



THE BOSTON CONSULTING GROUP



New Markets, New Rules

Will Emerging Markets Reshape Private Equity?

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New Markets, New Rules

Will Emerging Markets Reshape Private Equity?

In our previous White Papers on private equity, we assessed the implications of the private-equity shakeout and limited partners' likely preferences for the upcoming fundraising cycle, focusing primarily on developed markets.¹ With the balance of economic power shifting rapidly to emerging markets, many limited partners are now rethinking how they allocate their funds and negotiating with their general partners to shift a higher proportion of their dry powder toward emerging markets.² But should general partners allocate more attention to these markets? And, if so, on which particular markets should they focus? And using which business model?

In this White Paper, we address these questions on the basis of both an analysis of the largest data set of its kind and a unique framework for assessing the relative attractiveness of individual markets for private equity.

Key findings from our research include:

- ◇ The most attractive markets for investors are determined not just by their economic size, as measured by GDP, but also by the relative sophistication of their socioeconomic environments, including their regulatory and legal systems. Although China will continue to shape the private-equity landscape, other countries that may be off many investors' radar will have a surprising influence.
- ◇ The winning firms will use business models that differ from those that have served the private-equity industry so well in the past in developed markets such as the United States and Western Europe. Key success factors in emerging markets range from accepting minority rather than majority stakes in businesses to investing in companies that are focused on domestic rather than international markets.

The primary data for our analyses came from International Finance Corporation (IFC) and covered 176 private-equity funds in emerging markets. We analyzed 942 data points from deals by these funds, spanning 75 emerging markets. Since 2000, IFC has committed nearly \$3 billion to about 160 private-equity funds.³

The framework for assessing the relative attractiveness of markets for private equity, which takes into account both GDP and a country's socioeconomic environment, was based on The Global Venture Capital and Private Equity Country Attractiveness Index published by IESE.⁴ We also conducted qualitative interviews with key players within private-equity's emerging-market sector.

The following pages discuss our findings and their potential implications in more detail. The methodology and data set used in our analyses is described at the end of the paper.

Private Equity's Race to Emerging Markets

Private-equity firms' involvement in emerging markets has increased sharply over the last five years, fueled by a number of factors, including these markets' superior growth rates in GDP and their increasingly high returns in recent years for private equity.

1. Previous White Papers published jointly by BCG and IESE are cited in the bibliography.

2. Dry powder is the capital committed by investors into private-equity funds minus both the capital invested by the firm managing the fund and the capital investors will not be able to provide: the truly undrawn commitment.

3. This information was provided by IFC.

4. The index is at <http://vcpeindex.iese.us/>.

Emerging Markets' Share of Private Equity Is Large and Growing

Between 2005 and 2009, emerging markets' share of the total number of private-equity deals more than doubled from 12 to 30 percent, while their share of total deal value nearly tripled from 8 to 21 percent.⁵ (See Exhibit 1.) This jump was broadly in line with growth in emerging markets' global economic weight.⁶ In addition, 26 of the world's 30 largest private-equity firms invested in these markets over this period, and more than half, or 18, of these firms now have local offices in emerging markets.⁷

More significantly, strong signs suggest that firms intend to step up their involvement in emerging markets. Approximately one-fifth of global dry powder, equivalent to about \$231 billion or seven times annual deal volume (based on a five-year average), is earmarked for these markets, spanning all investment stages.⁸

Two-thirds—67 percent—of limited-partner investors surveyed by the Emerging Markets Private Equity Association (EMPEA) plan to increase their exposure to emerging markets during 2010 and 2011.⁹

