International Finance Corporation
World Bank Group

Emerging Market Private Equity

The Opportunity, The Risks & Ideas to Manage Them

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

MICHIGAN
ROSS SCHOOL OF BUSINESS

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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

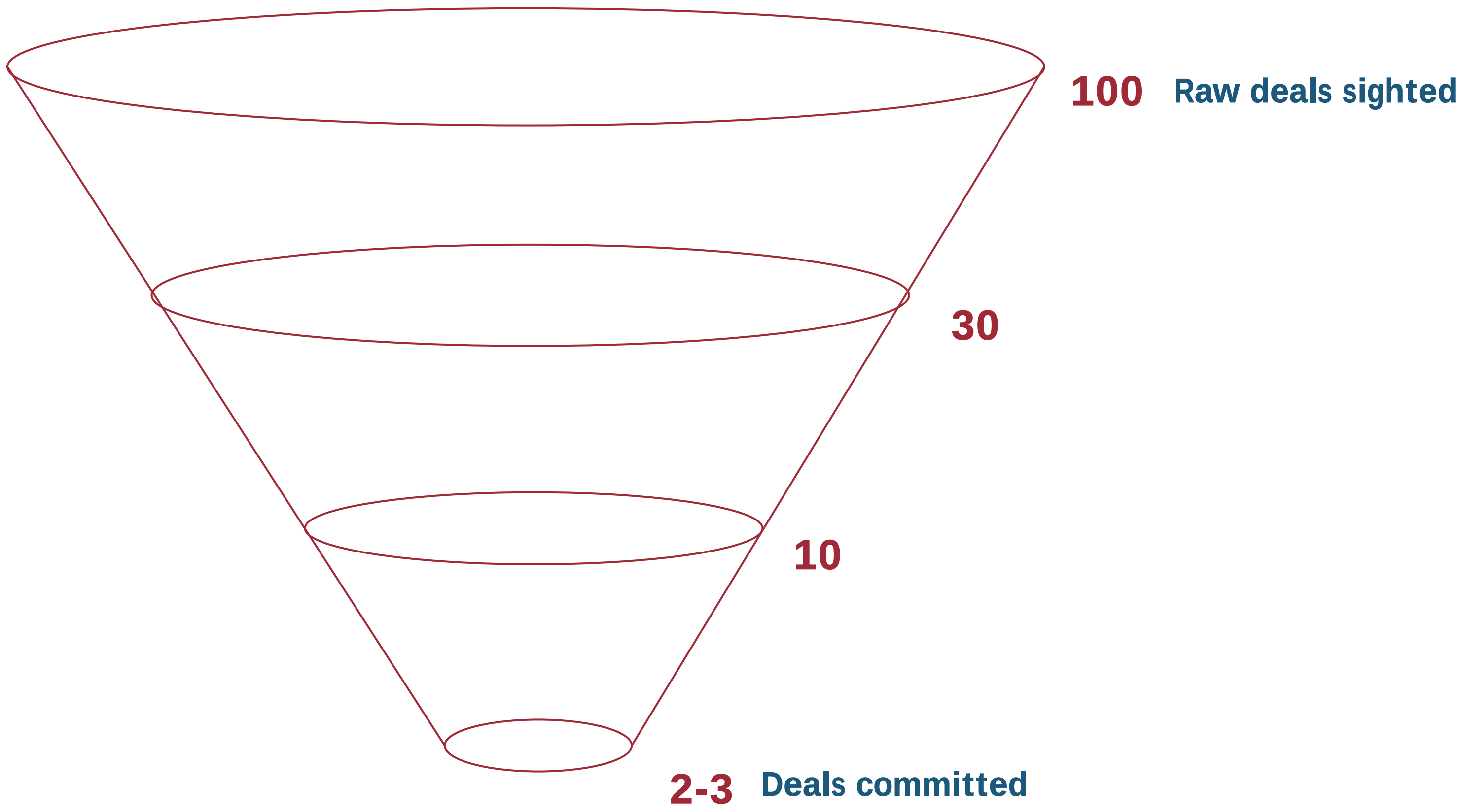
- The growth of the Opportunity - Scale

- The Nature of the Opportunity – Returns & Risk
    - What drives return
    - Minority Positions
    - Manager Skill Set
    - Diversification

