Emerging Market Private Equity

The Opportunity, The Risks & Ideas to Manage Them

David Wilton, Chief Investment Officer, Manager Global Private Equity, IFC
Summary

• Emerging Market PE has come of age
• It is different to PE in developed markets
• The differences in terms of risk can be mitigated and some favor EM
• The differences in terms of scale are less tractable
• PE in EM offers a very different sector exposure to public markets
• Investors with a modest minimum commitment size have a broader opportunity than many realize to create a geographically diversified high potential portfolio.
• Investors with a large minimum commitment size have less geographic scope and need to be mindful of flooding markets
Outline

• The growth of the Opportunity - Scale

• The Nature of the Opportunity - Returns & Risk
  - What drives return
  - Minority Positions
  - Manager Skill Set
  - Diversification
The Growth of the Opportunity
Where Can We Find Adequate Selectivity?

In 2000 IFC considered that only the BRICS + South Africa could support single-country funds.
Today, A Very Broad Opportunity

- Developed
- Single Country
- Regional Grouping
What Has Caused the Opportunity to Grow?

The significant expansion of the private equity opportunity in emerging markets since 2000 has been driven by an increase in the availability of control positions or minority positions with control-like rights.

This has had two main causes:

(1) The shift to more market-based economies since 1990
(2) Lowering of barriers to trade and capital flows since 2000
Measures of conditions for private business have improved across a wide range of emerging markets since the 1990s, leading to an increase in the number of companies of interest to PE.

The scale of the improvement in conditions for private business in EMs since 1990 is significant.

Source: Fraser Institute, Economic Freedom of the World (EFW) Index
Increased Openness Creates PE Deal Flow

Emerging markets have opened their trade and capital accounts since 2000, increasing both opportunities to expand and competition in domestic markets. This creates more situations where sale of equity with influence over the business is seen as desirable by owners in order to attract the capital or the skills needed to expand, to compete, or to increase focus on core business by sale of non-core business.

Exports + Imports as a Percentage of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>China</th>
<th>India</th>
<th>Brazil</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td></td>
<td></td>
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<td>2001</td>
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<td>2006</td>
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<tr>
<td>2007</td>
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<td></td>
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<tr>
<td>2008</td>
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</tbody>
</table>

Increase Over Period
- 86% China
- 110% India
- 41% Brazil
Considerable Scope to Grow

Even in the BRICs, fundraising as a percentage of GDP is low in EMs compared to the US, indicating much more room to grow.

PE Penetration/GDP 2010

Source: EMPEA
What Else Could Increase the Opportunity?

Total Demand for Equity

Control/Influence Positions

Growth Equity (given restricted leverage)

People can get close to (absence of distance Relationships with weak legal system)
Drivers of the Expanding Opportunity

Building Blocks to Achieve Maximum Potential in PE

Motives to Sell

- Market Based Economy (1990s)
  - Open Economy (2000s)

Structural Factors

- Governance, Transparency, Legal System, Taxation (Coming Soon?)
- Bank Lending and Debt Capital Market (Coming Soon?)
- Stock Exchange Liquidity (Coming Soon?)

- Increased Supply of Interesting Companies:
  - Entrepreneurial activity increases.
  - Companies emerge of the right size, growth, management quality to be interesting to PE

- Increased Motivation to Sell:
  - Competitive pressure to meet international efficiency standards.
  - Ability to expand offshore.
  - Spur deal flow—sale of non-core, help with offshore expansion, help with improving operations to meet competition

- Increased Opportunity through Trust:
  - Ability to contract at a distance with strangers widens pool of partners.
  - Due diligence easier, easier to partner with strangers.
  - Owners tax neutral between company and portfolio wealth, removes a barrier to sale

- Opportunity Expands to Lower Growth Companies:
  - Deal flow expands: slower growth companies become viable targets for PE

- Liquidity and potential returns enhanced:
  - Exit window improves: generally better exit multiples from listing.
  - Better returns stimulate deal flow

