What is it that makes us think these factors are important?

Private equity is a very local business

Access to deal flow, particularly truly proprietary deal flow, requires local contacts. Due diligence requires knowledge of the reputation of sellers (particularly in minority positions) and of local quirks in governance and transparency. Building teams in fast growing companies requires access to talented local management and the ability to win their confidence to leave stable, prestigious jobs. Capacity in each of these areas is enhanced if the GP’s team is both locally based and has senior local nationals. Even something as basic as efficient communication requires mutual respect and understanding that is greatly facilitated by local presence, which can take the form of either a dedicated local operation, a partnership between a foreign GP and a local firm, or a local branch of a foreign GP.

PE investors in EMs must know how to pull the primary lever for EM returns—growth

There is very little leverage in most EM PE transactions. A survey of IFC-invested funds shows average portfolio company debt-to-equity ratios of 0.74 (median 0.33), indicating that financial structuring skill is not a big driver of returns. Most return comes from top line growth and efficiency improvements. The same survey also shows average revenue growth of 37.8% (median 19.5%), strengthening the case that the ability to help companies grow, become more efficient, and manage the risks of growth is key. This is important because, the way in which returns are made dictate which skills are needed in the GP team. As Figure 3 shows, if return is growth-focused, operational experience — as a senior manager, entrepreneur or consultant — is the most relevant prior experience.

Figure 3: GP Experience – Required Skills Depend on Model

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

The ability of GPs to bring value-added skills to bear is made even more important in EMs by the prevalence of minority positions. While the fund will have elements of control and influence through a shareholders agreement, timely enforcement is usually very difficult. A successful relationship between the fund and the investee company depends much more on personal relationships than contractual terms. In particular, minority positions are successful when the GP is viewed as a valued partner by the majority owner. A valued partner is someone who has brought ideas to the table; actively helped the majority solve problems; stepped up in times of difficulty: these things are more than just attending board meetings and come more naturally to people with experience in operating companies than to finance people.

In good times, the benefit of being seen as a contributing partner is the majority’s willingness to fully share the upside on a successful transaction. We have seen cases where companies are unwilling to fully share the upside with passive minority shareholders who ‘had not done any of the work’. A resentful investee is often in position to manipulate accounts to deliver an enhanced-debt-like return to the minority on a structured exit. In bad times, the trust intrinsic to an active partnership enables transparency, discussion and mutual agreement on solutions. Without this trust, we have seen cases of investee managers re-reading the shareholders agreement and panicking at some of the actions available to the minority, leading to unilateral actions very damaging to the minority position.

Overall, the experience of funds in which IFC has invested with minority positions has been positive (see Figure 4) and we attribute this to the IFC-invested GPs being viewed as real partners thanks to their tangible value adding activities.

Figure 4: Comparative performance by Exit Type, Majority versus Minority Investments

Partnership has led to good performance from minority positions in all forms of exit, indicating that the risks associated with minority positions can be managed effectively.
Investor interest in emerging markets (EM) private equity (PE) is on the rise. For many investors, however, concerns over a range of issues—perhaps most importantly lack of information, particularly on performance—may prevent them from actually committing capital.

IFC reorganized the way it invested in funds in 2000, creating a department dedicated to fund investing. From January 2000 until December 2009, the return on IFC’s private equity funds (excluding real estate, debt and listed equity funds) was 18.1%, compared to the top quartiles of Cambridge indices over the same period of: Emerging Markets 16.2%, Asia ex-Japan 14.5% and US 14.1%. This is a significant improvement on the 4-5% return on IFC’s 1990’s funds and the 1990’s top quartile of 11.9%.

Figure 1 compares results with expectations at the time of investment for mature funds invested since 2000. Two points stand out: (i) the success rate with first time funds has been higher than expected, and (ii) track record is not automatically portable between different geographies.

Figure 2 illustrates the lack of negative differentiation in performance: first time funds were represented equally in the top and bottom 10% of funds in IFC’s portfolio; and funds in IDA (countries with less than $1000 per capital annual income) are a greater percentage of top performing funds than bottom performing ones.

The differentiating factor between the top and bottom 10% of funds was the quality of the GP. Figure 2 measures this with an average deal score (in the final column). All funds were assigned a score between 0 and 1 depending on the extent to which they met criteria we consider important to successful private equity investing in emerging markets: was the GP locally based; were a meaningful number of staff local nationals; did the team possess experience that would enable them to add value to companies such as prior experience in running companies, as entrepreneurs or as consultants; did someone in the team have prior experience in private equity? Funds in the top 10% overwhelmingly met these criteria while funds in the bottom 10% failed to meet them. Interestingly, the top 10% not only delivered superior financial returns but also performed significantly better in terms of development impact.

