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INVESTING FOR THE FUTURE
EMERGING MARKETS PRIVATE EQUITY

AVANZCAPITAL™
Connecting Investors Across the World

Avanz Capital Partners Ltd. is an independent investment firm that specializes in private equity across the emerging markets. It has been established to invest in private equity funds in emerging markets, with complementary direct and secondary activities.

www.avanzcapital.com

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Summary

Emerging markets private equity investments are increasingly being considered by many investors. Profitable and worthwhile opportunities in emerging markets private equity can be pursued, which are differentiated from public markets investments. The risks involved in investing in private equity (country, political and economic risks, market risks, and location-specific company risks) can be effectively dealt with through a number of approaches, including by investing in a diversified portfolio of private equity funds.

Avanz Capital believes private equity in emerging markets offers a salutary type of investment resource to countries on the path of growth and development. Private equity capital is stable, long-term and high-quality, and has been demonstrated globally to add value to companies and economies at large. At the same time, it compensates investors with the prospect of earning financial returns fully commensurate with the risks involved. Furthermore, robust investment in private equity has often been an important contributing factor to domestic capital market development from which it, in turn, derives value. This occurs as the greater liquidity afforded by broader and deeper financial markets leads to more efficient and favorable exits for private equity investors.

Private equity is generally considered an investment in companies that are not publicly traded. In the context of this paper, private equity refers to growth capital for expansion, buyouts (both private and public-to-private), late-stage venture capital, platform buildups, industry consolidations and structured equity. It is not taken to include real estate or special situations, such as distressed debt or the financing of turnarounds[1].

Many labels for emerging markets have been developed and defined for the purposes of describing similar characteristics, primarily based on economic conditions. The most common labels include BRICs, N-11, N-7, CIVETS, E7, the IMF's definition of Emerging and Developing Countries, or non-OECD countries[2]. Avanz Capital believes that there are several factors to consider together and does not rely individually on any classification for emerging markets private equity.

This paper explores relevant questions facing investors today for opportunities in emerging markets private equity, as follows:

(I) Why consider private equity in emerging markets?

(II) How is private equity in emerging markets different from the developed world?

(III) What is happening in emerging markets that is positive for private equity?

(IV) What are the prospects for private equity in emerging markets?

(V) What are the main risks associated with emerging markets private equity and how can these particular risks be effectively managed?

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[1] While its most common form is equity participation, private equity investment can also take the form of debt or mezzanine finance and, in fact, many private equity investors participate as both shareholders and creditors of the companies in which they invest. In Europe, private equity is often taken to be primarily (if not synonymous with) venture capital, an early stage of investment ranging from seed money, to start-up, to early sales and manufacturing, to expansion. However, in North America, the term private equity usually refers to "the buyout", whether in the form of a leveraged buyout (LBO) or a management buyout (MBO), and often involves a restructuring of the company under new private ownership.

[2] Please see Appendix I for commonly used definitions and groupings of emerging markets.

In the sections that follow, Avanz Capital presents the primary factors[3] they believe are creating tremendous opportunities for private equity in emerging markets. The case for emerging markets private equity investment is made in terms of three principal benefits: (1) evidence of sufficiently strong relative returns (when compared with relevant benchmarks) in support of claims that the additional risks involved have been covered; (2) evidence of the continued strong diversification benefits which emerging markets private equity investment has to offer, at a time when global convergence among markets and asset classes poses additional challenges through "tight coupling" to portfolio managers' search for effective diversification; and (3) additional scope for customizing attractive risk-adjusted returns by way of private equity fund manager best practice.

I. Why consider private equity in emerging markets?

Over the past 10 years, the average returns on private-equity investment in these markets have more than tripled.

- New Markets, New Rules, BCG/IESE November 2010

Economic Growth

Many institutional investors find investing in emerging markets private equity attractive. Not only have private equity investments in emerging markets been known to yield high returns[4], but when investors hold private equity investments in emerging markets as part of a broader investment portfolio with multiple asset classes, they:

- can expect to benefit from growth-based private equity investments in emerging and developing countries, the economies of which are expected to continue to grow for the foreseeable future at rates greater than those of advanced economies (see Figure 1 and text box below);

