# The benefits of private equity investment

**David Wilton**, Chief Investment Officer, **International Finance Corporation** (IFC), looks at how private equity can be beneficial; the different investment strategies of private equity and why they might lead to different perceptions on the benefits; and the policy environment required to develop private equity in a country.

IFC has backed private equity funds investing in emerging markets since the 1980s, and in 2000 established a group dedicated to investing in funds. We currently have a portfolio of over $3 billion committed to around 180 funds, with the wide geographical spread seen in figure 1.

IFC backs private equity funds as our experience has been that the combination of capital and expertise these funds provide helps companies to grow and to create jobs. In particular we have found that private equity funds are good at reaching and helping those fast growing smaller and mid-sized companies which make a large contribution to job growth. Table 1 shows clearly how private equity funds in emerging markets are reaching fast growing companies, which are in turn creating jobs at a much higher rate than local and regional averages. (All job and growth data used in this article come from either: (i) *Guest Commentary*: Implications for Job Creation and Achieving Good Financial Returns in Emerging Markets: An Analysis of Private Equity Funds Backed by IFC (Vintage 2000–2011), Private Equity Review, Emerging Markets Private Equity Association, December 2012; or (ii) Previously unpublished material from the same study).

Fast growing companies are expanding companies, often expanding beyond their home market as they grow and in the process helping to integrate regional economies. For example, in the portfolio we see companies in sub-Saharan Africa and Latin America expanding into neighbouring countries, of African and Indian companies expanding into each others' markets, and of North African companies expanding into sub-Saharan Africa.

The growth and job creation we see in our funds portfolio is economically sustainable, as it is consistent with profitability and attractive returns on capital. Table 2 compares the results of the top 10 performing funds in the study mentioned previously with the bottom 10, indicating the link between job growth and profitability.

| | SME | Larger company | Total/average |
|---|---|---|---|
| Number of companies | 235 | 284 | 519 |
| Total jobs created | 26,679 | 276,656 | 303,335 |
| Average jobs created per company | 114 | 974 | 584 |
| Average revenue growth per company | $14,112,910 | $140,863,906 | $81,644,178 |
| Average revenue growth per job | $120,694 | $132,294 | $131,208 |
| Investment by funds | $946,000,000 | $3,320,000,000 | $4,266,000,000 |
| Fund investment per job created | $35,459 | $12,000 | $14,064 |
| Jobs growth rate (annual) | 18.3% | 12.9% | 15.3% |
| Revenue growth rate (annual) | 29.8% | 14.9% | 21.5% |
| Average number of jobs at investment | 79 | 1,628 | 927 |
| Average revenue at investment | $4,130,336 | $231,354,368 | $125,616,452 |

Table 1. Job and growth data from IFC's funds portfolio

## ALL FUNDS ARE NOT CREATED EQUAL

To better understand the job and growth results IFC has obtained in its funds portfolio, it is necessary to understand something of how private equity works. After all, private equity in developed markets has been colourfully described as 'a pack of locusts', a description which does not fit the growth and job creation results we have seen in our portfolio. What might account for the large difference in perspective?

It is not accidental that the companies supported by funds in which IFC has invested are overwhelmingly faster growing companies. The focus on fast growing companies is a necessary result of the logic of the private equity business model, as it is transplanted to emerging markets. The lower access to debt finance – leverage – in most emerging markets drives private equity to focus on making companies grow. The primary focus of private equity in emerging markets is growth equity.

Private equity returns are driven by some combination of four factors: revenue growth; efficiency gains which improve margins; leverage;

| | Vintage 2000-2011 | |
|---|---|---|
| 82 funds | Top 10 | Bottom 10* |
| Average IRR | 33.7% | –22.7% |
| Average number of jobs created | 17,404 | 598 |
| Average rate of job growth | 13.9% | 10.4% |
| Average investment per job | $5,108 | $41,472 |
| Average revenue growth | $2,060,000,000 | $11,100,000 |
| Average rate of revenue growth | 17.2% | 4.5% |

Table 2. Return on capital, job growth and revenue growth for the best and worst performing funds

Note: IRR, the internal rate of return, is the standard private equity measure of return and refers to the compound annual return over the period for which an investment is held, measuring all cash flows at the time they occur. Private equity investments often have multiple rounds of investment and return cash at many occasions before final exit.

*Bottom 10 amount for average rate of job growth includes an outlier that would reduce this percentage to 6% if excluded.

