IFC's Experience in Emerging Markets Private Equity

David Wilton, Chief Investment Officer of the International Finance Corporation's (IFC) Investment and Private Equity Funds Department, shares the following myth-busting analysis of the true return potential of emerging markets private equity investing, and details some of the challenges facing a still-nascent industry.

IFC has been investing in private equity funds in emerging markets since the early 1990s and created a department dedicated to fund investments in 2000. This article touches on the highlights of this nearly two decades of experience. The take-aways from our experience are:

- The opportunity is geographically much more diverse than the concentration of capital raising in Asia would suggest. There are both return and diversification benefits from taking advantage of the broader opportunity.

- Emerging markets private equity is less risky than commonly perceived due to risk mitigants at the operating level.

- To invest successfully, due diligence needs to go beyond examination of track record and into the fit between specific strategic approach and medium-term local conditions.

The Opportunity is Very Broad

Around 60–70% of capital raised for emerging markets private equity in the last four years has been raised for Asia. And yet, as indicated by Exhibit 1 which shows our reading of the global EM PE opportunity, the investable geography is considerably broader.

Taking advantage of the full opportunity and investing across a wide range of regions is surprisingly beneficial. Exhibit 2 compares the returns of the top quartile funds in the Cambridge Emerging Market Index to top quartile performers in the Cambridge Asia ex-Japan Index and in IFC's private equity fund investments from 2000 up to different dates pre- and post-crisis.

The first point to notice is that, over the periods measured, the Cambridge Emerging Markets Top Quartile is consistently higher than the Cambridge Asia ex-Japan Top Quartile, indicating that there is benefit in diversifying beyond Asia. The second point is that IFC's returns across the entire PE portfolio have exceeded even the Cambridge EM Top Quartile over the same period. Part of the reason for IFC's average performance relative to the Top Quartile is that IFC, following its development mandate, has invested very broadly. For example, IFC's exposure to Africa is 14% versus the Index's weighting of 2%. While 70% of the Cambridge Index is weighted to Asia ex-Japan, only one-third of IFC's exposure is to Emerging Asian markets. The data from IFC's portfolio illustrates that private equity can deliver attractive returns across all regions of the emerging markets.

Emerging Markets Private Equity is Less Risky than Commonly Perceived

In looking at the emerging markets, investors tend to focus on macro and political risks and legal system and governance issues, ultimately concluding the risks are high. These are indeed important points to consider, however we think there are factors at the operating level in private equity in emerging markets worth consideration for a more informed picture of the risks.

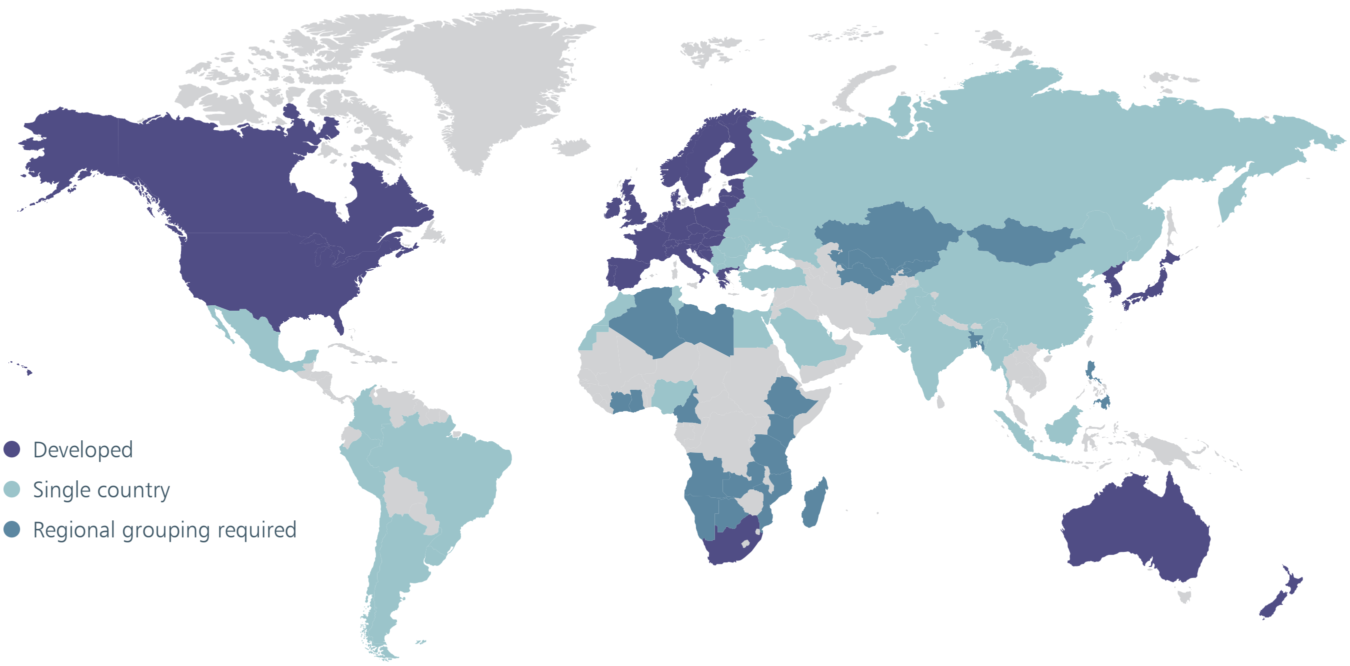
Downward trending risk—Since 2000 several dynamics have been at work gradually de-risking emerging markets private equity. They are, in summary, (i) the emergence of local private equity capacity across a wide range of countries, (ii) the longer experience of private equity and associated longer track records, and (iii) strong domestic growth permitting private equity firms to invest primarily in companies linked to domestic demand rather than export.

