Why Emerging Markets Private Equity

Rapid growth in emerging markets continues to attract investors, many of whom face pressure - against a backdrop of low performance of traditional investments - to seek the higher returns available in these markets, but face challenges determining where, how, and with whom to invest. This paper draws on the extensive experience of the International Finance Corporation (IFC) to dispel myths and highlight the contribution the emerging markets private equity asset class can make to an investment portfolio.

IFC, the private sector arm of the World Bank Group, is widely acknowledged as the pioneer and a market leader in emerging markets investing, with an enviable record of consistent annual profitability for over 55 years. IFC’s experience, investing directly and through funds, illustrates the potential of these markets, and suggests steps that investors can take to be positioned for success. Since 2000, IFC has committed $2 billion to 124 emerging markets private equity funds that have invested in ~1,000 underlying portfolio companies. With over 300 exits, IFC’s investment strategy has returned a pooled 20% IRR, which is well above the relevant benchmarks with an apparent reduction in volatility.

Our main observations regarding emerging markets private equity are:

(i) returns outperform both developed market private equity and emerging market listed stocks, while exhibiting low correlation with developed markets investment strategies; (ii) the scope is broad and growing – Asia funds dominate by number, but the opportunity today is much broader; (iii) risks are lower than conventional wisdom suggests and can be managed with sufficient resources and commitment.

Diversification and Returns

It is now evident that emerging market exposure is a helpful – indeed critical – part of any forward-looking investment portfolio. Emerging markets returns have caught up with and now exceed returns from developed markets. Figure 1 compares the returns from emerging markets private equity funds with US and European private equity funds.

![Figure 1: Emerging Markets PE Fund Investing: Returns and Diversification](image1)

This outperformance is rooted in the accelerating growth of household incomes and the aspirations of the emerging middle class in these countries. While public markets exist in many of these countries, our analysis and experience finds that better returns can be achieved by investing in private equity funds. Figure 2 compares the pooled mean returns for two emerging markets private equity indices by Cambridge Associates with a comparable public market return using the MSCI Global Emerging Markets Index.

![Figure 2: Emerging Markets PE Funds Outperform Public Markets](image2)

Significantly, both of the private equity indices outperform the index of listed companies. This is in part due to private equity funds accessing the most dynamic segments of these emerging economies. While listed indices in emerging markets are often dominated by stocks in the financial, materials and utilities sectors, private equity funds enable sectorial diversification into the consumer discretionary, industrials, IT, and healthcare sectors, which are more closely linked to burgeoning domestic demand than to export markets.

Private equity funds also enable access to opportunities in rapidly-growing, smaller developing countries, whereas listed companies and indices tend to provide a narrow concentration in the largest emerging markets, where growth may be moderating and valuations less attractive. IFC’s own private equity fund portfolio is significantly more geographically diverse than comparable indices. The advantage of this investment approach is clearly demonstrated with IFC’s portfolio steadily outperforming the top quartile threshold of both Cambridge Associates Emerging Market Private Equity Indices, reflecting benefits of diversification in both IRR and volatility (Figure 3).

![Figure 3: IFC’s Emerging Markets PE Fund Investing: Benefits of Diversification](image3)

Simply put, IFC’s experience demonstrates that emerging market private equity offers an attractive and competitive return opportunity with more diversification than is available through other instruments and exposure to the most dynamic growth areas of emerging markets.

Opportunity is Broad and Growing

Despite strong growth in recent years, overall penetration of private equity in emerging markets remains low relative to developed markets. In 2011, private equity investment as a share of GDP was ~1% for the US and ~0.8% for the UK. Even for the larger emerging markets, like China and India, penetration was near an order of magnitude lower. Several structural factors are expected to close this gap, including: international trade and the need to be globally competitive; well publicized examples of win-win deals between private equity firms and local entrepreneurs; and an increase in local private equity capacity. Growth-oriented firms in emerging markets increasingly recognize that they need external advice and guidance. They are willing to allow activist investors to have influence over corporate strategy, and fund managers have responded by starting funds in those regions. Furthermore, those managers who were new in the early 2000s are now more seasoned and can point to their own examples to educate entrepreneurs on the benefits of private equity.

Figure 4 shows the steady rise in the proportion of private equity funds focused on emerging markets, with these funds accounting for 15% of global private equity

1. 25% of funds in IFC’s portfolio are Africa focused vs. 4% for the CA index; 55% of funds in the CA index are Asian EM focused but only 25% of IFC’s investee funds are focused on that region.