Scale

- Size of the Economy
  - Scalability
  - Larger Economy, larger ability to scale PE

India, China pre-2000. High GDP growth, little proper deal flow for PE

India, China, Colombia, Brazil, Turkey, etc

Size enables some countries to scale without all blocks in place

Chile, New Zealand

China, India, Brazil, USA, EU
The Nature of the Opportunity

- Different to Developed Market PE
  - Minority Positions
  - Growth Focus

- Diversification
### Comparative Net "End-to-End" Returns as of June 30, 2011

<table>
<thead>
<tr>
<th></th>
<th>US Private Equity Index</th>
<th>W. Europe Private Equity Index</th>
<th>Emerging Markets VC &amp; PE Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 Years</td>
<td>6.6</td>
<td>1.1</td>
<td>11.2</td>
</tr>
<tr>
<td>5 Years</td>
<td>10</td>
<td>11.3</td>
<td>15.5</td>
</tr>
<tr>
<td>10 Years</td>
<td>11.4</td>
<td>19.3</td>
<td>12.1</td>
</tr>
<tr>
<td>15 Years</td>
<td>12.5</td>
<td>18.8</td>
<td>9.7</td>
</tr>
</tbody>
</table>

Source: Cambridge Associates
What Happened?

• Localization has de-risked private equity in emerging markets somewhat.

• Considerably less leverage - more resilient to macro and cyclical shocks.

• Risks such as minority positions, contract enforcement and operating/execution risk can be mitigated by a GP with the right skill set.

• Exits do exist

• Increase in experienced GPs

• Early mover advantage - first time fund risk is lower than expected
## Differences: EM and Developed Market PE

<table>
<thead>
<tr>
<th><strong>EM PE difference to US/EU PE</strong></th>
<th><strong>Scale Impact</strong></th>
<th><strong>Risk Impact</strong></th>
<th><strong>Risk Mitigation</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Return driven by growth rather than leverage</td>
<td>Lower leverage reduces the number of companies suitable for acquisition</td>
<td>Less subject to macro and cyclical risk than LBO. Higher execution /operational risk</td>
<td>Select GP able to manage operational risks</td>
</tr>
<tr>
<td>Mostly minority positions</td>
<td>Lower investment per transaction</td>
<td>Implementation of value/exit plan requires cooperation of majority. Shareholders agreement may be difficult to enforce. Exit may be difficult.</td>
<td>Select GP with the skills required to become viewed by the majority as a partner. IFC’s experience is that ability to form a strong relationship achieves cooperation and mitigates enforcement risks. IFC experience is that minority exits compare favorably to control exits.</td>
</tr>
<tr>
<td>Weak Contract enforcement</td>
<td>Limits the range of people a GP can work with, limiting deal flow.</td>
<td>Enforcement of shareholders agreement can be difficult.</td>
<td>Select GP with the skills required to become viewed by the majority as a partner. IFC’s experience is that ability to form a strong relationship achieves cooperation and mitigates enforcement risks.</td>
</tr>
<tr>
<td>Smaller Companies</td>
<td>Smaller transaction sizes.</td>
<td>Potentially longer time to scale to size required to exit. Smaller companies may be more vulnerable to macro shocks.</td>
<td>In IFC’s experience transaction sizes have to become quite small before there is a noticeable increase in negative outcomes.</td>
</tr>
<tr>
<td>Exits: Limited IPO, less liquid stock exchanges, less M&amp;A activity</td>
<td>Limits capital willing to enter the market to that with less time sensitivity and more tolerance for illiquidity.</td>
<td>Less developed capital markets reduce exit opportunities. Can be either trapped or need to give up some return to secure an exit.</td>
<td>IFC’s experience is that while returns on IPO are higher, trade sales provide good returns. GP needs to be aware of volatility in the exit window and be prepared to opportunistically exit even if it appears premature. LPs need to be aware of the greater difficulty of exiting listed stocks and ensure alignment of interest with the GP on distributions in kind.</td>
</tr>
<tr>
<td>Availability of experienced GPs</td>
<td>Not possible to crystalize the PE opportunity without a competent GP.</td>
<td>Huge return quartile gaps in PE. Lack of experience greatly increases risk.</td>
<td>IFC returns from 1st time funds have been surprisingly good – in excess of 20%. There appears to be an early mover advantage. Still, not for the faint of heart.</td>
</tr>
</tbody>
</table>
Drivers of Return in Private Equity

A PE fund can achieve the same IRR through any of four basic strategies: leverage, multiple expansion, growth and efficiency.