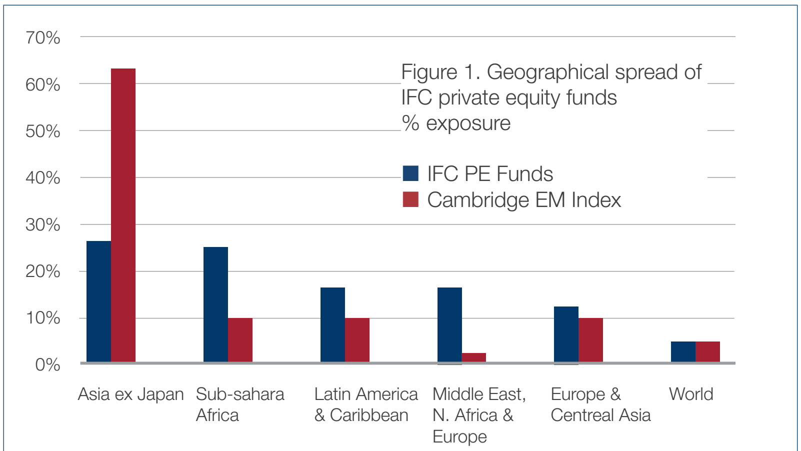


Figure 1. Geographical spread of IFC private equity funds % exposure

| | IRR | Equity | Cash out by Divident, Stock Purchase etc | P/E at Entry | P/E at Exit | Revenue Groth 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 |

Table 3. Examples of how a 25 per cent IRR can be created

and an increase in the valuation multiple applied to the company's earnings. Table 3 shows the outputs from an IFC model which provides a guide to what this means. Each line approximates how a gross IRR of 25 per cent can be achieved *using only one of the four drivers of return at a time* (there are other variables in the model which do not appear in the table). In reality private equity transactions will use some combination of these four factors, but separating them out as Table 3 does makes it easier to understand each factor.

In the first line, a company with stable revenues (0 per cent revenue growth) is leveraged 70 per cent (30 per cent equity) and 55 per cent of the free cash flow is paid to the equity holders as dividends which, in this setting of the model, generates the target return on equity of 25 per cent. This approximates to a leveraged buyout.

In the second line there is only 25 per cent leverage; only 10 per cent of free cash flows are paid out as dividends; there is no revenue growth or improvement in efficiency (margins remain at 5 per cent). However, the valuation multiple applied to the earnings increases from 6 to 14 and this higher valuation creates the 25 per cent IRR to investors. This approximates to a momentum or arbitrage investment.

| | Revenue growth rate (%) |
|---|---|
| **All companies** | **21.5** |
| Revenue at investment: < $5 million | 36.2 |
| $5 to $15 million | 18.8 |
| $15 to $30 million | 19.2 |
| $30 to $50 million | 7.9 |
| $50 to $100 million | 14.8 |
| $100 to $250 million | 13.2 |
| $250 to $500 million | 6.0 |
| > $500 million | 4.4 |

Table 4. Revenue growth by revenue at the time of initial investment

| | | |
|---|---|---|
| Positive Motivation to Sell | - Strong growth situation<br>- Pre-Listing Clean-Up<br>- Geographic Expansion | Minority<br>Minority<br>Minority |
| Neutral Motivation to Sell | - Generational changes<br>- Conglomerate focusing on Core Business selling non-Core<br>- Privatization | Majority<br>Majority |
| Multiple Expansion | - Distressed Business<br>- Distressed owners | Majority<br>Majority |

Table 5. Motivating situations

In the third line, leverage again is only 25 per cent; there is no increase in the valuation multiple or margins and only 10 per cent of free cash flow is paid out in dividends. However, revenue is growing at 20 per cent per annum and this growth in revenue creates a 25 per cent IRR for investors. This approximates to a growth equity investment.

In the fourth line leverage is also 25 per cent; there is no change in the valuation multiple; and there is also no growth in revenue. However, the profit margin on the business improves from 5 per cent to 30

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per cent and this improvement in margins creates a 25 per cent IRR for investors. This approximates to an improvement in efficiency through, for example, better cost control; or to a realignment of a business into higher margin products.

In emerging markets there is relatively little leverage used – in 2009 IFC found that the average debt-to-equity ratio of companies inside funds it had backed was 74 per cent, and the mean 33 per cent. While the availability of leverage varies across markets, it is generally the case that lack of leverage in emerging markets drives private equity in emerging markets toward a growth equity business model. To achieve a 25 per cent gross IRR through growth and be attractive to private equity investors, companies will need annual revenue growth of around 12–20+ per cent (depending on all the variables in play).