Figure 1: A large number of countries' GDP are expected to grow ≥ the World

Region/Group Name	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
World	4.6	5.2	5.4	2.9	-0.5	5.0	4.4	4.5	4.5	4.6	4.7	4.7
Advanced economies	2.7	3.0	2.7	0.2	-3.4	3.0	2.4	2.6	2.5	2.5	2.4	2.4
Euro area	1.7	3.1	2.9	0.4	-4.1	1.7	1.6	1.8	1.8	1.9	1.8	1.7
Emerging and developing economies	7.3	8.2	8.8	6.1	2.7	7.3	6.5	6.5	6.5	6.7	6.7	6.8
Central and eastern Europe	5.9	6.4	5.5	3.2	-3.6	4.2	3.7	4.0	3.9	3.9	3.9	3.9
Developing Asia	9.5	10.4	11.4	7.7	7.2	9.5	8.4	8.4	8.5	8.6	8.6	8.6
Latin America and the Caribbean	4.7	5.6	5.7	4.3	-1.7	6.1	4.7	4.2	3.9	3.9	3.9	3.9
Middle East and North Africa	5.4	5.8	6.2	5.1	1.8	3.8	4.1	4.2	4.3	4.9	5.0	5.2
Sub-Saharan Africa	6.2	6.4	7.2	5.6	2.8	5.0	5.5	5.9	5.7	5.7	5.6	5.4
Select Countries												
United States	3.1	2.7	1.9	0.0	-2.6	2.8	2.8	2.9	2.7	2.7	2.7	2.7
Canada	3.0	2.8	2.2	0.5	-2.5	3.1	2.8	2.6	2.5	2.1	2.0	1.9
Japan	1.9	2.0	2.4	-1.2	-6.3	3.9	1.4	2.1	1.7	1.5	1.3	1.2
Brazil	3.2	4.0	6.1	5.2	-0.6	7.5	4.5	4.1	4.1	4.2	4.2	4.2
Russia	6.4	8.2	8.5	5.2	-7.8	4.0	4.8	4.5	4.3	4.2	4.0	4.0
India	9.2	9.7	9.9	6.2	6.8	10.4	8.2	7.8	8.2	8.1	8.1	8.1
China	11.3	12.7	14.2	9.6	9.2	10.3	9.6	9.5	9.5	9.5	9.5	9.5
Indonesia	5.7	5.5	6.3	6.0	4.6	6.1	6.2	6.5	6.7	7.0	7.0	7.0
Vietnam	8.4	8.2	8.5	6.3	5.3	6.8	6.3	6.8	7.2	7.4	7.5	7.5
Turkey	8.4	6.9	4.7	0.7	-4.7	8.2	4.6	4.5	4.1	4.1	4.0	4.0
Colombia	4.7	6.7	6.9	3.5	1.5	4.3	4.6	4.5	4.5	4.5	4.5	4.5
Mexico	3.2	5.2	3.2	1.5	-6.1	5.5	4.6	4.0	3.4	3.2	3.2	3.2
Kenya	6.0	6.3	7.0	1.6	2.6	5.0	5.7	6.5	6.8	6.8	6.7	6.6
Nigeria	5.4	6.2	7.0	6.0	7.0	8.4	6.9	6.6	6.3	6.3	6.0	6.0
South Africa	5.3	5.6	5.6	3.6	-1.7	2.8	3.5	3.8	4.2	4.4	4.5	4.5

≥ World GDP, by year

Gross Domestic Product (GDP) % Change, constant prices - Actuals and Forecasts – 2005 to 2016
Source: International Monetary Fund, World Economic Outlook Database, April 2011

[3] This paper provides an overview and references work previously made available to the public. Annex II of this paper provides a comprehensive resource list of relevant and recent publications that are available for emerging markets private equity.

[4] Ideally, comparisons among investment alternatives would be based on risk-adjusted returns. This, however, is much more of a challenge in the case of private equity than in the case of exchange-traded securities because of long lead times prior to an event of "price discovery" as well as the fact that many of the relevant risks in the case of private equity do not readily lend themselves to quantification. Consequently, they are not adequately captured in a statistical measurement (such as the standard deviation of historical returns) as they often take the form of future uncertainties with limited information as to relevant associated probabilities.

Economic Growth Prospects 2012 – 2016

According to the *Economist* (June 30, 2011) emerging markets produced more than four-fifths of global real GDP growth over the past five years.

Over the next five years, the IMF *World Economic Outlook* envisages world economic growth of just over 4.5% annually. Given that the developed world is expected to continue the ongoing process of financial de-leveraging with annual growth of only around 2.5% over this period, the higher global growth is expected to be achieved by growth rates in the emerging and developing economies of between 6.5% and 7% annually.

The World Economic Outlook also anticipates the strongest regional GDP growth to be achieved in emerging Asia (over 8.5% each year in real terms), followed by Sub-Saharan Africa, which is expected to realize real GDP growth consistently over 5.5% each year. The forecast further anticipates the fastest growing countries in terms of annual real GDP growth rates to be China (over 9.5%), India (over 8%), Indonesia and Vietnam (between 6.5% and 7.5%).

- have access to opportunities for early participation in sectors and markets poised to take off in large emerging economies, which are experiencing the rapid expansion of a middle class with newly-acquired purchasing power;
- can be fairly confident of robust financial returns from private equity since many emerging-market countries are producers of natural resources, which are essential to the ongoing global economic recovery. Such markets are currently experiencing strong and sustained international demand with higher prices. This benefits both the economies of these countries generally, as well as the many companies positioned to take advantage of the broader economic growth that this commodity revenue is generating;
- have access to opportunities through private equity in emerging markets to participate in a steady stream of promising new investments in related companies such as supply-chain partners (customers and suppliers), often with synergies and further diversification benefits in relation to the initial portfolio company investments; and
- are able to avail themselves of high-quality diversification benefits[5] which are more difficult to find among other asset classes[6] as international financial markets become increasingly interconnected and thus correlated.

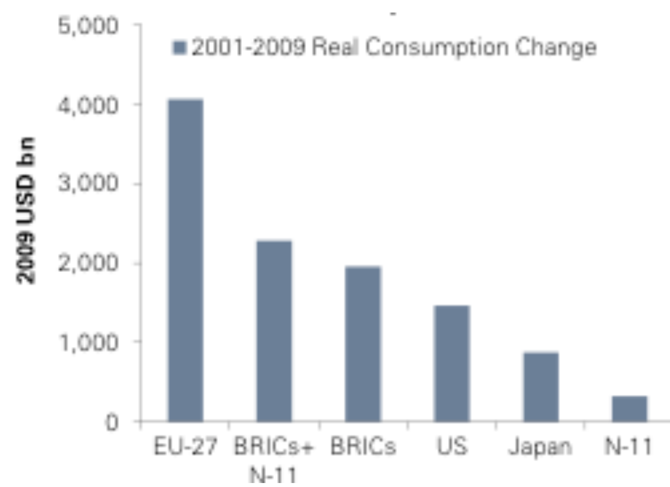
Population Growth

Economic growth in emerging markets has led to the rise of the middle-class consumer and very young populations, which is in turn helping to drive further economic growth in these economies. This has had a number of effects on the patterns of economic development:

[5] As indicated in the footnote 4, private equity involves a significant amount of uncertainty which tends to elude precise measurement. Considering that structural and contractual risk mitigation techniques can also be applied with private equity investments, the case for being able to achieve real and significant diversification benefits with emerging markets private equity seems robust even though difficult to measure accurately (See Meyer and Mathonet, Chapters 7 & 8).