Most funds use a blend of the four.

In EMs IRR is driven by growth & efficiency

<table>
<thead>
<tr>
<th></th>
<th>IRR</th>
<th>Equity</th>
<th>Cash out by Dividend, Stock Purchase etc</th>
<th>P/E at Entry</th>
<th>P/E at Exit</th>
<th>Revenue Growth p.a</th>
<th>Margin Improves from 5% to x%</th>
<th>Holding Period Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leverage</td>
<td>25%</td>
<td>30%</td>
<td>55%</td>
<td>6</td>
<td>6</td>
<td>0%</td>
<td>5%</td>
<td>5</td>
</tr>
<tr>
<td>Multiple Expansion</td>
<td>25%</td>
<td>75%</td>
<td>10%</td>
<td>6</td>
<td>14</td>
<td>0%</td>
<td>5%</td>
<td>5</td>
</tr>
<tr>
<td>Growth</td>
<td>25%</td>
<td>75%</td>
<td>10%</td>
<td>6</td>
<td>6</td>
<td>20%</td>
<td>5%</td>
<td>5</td>
</tr>
<tr>
<td>Efficiency</td>
<td>25%</td>
<td>75%</td>
<td>85%</td>
<td>6</td>
<td>6</td>
<td>0%</td>
<td>30%</td>
<td>5</td>
</tr>
</tbody>
</table>

*Source: IFC model*
Returns on Private Equity in Emerging Markets are Driven More by Growth than Leverage

Higher growth and lower leverage makes the source of risk in EM PE less cyclical and more operational.

Companies in IFC-invested Funds:

<table>
<thead>
<tr>
<th></th>
<th>Median</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual revenue growth *</td>
<td>19.5%</td>
<td>37.8%</td>
</tr>
<tr>
<td>Debt-to-equity ratio **</td>
<td>0.33</td>
<td>0.74</td>
</tr>
</tbody>
</table>

US Comparable: 2.1

Sample: 2009 * 527 companies in IFC-invested funds with holding time of at least one year  ** 604 companies in IFC-invested funds, not including financial services.
## Large Measurable Job Creation

### All Companies *

<table>
<thead>
<tr>
<th></th>
<th>Median</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual rate of job growth</td>
<td>11.9%</td>
<td>22.3%</td>
</tr>
<tr>
<td>Comparable regional job growth</td>
<td></td>
<td>2-3%</td>
</tr>
</tbody>
</table>

### SMEs **

<table>
<thead>
<tr>
<th></th>
<th>Median %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth in Revenue (CAGR)</td>
<td>13%</td>
</tr>
<tr>
<td>Growth in Jobs (CAGR)</td>
<td>15%</td>
</tr>
<tr>
<td>Growth in Female Jobs (CAGR)</td>
<td>15%</td>
</tr>
</tbody>
</table>

Source: * Companies in Funds backed by IFC in early 2009  ** SME focused Funds backed by IFC as of mid 2011
Growth Focus, With Variants

- SSA
- China
- Vietnam
- India
- Brazil
- Egypt
- South Africa

- Organic Growth
- Organic + Inorganic Growth
- Growth + Leverage
Manager Skill Set is Key to Risk Management

IFC’s experience is that the differentiating factor in fund quality is the Manager’s skill set, not 1st time fund risk or a frontier focus.