Why do we focus on local presence; local nationals as staff; value-addition capacity through past experience in running or advising companies; and private equity experience; as primary indicators of potential success?

The obvious answer, as backers of first time funds, is that in the absence of track record we are forced to identify other indicators and these are the indicators we have found most useful. Clearly a long and successful track record replete with exits would be even better as an indicator (with the usual caveats on team stability, motivation when fees become large at bigger fund sizes and the scalability of the investment model at larger investment sizes), but the entire asset class is still nascent and drawing new entrants, so we do not usually have the benefit of long track records.
Knowing how to identify and manage a path to exit takes experience

The task of the GP in bringing an investee to exit is to ensure the company is attractive to potential trade buyers or the IPO market: transparency, good governance, a certain scale or market share, certain profitability or growth levels, valuation levels. Experienced PE professionals know what sells, know how to develop (and agree with the majority) on plans and milestones that will move the company towards that exit window, and know how to work with company management to execute the plan and exit within the target time frame. This thought process — backward from exit to acquisition — comes naturally to experienced PE professionals but is not necessarily obvious to people from other backgrounds who may be more easily distracted by single pieces of the equation — ‘it’s cheap!’ ‘the growth is fantastic!’ An experienced PE professional can weed out companies with limited exit prospects and focus on the most promising opportunities.

A limited window of opportunity: prospects for first time funds in more crowded markets

IFC’s success investing in first time funds has been noted already. While we think part of this success is due to good selection criteria focused on the skills of the individuals in a team, a large part of it is also due to the under-penetrated nature of many emerging markets. IFC’s experience backing many early-mover funds has shown that with less competition for deal flow, novice GPs have more time to spend on due diligence and understand companies, helping them to avoid mistakes of haste. As PE penetration in emerging markets rises we think the risk of backing new teams will also rise.

The Rise of Chinese RMB Funds

BY YING WHITE, AKIN, GUMP, STRAUSS, HAUER & FELD LLP

There have been monumental changes in private equity and venture capital in most parts of the world as financial crises have ushered in an era of tight credit, low equity values and the virtual disappearance of IPOs. By contrast, China has emerged apparently prepared to repeat the same growth story that businesses experienced starting in the 1990s.

In a global investment environment that is currently less favorable to private equity, the opportunity to invest in the world’s fastest-growing economy can provide an important lifeline. Chinese private equity is still in its youth, particularly when compared to corporate activity, which has just experienced over 20 years of extremely fast-paced mergers and acquisitions activity. Just hitting the 10-year mark, private equity in China is now entering the high end of a cycle that should last a minimum of 10 more years. This year is already breaking all previous records. According to recent press reports, 45 private equity funds raised US$19.1 billion, which is six times as much as the amount raised in the second quarter of 2009 and three times as much as the figure for the first quarter of 2010.

However, there have been recent changes in regulations that may give investors the sense that private equity investing in China is challenging. For those willing and able to overcome these challenges, the rewards can be great. Those firms that cannot, however, may be increasingly marginalized in one of the fastest-growing economies in the world.

The new paradigm for private equity investing in China has a number of unique characteristics that set it apart from the pattern in other emerging markets, such as the use of the Chinese renminbi (RMB) instead of the U.S. dollar.

For example, regulatory changes have made it difficult for international private equity managers to utilize traditional special purpose vehicle (SPV) structures for their China investments. In the past, Chinese companies set up offshore structures with the ultimate holding companies incorporated in Hong Kong, BVI, the Cayman Islands or elsewhere outside China. These offshore companies could take in U.S. dollar investments from private equity funds and then IPO outside of China. The international private equity funds put U.S. dollars in and took U.S. dollars out. The current regulations make investing in U.S. dollars more difficult compared to investors with access to Chinese RMB. In addition, currently there are policies in place — as well as market-driven preferences — for exits to take place on China’s domestic exchanges, either in Shanghai or Shenzhen.

The consequences of these policies and market factors may have some positive benefits for private equity funds. While the U.S. dollar may still be the preferred currency because of its full convertibility, global acceptance and stability, the Chinese RMB has several advan-