If the companies in IFC's funds portfolio have been successfully selected as growth equity investments then, given the low levels of leverage typically used in emerging markets, we should expect a minimum growth in revenue of around 12 per cent. The average annual rate of growth in revenue of the companies in the sample is in fact 21.5 per cent.

A further implication of the logic of the private equity business model is that we would expect to see much faster revenue growth in smaller companies in the funds portfolio than in larger companies. While there may be a general expectation that successful smaller companies can enjoy higher growth rates than larger ones, as they are expanding off a low base, in the context of private equity investment, there is a very pragmatic reason why this needs to be the case. Private equity funds need to be able to sell the stakes in the companies they acquire. The valuation placed on a company by a trade buyer or an initial public offering (IPO) will generally be more attractive than the valuation the fund can obtain if it needs to place its stake in a company back to the majority owner. To achieve a trade sale or an IPO a company will need to have the characteristics these types of buyers require: a certain size, market share, growth rate, profitability, governance, transparency. To achieve the size required for a trade sale or IPO, the smaller the company is at acquisition, the faster it needs to grow.

Table 4 shows the average annual rate of growth of revenue for different revenue brackets of company in the sample. There is a decrease in the rate of revenue growth as the initial acquisition size of the company gets larger. Revenue growth below 12 per cent in the largest companies may indicate that these companies had access to considerably more leverage than the average.

All this is to say that in emerging markets private equity has a strong incentive to identify and support the fastest growing companies and, in the process, support those companies that are creating jobs at much higher rates than the general economy.

## Policies to foster a private equity industry

For a private equity industry to develop there needs to be a supply of suitable companies in which to invest; a range of options with which to create a return on the equity invested in these companies within the three to seven year holding period dictated by the typical ten-year life of a fund; and the ability to successfully exit the investment.

There are a number of building blocks which help to create these conditions (see Figure 2); and the potential scale of the private equity industry in a country is a combination of the number of building blocks which are in place and the size of the economy. A small number of building blocks in place in a large economy can lead to a larger private equity industry than a country with many building blocks in place but a small economy.

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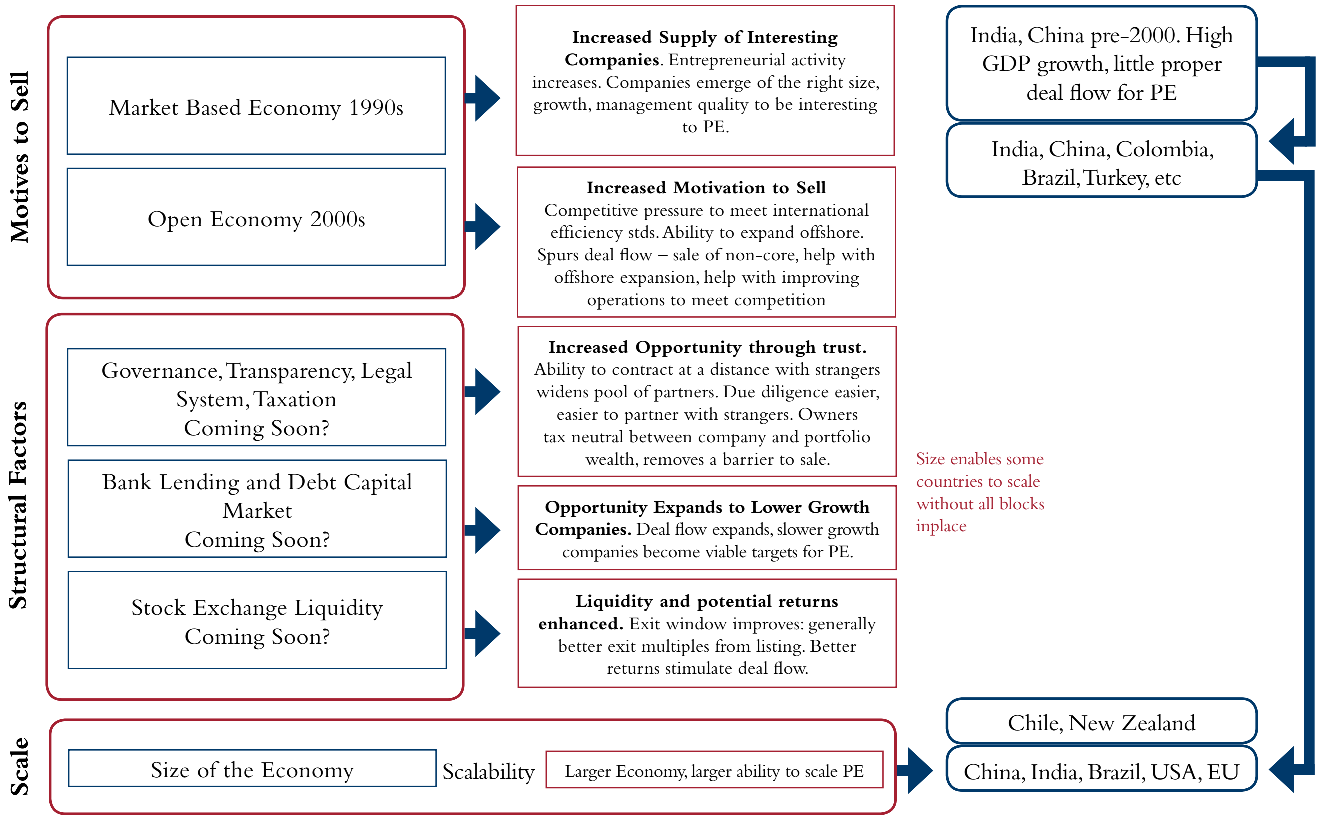
'Suitable' companies for private equity are those with a combination of size and growth which will allow a private equity fund to bring them up to the standard required for an IPO or trade sale within three to seven

