IFC’s David Wilton on making PE work in emerging markets

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As the world’s largest development finance institution, the International Finance Corporation (IFC) is one of the most active private equity investors in global emerging markets. And while its mandate dictates its activities in these up-and-coming regions, its focus on first-time funds and frontier countries differentiates it at a time when LPs of all kinds are keen to establish themselves in new markets.

The nature of the investments and markets that it focuses on also informs its approach when it comes to fund selection and analysis, says David Wilton, chief investment officer of the IFC’s global private equity activities.

“Because of our mandate we are looking at over 50 per cent first-time funds. We do not have track records for due diligence, so we have got to understand how the money is made for us to work out what skill-sets to look for in these new teams.

“This is where understanding the markets and what drives returns in the markets is important. If you don’t understand what will drive the returns in a market, you do not know what skills to look for in private equity teams.”

Currently 75 per cent of IFC’s activities is taken up with lending, with the remaining 25 per cent made up of investments - both in funds and direct. In 2011, it invested $12.2bn in 518 projects, with an additional $6.5bn going into the private sector.

Its fund investment activities have not always proved successful since being launched in the late 1980s, however. At the time it was seen as an ideal way of getting the skill, knowledge and equity to companies in emerging markets, according to Wilton. “Private equity in emerging markets is not an LBO business model, it is almost entirely growth equity. At the time we believed that if we found the managers with the right skill-sets, then companies would grow in a more stable way.”

Nascent markets

However by the late nineties it became apparent that these funds were underperforming IFC’s direct investments. He explains, “We created a dedicated funds department to look at the problem, pulling all the existing fund investments together – at the time around 120. We analysed the portfolio to try and work out what had gone wrong, and whether it was something the IFC should continue doing, or whether the markets were too nascent for this kind of approach.”

The conclusion was that emerging markets fund investment remained a good business, but just needed to be carried out differently – particularly in markets that in hindsight had been too nascent for this kind of investment.

He adds, “We had looked at the growing demand for equity finance, and presumed that it must equate to good private equity opportunities – but it doesn’t. There is no necessary link between the two. Private equity needs control or influence, and in the 1990s the demand was more for passive equity. We hadn’t been doing the right analysis.”

As a result, from 2000 it changed its approach, which has continued to this day. Wilton says, “We start off by looking at each new country where we are considering a fund, and ask what is driving deal-flow that is suitable for private equity – be it generation change, growth that can’t be financed internally, conglomerates selling off non-core businesses, privatisation, distressed sellers, or simply hand-holding to support sustainable expansion.”

Speed bumps

“Often fast-growing companies hit a lot of speed bumps and need help to be able to grow in a sustainable way. If there are enough of these factors, then we decide a dedicated country fund is viable and look to find a manager.”

If there isn’t deemed to be enough deal-flow, there is also the option to pull up to a sub-regional or regional level. And while back in 2000 it was only the BRICS and South Africa that arguably merited single-country funds, a regional approach did not always sit well with a strategy that depended on understanding businesses at ground level.

“The problem with doing that is that it can be a very local business and you do need teams that are embedded in the local business community and markets. If you pull up to regional level you lose some of that contact,” he adds.

“This has changed an awful lot, and there are now 20 to 30 countries where you can do a dedicated country fund. As the deal-flow has grown over the years, the quality of the opportunity and the quality of the business has improved a lot. Once you have these teams embedded they get better deal-flow, they understand how to do due diligence better, they can identify problems and improvements and it is a much better proposition.

“The quality of the opportunity has improved and de-risked. Now it is a much higher-quality, lower-risk opportunity than it was back in 2000.”

The IFC is a member of the World Bank Group and is the largest development institution focused exclusively on the private sector.

Established in 1956, the IFC’s work in more than 100 developing countries allows companies and financial institutions in emerging markets to create jobs, generate tax revenues and improve corporate governance and environmental performance.

IFC Asset Management Company mobilises and manages funds on behalf of a wide variety of institutional investors—including sovereign funds, pension funds, and development finance institutions. It has approximately $4.1bn in assets under management.
“If you don’t understand what will drive the returns in a market, you do not know what skills to look for in private equity teams”

IFC steps up game in changing Asian markets

Investment strategies can vary from country to country – particularly with those exceptions, or “oddities” as Wilton calls them, where the local public market is very active and it has historically been easy to list.

While regions such as Africa have a culture of growth equity and teams with good operating skills, identifying capable managers in some Asian countries can often prove a more challenging task – having historically relied on momentum strategies in sympathetic share markets.