The most important of these trends is the emergence of local private equity capacity. Private equity is a very local business. Consequently, competent local capacity is very important to managing risks. IFC has repeatedly seen this to be true, especially as one goes below the level of large international-scale companies—which is where most future deal flow lies. Access to transactions requires the right local connections to build trust and credibility with company owners; adequate due diligence depends on an intimate knowledge of local accounting, governance and regulatory quirks; attracting quality executives to investee companies requires sufficient trust and belief in the GP for local executives to leave safe and prestigious positions; and, finally, local knowledge helps to obtain the best access to limited local debt finance.

Growth in the supply of local private equity capacity has followed growth in demand for advice and guidance: an increasing number of growth-oriented firms are willing to allow activist investors to have influence over corporate strategy. In 2000, we considered only the BRICs and South Africa to have adequate influence/control deal flow to support dedicated country funds. Outside those countries, deal flow was thin enough that, to get adequate selectivity, regional coverage was required. But, with regional coverage, how do you afford the resources required to be truly local in each country? As Exhibit 1 shows, there is now enough deal flow to support dedicated country funds in many more countries than ten years ago.

Growth in attractive deal flow to support local private equity capacity has been driven by (i) deregulation of domestic markets in the 1990s which spurred the growth of private enterprises and (ii) reduction in barriers to trade and capital flows in the 2000s. For example, trade flows (exports + imports) grew from 38% of China's GDP in 1999 to 70% by 2008, and from 25% of India's GDP to well over 50% over the same period. Greater exchanges of goods and investment capital heightened the need for improved business practices at internationally competitive levels and created opportunities for regional and international expansion. In turn, owners of companies became increasingly open to partnership with, or sale to, third parties with the skills to help grow their companies. The

Exhibit 1: IFC's View of the Global EM PE Opportunity



Note: Graphic reflects IFC analysis of the investable funds universe in the emerging markets, i.e., "single country" indicates markets in which country-dedicated vehicles are available for investment; "regional grouping required" indicates markets accessible via regional funds.

extent of this opening up is illustrated by the Franklin Institute's Economic Freedom of the World (EFW), which shows a strong trend toward deregulation of domestic markets in the 1990s.

Focus on Domestic Growth—Associated with domestic market liberalization is the growth-off-a-constrained-base which creates domestic momentum somewhat insulated from global macro trends. The large majority of companies in which IFC-backed funds have invested (72%) are focused on domestic or regional growth opportunities. Interestingly, this growth in domestic consumption and manufacturing appears to be captured earlier in private equity than in the listed markets. A comparison of the sectors in which companies in IFC-backed funds operate compared to the sectors in the MSCI EM + Frontier Index shows private equity to have significantly greater exposure to the Consumer Discretionary (26.4% vs. 5.6%), Industrials (10% vs. 6.7%), Telecommunications Services (18.3% vs. 9.1%) and Healthcare (4.9% vs. 2.2%) sectors.