[6] The difficulty lies principally among a range of broad investment alternatives and does not apply for example to holding capital in the form of "safe haven" currencies with strong negative correlations with respect to most investment classes, and which would otherwise involve liquidating fund investments to hold what in effect would be "cash balances". See "Risk on – risk off" – how a paradigm is born. HSBC Global Research. 02 August, 2010.

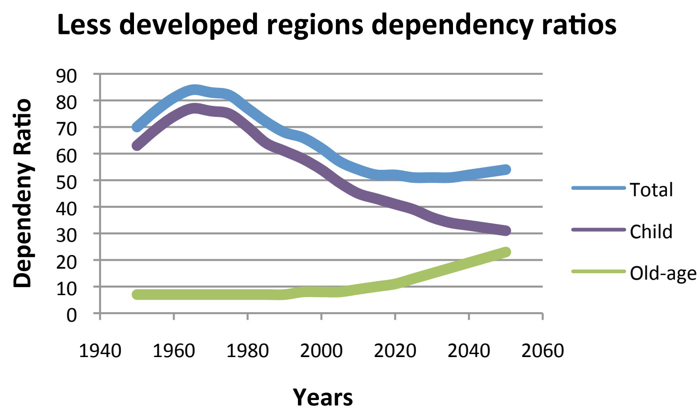
- Entrepreneurial activity is improving and the number of growth companies is increasing. Accompanying the rise of the middle-class consumer, many countries have moved to market-based economic policies thereby attracting entrepreneurs, including diaspora returning home who are leading companies' growth in their local markets and/or expanding abroad.
- Higher returns are realized from production for local markets due to more likely growth in demand from domestic consumers rather than from exports. The middle-class consumer boost is supporting impressive expected future GDP growth (two to three times faster than developed nations, according to IMF April 2010 estimates). As Figure 2 shows, since 2000, the BRICs have added to global consumption more than the US. China has already overtaken Japan as the world's second largest economy. As a result, economic growth has led to greater prosperity and an increased standard of living, which has in turn boosted domestic consumption throughout emerging markets.
- **Figure 2: The BRICs added more to global consumption than the US since 2000**



Source: GS Global ECS Research based on IMF data and national sources.
See definitions of country groupings in Annex I.

- Well-educated consumers are advancing into higher income bands. The massive young populations across many emerging markets as well as the pattern of consumer demand for products and services are changing. New products become affordable -- electric appliances before cars and consumer durables typically ahead of luxury goods -- and the timing of these investment opportunities will vary by country. Figure 3 shows the recent steady decline in dependency of the young as significant numbers join the labor force, with the result that the total dependency ratio levels off and only starts to rise gradually well after the year 2020 as populations increasingly age.

Figure 3: Dependency ratios



Source: World Bank, Databank; estimates begin after 2009

- As an illustration of the prospect for higher returns to be realized by including emerging markets private equity in the investment portfolio mix, Figure 4 shows the extent to which returns (measured as internal rates of return or IRRs) to emerging markets private equity fund investments of the International Finance Corporation (IFC) exceeded the MSCI Index for publicly-listed and traded companies in emerging markets over the decade post-2000. The IFC All PE Funds returns also outperformed the Cambridge EM Top Quartile benchmark by two to five percentage points.

Figure 4: IFC's Private Equity Funds Performance

IRR from 2000 to …	Sept-09	Dec-09	Mar-10	Jun-10	Sept-10
IFC All PE Funds*	17.0%	18.1%	20.1%	19.5%	18.8%
MSCI (IFC PE Funds cash flows)**	12.1%	13.4%	13.1%	9.6%	13.3%
Cambridge EM Top Quartile	12.7%	16.2%	16.8%	14.1%	17.0%

Source: International Finance Corporation, http://www.ifc.org/ifcext/cfn.nsf EM_PE_Sharing_IFCs_Experience_v9_February2011.pdf
** All Private Equity funds invested by IFC since 2000, calendar year. Excludes debt, infrastructure & real estate funds.*
*** Matching cash flows to IFC Private Equity Funds invested/divested from MSCI.*

II. How is private equity in emerging markets different from the developed economies?

Like the variety of cultures and languages found within these countries, emerging markets private equity is significantly different from that of the U.S. and Western Europe.

Some of the ways in which private equity in emerging markets has advantageous characteristics distinct from private equity in developed countries include:

- Greater emphasis is placed on value creation through improving operational efficiency and bolt-on deals rather than through the use of financial leverage, although this distinction is less pronounced as private equity firms in developed markets increasingly shift their focus away from financial engineering towards improving operating performance.
- Ample opportunity exists to invest in companies with high revenue and profit growth potential because of the continuing prevalence of family-owned

businesses, which are well situated to take advantage of technology and management innovations from developed countries. Companies in emerging markets value the ability to leap-frog into a more advanced stage of development by working with growth equity investors who add value by professionalizing their operations, increasing their efficiencies, improving governance and transparency, linking into global markets, and taking advantage of the growing interest of investors.

