other second round funds to follow, thus benefiting the wider industry. It also encourages local market development by backing local teams.

"Someone local has better access than someone from outside," he says. "Also someone local knows reputations better. In these countries the legal systems aren't functioning as they do in the developed markets, so if anything goes wrong it will take a long time to turn it round. So you need a local team." IFC itself mirrors this approach by having half of its team based in countries around the world, with only half at the head-office in Washington, DC.

Sources suggest that there are some questions internally from the board of IFC as to why it is in the business of backing funds, as opposed to making direct investments that alleviate poverty. This comes down to a question of culture: IFC is at heart a debt house, although it has been trying to focus on equity in recent years. With only 5% of IFC's total assets the private equity funds business is probably non-core. But it does have a remarkable impact on the emerging market private equity business. And emerging market private equity does have a huge impact on economic development in many of the countries in which they invest, not least by contributing to the development of the local financial markets.

The IFC is a member of the World Bank Group. Founded in 1956, its primary purpose is the provision of debt and equity funding for project finance in developing countries.