Low leverage—Private equity in emerging markets is based upon growth, not financial gearing. The average compounded annual revenue growth of IFC-invested funds' portfolio companies is 37.8% (median 19.5%). The average debt-to-equity ratio for these same firms is 0.74 (median 0.33). While these low levels of debt naturally reflect the underdeveloped nature of local financial systems, they also contribute to considerable resilience in a downturn.

Relatively less competition for transactions—Despite the strong growth in capital committed to private equity in emerging markets between 2005 and 2008, private equity commitments as a percentage of GDP, even for the BRICs, remain well below the levels in developed markets. While part of this is structural—without access to debt finance, slower growing companies cannot be made into suitable private equity transactions—emerging markets remain relatively under-penetrated.

Exhibit 2: Private Equity Performance Benefits from Diversification

IRR from 2000 to...	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09
IFC – All Private Equity Funds	22.9%	15.6%	14.4%	15.9%	17.0%
Cambridge EM Top Quartile	16.9%	10.7%	9.4%	10.3%	12.7%
Cambridge Asia ex-Japan Top Quartile	14.9%	10.6%	6.6%	8.5%	9.0%

Source: IFC Portfolio, Cambridge Associates LLC.

Misperceptions—Three widely held misperceptions are that: (i) the minority positions common in emerging markets private equity are too risky due to lack of proper legal systems, governance and transparency; (ii) emerging markets private equity faces constrained exit opportunities and therefore emerges slowly from the J-Curve; and (iii) small companies are risky and it is too risky to compound small company risk with emerging markets risk. In our experience none of these perceptions is true.

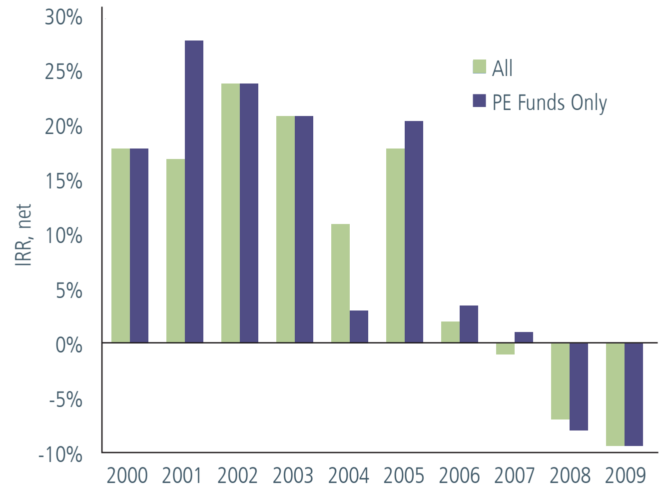
Exhibit 3 compares median and average IRRs of companies in IFC-backed funds for minority and majority positions across different exit routes: minority positions have been very successful, for reasons elaborated on below. Exhibit 4 shows IFC's returns by fund vintage year. As of December 2009, 2007 vintage funds had already emerged from the J-Curve. Exhibit 5 indicates that experience has been positive with deal sizes as low as US$2 million.

Due Diligence in Emerging Markets—Lessons from IFC's Experience

Due diligence in developed markets focuses on verification of track record, attribution of track record and assessment of team stability. In emerging markets it is necessary to probe further, firstly into the workings of the private equity model itself in the local environment and secondly to assess the stability of the model in the rapidly evolving and dynamic environment that characterizes most emerging markets.

Due diligence needs to match the GP's skills to the deal flow—During my time managing the World Bank Pension Fund's private equity portfolio in the 1990s, we looked into how each of our funds made its returns—simplistically put, what combination of leverage, multiple expansion, revenue growth and improved efficiency was behind the returns. We found there was, at a general level, a relationship between the drivers of the IRR and the background of the GP's team. For example, teams heavy with investment bankers tended to use leverage more as a return driver and teams heavy with former company managers tended to favor revenue growth and efficiency.