- Lower overall debt-to-equity ratios of target companies are the norm after the private equity investment is made (at least in comparison to typical LBOs and MBOs of past years).
- Financial returns from minority interests in emerging markets private equity have been higher than those associated with majority interests and stand in contrast with private equity returns in a number of more developed markets[7].
- Private sector transactions are the most common with fewer public-to-private transactions in contrast with the developed economies.
- A longer investment cycle can be expected, given the degree of improvement possible in emerging markets and the lower base from which growth can take off, but the rewards to patient strategic investors can be substantial.
- Different levels of development are discernible across emerging markets, but what they have in common, particularly in the smaller countries, is a private equity culture that understands issues of building scale and an increasing focus on regional (cross-border) expansions.

III. What is happening in emerging markets that is positive for private equity?

PE investments into emerging markets increased 110% between 2009 and 2010, according to Reuters, and the trend has no signs of slowing.

- Fortune / Term Sheet, December 2010

Although buffeted by the impact of the global financial crisis of 2008, private equity in emerging markets has seen marked progress with respect to the investment environment in a vast number of the emerging-market countries. In addition to the reasons presented above to consider private equity in emerging markets, some of the more salient positive developments as well as some of the risks are presented below.

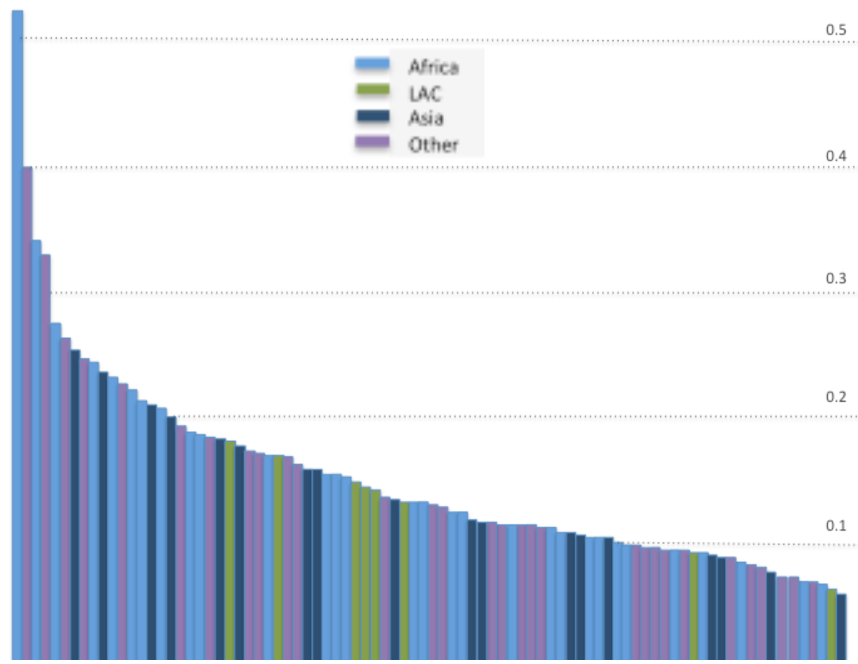
- Governments increasingly have learned from the financial crises of the previous two decades and are avoiding many of the economic policy mistakes of the past. There is also growing appreciation of the advantages to be gained when national wealth is more widely (and fairly) dispersed. Additionally, in certain sectors a number of governments, where their countries are part of an economic union or trading bloc, are relinquishing their sovereignty in connection with policy prerogatives in spheres such as trade, finance and cross-border transportation in order to harmonize regional policy. This augurs well for companies with the desire and capacity to expand regionally.
- Greater attention is being paid to both: (1) the “rule of law”, including efforts to curb crime and corruption and enforce contracts; and (2) the introduction of appropriate laws, regulations and institutional arrangements to help foster sustainable business activity, all of which were recently accelerated as a result of the global financial crisis.

[7] Heino Meerkatt (BCG) and Heinrich Liechtenstein (IESE), *New Markets, New Rules* November 2010, page 9

- Rapid domestic expansion is visible in many sectors given that emerging markets are starting from a relatively low base of private equity activity. Entrepreneur-led companies are seeking capital to finance their growth and help them access overseas markets, while family-owned businesses are turning to outside investors to ease succession issues and ownership transitions.

- Improvements in local business conditions are giving rise to increased formation of new businesses. Advancements in the regulatory environment are discernible in many emerging markets as demonstrated in the World Bank Group's *Doing Business Report 2011*. This is leading to enhanced business activity and the encouragement of firms to make investments resulting in job creation and improved productivity. Figure 5 shows the extent to which positive changes have been introduced in the general business environment by a significant number of countries.

Figure 5: In the past 5 years about 85% of economies have made it easier to do business.



Source: Doing Business Report 2011

- Several decades of reforms and economic development initiatives have placed many "developing countries" in the "emerging markets" category, making them targets for growing investment flows. It is important to recognize the significance of the impact resulting from many years of knowledge and technology transfers from global corporations and the international financial community, including private institutions, multi-lateral institutions and governments across the world.

- Business, financial and legal reforms and improvements in management of national economies should lead to an increase in the number of well-managed companies. The best companies will not only have the opportunity to grow faster but will become more competitive internationally and in some cases grow beyond their borders.

- Most importantly, a confluence of factors has brought down inflation and interest rates across the globe; in large measure, this has been due to: (1) the "peace dividend" following the dismantling of the Berlin Wall, the dissolution of the Soviet Union and the major changes in the geopolitics of Eastern Europe; and (2) the global dismantling of high barriers to both international trade and international capital flows.