5. These data are from Mergermarket and Thomson Reuters.

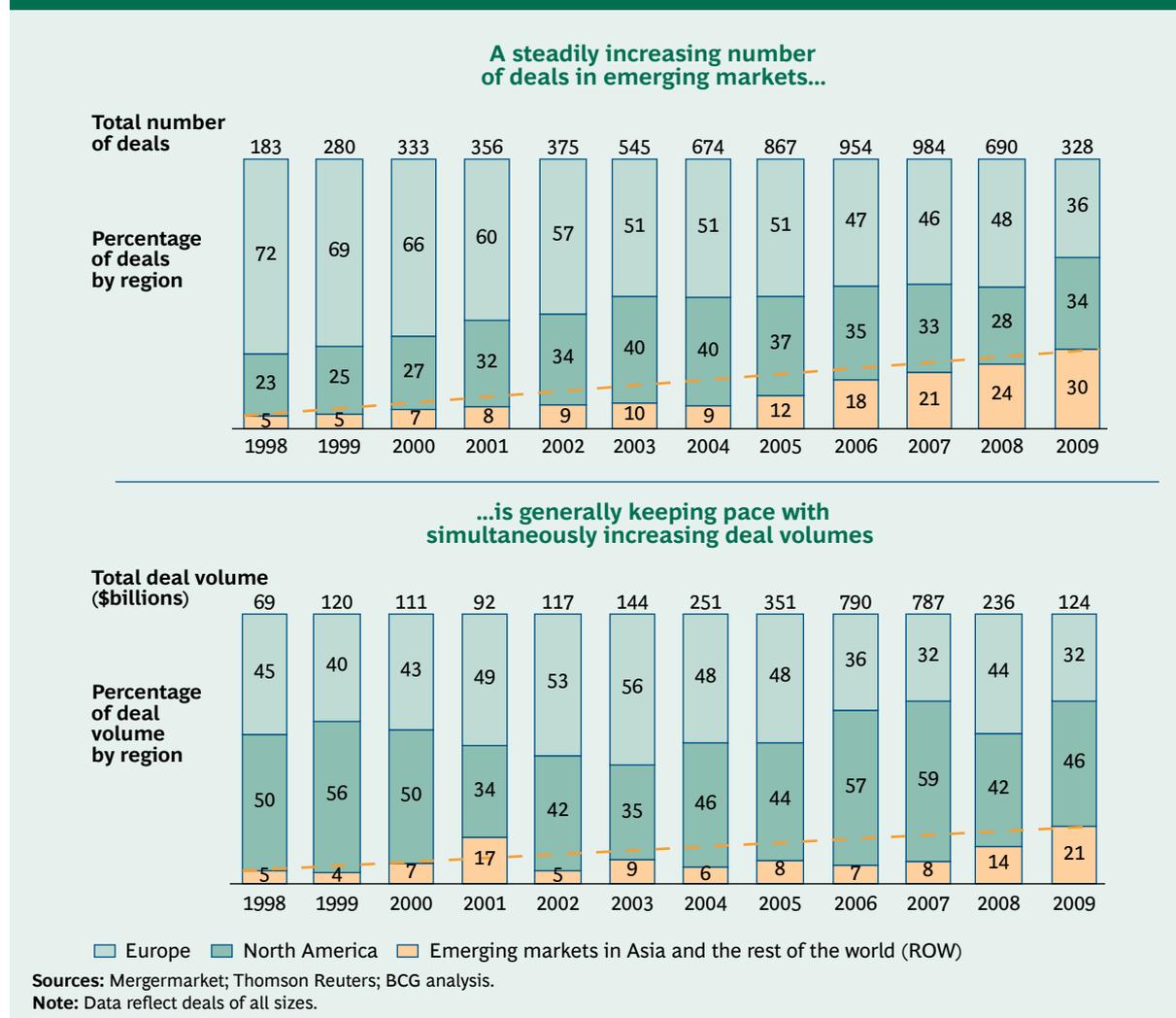
6. Non-OECD countries accounted for 25 percent of global GDP in 2009, according to the Economist Intelligence Unit.

7. These data are from corporate home pages and Thomson Reuters. Nearly all private-equity offices in emerging markets are located in BRIC countries (Brazil, Russia, India, and China).

8. Emerging Markets Private Equity Association (EMPEA) (April 2010).

9. EMPEA and Collier Capital (2010).

Exhibit 1. In 2009, Emerging Markets Accounted for 30 Percent of Deals—and 21 Percent of Deal Volume



Four Main Forces Are Driving the Shift Toward Emerging Markets

Private-equity investors are being pushed and pulled toward emerging markets by a variety of factors that are likely to lead to a rise in these markets' share of private equity. At one level, increasingly intense competition for deals in developed markets, coupled with difficulties in raising debt in the wake of the crisis, are pushing investors toward these markets. More critically, four positive long-term trends are pulling investors toward emerging markets:

- ◇ Superior GDP growth
- ◇ Significantly higher net returns since 2000
- ◇ Greater resilience to the current financial crisis
- ◇ An increasingly attractive socioeconomic environment

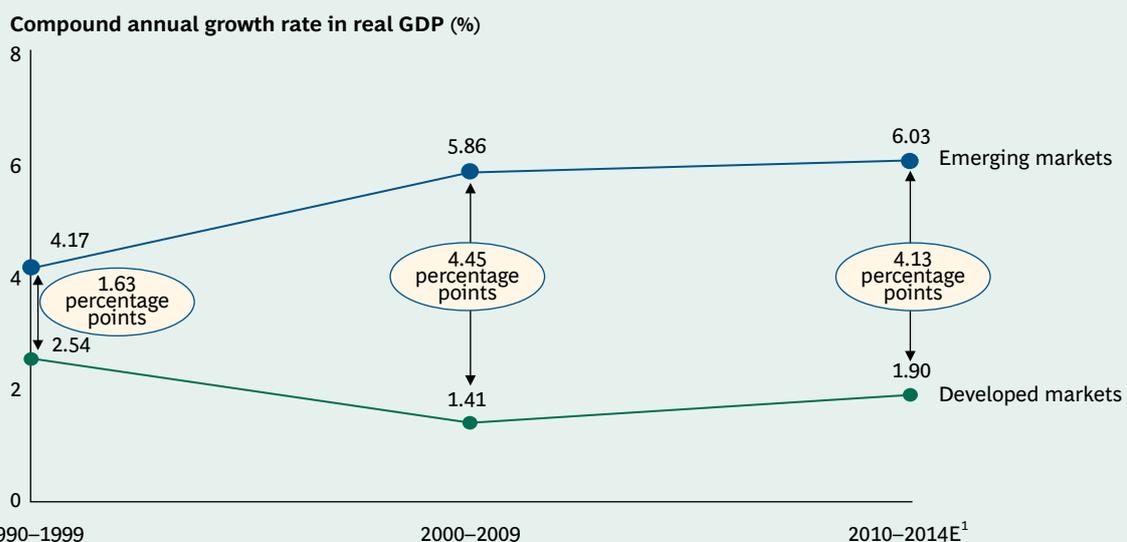
Superior GDP Growth. As Exhibit 2 shows, emerging markets have a higher long-term growth rate for GDP than developed markets do, pulling private equity into emerging markets. Since 1990s, the gap between the growth rates in GDP for emerging and developed markets has widened from 1.63 percentage points for the period from 1990 through 1999 to 4.45 percentage points for the period from 2000 through 2009. Although this gap is forecast to narrow slightly over the next five years, it will remain large—at an estimated 4.13 percentage points for the period from 2010 through 2014—sustaining the pulling power of emerging markets for private-equity firms.¹⁰

Significantly Higher Net Returns Since 2000. Viewed over the long term, the *average* performance of private equity in emerging markets appears relatively unappealing. When Florencio Lopez-de-Silanes of EDHEC Business School analyzed 7,453 global investments made over the last 30 years, for example, he found that emerging markets' internal rate of return (IRR) for private equity was just 12 percent, about half the level achieved in the United States (25 percent) and Europe (22 percent) during the same period.¹¹

10. BCG (2009).

11. Lopez-de-Silanes (2009).

Exhibit 2. The Gap in GDP Growth Rates Has Widened Since the 1990s



Sources: Economist Intelligence Unit (EIU); BCG analysis.