Wilton says, “India, Vietnam and China have had their private markets distorted in different ways by the listed markets.

“In Vietnam, for example, pre-crisis there were about 65 private equity funds. Looking closer, maybe three were actually recognisable as genuine private equity, the rest were just guys playing the valuation-multiple game. The government was corporatising state-owned enterprises, listing them on the OTC market and then taking them to the listed market. Each step in that you got a pop in the valuation multiple, so if you got in early, there was a nice conveyor belt you could ride.”

Although it was labelled private equity and the companies were technically private, it was not how you would view it traditionally, Wilton adds, “The focus is on passively getting a valuation multiple pop, and that game ended very suddenly when the share market went. Then the only people left standing were the ones who were actually doing real private equity.”

He says, “There is a similar thing going on in India, and many of these funds are just doing a lot of PIPE deals.

“Regardless of what they said, much of their strategy relied on the public market momentum. The people that ran them were mainly investment bankers and very few of them had any operating ability – I can think of two that had real value-added operating skills. Consequently we didn’t do much in India. We like guys that have that skill-set to do growth equity.

“After the share market declined significantly that strategy was clearly not viable and the type of managers coming to market now are very different to what we saw before the crisis. Now, there are teams with a lot of operating capacity, as you can’t play a nice easy game of momentum – you need to roll up your sleeves and actually do growth equity.

“India has a pretty deep bench of management talent, so these funds are staffing up with this operating expertise.”

Wilton adds, “In my view the qualities of the GPs coming to market now are much higher than what we saw pre-crisis.

“Also the amount of dry powder is declining and private market prices are beginning to show signs of softening. Consequently we have really stepped up what we are doing in India.”

Market characteristics
External investors often find that new markets frequently display different approaches to making money, whether through top-line revenue growth, margin improvements, financial leverage or expansion through acquisitions.

Fund investments therefore take on a different complexion depending on the region in question, according to Wilton.

“Emerging markets have very limited leverage, bar a few places such as South Africa, or at the larger deal sizes where some international banks can be found. Generally, there is not much leverage and it is all growth equity.”

He adds, “In a market with a lot of leverage, a lot of returns will come from financial structuring, and in these markets investment bankers make fine private equity people. In markets where it is mostly growth equity, investment banking and structuring skills are not as relevant, and this is not what you want in a GP. We want people that have run companies, that have been entrepreneurs or have been consultants in that region and have the necessary operating skills.

“These skills provide the ability to add value and, importantly in countries where enforcement of a shareholders’ agreement can be difficult, they can help the GP be viewed as a partner by the companies in their portfolio, so the relationship helps to enforce the agreement.”
“The quality of the opportunity has improved and de-risked. Now it is a much a higher-quality, lower-risk opportunity than it was back in 2000”

In practice, private equity investments in these markets usually take the form of minority positions. Often company owners might be looking for help and guidance as much as money – and the ability to source deal flow is better if you can also offer this business support.

“Obviously, if you can add value then the outcome should be more favourable,” Wilton says. “We have seen, say, in China, in the early 2000s companies were growing at 50 per cent top-line growth and, in these circumstances, if a few mistakes are made and growth drops by a few per cent, you are still going to get a good IRR.

“These days, growth is more 20 to 30 per cent, and if you don’t have leverage, to get that 25 per cent gross IRR you need to make sure that growth is consistent. Operating skills help to ensure you stay on a steady course and, with a greater need for consistency, the value of operating skills has gone up.”

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Another criterion that understandably sits high up on the list is locality, and as Wilton says, “We don’t think fly in, fly out, works.” He adds, “We don’t think track record can transfer between countries. A GP might have a gilt-edged track record from the US or Europe, but unless we like the look of the local team, we just don’t think it is transferable. They need to be physically there, ideally locals, or expats who have been there long enough to understand how things work.”

Early mover
Because of its development mandate, IFC tends to be an early mover going into markets, and by definition this means backing inexperienced teams. Having managed the World Bank pension fund’s private equity portfolio back in the 1990s, Wilton is familiar with the established practices of institutional investors. In that context, you simply “would not touch” a first-time fund, he says.

“The guys we are looking at are not spinning out from anything – they are often coming together for the first time. However, it has proven successful. When we first started doing this I thought we were taking a very big risk, but it turns out the risk wasn’t as big as I thought it was. It turns out there is a pronounced early-mover advantage.

“If you understand how the money has to be made, and find the team with the right skill-set, in a less penetrated market they will have time to understand the company, to identify the problems, and then they can price it properly. In a more competitive market, you do not have that time and a neophyte team under pressure will make mistakes.”