Figure 2. Building blocks to achieve maximum potential in PE




> Faced with a more competitive environment business owners become more willing to combine with or sell to competitors.

years. Companies with the right combination of size and growth are much more likely to exist in a market-based economy than in a state-based economy.

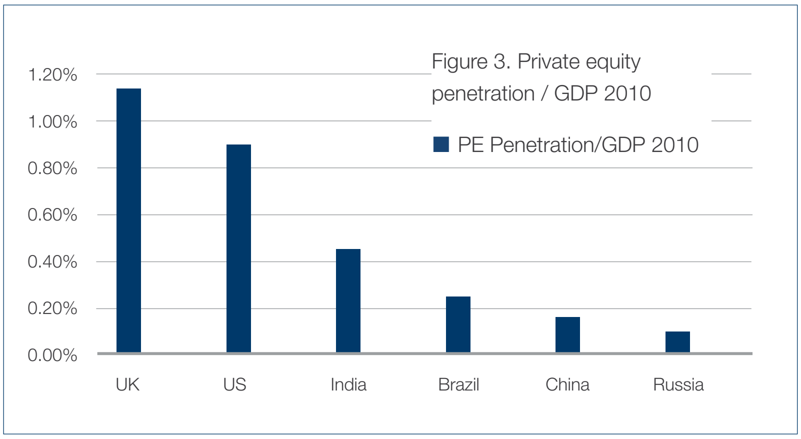
One of the drivers of the growth of private equity in emerging markets in the last ten years has been the shift to market-based economies that took place in the 1990s. The greater incentives in a market economy to innovate, take risk and create personal wealth have lead to a larger number of companies with sufficient scale and/or growth to be interesting to private equity.

For a company to be suitable for private equity it is also necessary that the private equity fund is able to have significant influence over decision-making. Private equity is not passive equity. For the private equity fund it is much more certain that value can be created and an exit achieved in a limited time period if the fund has either outright control of a company or a minority position with significant control-like rights through a shareholders' agreement. For private equity to take root there must be a large enough group of owners of companies who are willing to give up total or partial control of their companies. It is not enough that owners of companies would like additional equity financing – they need to be prepared to give up some degree of control to obtain it.

There are only a limited number of situations which motivate owners of companies to part with control, the most prominent of which are listed in Table 5. A significant contributor to the growth of private equity in emerging markets since 2000 has been the opening of economies to trade and capital flows, as this creates both opportunities and competitive pressures which make owners of companies open to active third party investors.

The internal business dynamic in a closed economy is quite different from that in an open one. In closed economies, business owners tend not to focus on a core business and use spare cash flow to diversify, creating conglomerates. They are also less aware of foreign standards of efficiency and seek offshore expansion less actively. In this less competitive environment they see less need for external advice.

> Each market has its own networks for sourcing transactions, its own quirks in due diligence and its own approach to operating businesses.