Note: Developed markets include all OECD countries; emerging markets include all non-OECD countries.

¹These figures are projected by the International Monetary Fund.

These numbers take into account neither the higher country risks nor the lower leverage associated with some emerging markets.

However, since 2000, private-equity returns have started moving upward, as an analysis of IFC's portfolio of private-equity investments in emerging markets illustrates. (See Exhibit 3.) Before the 1990s, the portfolio was producing an average return slightly above 4 percent, rising to 5.3 percent for the period between 1990 and 1999. Since 2000, returns have leapt to over 17 percent. This finding is confirmed by an analysis of data from EMPEA and Cambridge Associates, which shows that the gap between private equity's returns in emerging and developed markets has been narrowing rapidly since the turn of the twenty-first century, with returns from emerging markets pulling ahead in recent years by a significant margin.¹²

Greater Resilience to the Current Financial Crisis. Emerging markets not only generate returns comparable to those of their developed-world counterparts but also appear to be more resilient to the current financial crisis. This insight is based on a comparison of the “total-value/paid-in” ratio computed by Cambridge Associates on September 30, 2009, in the wake of the financial crisis.¹³

For funds created during two vintage periods—from 2003 through 2005 and from 2006 through 2007—Cambridge Associates analyzed the share of funds that were worth more *after* the economic crisis than when they were originally paid in. This analysis revealed that a significantly higher proportion of funds in emerging markets were worth more for these two periods (72 percent and 39 percent for the periods, respectively), than in either the United States (64 percent and 29 percent) or Europe (50 percent and 10 percent).¹⁴

One of the reasons why private equity in emerging markets appears to have been more resilient to the recent crisis is that it is comparatively less dependent on leverage than in developed markets.¹⁵

12. EMPEA and Cambridge Associates (2010). Returns across geographies are not fully comparable, as private-equity investments in emerging markets have a higher country risk profile and might differ in the degree of leverage used in the transactions, and the data for the emerging markets also includes venture capital.

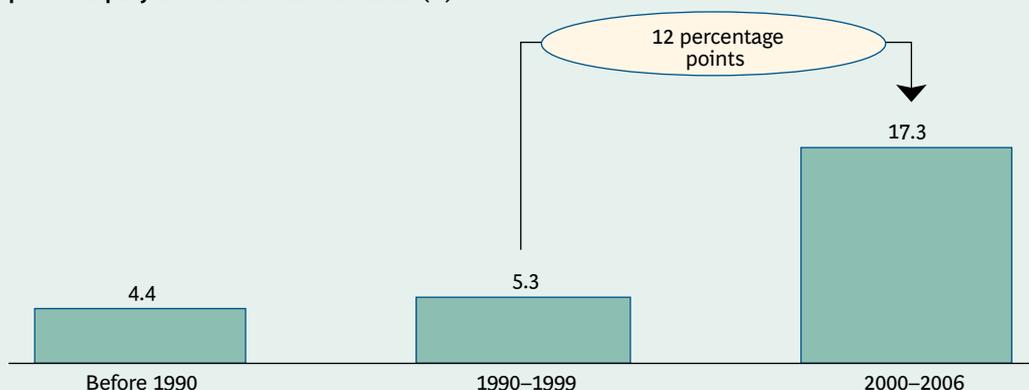
13. Cambridge Associates (2010). This data set for emerging markets includes venture capital and is not adjusted for country risk or variances in leverage risk across emerging markets and developed countries.

14. Ibid.

15. While private equity in developed markets has shown debt-to-equity ratios between 2 and 3, IFC's data showed a much lower ratio of 0.37.

Exhibit 3. Private-Equity Performance in Emerging Markets Has Improved Greatly Since 2000

Cash flow internal rate of return (IRR) for private-equity investments in IFC funds¹ (%)



Sources: IFC's fund-level data; BCG analysis.

Note: Data reflect 176 private-equity funds in emerging markets.

¹The return is net of fees and carried interest; the cutoff for fund data was the 2006 vintage year.

An Increasingly Attractive Socioeconomic Environment. Several proposed changes to the regulatory and fiscal environments in developed markets are making emerging markets' socioeconomic environments relatively more attractive for private equity. The United States, for example, is reconsidering how it taxes carried interest income and is planning to increase taxes for private-equity managers.¹⁶ Similarly, the European Union's Directive on Alternative Investment Fund Managers (the AIFM Directive), currently under discussion, could lead to more onerous regulations for the alternative investment sector.¹⁷

Countries That Could Reshape Private Equity

The scale of the opportunity for private equity in each emerging market is obviously determined by the size of that country's economy. However it is the relative sophistication of the countries' socioeconomic environments, including the degree of their market orientation and economic openness, that will decide whether private-equity firms will be able to unlock the full scale of this opportunity.