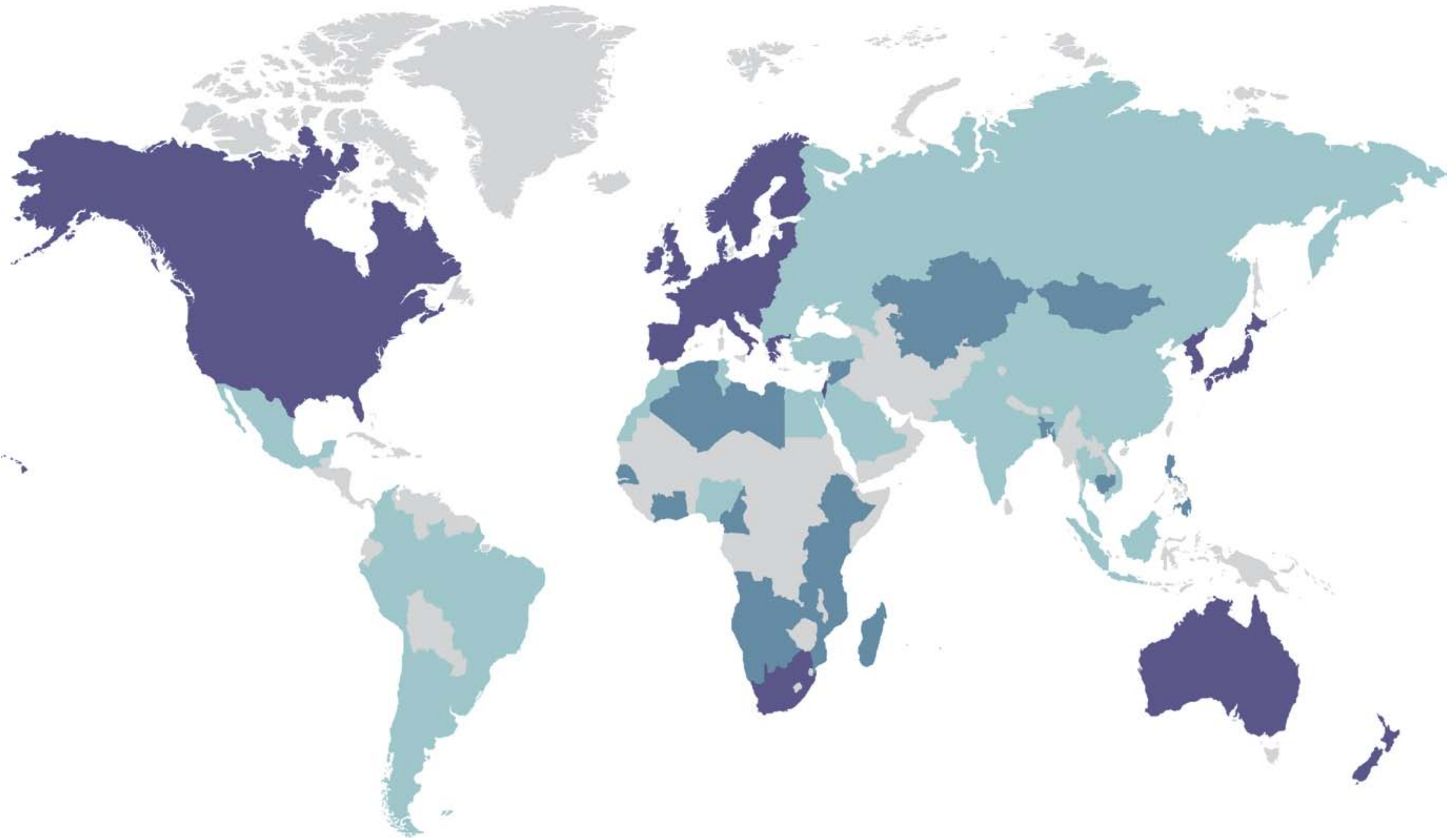
The Growth of the Opportunity

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

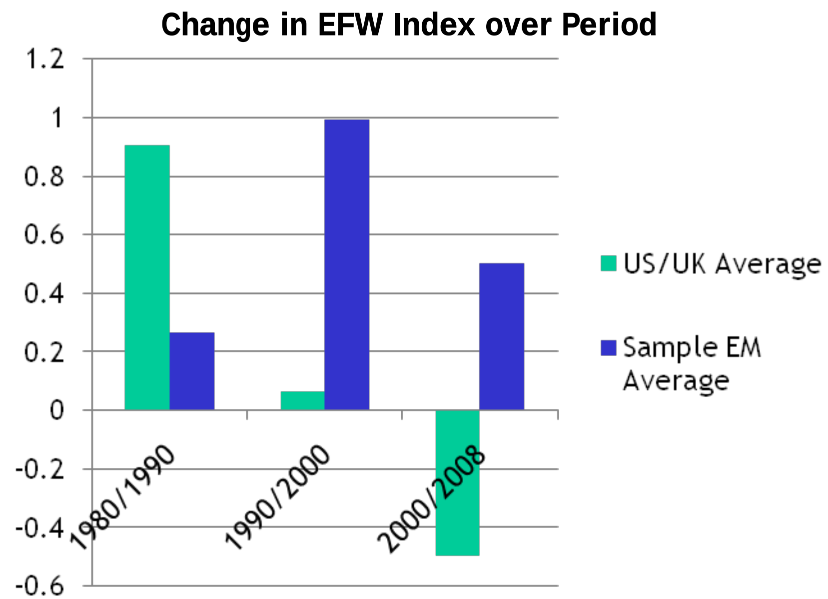
(2) Lowering of barriers to trade and capital flows since 2000

Shift to More Market-Based Economies

EFW Index Levels

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.

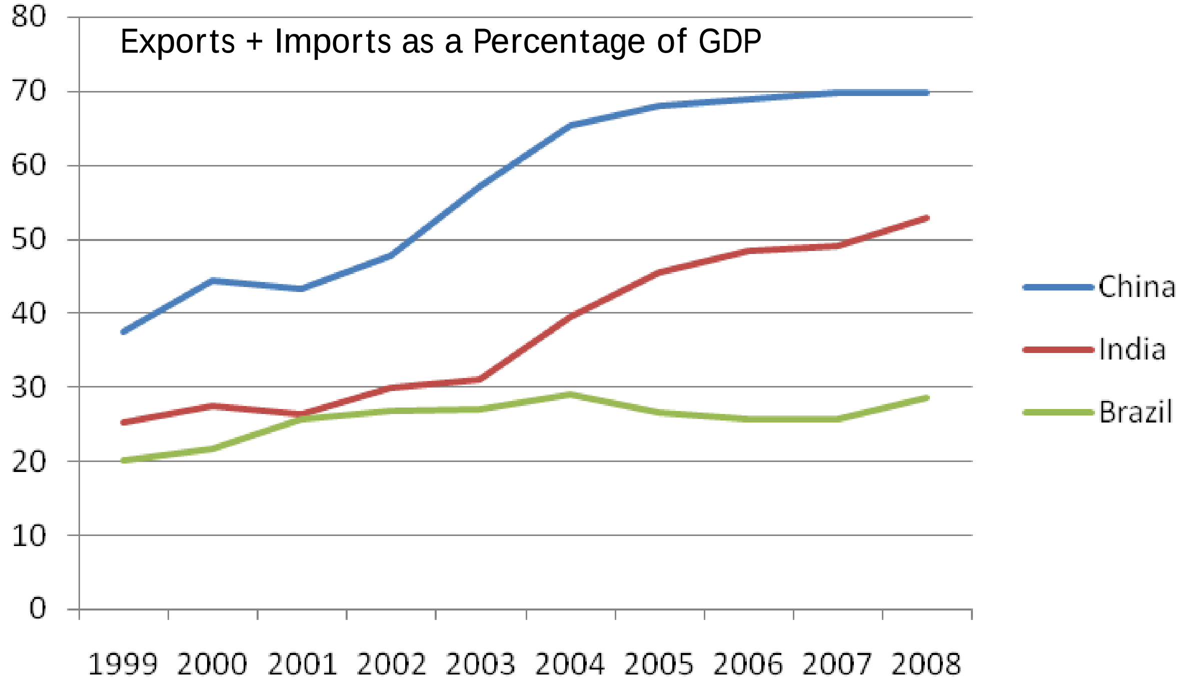


Source: Fraser Institute, Economic Freedom of the World (EFW) Index

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.