<table>
<thead>
<tr>
<th>Top 10%</th>
<th>Bottom 10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRR as of March 2009 (simple average %)</td>
<td>46.6%</td>
</tr>
<tr>
<td>Development Impact Score</td>
<td>2.10</td>
</tr>
<tr>
<td>Highly Suc = 3 HighlyUn S = -1</td>
<td></td>
</tr>
<tr>
<td>1st Time Funds %</td>
<td>53%</td>
</tr>
<tr>
<td>IDA % (&lt;$1000 GDP per capita)</td>
<td>27%</td>
</tr>
<tr>
<td>Average Deal Quality Score</td>
<td>0.97</td>
</tr>
<tr>
<td>Max = 1 Min = 0</td>
<td></td>
</tr>
</tbody>
</table>

- Sample: 150 Funds in IFC portfolio (invested pre- and post- 2000) as of March 2009, excluding those in the J-curve.

The Same
More Top 10% in the Frontier
### Prevalence of Minority Positions

**Minority/Majority Driven by Motivation of Sellers**

<table>
<thead>
<tr>
<th>Positive Motivation to Sell</th>
<th>- Strong growth situation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>- Pre-Listing Clean-Up</td>
</tr>
<tr>
<td></td>
<td>- Geographic Expansion</td>
</tr>
<tr>
<td></td>
<td>Minority</td>
</tr>
<tr>
<td></td>
<td>Minority</td>
</tr>
<tr>
<td></td>
<td>Minority</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Neutral Motivation to Sell</th>
<th>- Generational Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>- Conglomerate focusing on Core Business selling non-Core</td>
</tr>
<tr>
<td></td>
<td>- Privatization</td>
</tr>
<tr>
<td></td>
<td>Majority</td>
</tr>
<tr>
<td></td>
<td>Majority</td>
</tr>
<tr>
<td></td>
<td>Majority</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Negative Motivation to Sell</th>
<th>- Distressed business</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>- Distressed owners</td>
</tr>
<tr>
<td></td>
<td>Majority</td>
</tr>
<tr>
<td></td>
<td>Majority</td>
</tr>
</tbody>
</table>
Motivation of Sellers Differs Across Countries

- China
- India
- Vietnam
- SSA
- Turkey
- Brazil
- South Africa
- Egypt

Growth

Growth + Gen Change + Non core

Consolidation + Growth

Consolidation + Gen Change + Growth

LBO + Gen Change + Growth
Partnership has lead to Good Performance from Minority Positions

Minority positions (blue) have performed well in all forms of exit, indicating that the risks associated with minority positions can be managed effectively.

Sample: Exits of 61 majority positions and 251 minority positions from IFC invested funds
Successful Minority Requires Partnership

• Partnership reduces risk where the legal system does not easily support enforcement

• Partnership comes from high value-add

• High Value-Add is also needed to
  - Access transactions
  - Influence company direction
  - Influence Exit

• High Value-Add = active advice and hand-holding
  based on own experience
  ≠ sitting on the Board as a general sounding board
Being Local is Very Important

Fly-In, Fly-Out Used to Work. Now much more competitive.

Fly-In, Fly-Out has Never Worked.

Access, reputation checking, due diligence, management, acquiring talent, acquiring leverage

All are Highly Local
Ways of Being Local

<table>
<thead>
<tr>
<th>GP Type</th>
<th>How Become Local?</th>
<th>Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local GP</td>
<td>Fully local operation</td>
<td>Good access to transactions, talent, due diligence. Funding typically limits access to largest deals - need to syndicate. (This is slowly changing)</td>
</tr>
<tr>
<td>Foreign GP</td>
<td>Affiliation with local GP</td>
<td>Access to largest deals with full local skill set. Not access deals local affiliate can do for itself.</td>
</tr>
<tr>
<td>Foreign GP</td>
<td>Local office</td>
<td>Local skills + broader deal access. Expensive. Need to ensure alignment and influence with HQ.</td>
</tr>
</tbody>
</table>
### GP Experience - Required Skills Depend on Model