We have developed a framework for assessing the relative attractiveness of emerging markets for private equity that takes into account both their economic scale and their socioeconomic conditions.¹⁸ (See the sidebar "Assessing a Country's Socioeconomic Environment.") All the countries in our framework have the basic level of deregulation and economic openness required to attract some private-equity investments.¹⁹ (See Exhibit 4.) A country's relative attractiveness and position within the framework are determined by the degree of sophistication of various socioeconomic factors, such as economic openness, governance, investor protection through the legal system, and liquidity of local stock and debt markets. The framework

16. Committee on Ways and Means, U.S. House of Representatives (2010).

17. European Private Equity & Venture Capital Association (2010).

18. All data and analysis are focused on later-stage investments and do not include venture capital.

19. Our selection of countries is based on the emerging markets of the Dow Jones Total Stock Market Index.

Assessing a Country's Socioeconomic Environment

We based our assessment of a country's socioeconomic environment on a combination of factors from The Global Venture Capital and Private Equity Country Attractiveness Index published by IESE. These factors, which reflect a country's degree of deregulation and economic openness, include the following indicators and indices:¹

- ◇ The depth of the capital market and access to debt and credit facilities, including IPO and M&A market volumes, and the number of IPOs and deals
- ◇ Taxation, including the marginal corporate-tax rate, as well as tax on profits and the capital gains tax
- ◇ Investor protection and corporate governance, including the extent of disclosure index, extent of director liability index, ease of shareholder suits index, strength of legal rights index, efficacy of corporate boards, legal enforcement of contracts, property rights, intellectual property protection, judicial independence, the impartiality of courts,

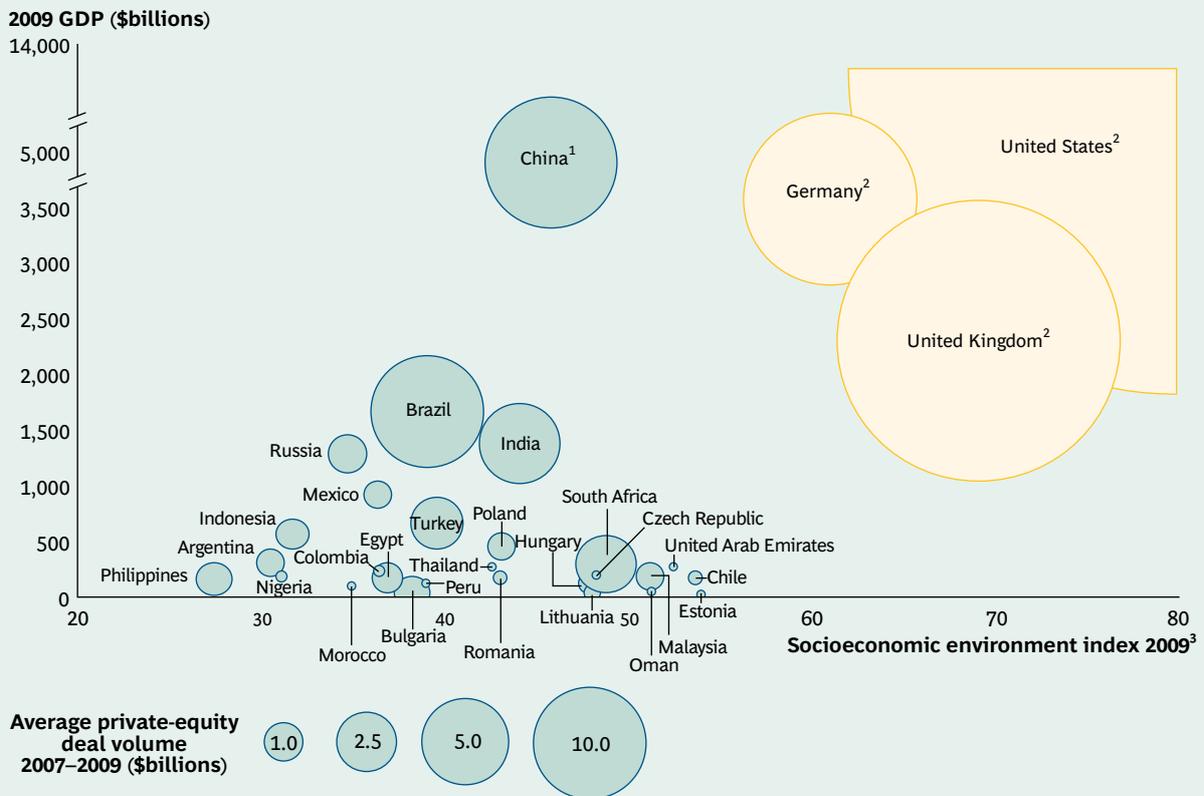
the integrity of the legal system, rule of law, and regulatory quality

- ◇ The human and social environment including the difficulty of hiring index, rigidity of hours index, difficulty of redundancy index, firing costs, bribing and corruption index, control of corruption, extra payments and bribes, business costs of crime and violence, and the costs of organized crime
- ◇ Entrepreneurial culture and opportunities, including: the time, cost, and recovery rate of closing a business, as measured by indicators from IFC and the World Bank.

The corresponding GDP figures used to plot a country's overall attractiveness for private equity, relative to its socioeconomic environment, are based on 2009 country GDP data from the Economist Intelligence Unit.

1. The index is available at <http://vcpeindex.iese.us/>.

Exhibit 4. Several Emerging Markets Have Socioeconomic Environments Attractive to Private Equity



Sources: IESE, The Global Venture Capital and Private Equity Country Attractiveness Index, 2009/2010 Annual; EIU; Thomson Reuters; BCG analysis.