Opening the economy changes the internal dynamic. Facing greater external pressure, firms look more to build a competitive core business and sell off non-core businesses to fund the growth and improvement of the core business. Entrepreneurs are more interested in partnering with groups who can help to make the core business more competitive, expand production lines or expand offshore. Faced with a more competitive environment business owners become more willing to combine with or sell to competitors, creating platform build up and industry consolidation opportunities. If several countries in a region make a similar shift towards more market-based open economies, opportunities arise to create larger, more efficient, multi-country businesses.

The shift to market-based economies in the 1990s encouraged larger better managed companies to develop and created growth, while the opening of economies after 2000 made activist third party capital attractive to help grow companies, improve efficiency and expand offshore. The resulting increase in availability of outright control or minority positions with control-like rights created the conditions in which private equity can thrive. As the availability of deal flow has increased across multiple countries, so has the quality of the investment opportunity. The obvious point is that greater deal flow allows greater selectivity. The less obvious point is that the increase in deal flow made it viable for fund managers to become local.

In IFC's experience private equity is a very local business, so the ability to be local is important. Each market has its own networks for sourcing transactions, its own quirks in due diligence and its own approach to operating businesses. Someone local, both physically and culturally, will have better access to potential vendors through belonging to local networks; will be better placed to understand the reputations of vendors; will understand the particulars to be aware of in due diligence in the local market, such as the number of sets of accounts and family or relationship ties in companies up and down the supply chain which may not transfer to a new owner; will be better placed to identify talented local managers and convince them to leave comfortable and prestigious positions in more established firms for the higher risk/reward of a private equity backed firm; and will be better positioned to understand cultural factors that will assist a close working partnership to develop during the holding period, creating a bond that can be used to enforce the shareholders' agreement independent of legal channels.

What might be the next steps for further expanding deal flow in emerging markets? Using capital committed as a percentage of GDP as a measure of market development, the emerging markets, including Brazil, Russia, India and China, are currently much less developed in terms of private equity than the US and Europe – see Figure 3.

To support the continued growth of private equity the trend of the last 20 years to more market-based and more open economies needs to be sustained and extended. If current economic stresses in the global economy were to lead to policies of protectionism and balkanisation, it would tend to limit the further growth of private equity and, at the extreme, cause it to shrink.

Beyond a continuation of the existing trends, two developments at the local level will help to grow the private equity opportunity – improved access to debt finance and improved ability to enforce contracts. These are two of the 'structural factors' in Figure 2 above.

Private equity in emerging markets uses relatively little debt as its availability is limited. As a generalisation banks largely remain focused on lending against assets rather than cash flow, and debt capital markets are very under-developed. Pre-crisis companies within funds in which IFC had invested had average and median debt-to-equity ratios of 0.74 and 0.33 respectively compared with an average ratio a little above 2 in developed markets. The availability of leverage has a direct impact on the number of companies that make suitable targets for private equity. The less leverage that is available, the higher the revenue growth that is required in order to meet the target return on equity. In a low leverage environment, only faster growing companies are suitable acquisitions for private equity funds. The more numerous companies with more modest growth rates are not capable of generating the target return on equity without additional leverage. By increasing the supply of debt finance, more developed debt markets in emerging markets would increase the number of companies that are potentially attractive acquisitions for private equity.

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A large number of emerging markets have weak legal systems in which contract enforcement is difficult or very slow. An efficient legal system allows strangers to collaborate as the ability to efficiently enforce a contract reduces the need to have a very close relationship with and deep knowledge of the other party. An enforceable contract allows trust in the absence of a deep and personal relationship. By widening the circle of people in whom you can place trust, enforceable contracts make it possible to do business with many more people. Conversely, if contracts are not easy to enforce, your circle of trust and the people with whom you can do business are limited to those with whom you have a personal relationship, possibly as limited as family members. Weak legal systems in emerging markets limit deal flow by limiting the number of people with whom a fund manager can do business. Strengthening legal systems would increase deal flow by increasing the possibility of doing business with people who are less personally known.

> “An efficient legal system allows strangers to collaborate as the ability to efficiently enforce a contract reduces the need to have a very close relationship.”

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**The International Finance Corporation** (IFC), a member of the World Bank Group, is the largest global development institution focused exclusively on the private sector in developing countries. Established in 1956, IFC is owned by 184 member countries, a group that collectively determines the policies. IFC's work in more than 100 developing countries allows companies and financial institutions in emerging markets to create jobs, generate tax revenues, improve corporate governance and environmental performance, and contribute to their local communities. IFC's vision is that people should have the opportunity to escape poverty and improve their lives.

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