2. The sector and geographic focus of these funds results in a partial decoupling of performance, with additional diversification benefits. CA finds a correlation of only 0.57 between vintage 2000-2011 US and emerging markets PE funds (0.53 for top quartile).
fundraising in 2011\textsuperscript{3}. This trend, a clear reflection of the dynamism of the developing world, is in part led by the growth of ‘first-time’ or ‘early-mover’ funds. This is also reflected in IFC’s portfolio: more than 50% of funds backed by IFC since 2000 fall into this category. Many of these funds are managed by individuals who have spun out of more established teams or are from the corporate world. Based on their prior experience, they may spot an untapped trend or strategy and seek to exploit it. Such funds have collectively outperformed IFC’s portfolio as a whole (with a pooled 26% vs. 20% IRR since 2000), albeit with smaller funds sizes, suggesting that early-mover funds are an important return component to any emerging markets private equity funds portfolio.

**Opportunity is Less Risky than Commonly Perceived** …
Emerging markets may come to the attention of investors when macro/political risks, or legal system/governance issues are reported, and this may lead them to conclude that the risks in these markets are high. However, IFC’s experience in these countries over more than 55 years strongly suggests that a more systematic approach and deeper examination is merited.

While broad macro and governance risks have been steadily declining in emerging markets\textsuperscript{4}, investors may be put off emerging markets private equity by perceptions that no longer comport with reality. For example, as noted above, the higher proportion of first-time managers in these markets can actually de-risk and enhance a portfolio. Other misconceptions include: that minority positions, common in emerging markets private equity, are too risky; that exit opportunities are constrained such that funds emerge slowly from the J-curve; and that it is too risky to compound small company risk with emerging markets risk. However, analysis of IFC’s private equity funds portfolio indicates that exits from minority positions have generally been successful; that, as of mid-2012, 2009 vintage funds had already emerged from the J-curve; and that IFC’s experience has been positive across investee funds investing in deal sizes as low as US$2 million. This is not to say that there are no risks or issues to consider when investing in emerging market private equity funds, but many risks can be addressed by identifying the most promising managers and by careful due diligence.

**... and Can Be Managed with Appropriate Due Diligence**
IFC maps the funds in emerging markets on an ongoing basis. Dedicated staff based in each region monitor local conditions and identify potential new managers. The global funds team, based in Washington DC, maintains contact with global fund managers as they seek to expand into emerging markets. Deep and broad local presence, insight and real time information are the foundations of IFC’s consistently strong results. As in developed countries, due diligence in emerging markets focuses on fund team and track record; but in the latter, probing deeper by seasoned, on-the-ground professionals with deep local knowledge of market conditions, risks, and opportunities, is critical.

For example, understanding the relationship between the required skill set for a successful manager and the drivers of returns for the fund is critical. Little leverage is used in most emerging markets, so growth is an important driver of anticipated returns in most transactions, as are operational/efficiency improvements. It is thus important to have a team with the right skills to help companies grow and scale their operations. These value-added skills are especially important given the prevalence of minority positions in emerging markets private equity. Experience shows that minority positions work well when the manager is seen as a genuine partner by the majority owner and makes valued contributions to growing and improving the business, rather than merely acting as a sounding board.

Since change is a constant in emerging markets, the predictive power of a past track record may be less than in developed markets. This underscores the importance of identifying managers with the skills required to manage the type of deal flow particular to a given market. It also illustrates the advantage that early-movers enjoy: in a less competitive environment, new fund managers have more time to consider transactions and are not driven into errors by haste. As markets mature, competition and time pressure on decision-making escalate, increasing the risk of backing new managers. IFC has learned through its long experience that, rather than a largely formulaic approach to verifying a manager’s track record and its attribution to the team, it is necessary to delve further into the strategy that generated the track record and to examine whether conditions are likely to remain favorable for that strategy in the years to come. This type of “deep dive” into team and performance is a key risk mitigant and driver of returns.

**Conclusions**
IFC’s experience of successfully investing in emerging markets private equity funds strongly suggests that the returns and diversification benefits are attractive; that the opportunity is geographically and sectorially broader than many investors perceive and will continue to grow; and that emerging markets private equity is less risky than is commonly thought. However, systematic mapping is essential and due diligence must be tailored and deepened to align with the nuances and dynamics of private equity investment in emerging markets. IFC continues to invest successfully in emerging markets private equity and believes the asset class offers an often underutilized opportunity for many investment portfolios.

\textsuperscript{3} Emerging Markets Private Equity Association, 31 March 2012.

\textsuperscript{4} See: \url{http://www.doingbusiness.org/}

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