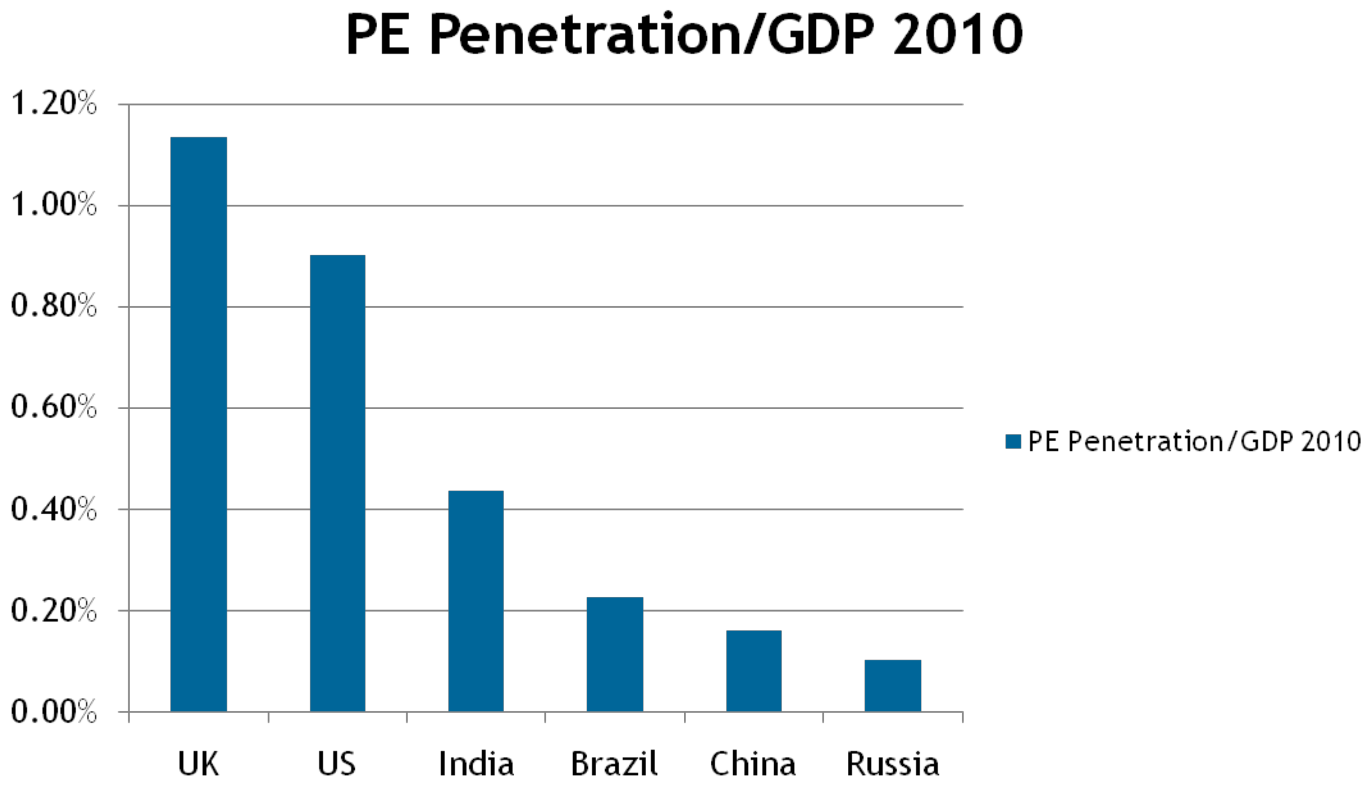


Increase Over Period

86% China
110% India
41% Brazil

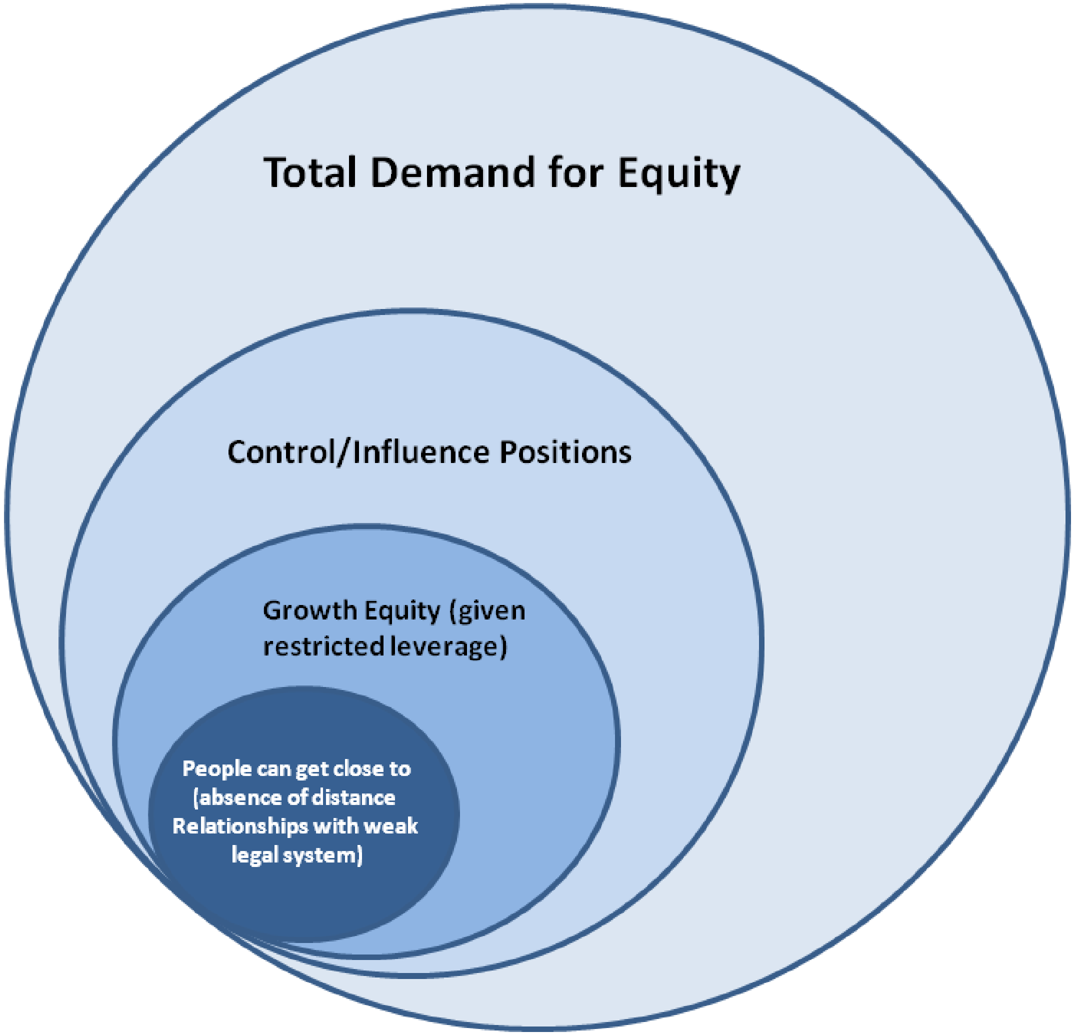
Considerable Scope to Grow

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



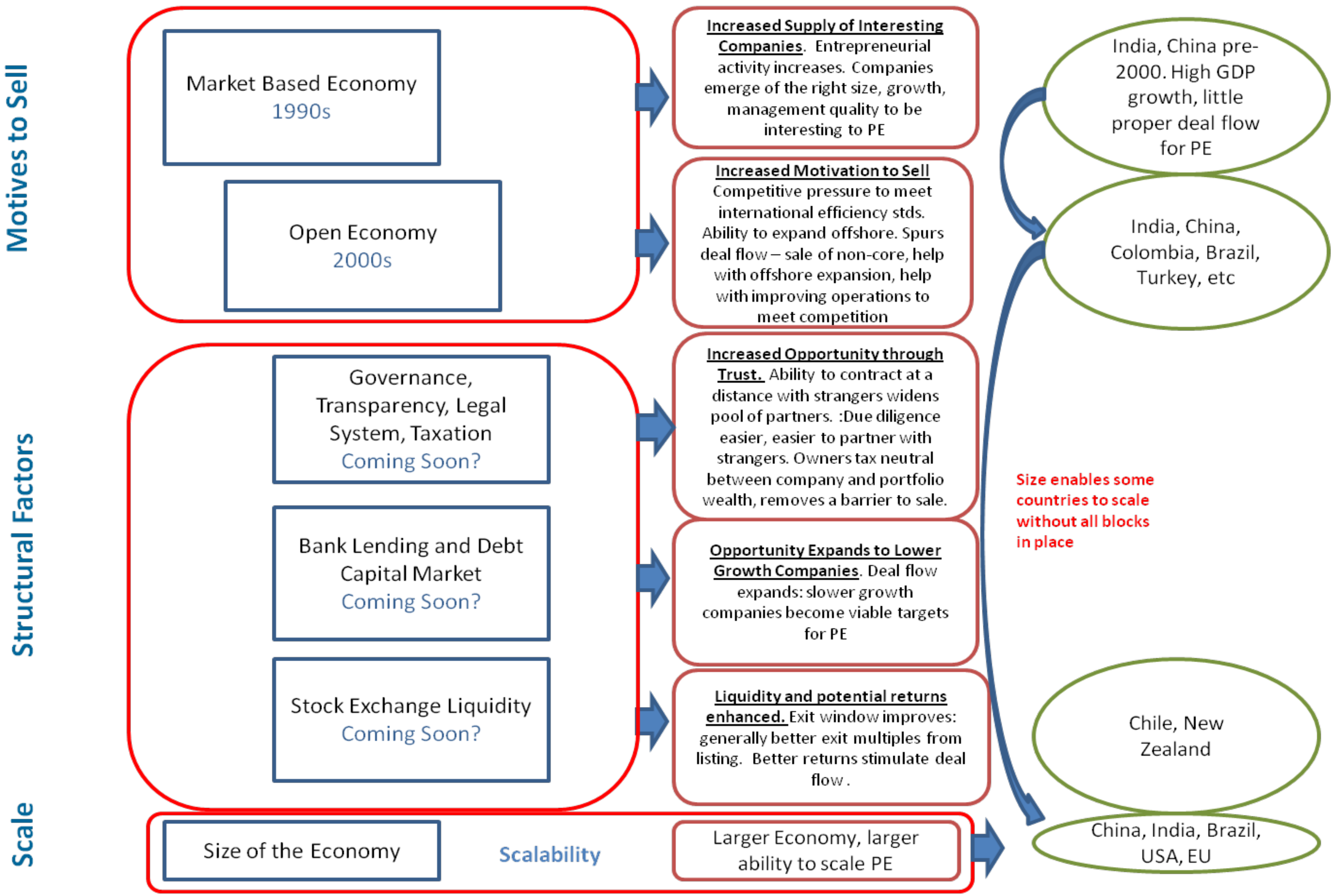
Source: EMPEA

What Else Could Increase the Opportunity?



Drivers of the Expanding Opportunity

Building Blocks to Achieve Maximum Potential in PE



The Nature of the Opportunity

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

EM PE Returns Have Caught Up and Passed US/EU

	Comparative Net "End-to-End" Returns as of June 30, 2011		
	US Private Equity Index	W. Europe Private Equity Index	Emerging Markets VC & PE Index
3 Years	6.6	1.1	11.2
5 Years	10	11.3	15.5
10 Years	11.4	19.3	12.1
15 Years	12.5	18.8	9.7

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

EM PE difference to US/EU PE	Scale Impact	Risk Impact	Risk Mitigation
Return driven by growth rather than leverage	Lower leverage reduces the number of companies suitable for acquisition	Less subject to macro and cyclical risk than LBO. Higher execution /operational risk	Select GP able to manage operational risks
Mostly minority positions	Lower investment per transaction	Implementation of value/exit plan requires cooperation of majority. Shareholders agreement may be difficult to enforce. Exit may be difficult.	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.
Weak Contract enforcement	Limits the range of people a GP can work with, limiting deal flow.	Enforcement of shareholders agreement can be difficult.	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.
Smaller Companies	Smaller transaction sizes.	Potentially longer time to scale to size required to exit. Smaller companies may be more vulnerable to macro shocks.	In IFC's experience transaction sizes have to become quite small before there is a noticeable increase in negative outcomes.
Exits: Limited IPO, less liquid stock exchanges, less M&A activity	Limits capital willing to enter the market to that with less time sensitivity and more tolerance for illiquidity.	Less developed capital markets reduce exit opportunities. Can be either trapped or need to give up some return to secure an exit.	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.
Availability of experienced GPs	Not possible to crystalize the PE opportunity without a competent GP.	Huge return quartile gaps in PE. Lack of experience greatly increases risk.	IFC returns from 1st time funds have been surprisingly good – in excess of 20% net. There appears to be an early mover advantage. Still, not for the faint of heart.