¹Thomson Reuters valued China's deals at \$1.9 billion; we replaced this with the deal value of \$10.3 billion as set by Zero2IPO.

²The United States, United Kingdom, and Germany have been included in order to illustrate the current scale of private equity in developed markets and, by implication, the potential scale of the opportunity for emerging markets.

³The index is based on selected parameters of the IESE PE attractiveness index. It takes into account capital markets, taxation, investor protection, social environment, and entrepreneurial culture, excluding economic activity (nominal scores calculated with linear aggregation method). The higher the index rating, the more attractive the market.

is dynamic: as countries improve their socioeconomic environment, their attractiveness for private equity will increase, affecting their relative positions within the framework. Ultimately, the countries themselves control their relative attractiveness and their ability to attract investment to accelerate their development. (See the sidebar "Accelerate or Stagnate: How Emerging Markets Can Attract Private Equity.")

Although large economies such as China have dominated the emerging-market headlines, our analysis reveals a much more nuanced picture of the relative opportunities that the different emerging markets offer.

We have identified three broad categories of countries, each presenting unique opportunities and challenges at different points of time, depending how their economies and socioeconomic environments evolve:

- ◇ The stand-out country: China
- ◇ Markets with potentially large opportunities
- ◇ Countries with specific socioeconomic challenges

Accelerate or Stagnate: How Emerging Markets Can Attract Private Equity

An Interview with David Wilton, Chief Investment Officer, IFC's Private Equity & Investment Funds Dept.

David Wilton is responsible for IFC's global investment program in emerging market funds. He shared his thoughts about private equity in emerging markets, which are excerpted here.

How does private equity contribute to the development of emerging markets?

What private equity brings that other types of investments don't is real, live expertise and experience—not just capital. It helps companies grow quickly and sustainably. Very often, the businesses in these markets are family-run companies with rapid growth rates, unlike their counterparts in developed markets.

Private equity helps them overcome the growing pains by professionalizing their management; introducing transparency, and helping them understand how to manage growth sustainably. If there was no private equity, a lot of companies would struggle to deal with structural issues such as how to replace cousin Joe with a professional manager and how to identify and implement internationally competitive practices.

The impact of private equity in these markets is very tangible. In the companies that the IFC is backing, we're seeing job growth rates of around 22 percent on average, compared to 2 to 4 percent for the countries as a whole.

What do emerging markets need to do to make themselves attractive to private equity?

You need a combination of factors to generate private-equity deal flow. If you look at where private equity has expanded, having a market-based economy is clearly the first prerequisite for creating a strong growth situation that will be attractive to private equity. Removing intrusive regulation and lightening the regulatory burden in other areas is part of this process. For large markets such as China, a market-based growth environment can sometimes be enough to trigger sufficient deal flow—but in most markets, it's rarely enough.

Barriers to international trade and capital flows also have to be lowered so that companies are put under pressure to compete internationally and to specialize where they have competitive advantage.

This shift forces conglomerates to start to focus and sell off noncore businesses. We have seen the impact that lowering barriers to trade and capital flows has had on deal flow in South Africa, Morocco, East Africa, and Colombia, for example.

But attracting private equity isn't just about removing negatives, you also have to introduce positives. The more positives, the greater the deal flow.

What are the positive steps needed to accelerate deal flow?

Greater transparency and a faster, more efficient legal system are two important measures. Once you get this happening, deal flow will jump as due diligence will become easier. Legal improvements also allow private-equity firms to contract at a distance, knowing that the contracts can be enforced. It also makes it easier for banks to lend for debt capital. Getting banks and capital markets working is important to expand private equity to lower-growth companies. The final and harder stage is establishing local stock exchanges with the size and transparency to provide the liquidity and lower cost of capital that is needed for an active IPO market. However, in many countries, the absence of an active IPO market hasn't dampened interest, although we know that IPOs tend to produce the best returns.

How easy is it to achieve the transformations?

Things take time because countries usually want to do things in stages to stay within their comfort zones. What you usually find is that when a country sees one of its neighbors doing well, political and business pressures for reform start building up within the country.

How can international development organizations facilitate this transition?

Policy organizations such as the World Bank and IMF have played an important role in creating the building blocks for market economies, greater transparency, and other elements that are essential for attracting private equity to developing markets. Also, the IFC, CDC [the United Kingdom's development finance institution], European Bank for Reconstruction and Development (EBRD), FMO [the entrepreneurial development bank of the Netherlands], and others have played a fairly big part in backing first-time funds in emerging markets—and once you get these in place, the commercial money follows. In addition, IFC has helped sustain the momentum by investing countercyclically during the financial crisis to plug the gaps. There's now a good basis for moving forward, although things can always get better—and I'm sure they will. Ten years ago, there were only four or five emerging markets that we thought could sustain country-dedicated funds, today there are more than 20.