Exhibit 4: Comparative IRRs by Vintage Year

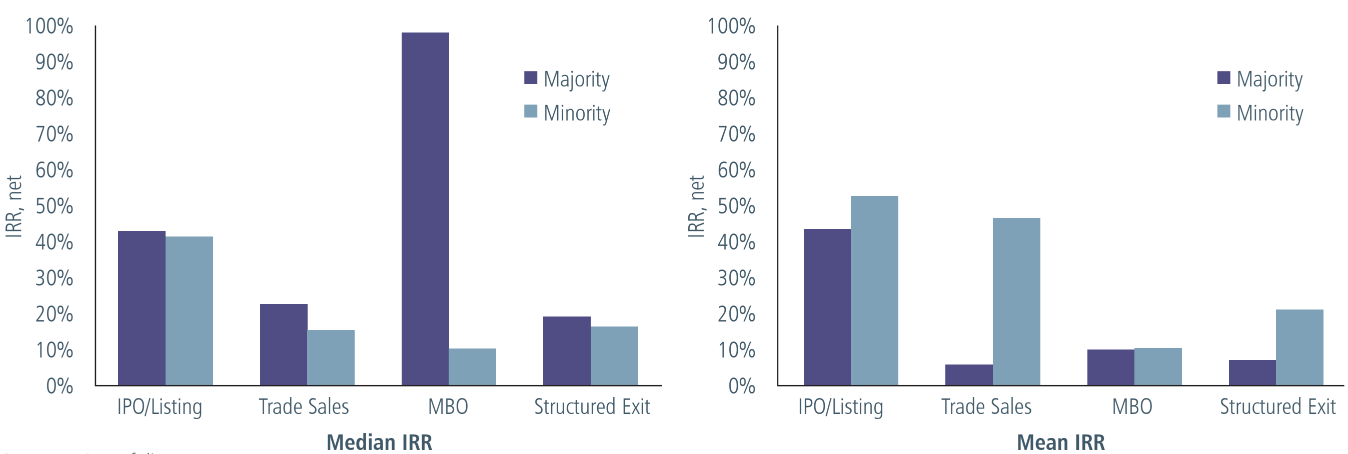


Source: IFC fund investments by vintage year as of Dec 2009; Cambridge Associates LLC.

Taking this relationship between the GPs skill set and drivers of returns to emerging markets and reversing it, the question becomes, "If the local deal flow looks like x, what skill set is best suited to execute the appropriate strategy?" As noted above, there is little leverage available in most emerging markets, so growth is an important component of the majority of transactions. In most situations it is important to have a GP team with the right skills to help companies grow and deal with the complexities of corporatization.

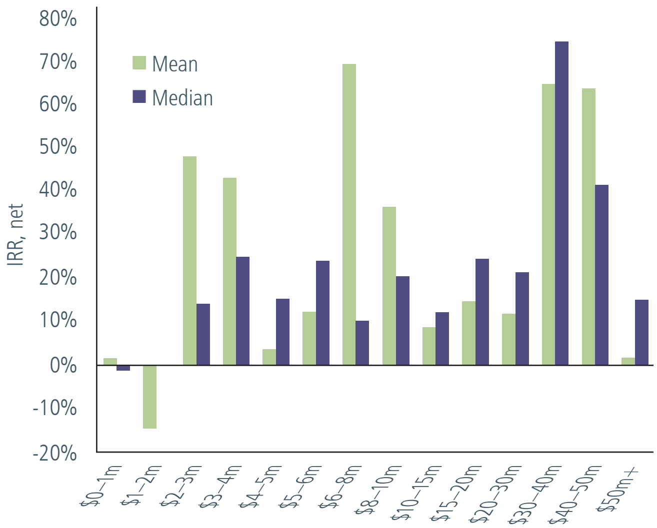
The GP's value-added skills are especially important given the prevalence of minority positions. IFC's 1990s fund investments were littered with minority positions which had not worked. Investigating this, it appeared that minority positions worked well when the GP was seen as a partner by the majority: GPs were viewed as partners when they were seen to make valued contributions to growing and improving the business. If the GP was seen as an intel-