<table>
<thead>
<tr>
<th>Return Driver</th>
<th>Source of profit</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 Consultancy</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 a higher price / earnings multiple</td>
<td>Private Equity – acquire based on what you can sell</td>
</tr>
</tbody>
</table>

**Example:**
- **Arbitrage** focuses on pricing multiple differential between private and public/market and is suitable for Investment or Merchant Banking Consultancy.
- **Leverage** involves leveraging a company with stable earnings, suitable for Investment Banking.
- **Earnings growth** emphasizes increasing earnings through expansion or acquisition, suitable for Corporate Operations, Entrepreneurial, Consulting.
- **Margin expansion** highlights increased profits via improved efficiency or shifting product to higher margin niche, suitable for Corporate Operations, Entrepreneurial, Consulting.
- **Improved transparency and governance** boosts earnings attract a higher price, as buyers feel more informed and protected, suitable for Corporate Operations, Entrepreneurial, Consulting.
- **Multiple expansion due to growth or profits** addresses earnings of company attract a higher price / earnings multiple, suitable for Private Equity – acquire based on what you can sell.
First Time Fund Risk is Lower Than Expected

IRR from 2000 to June 30\textsuperscript{th} 2011:

- IFC all Funds: 18.5%
- 1\textsuperscript{st} Time Funds: 21.0%
- Non-1\textsuperscript{st} Time Funds: 14.0%
What We Have Not Looked For

- Well known brand
- Fund III+ with full-exit track record
- Top Quartile Record Outside the Target Market
Clear Gains From Diversification

<table>
<thead>
<tr>
<th>IRR from Jan '00 to ....</th>
<th>Jun 30 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFC: Private Equity Funds*</td>
<td>22.2%</td>
</tr>
<tr>
<td>IFC: All Funds**</td>
<td>18.5%</td>
</tr>
<tr>
<td>Cambridge EM PE Top Quartile***</td>
<td>19.8%</td>
</tr>
<tr>
<td>Cambridge Asia EM PE Top Quartile***</td>
<td>21.7%</td>
</tr>
<tr>
<td>Cambridge US PE Top Quartile***</td>
<td>17.4%</td>
</tr>
<tr>
<td>MSCI (IFC PE Fund Cashflows)****</td>
<td>12.8%</td>
</tr>
</tbody>
</table>

IFC has out-performed the Emerging Market Index with a much more geographically diversified exposure.

* Includes: Agribusiness, Cleantech, Midcap, Mining, Pharma, SME, VC and Healthcare Funds
** Includes: Agribusiness, Cleantech, Midcap, Mining, Pharma, SME, VC, Healthcare, Debt, Forestry, Infrastructure, Listed, Real Estate, Secondary Funds
*** All PE Fund types excluding Forestry, Infrastructure, Real Estate, and Secondary Funds
**** Identical cashflow stream converted into cumulative MSCI shares; valued as the new terminal value (on 6/30/11) for the series of cashflows
Diversification vs Public Equity

**Sector Exposures**

- Energy
- Financials
- Consumer
- Health care
- Industrials
- Info Tech
- Materials
- Telecom
- Other

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Emerging Market Private Equity

- Energy: 4.7
- Financials: 13.8
- Consumer: 21.5
- Health care: 5.5
- Industrials: 22.2
- Info Tech: 15.5
- Materials: 1.5
- Telecom: 9.6
- Other: 5.6

MSCI Emerging Markets

- Energy: 14.5
- Financials: 24.7
- Consumer: 14.4
- Health care: 7.5
- Industrials: 12.1
- Info Tech: 14.9
- Materials: 7.3
- Telecom: 3.6
- Other: 1.0

Source: Cambridge Associates
Possible future changes:

• Increased competition
  = risk profile of 1st time funds increases

• Increased deal flow via greater access to leverage
  = expansion of key GP skill set
  = increasing risk profile

• Increased local funding, LP comfort with local GPs
  = less syndication available for Foreign GPs
Thank You

For further information on IFC’s experience investing in emerging market private equity please see our website http://www.ifc.org/funds under the publications tab.