The Stand-Out Country: China

As the world's second-largest economy, China has recently enjoyed significant private-equity activity of \$6.5 billion.²⁰ The country's growth capital accounted for more than half (53 percent) of private-equity investments in China in 2009, while buyouts accounted for 25 percent.²¹ By contrast, 27 percent of total private-equity investments in the United States were targeted at growth businesses during that year, while buyouts accounted for about 36 percent.²²

Although China ranks lower than mature markets from a socioeconomic perspective, its relatively large deal flow has been fueled primarily by the size and growth of its economy. To sustain and even accelerate the growth of private equity, the country will need to improve its socioeconomic environment—for example, by strengthening and stabilizing its legal system. And there are encouraging signs that China is moving in this direction. In August 2010, the country passed an important milestone in the institutionalization of its private-equity industry when it temporarily lifted a restriction on the ability of state-registered insurers to invest in private equity.²³

In many established private-equity markets, the huge assets and long-term investment cycles of insurers have played a key role in providing a large and stable investor base for private-equity funds. Under the new arrangements, China-registered insurance companies will be able to invest up to 5 percent of their latest quarter's assets in private equity, potentially injecting an estimated \$33 billion into the country's private-equity industry.²⁴

Markets with Potentially Large Opportunities

Countries such as Brazil, India, Turkey, Poland, South Africa, and Malaysia, achieve the same or higher levels of socioeconomic development as China, but have smaller economies. Consequently, these countries could be attractive either because they have high levels of economic development, as Malaysia, or because they have relatively large economies, as Brazil.

Indeed, Brazil highlights many of the challenges and opportunities that investors face in these countries. Fueled by the country's industrial-development policy and relative macroeconomic stability, the value of private-equity deals in Brazil increased from \$2.9 billion in 2005 to \$3.5 billion in 2009, and, for the period from 2008 through 2009, it accounted for 0.12 percent of GDP—compared with 0.80 percent in the United States.²⁵ These investments have been distributed relatively evenly across industries and demonstrate a strong focus on growth capital.²⁶ IPOs have proven to be the most profitable and popular route for exiting, accounting for 55 percent of exits.²⁷ In addition, like many emerging markets, Brazil, as compared with developed countries, weathered the financial crisis fairly well, experiencing only a relatively small drop in fundraising.²⁸

However, the question is whether the private-equity industry in Brazil, which is now the fourth largest employer in the global private-equity sector, can sustain its rise. Investors are betting that it will. Since 2006, committed capital allocations to Brazil have more than doubled to \$27 billion, amounting to more than eight years of average deal volume for the period from 2007 through 2009. In 2009, Brazil accounted for 18 percent of fundraising in emerging markets.²⁹ But unless the socioeconomic environment improves and the economy grows sufficiently, there will not be enough deal flow to justify the huge influx of capital—a reality that could potentially lead to disappointing results.

20. This figure, which measures equity capital invested in 2009, is from Thomson Reuters.

21. These percentages are from Thomson Reuters, which includes in growth capital the Thomson investment categories of "expansion" and "later stage."

22. Data are from Thomson Reuters.

23. Private Equity Online (2010).

24. Ibid.

25. GVcepe (Center for Private Equity and Venture Capital Research at Fundação Getulio Vargas EAESP) (2010).

26. Ibid.

27. GVcepe (2008).

28. GVcepe (2010).

29. Ibid.

Countries with Specific Socioeconomic Challenges

Some countries such as Russia, Nigeria, Argentina, and Indonesia present an apparently high-risk challenge to investors because of their relatively low-ranking socioeconomic environments. Although limited competition makes successful deals in these countries possible, investors need an in-depth understanding of managing the socioeconomic challenges.

New Rules of the Game

The general partners' business model in developed markets is built on taking full ownership and differentiating themselves from each other by the size of their equity investments and their governance models. In emerging markets, our analysis of IFC's unique data set indicates that a very different model is required for private-equity firms to succeed.³⁰ Specifically, we identified the following seven points of difference in emerging markets:

- ◇ Minority deals are more successful than majority deals.
- ◇ Investments in businesses focused on domestic markets outperform those targeting internationally oriented companies.
- ◇ Sector selection can make a difference. In the past, the telecommunications, health care, and materials sectors have had the highest returns.
- ◇ First-time funds match and sometimes exceed the returns achieved by experienced fund managers.
- ◇ Funds with a strong local presence significantly outperform international funds without a local presence.
- ◇ Performance of top-quartile funds is strongly driven by increases in the revenues of the portfolio companies, not by leverage.
- ◇ The size of the fund matters. Bigger funds outperform smaller ones.

Minority Deals Are More Successful than Majority Deals

By analyzing IFC's data, we found that minority investments produced returns that were three times higher than those of majority stake investments. Across all subasset classes, minority deals were also the most common and successful type of private-equity investment in emerging markets. One possible explanation for this is that many businesses in emerging markets are still in the early phases of their corporate life-cycles, and the owners are not willing to sell the entire business while they are still developing it. Minority investments account for 86 percent of all emerging-market deals in IFC's data set. These results contrast starkly with the situation in developed markets, where private equity is built on an active ownership model that requires a clear governance mandate to create value.³¹ In emerging markets, this compromise (minority versus active ownership) has been resolved and potentially offers a blueprint for private-equity investments in the United States and Western Europe.

Investments in Businesses Focused on Domestic Markets Outperform Those Targeting Internationally Oriented Companies

Although there are reasonable arguments for investing in both domestically and internationally oriented businesses in developed markets, our analysis of IFC's data paints a different picture in emerging markets. On average, returns on investments in businesses that target domestic markets outperform those targeting internationally oriented companies by about 18 percentage points. The scale of this difference cannot be explained by superior domestic GDP growth alone. The limited and general partners we interviewed as part of our research told us that the most likely explanation for the difference is that domestically oriented businesses are able to leverage their unique and in-depth expertise in their home markets, while internationally oriented businesses are often built on unsustainable labor-cost arbitrage.

30. A description of the data set can be found in the Data Set and Methodology section of this paper.

31. BCG and IESE (2009).

Sector Selection Can Make a Difference

Investors should be aware that some sectors in emerging markets can produce significantly higher returns than others. For the period from 1978 through 2009, the top-three sectors in the IFC portfolio were telecommunications, health care, and materials. (See Exhibit 5.)