- Emerging-market countries endowed with abundant petroleum resources figure prominently among surplus countries in foreign asset accumulation while China and the countries called "emerging Asia", are representative of those countries which have experienced recurring trade surpluses as a result of broader macroeconomic conditions and policies. The macroeconomic policies of this latter group of countries have been shaped by lessons learned from the financial crises of the past two decades. Their response to financial crisis, given their existing foreign indebtedness, has been to maintain policies that ensure price advantage for their exports while compressing domestic demand to avoid inflationary buildup[8]. Although this makes sense from the perspective of a single country, the concern is that when several countries, representing a significant portion of world trade, are following such policies, this increases the potential for systemic instability with attendant risks and costs. Figure 6 below, from an IMF staff position note, shows how the imbalances unfolded post-2000.

Figure 6: Average current account balances (in percent of world GDP)

	1996-2000	2001-2004	2005-2008
United States	-0.8	-1.4	-1.4
Peripheral Europe	-0.1	-0.4	-0.8
Rest of the World	-0.3	0	-0.3
China	0.1	0.1	0.6
Emerging Asia	0.1	0.2	0.2
Japan	0.3	0.3	0.3
Oil Exporters	0.2	0.4	1.0
Core Europe	0.2	0.4	0.7
Discrepancy	-0.3	-0.3	0.4

Source: Olivier Blanchard and Gian Maria Milesi-Ferretti, IMF Staff Position Note December 22, 2009 SPN/09/29, Please see Annex I for country groupings.

- The causes of the imbalance are complex. After the year 2000, the world economy experienced a shift that has led economists and policy-makers to voice concern over a deepening phenomenon of "global imbalance". While the US and a few European countries were accumulating fiscal and external deficits, a significant number of previously capital-scarce countries began a steady process of net foreign asset accumulation[9]. For the deficit countries, many reasons were advanced for incurring the additional debt associated with

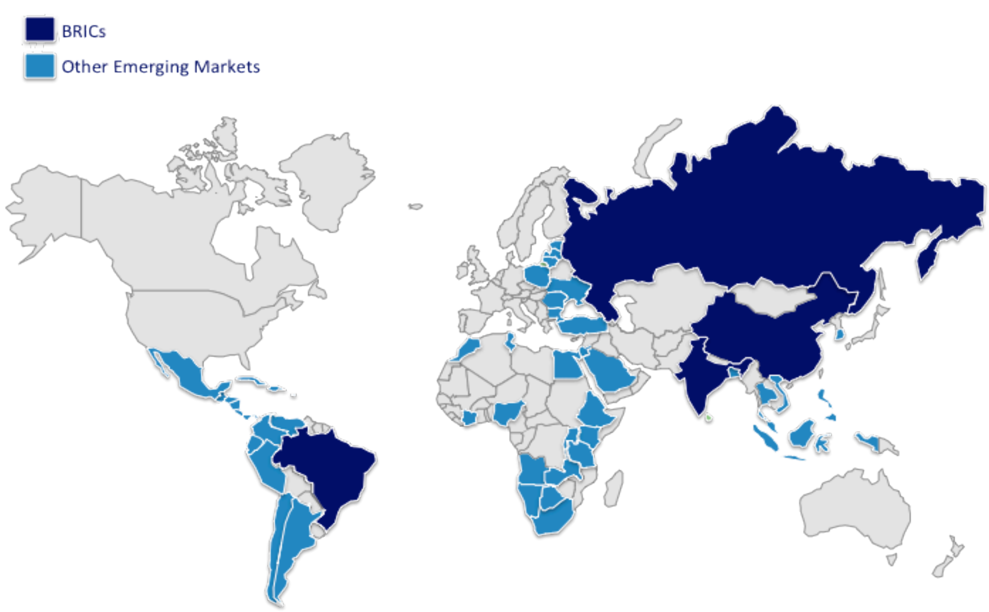
[8] Continuous technological breakthroughs combined with the reduction, if not elimination, of previous barriers to trade and investment concurrently reinforced the process of "globalization", permitting even greater specialization among countries in manufacturing, packaging and distribution. It even promoted international trade in services which had previously been strictly domestic in nature.

[9] To manage this new wealth, more than forty surplus countries have established sovereign wealth funds (SWFs), which in 2010 controlled total assets of over US$4 trillion. This is in addition to over US$7 trillion in state-owned pension and stabilization funds and another US$7.7 trillion in other official foreign exchange reserves. Some of the SWFs have, in fact, become investors in a few of the global private equity firms. Many SWFs have invested in private equity funds.

high spending levels, whereas for the new surplus countries the change of fortune seems to have either been the result of buoyant commodity export prices or macroeconomic management aimed at export-led growth. In fact, countries with different resource endowments, demographic characteristics and behavior, and capital in place can usefully transact with one another to their mutual benefit with resulting surpluses and deficits[10]. It is when the pattern of imbalance begins to trend and to concentrate as a result of policy and institutional distortions that systemic risk begins to mount. The main risk in Figure 6 is the percentage weight of the US deficit, representing 56% of all deficit countries, which, considering that all countries must balance to zero, raises questions as to how US deficit reduction would impact current surplus countries. The global financial crisis that unfolded in 2008 seems to have slowed the aforementioned trends in the financial system. It has also highlighted the risks involved.

- Despite their anticipated contribution to world economic growth and global financial diversification, some emerging-market economies will be more vulnerable than others to global events in general, as well as to future changes in trade balances.
- The soundest emerging markets destinations for private equity investing will be those countries that have a combination of the requisite economic growth, financial stability and hospitable business environments discussed in sections I and II above in addition to a healthy supply of fund managers from which to select investment opportunities from a range of companies and industries. Figure 7 shows the emerging countries with active or promising private equity fund investment prospects identified between the BRICs and other emerging markets.