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

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

•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:

	Median	Average
Annual revenue growth *	19.5%	37.8%
Debt-to-equity ratio **	0.33	0.74
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

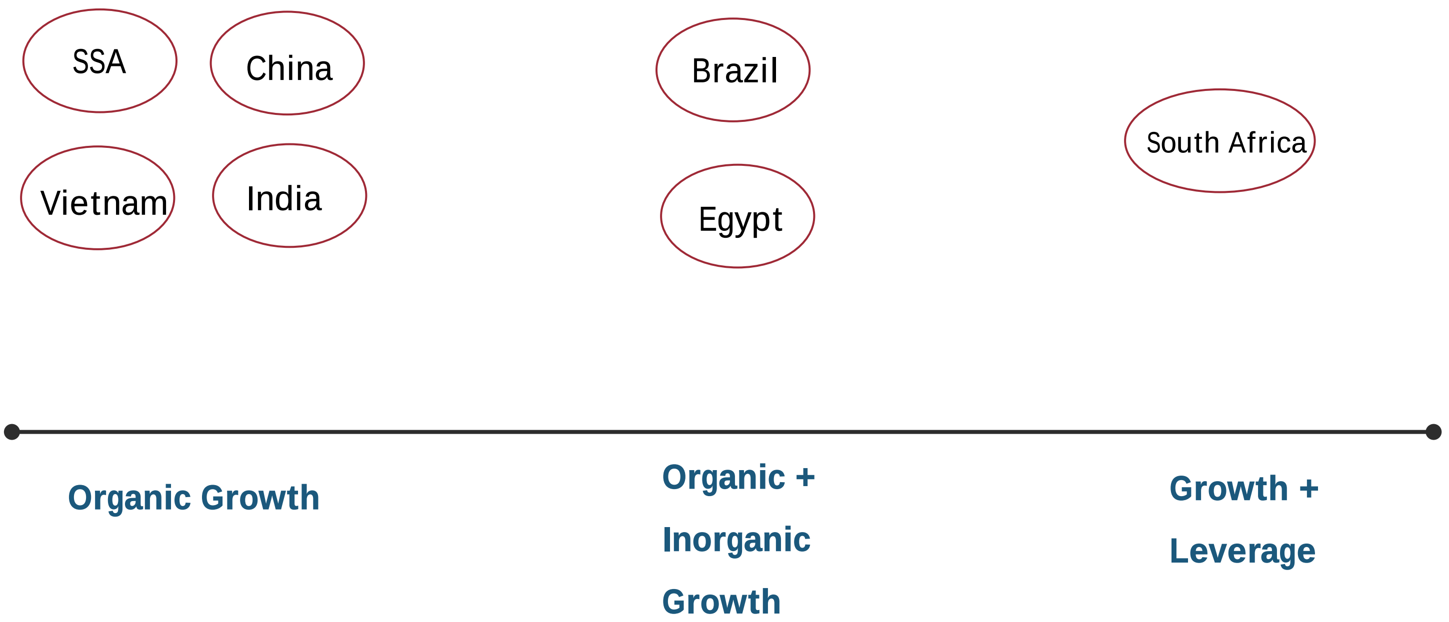
Large Measurable Job Creation

*All Companies **	Median	Average
Annual rate of job growth	11.9%	22.3%
Comparable regional job growth		2-3%

**SMEs ** **	**Median %**
Growth in Revenue (CAGR)	13%
Growth in Jobs (CAGR)	15%
Growth in Female Jobs (CAGR)	15%

Source: * Companies in Funds backed by IFC in early 2009 ** SME focused Funds backed by IFC as of mid 2011

Growth Focus, With Variants



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.

	IRR as of March 2009 (simple average %)	Development Impact Score Highly Suc = 3 HighlyUn S = -1	1st Time Funds %	IDA % (<$1000 GDP per capita)	Average Deal Quality Score Max = 1 Min = 0
Top 10%	**46.6%**	**2.10**	**53%**	**27%**	**0.97**
Bottom 10%	**-38.3%**	**0.14**	**53%**	**13%**	**0.17**

The Same

More Top 10% in the Frontier

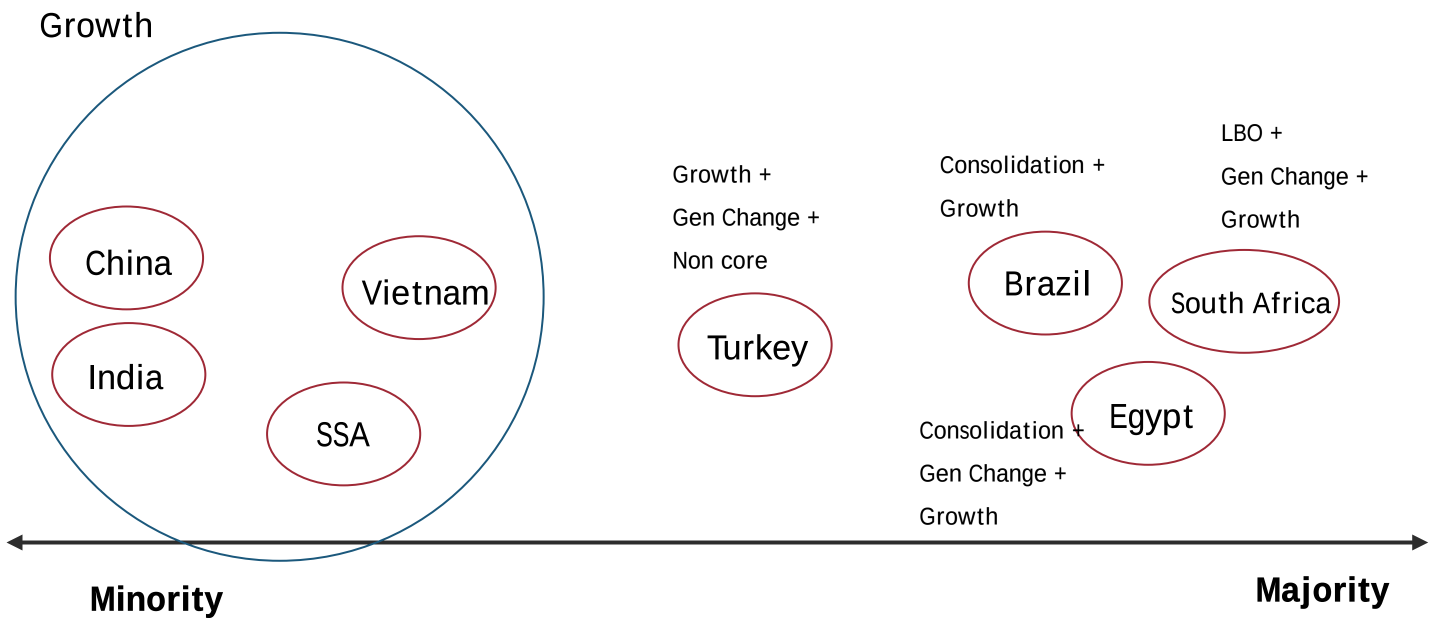
•Sample: 150 Funds in IFC portfolio (invested pre- and post- 2000) as of March 2009, excluding those in the J-curve