Telecom's strong performance could be attributed to the advent of cellular technology in an environment without an established telecommunications infrastructure, enabling cellular technology to jump ahead and scale up rapidly. As there was no real basis for estimating the potential demand for these cellular services, the licenses that were awarded were probably undervalued—a miscalculation that is unlikely to be repeated. Most of the gaps in this market have now been filled, thus, on balance, future returns are likely to be less buoyant. The high returns of health care and materials, in turn, are probably due to growth in consumer demand, a trend that is expected to continue. While it is important to analyze potential future developments in individual sectors, it also important to recognize that specialization carries risks in emerging markets. Academic research has shown that greater specialization produces lower returns in emerging markets.³²

First-Time Funds Match and Sometimes Exceed the Returns Achieved by Experienced Fund Managers

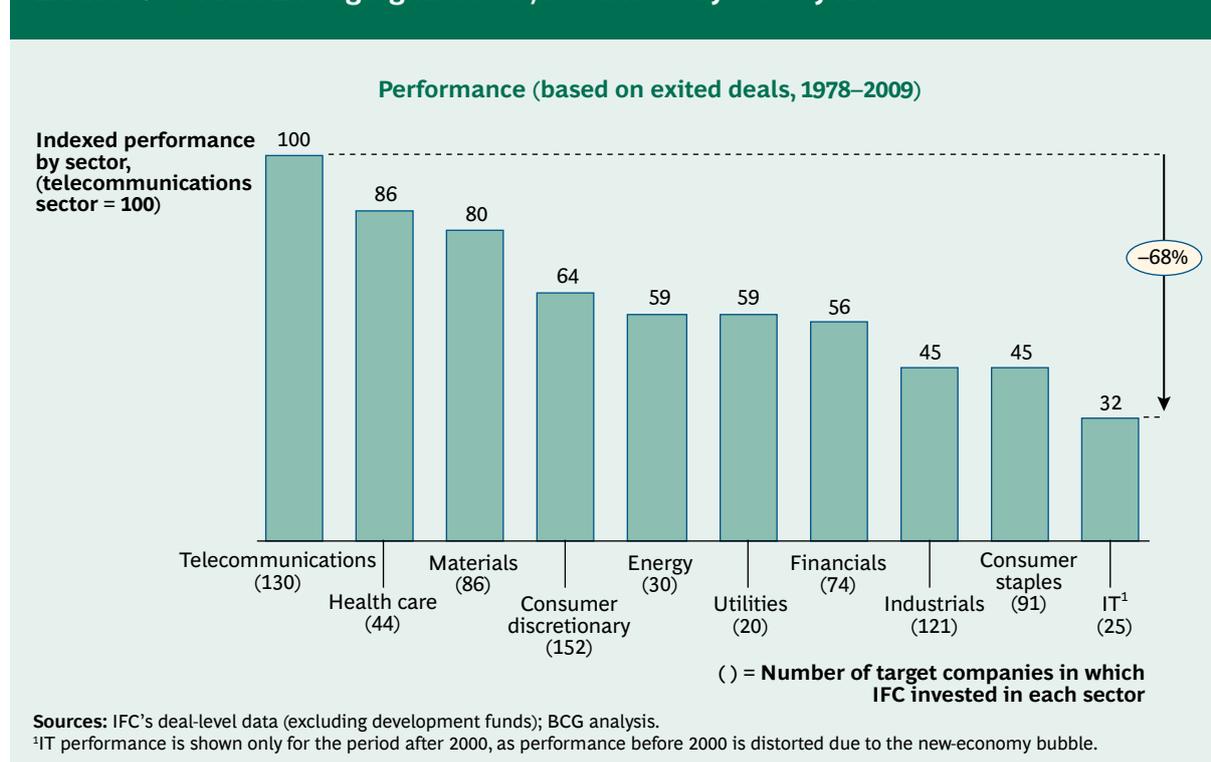
Limited partners' traditional concerns about first-time funds are not necessarily warranted in emerging markets. We found that 46.2 percent of the top-quartile performers in the IFC's data set were first-time funds for the period from 2000 through 2006. Moreover, first-time funds achieved approximately the same performance level that repeat funds did.

Funds with a Strong Local Presence Significantly Outperform International Funds Without a Local Presence

Our research indicates that a strong local presence and experience are critical for success. On average, the returns of domestic and international funds with local offices are more than five times higher than the

32. Markus Taussig (2010). "Private Equity at the Frontier: A Model Approach to Incomplete Institutions?" Working paper, Harvard Business School.

Exhibit 5. Within Emerging Markets, Returns Vary Widely Across Sectors



returns of international funds without local offices. Local offices not only enable funds to plug into the local deal network but also provide the only way to navigate in the different and difficult socioeconomic circumstances. Many international firms have already taken the necessary steps: more than half of the world's 30 largest private equity firms now have local offices in emerging markets, predominantly in BRIC countries.