Figure 7: Map of emerging markets with private equity opportunities



Source: Avanz Capital Partners

[10] Moreover, there can be little doubt that the current pattern of trade imbalance with the attendant phenomenon of globalization has afforded many companies in emerging markets the opportunity to participate in global supply chains.

- Not all emerging-market countries are experiencing similar development and therefore, will not necessarily share in the same growth prospects. Although it is not clear how changes in the current global imbalances will unfold, it is evident that the risk is not spread evenly. At the same time that such imbalances convey risk, however, they also present sizeable opportunities for solid risk-adjusted returns, provided that countries, funds and target companies are selected judiciously.

IV. What are the prospects for emerging markets private equity?

The work of Goldman Sachs, IFC, Cambridge Associates and others on economic growth and its sustainability in emerging markets has helped focus investor interest, including the interest of private equity investors. Emerging markets' share of private equity investing is large and growing.

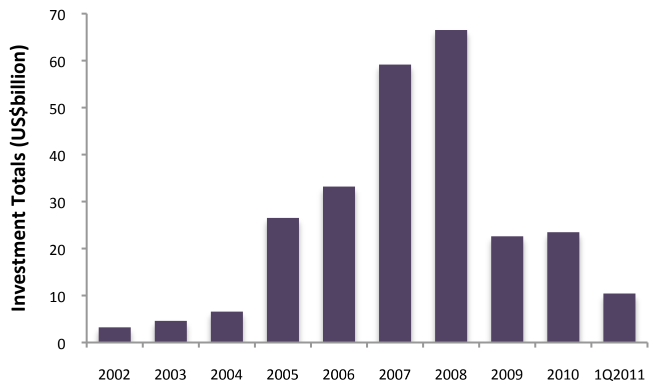
The trends described below represent positive developments that bode well for future investments in emerging markets private equity.

- Emerging markets' share of the total number of private equity deals more than doubled from 12% to 30%, while their share of total deal value nearly tripled from 8% to 21% between 2005 and 2009[11]. Looking forward, emerging markets have a huge untapped potential and many of them are making credible efforts to undertake domestic reforms to support sustainable economic growth. For those countries that maintain political stability and succeed with their structural reforms, their future is promising.
- Significant growth-oriented private equity opportunities exist today beyond the small group of countries in which most emerging-market investments are currently concentrated given the number of high-growth, stable economies. Reinforcing these opportunities are: (i) increased political stability in many countries and regions; (ii) the geographically dispersed spatial pattern of global supply chains; and (iii) the continuous institutional search for investments in new business opportunities, which large companies engage in to achieve economies of scale through outsourcing efficiencies and the tapping of new markets. When the supply chains of global companies are disrupted, new opportunities emerge for companies across emerging countries. For those companies in emerging markets sufficiently competitive and agile to become alternative end-distributors and those which can fill in as low-cost and reliable alternative sources of raw materials, intermediate goods and services, the opportunities to provide global companies with supply-chain resiliency (as major world events shift the global business landscape) are significant and represent mutually beneficial value addition. While the dislocations prompting the reconfiguration of the supply chain are usually temporary, the new supply-chain arrangements benefitting cost-effective companies have nonetheless been known to endure. The companies in emerging markets benefiting from these developments could be highly interesting candidates for private equity investment.
- Private equity is a vehicle of change with real influence and real growth potential. It promotes the development of "champions", market leaders and companies that are sought out by investors. This catalyzes other business leaders to emerge and their number and depth increase. Where private equity should be focused is the mid-market companies, which are driving the growth. Figures 8 and 9 present respectively the amounts of funds raised for private equity in the emerging markets in billions of US dollars and emerging markets'

[11] BCG/IESE Business School, *New Markets, New Rules*, November 2010

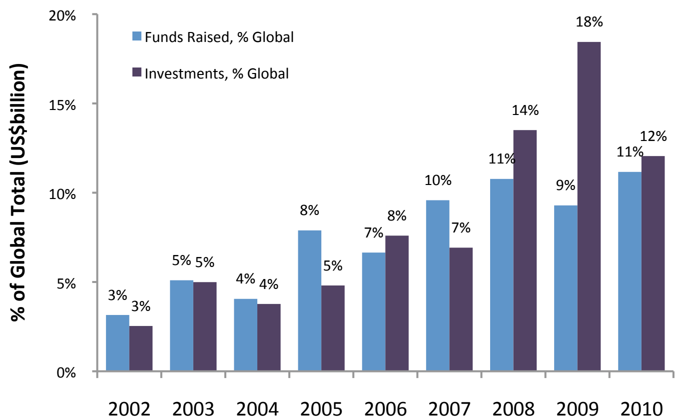
share in both global private equity funds raised and invested over the period 2002-Q1 2010.