Prevalence of Minority Positions

Minority/Majority Driven by Motivation of Sellers

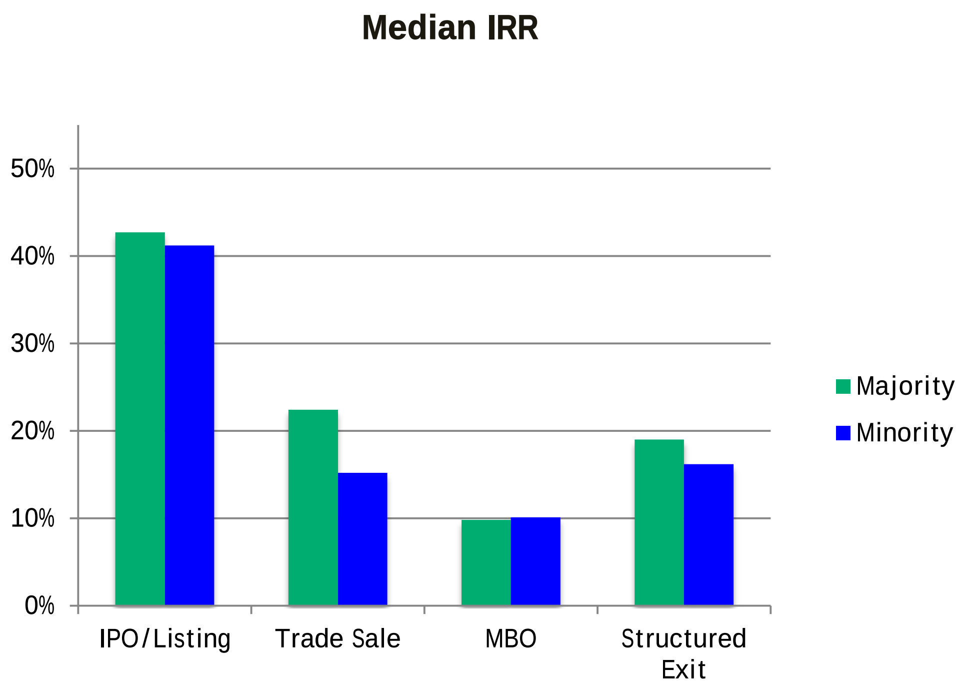
Positive Motivation to Sell	- Strong growth situation - Pre-Listing Clean-Up - Geographic Expansion	Minority Minority Minority
Neutral Motivation to Sell	- Generational Change -Conglomerate focusing on Core Business selling non-Core - Privatization	Majority Majority Majority
Negative Motivation to Sell	- Distressed business - Distressed owners	Majority Majority

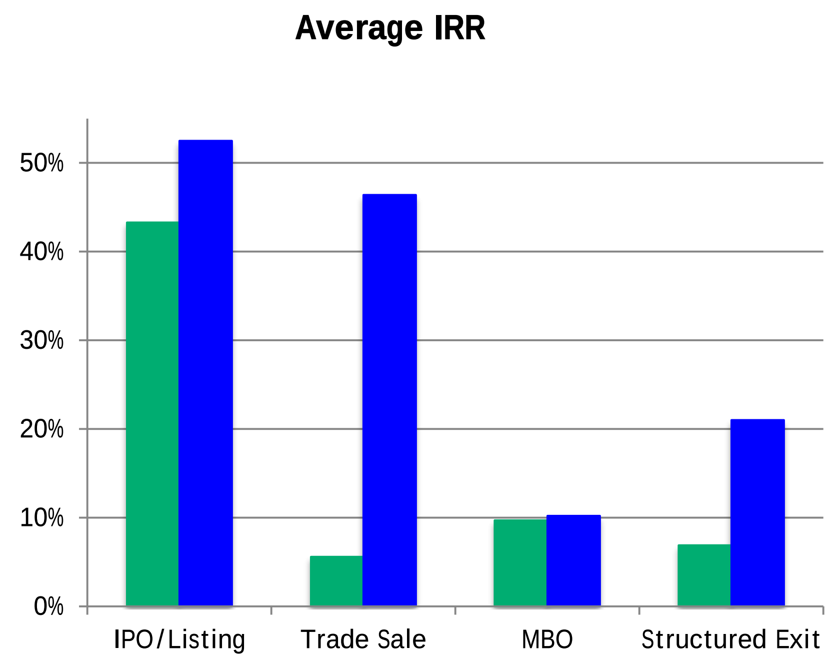
Motivation of Sellers Differs Across Countries