Performance of Top-Quartile Funds Is Strongly Driven by Increases in the Revenues of the Portfolio Companies, Not by Leverage

Top-quartile funds with vintage years between 2000 and 2006—that is, funds that made their first investment during this period—saw the revenues of their portfolio companies grow by a factor of 5.5, more than three times faster than bottom-quartile funds grew at similarly low debt-to-equity ratios. The key driver behind these superior returns was not leverage but the revenue growth of the portfolio firms. Although a large share—40 percent—of all investments in the IFC portfolio—could be classified as growth capital, rather than buyout private equity, our findings indicate that private-equity firms that support growth initiatives for their portfolio firms will outperform their peers.³³

The Size of the Fund Matters

An analysis based on IFC's data for emerging-market funds revealed a slightly positive correlation between a fund's size and its returns—at least in today's emerging markets. This appears to contradict previous research by Lopez-de-Silanes, who found that returns decline as funds increase the value and number of their investments.³⁴ We believe that there is a minimum size for funds in emerging markets, enabling private-equity firms, especially those from abroad, to build a presence in local business communities. Also, according to IFC, the mid-cap market seems more profitable than the small-cap space in emerging markets. But once funds get beyond a certain size, diseconomies of scale might kick in.

Implications for Investors

Private equity's shift toward emerging markets is not only strong and accelerating, it is likely to reshape the way general and limited partners view markets and manage their assets, challenging many of the accepted norms of the developed world. How investors respond to these new demands will determine tomorrow's winners and losers.

Limited Partners with Local Insights Have Significant Potential

Limited partners may want to look more closely at geographically specialized firms, with a larger “fund of funds” possibly playing an intermediary role for smaller limited partners that cannot afford multiple approaches in emerging markets. Our research suggests that there could be a significant opportunity for fund-of-funds intermediaries with deep local knowledge.

An analysis of 1,049 funds of funds in the Thomson Reuters data set revealed that 5.3 percent (56 in total) were based in emerging markets and half of those were registered in Hong Kong and China. Moreover, less than 2 percent (20 funds) were based outside BRIC countries, and none were based in Brazil. Two were located in South Africa.

Given the strong recent track record of returns from private-equity investments in emerging markets, limited partners should assess their overall exposure to these markets and create the capabilities and networks to invest directly in local general partners in the future.

Global General Partners Will Have Select Opportunities

There are no obvious scale advantages that position established general partners from the United States and Western Europe to succeed in emerging markets. Nevertheless, it is essential that such firms engage in emerging markets in order to benefit from these markets' higher returns and growth, as well as to build capabilities to support the operational value creation of their global portfolios and to strengthen their brands' attractiveness. Since the private-equity model for emerging markets differs from the developed-

33. BCG and IESE (2009).

34. Lopez-de-Silanes (2009).

market model, and since the key driver for success is understanding the local business environment, global general partners need to decide in which countries to build a local network. Teaming up with a local general partner can also be a key first step.

Local General Partners Will Grow Aggressively

Local general partners with a solid track record and well-established local networks are likely to attract an increasing share of capital commitments from global limited partners. To preserve this competitive advantage relative to global players, local general partners will have to expand their funds. We also expect strong growth among new funds. As our research has shown, first-time funds can perform well.

Flexibility Will Be Critical

To succeed in emerging markets, investors need to be flexible and prepared to shed the developed-world norms that have worked so well in mature markets. For example, firms will have to prepare to take minority rather than majority stakes. They will have to consider investing opportunistically across subasset classes and industries. Although mature markets have set the pace in private equity in the past, they could learn lessons from the success in emerging markets.

Data Set and Methodology

Our analysis draws on one of the most comprehensive data sets of emerging markets funds at the portfolio-firm level.

Data Set

IFC's data cover the period from 1978 through 2009. Since 2000, IFC has supported funds accounting for 10 percent of the private-equity space in emerging markets and has committed nearly \$3 billion to about 160 global private-equity funds. To ensure that our analysis reflects only commercial private equity, the data set excludes the noncommercial funds in which the IFC invested in accordance with its development mandate. Due to confidentiality issues, IFC performed all analysis of data from private-equity funds and deals.

The data set comprises:

- ◇ Data from 176 funds, balanced on a regional basis. To avoid J-curve effects and potential distortions from the economic crisis, the cutoff for the data was funds with a vintage year (that is, created) after 2006.
- ◇ A total of 942 data points from deals made by the above-mentioned funds; only exited deals were included in the analyses. Some information about the deals was collected via surveys of fund managers; therefore, a response bias is possible for some answers, and not all data points contain complete information.
- ◇ Data from 75 emerging-market countries. The top three countries were India (accounting for 11.56 percent of total fund value), Brazil (6.8 percent), and China (6.16 percent).

Fund-level IRR was calculated on a cash flow basis. The analysis does not provide an IRR at the deal level, as only cash-in and outflow of deal-level data is available. Therefore, we do not show the IRR for deal-level data but instead use the results as indicators of performance in a relative comparison.

Methodology: Estimating Available Dry Powder in Emerging Markets at \$231 Billion

The data used to estimate emerging-market dry powder originated from three sources:

- ◇ Local and regional funds in emerging markets as reported by EMPEA, which used the assumption of a five-year investment period. (Totals \$208 billion.)³⁵
- ◇ The dedicated emerging-market funds of global private-equity houses. This included the dry powder of all the dedicated emerging-market funds of the top-30 private-equity firms as listed in the Preqin database. To avoid double counting, it excludes funds raised by EMPEA members. (Totals \$14 billion.)³⁶
- ◇ The emerging markets' estimated share of global private-equity funds. Two approaches were used to estimate dry powder. When the number of partners in emerging markets was available, we estimated the average dry powder available per emerging-market partner. For other firms, we looked at the historic track record of emerging-market investments and assumed a similar share of investments in these markets for the remaining dry powder. We assumed no investments in emerging-market countries by firms that had no local offices and no past activity there. (Totals \$9 billion.)³⁷

35. EMPEA (April 2010).

36. These data are from Preqin.

37. These data are from Preqin.

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