Figure 8: Emerging Markets Private Equity Fundraising Totals



Source: EMPEA, Industry Statistics Q1 2011

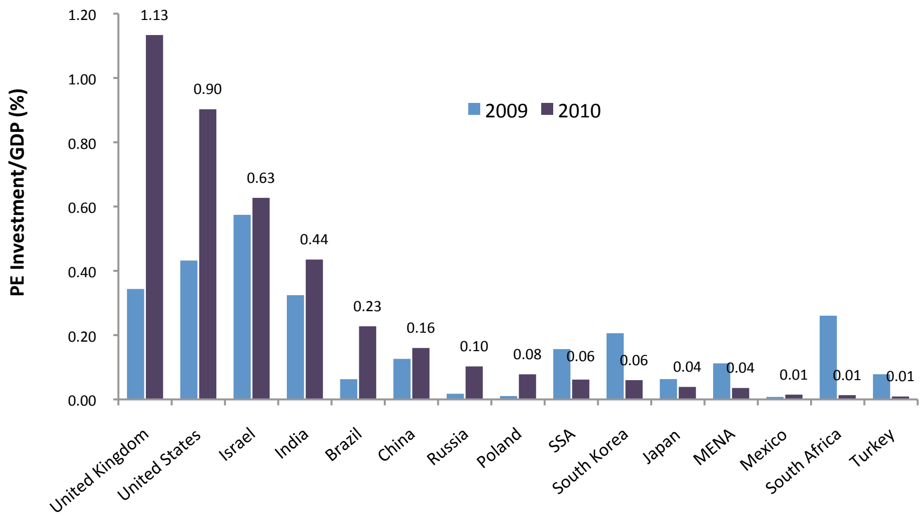
Figure 9: Emerging Markets Private Equity Activity as % of Global Total



Source: EMPEA, Industry Statistics Q1 2011

- The private equity industry in emerging markets is still at relatively low penetration, despite high growth in funds raised in recent years. The industry is gaining significant support from many local governments, as evidenced by recent changes in regulations in many jurisdictions allowing local pension funds to invest in private equity funds. The most recent statistics from the Emerging Markets Private Equity Association (EMPEA) show the penetration rates of private equity funds investments as a percentage of GDP in 2009 as compared to 2010 (Figure 10). The private equity industry in emerging markets is expected to continue to grow as these economies catch up to more developed markets. While Israel and India enjoy relatively better private equity penetration, this is in contrast to Mexico, Russia, Poland and China that have further to go.

Figure 10: Global Private Equity Penetration, as of December 31, 2010

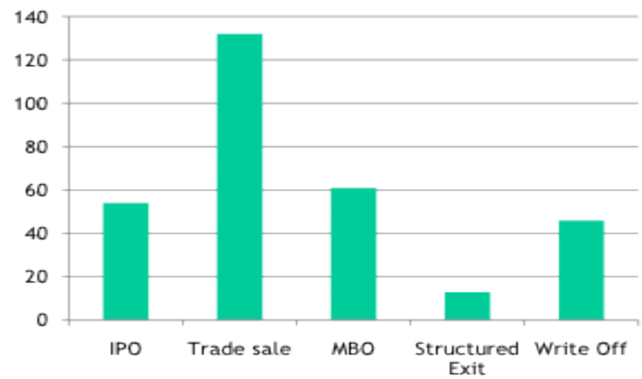


Source: Emerging markets – EMPEA, United Kingdom – Centre for Management Buy-Out Research, United States – PitchBook, Israel – Israel Venture Capital Research Center, Japan – Asia Private Equity Review. All GDP data – International Monetary Fund. Methodology: Annual private equity investment divided by annual gross domestic product.

- Improvements in quantity and quality of deal flow and structures are discernible. The breadth and depth of deal flow available for emerging markets private equity have expanded in the last decade in an increasing number of countries. An exploding number of local/country-based funds have brought expertise closer to companies. Local business networks are leveraged better by investors operating in the local markets.
- There are many new private equity investment teams are being formed, comprised of individuals with the requisite experience and track record who have the potential to become the next generation of top-quartile fund managers. Many of these managers, including a number that have been funded by development finance institutions, are well advanced in investing their current funds and plan to return to market in the next 6 to 24 months.
- Trade sales are more readily available than IPOs in emerging markets for private equity exits. Relatively low venture capital activity is mainly the result of a lack of supporting “infrastructure” needed to incubate, cross-fertilize and guide start-ups in a knowledge economy. But beyond this important aspect, venture capital is further impeded by the limited liquidity available in nascent public markets in the developing world. On the other hand, growth capital transactions are expected to continue to exit via trade sales and take advantage of IPO markets as they develop. Latin America is already experiencing a boost in local public markets. For instance, Peru and Colombia announced a plan to merge their stock markets, which will increase the market value of listed companies. Discussions are underway to integrate these stock markets with Chile and should help to standardize taxes, such as on capital gains. It is important to note, however, that although the IPO is a popular exit in countries with vibrant and highly liquid stock exchanges, for countries where stock exchanges have limited liquidity or else liquidity is concentrated in a few securities, investors often do not consider the IPO to be a final exit. Figure 11

shows the distribution of exits by type in connection with 325 IFC private equity transactions with trade sales clearly the most common.

Figure 11: Number of Exits



Source: 325 exits from IFC invested funds, International Finance Corporation, http://www.ifc.org/ifcext/cfn.nsf EM_PE_Sharing_IFCs_Experience_v9_February2011.pdf

- Finally, residual concerns of private equity investors in connection with long lock-up periods and lack of liquidity are addressed by the developing market for secondary positions in private equity interests. The market for secondary positions (secondaries) has grown rapidly and has deepened. Transactions in secondaries can take the form of sale of private equity fund interests or alternatively the direct sale of interests in private equity portfolio companies. While the largest segment of this market pertains to investment positions in US and European buyouts, the market for investment interests in emerging markets private equity has also been developing quickly in recent years.

V. What are the main risks associated with private equity in emerging markets and how can these particular risks be effectively managed?

All investment involves risk; investment in emerging markets private equity is no exception. Those aspects of emerging markets private equity risk which are usually seen to distinguish it from the investment risk encountered in developed countries can be usefully examined in terms of three main investment risk categories – external risk factors (including political and institutional framework risk), market risk factors (including liquidity risk) and company risk factors.