Exhibit 3: Comparative Exit IRRs for Majority and Minority Positions in IFC-invested Funds



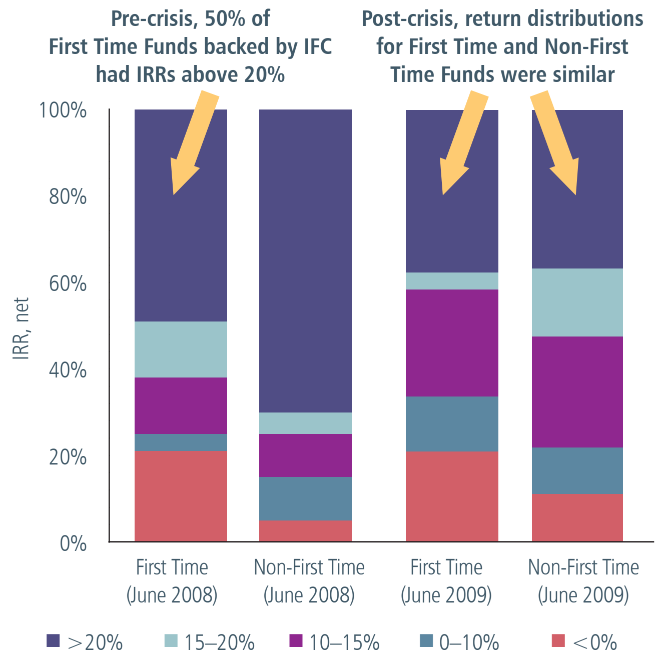
Source: IFC Portfolio.

Exhibit 5: Comparative IRRs by Investment Size



Source: IFC Portfolio.

Exhibit 6: Comparative IRRs, First Time Funds and Non-First Time Funds, Pre- and Post-Crisis



Source: IFC Portfolio.

ligent person and a good sounding board, but nothing more, there was no feeling of partnership, and this led to problems when the deal went well, and different problems when it went badly.

When a deal was successful, the majority resented sharing the full equity up-side with a passive partner and found ways to reduce the minority's return to the level of enhanced debt. When a deal struck difficulties, the majority read the shareholders agreement more carefully, became frightened by the wide rights of the minority, and became obstructionist or at worst resorted to criminal action to protect themselves from the potential exercise of draconian minority rights.

The success of minority positions in Exhibit 3 is attributable to the GP being both local enough and having the right skills to be viewed as a partner by the majority.

Past Performance is Not Necessarily the Gold Standard in Evolving Conditions—As change in emerging markets is constant, the predictive power of past track records may be less than in developed markets. Indeed, we have not seen a clear performance discount for first time fund managers. As a result, rather than simply verifying the track record and attribution to the team, it is necessary to enquire further into the strategy that generated the track record and whether conditions are likely to remain favorable for that strategy in the years to come.

The process for evaluating first time fund managers will, by necessity, have to evolve as private equity further develops and these markets mature. IFC has been successful in selecting first time managers: Exhibit 6 shows the performance of the mature first time funds backed by IFC pre- and post-crisis. Before the crisis, 50% of the mature first time funds had net IRRs in excess of 20% compared to 70% of mature non-first time funds. The crisis appears to have affected both first time and non-first time funds equally. Part of this success is attributable to selecting GPs with the skills required to manage the type of deal flow particular to a given market. In addition, relatively lower levels of competition for transactions also contributes to relatively stronger performance. In a less competitive environment where there is less time-pressure on decision making, newly minted GPs have more time to think through transactions and are not driven into errors of judgment through haste. However, as markets mature, competition and time pressure on decision making will increase, increasing the risk in backing first time funds.

In closing, to invest successfully in markets that continue to evolve, due diligence must include a closer examination of what drove past returns and ask whether this strategy has the potential to achieve the same degree of success in the future with the same level of risk. LPs should also ask if the GP's team has the right mix of skills to be able to adapt to changing conditions.

David Wilton is Chief Investment Officer for IFC's Private Equity and Investment Funds Department with responsibility for IFC's investment program in emerging market funds globally, and a member of the Pension Finance Committee of the World Bank Group. David joined the Funds Department of IFC at its inception in 2000 and has been responsible for turning around the portfolio and developing the funds strategy.