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

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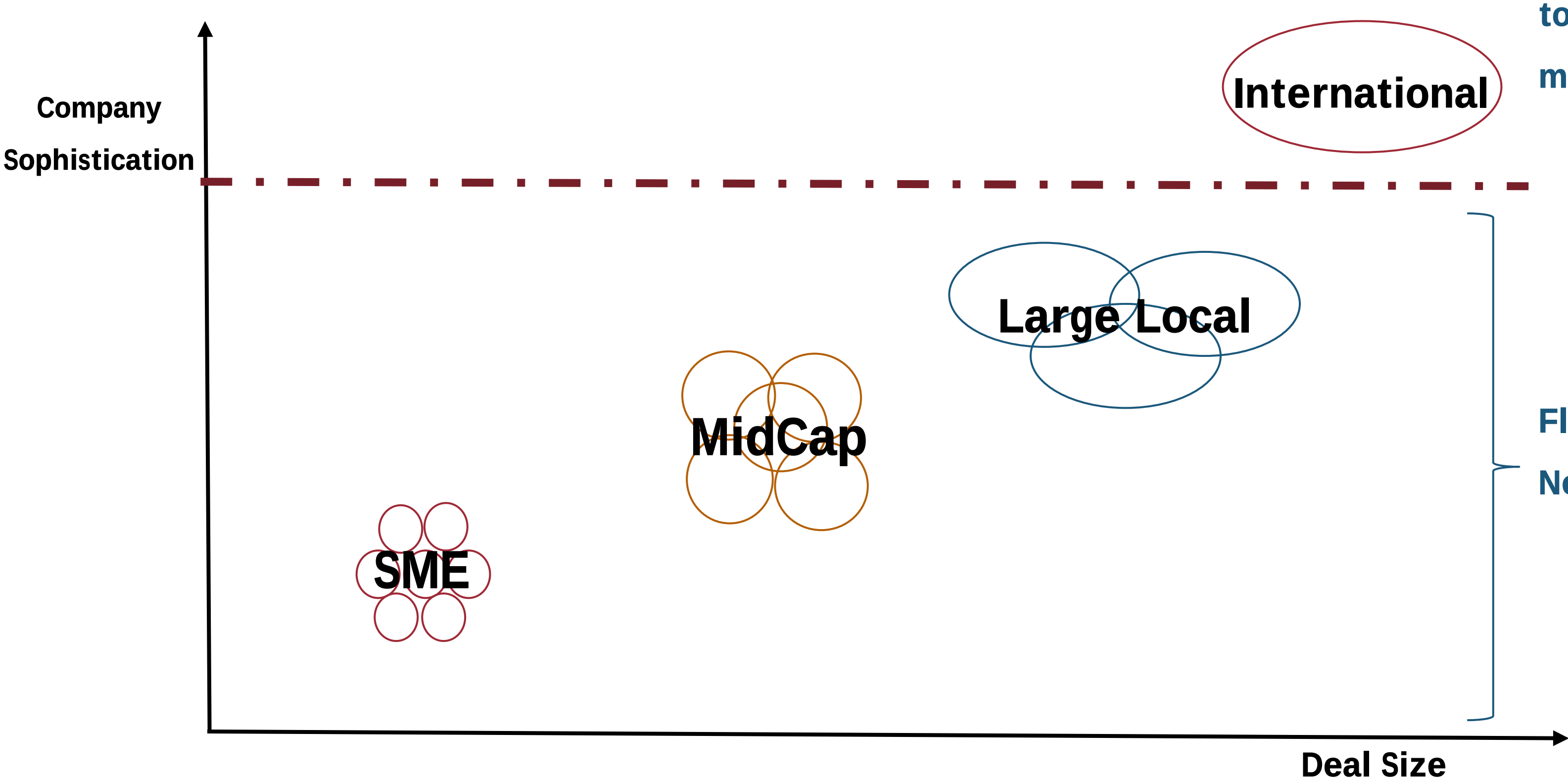
Successful Minority Requires Partnership

- 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

<u>All are Highly Local</u>

Ways of Being Local

GP Type	How Become Local?	Issues
Local GP	Fully local operation	Good access to transactions, talent, due diligence. Funding typically limits access to largest deals – need to syndicate. (This is slowly changing)
Foreign GP	Affiliation with local GP	Access to largest deals with full local skill set. Not access deals local affiliate can do for itself.
Foreign GP	Local office	Local skills + broader deal access. Expensive. Need to ensure alignment and influence with HQ.

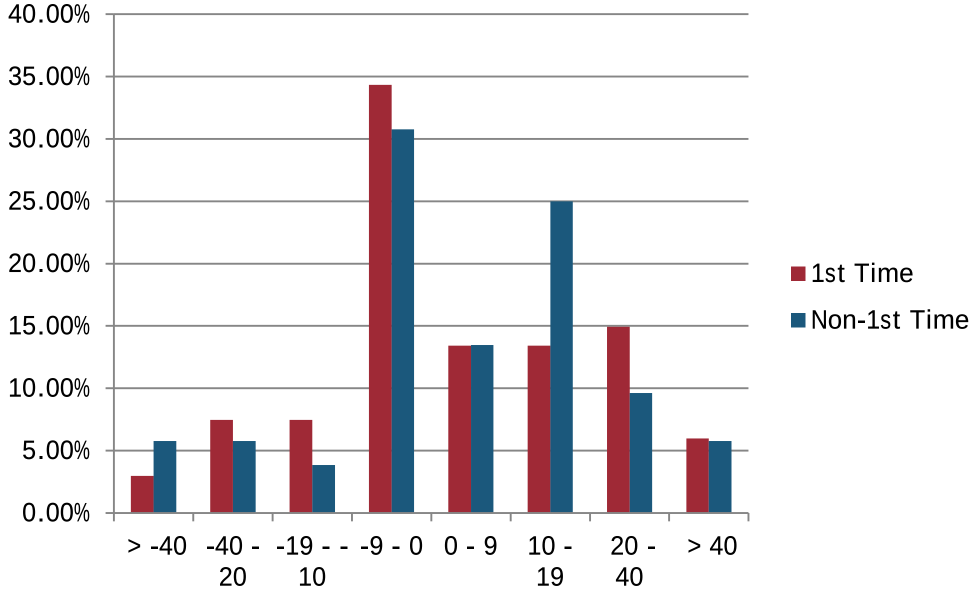
GP Experience - Required Skills Depend on Model

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

First Time Fund Risk is Lower Than Expected

IRR from 2000 to June 30th 2011:

IFC all Funds	**18.5%**
1st Time Funds	**21.0%**
Non-1st Time Funds	**14.0%**



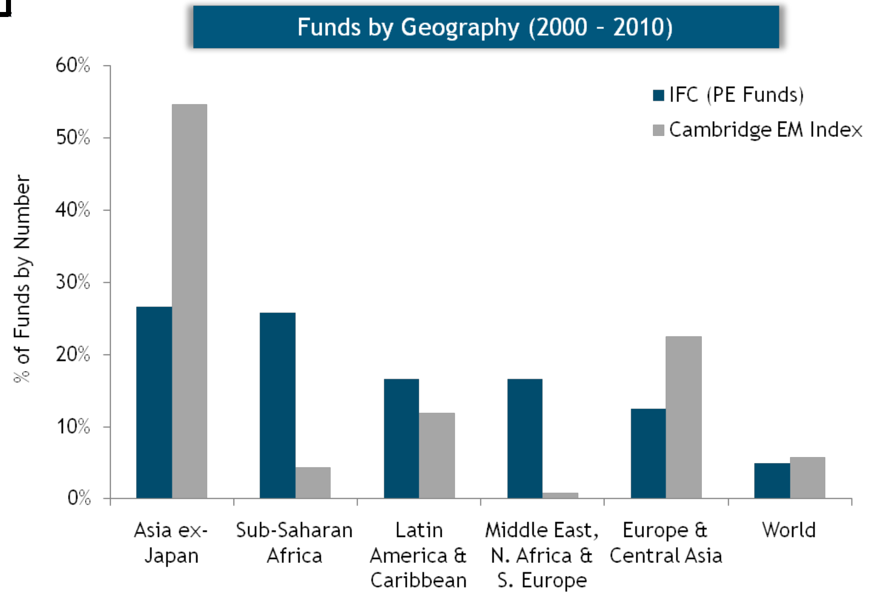
What We Have Not Looked For

- Well known brand
- Fund III+ with full-exit track record
- Top Quartile Record <u>Outside</u> the Target Market

Clear Gains From Diversification

IRR from Jan '00 to	Jun 30 2011
IFC: Private Equity Funds*	22.2%
IFC: All Funds**	18.5%
Cambridge EM PE Top Quartile***	19.8%
Cambridge Asia EM PE Top Quartile***	21.7%
Cambridge US PE Top Quartile***	17.4%
MSCI (IFC PE Fund Cashflows)****	12.8%

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



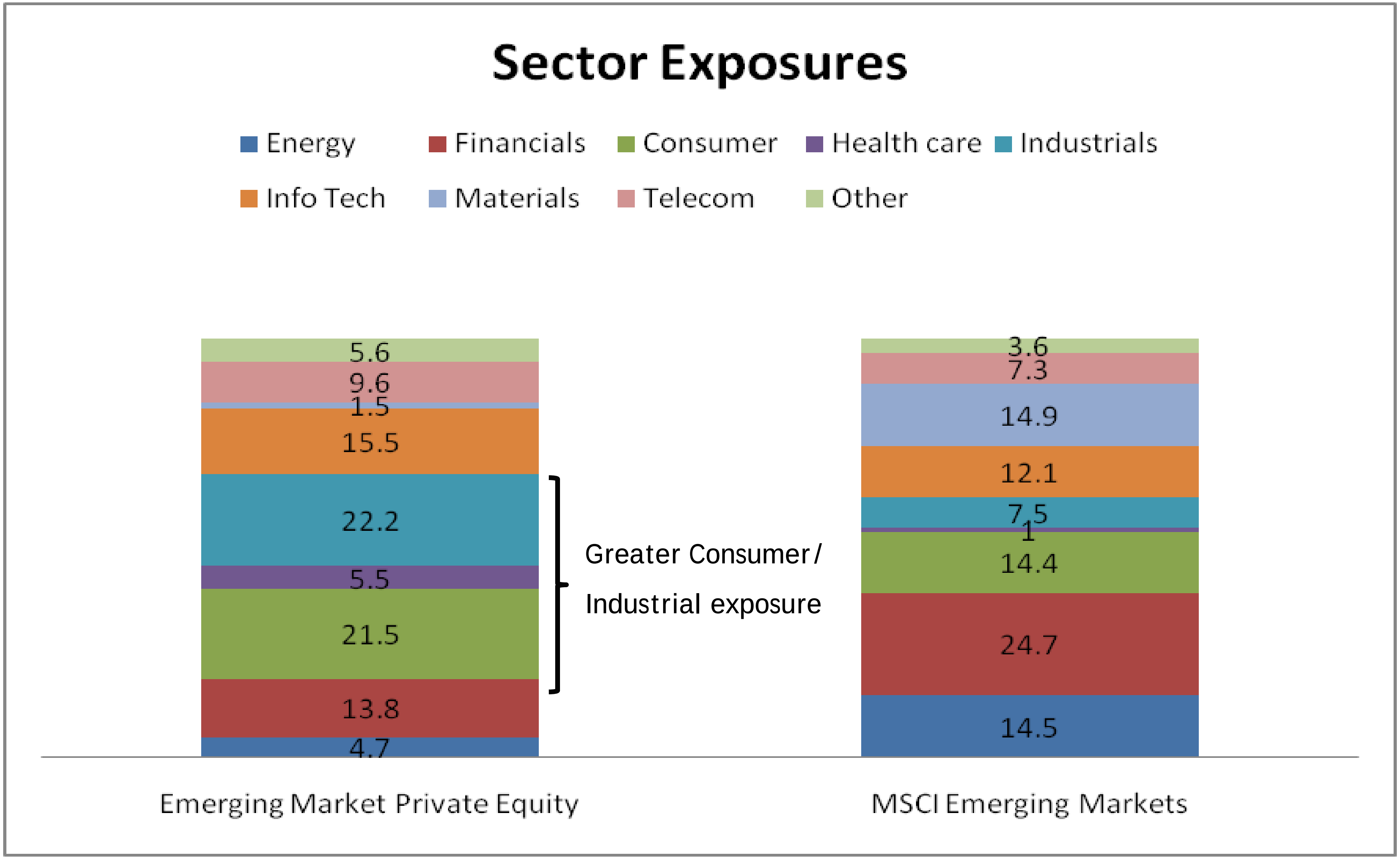
* Includes: Agribusiness, Cleantech, Midcap, Mining, Pharma, SME, VC and Healthcare Funds

** 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



Source: Cambridge Associates

Change – the Guaranteed Constant

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