- The **external business environment** in emerging-market countries is often seen to involve a higher level of political risk than in developed countries. This occurs not only in the extreme cases of civil unrest and hostilities among states, but also through the less than transparent influence that concentrations of political power can exert in the business sphere. Moreover, economic distortions and procedural deficiencies involving the local institutional and regulatory framework can create both impediments to business as well as the false security of profit-making opportunities based mainly on regulatory arbitrage. In such cases, the associated investments are particularly vulnerable to future policy and institutional change.

Most emerging economies are doing better than developed economies and look like they will for some time. But investor success depends on picking the right manager, regardless of the macro environment.

- Triago Quarterly, April 2011

- **Market risk** in emerging markets most commonly takes the form of illiquidity risk, which hampers effective investment exits. This is most obvious in countries that lack breadth and depth to their financial systems (for example, by not having well-developed stock and commodity exchanges and a functioning debt market, along with inadequacies in the financial rules and institutional infrastructure needed to afford the exchanges efficacy). However, it also becomes manifest in countries in which trading in financial instruments and access to affordable credit is heavily concentrated in only a few companies. It also occurs where the rules governing capital repatriation are especially onerous. And it extends to the additional systemic risk involved when shallow and unstable local markets magnify the adverse impact of unfavorable news events, giving rise to pronounced price volatility and "contagion".
- **Company–level risk** particular to emerging-market countries stems from deficiencies in corporate governance, distortions associated with financial reporting (particularly where local accounting rules tend to obscure the true financial state of enterprises), as well as country- and sector-specific sources of operational risk.

While the aforementioned risks are well known, best-practice fund management in connection with emerging markets private equity goes a long way toward mitigating and managing these risks through such conventions as:

- Ensuring the careful screening of target company sponsors to avoid "politically-exposed persons (PEPs)" as well as undertaking the due diligence needed to ensure that fund management adheres to similar prudent practices in this connection.
- Ensuring that careful screening is undertaken (both in the case of direct investments as well as by fund managers) with respect to the sustainability of profitable business operations free of policy-based distortion. This is not to imply that all businesses in sectors and countries involving policy-based distortion are completely avoided but rather that sensitivity testing is conducted to make sure that core business would be sufficiently resilient and sustainable in the event that subsidies and other distortionary benefits were removed.
- Working closely with fund managers to provide investors with the best protection available through investment design features (incorporating: political risk insurance where relevant and available, cost-effective hedging strategies where practicable, innovative corporate and financial vehicle structures, and on-balance-sheet and off-balance-sheet credit enhancements for risk abatement as appropriate, etc.).
- Undertaking, through regular review and adjustment of investment portfolios, to achieve appropriate diversification benefit within the framework of fund articles of incorporation and investment agreements as well as in observance of sound prudential norms.

Conclusion

Investors can benefit from the extraordinary opportunity offered by private equity in emerging markets. Carefully selected well-performing funds, managed by experienced fund management teams with demonstrable past performance, would provide an investment opportunity to take advantage of the growth and diversity found in emerging markets. A well-constructed emerging markets private equity portfolio is expected to provide financial investors with outsized returns, balanced risks and appropriate exposure to the most promising companies across diverse regions, industries and vintage years.

ANNEX I: Common Definitions and Groupings for 'Emerging Markets'

- **BRICs**: Brazil, Russia, India and China. Some emerging markets commentators are starting to add South Africa as the S in BRICS.

- **N-11:** The "Next 11" as defined by Goldman Sachs (Global Economics Paper No: 134, 1st December 2005) are Bangladesh, Egypt, Indonesia, Iran, Korea, Mexico, Nigeria, Pakistan, Philippines, Turkey and Vietnam, the next set of large-population countries beyond the BRICs.

- **N-7:** A sub-set of the N-11 countries, namely Egypt, Indonesia, Mexico, Nigeria, Philippines, Turkey and Vietnam.

- **CIVETS**: Acronym coined by Economist Intelligence Unit in 2009 for favored emerging markets as follows: Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa. The term has also been propagated by HSBC. These countries are favored for several reasons, including a dynamic and diverse economy and a young and growing population.

- **E7:** A group of seven emerging countries whose economies are predicted to become much larger than the G7 countries by 2050. The term was coined by PricewaterhouseCoopers in 2006 and includes in order of size of their economies by 2050, China, India, Brazil, Mexico, Russia, Indonesia and Turkey.

- **Emerging and Developing Countries:** There are 150 countries defined by the International Monetary Fund (IMF) Emerging and Developing Countries, also referred to as Emerging Markets. The IMF uses a flexible classification system that considers (1) per capita income level; (2) export diversification—so oil exporters that have high per capita GDP would not make the advanced classification because around 70% of exports are oil; and (3) degree of integration into the global financial system. IMF member countries are either "Advanced" or "Emerging and Developing".

- **Organisation for Economic Co-operation and Development (OECD):** Comprised of 34 countries, the OECD members are: Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States.

- **Country Groupings for Figure 6 on page 9:** ***EUR surplus*****:** Austria, Belgium, Denmark, Finland, Germany, Luxembourg, Netherlands, Sweden, Switzerland; ***EUR deficit:*** Greece, Ireland, Italy, Portugal, Spain, United Kingdom, Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Turkey, Ukraine; ***Emerging Asia:*** Hong Kong, S.A.R. of China, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan province of China, Thailand; ***Oil exporters:*** Algeria, Angola, Azerbaijan, Bahrain, Republic of Congo, Ecuador, Equatorial Guinea, Gabon, Iran, Kazakhstan, Kuwait, Libya, Nigeria, Norway, Oman, Qatar, Russia, Saudi Arabia, Sudan, Syria, Trinidad and Tobago, United Arab Emirates, Venezuela, Yemen; ***Rest of the world:*** remaining countries

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