

PRIVATE EQUITY INVESTING IN EMERGING MARKETS

*Opportunities for
Value Creation*

ROGER LEEDS

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Private Equity Investing in Emerging Markets

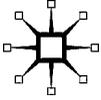
Opportunities for Value Creation

Roger Leeds

with

Nadiya Satyamurthy

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For Ellen, my role model in life.

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Quick Reference Guide

100-day plan: An action plan mapped out by a private equity fund in collaboration with the senior management of a portfolio company to be implemented during approximately the first 100 days post-investment. The plan is designed to outline which value-enhancement initiatives should be implemented during the initial months of a private equity partnership, when management is believed to be most receptive to making important changes.

Angel investor: A high net worth individual, often with extensive industry expertise, who invests her own capital in entrepreneurial start-up companies.

Asset class: A classification of financial assets based on assumptions about the similarities of their risk, return, and liquidity characteristics. Private equity is considered its own asset class, and this book contends that emerging markets private equity, which has a unique set of characteristics, should also be considered a separate asset class.

Asymmetric information: A term that refers to a reality in nearly all transactions: one party (e.g., a company owner) possesses more information that is relevant to the transaction than the other (e.g., the investor). In private equity, the company management knows more about the underlying operations of the business than the investor, which may result in the investor making decisions regarding the investment that are based on incomplete or inaccurate information.

Carried interest (carry): The share of profits from a private equity fund's investments that are allocated to the general partner, typically after the limited partners receive their original investment and agreed-upon preferred return (or hurdle rate). The standard practice in private equity is a 20 percent carry (also known as a performance fee) allocated to the GP.

Committed capital (commitments): The total amount of capital from limited partners and general partners that is allocated to

a particular fund. The term also refers to the specific amount of capital a limited partner contractually commits to a private equity fund.

Comparables (comps) analysis: A valuation methodology that involves comparing a company's historical performance with similar companies in the same industry, usually by using financial ratios.

Convertible securities: A debt or equity security that under certain specified conditions related to company performance may be converted into another security (usually common stock). There are various types of convertible securities, each with its own well-defined rights and conversion conditions.

Deal flow: A term used by asset managers (e.g., venture capital funds and private equity funds) to refer to the availability of new investment opportunities. In private equity, it refers to companies that are likely to meet the fund manager's investment criteria.

Development finance institutions (DFIs): Institutions that are backed by governments to provide financing and technical assistance for projects in developing countries for the purpose of spurring economic growth and development. Examples of well-known multilateral DFIs that focus on the private sector include the World Bank's International Finance Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD).

Discounted cash flow (DCF) analysis: A valuation methodology that measures the profitability of a prospective investment by projecting a company's potential cash flows over a period of years and then discounting these financial flows back to the time of the initial investment to establish a present value. According to this methodology, a potential investment is generally considered attractive if the present value of the discounted cash flows is higher than the anticipated initial investment.

Distribution waterfall: The method of establishing the order of financial distributions as a private equity fund realizes its investments. For example, usually a distribution waterfall specifies that general partners only receive profits from an exited investment

after the limited partners receive their original investment and a specified preferred return.

Due diligence: The evaluation of a potential investment. With private equity, due diligence refers to the process undertaken by the fund manager to assess the operational, financial, and managerial strengths and weaknesses of a prospective portfolio company in order to determine whether the company satisfies its investment criteria.

EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization): A common measure of a company's net income (profitability) before making adjustments for interest expense and/or tax obligations.

ERISA: The United States Employee Retirement Income Security Act of 1974, which established minimum rules for pension plan investing activity, as well as the tax effects of such investments. ERISA is relevant to private equity in particular because it included the so-called Prudent Man Rule, which forbade pension fund managers from investing in alternative assets such as private equity because of their risk profile. Once the rule was repealed in 1979, pension funds quickly became a major source of funding for private equity and the industry began to experience explosive growth.

Exit: Refers to a private equity fund's sale of all or a portion of its stake in a portfolio company, usually via an initial public offering (IPO), trade sale, or sale to another financial investor.

Fund of funds: An investment fund that raises capital from institutional investors, and then functions as a limited partner, making investments in a number of individual private equity funds. Fund of funds offer their investors greater diversification by holding a portfolio comprising a number of GPs, typically with differentiated strategies, which in turn invest directly in companies.

General partner (GP or fund manager): One or more individuals who are responsible for the day-to-day operations of a pool of capital (the fund), usually structured as a limited liability partnership. In private equity, the GP is responsible for raising capital from a group of institutional investors (the LPs), identifying

potential companies in which to invest, and actively overseeing the companies within its investment portfolio until the exit.

Growth capital: A term that generally describes significant minority private equity investments in companies that are relatively well established and seek to increase their growth and profitability by improving and maximizing efficiency within their operations, and expanding into new products, industries, or markets.

Hedge fund: A pooled investment fund that differs from private equity in that it targets investments in liquid assets, such as securities, instead of illiquid assets, such as private companies.

Hurdle rate (preferred return): The minimal acceptable return a limited partner must receive from a private equity fund investment before a general partner may begin to share in the profits generated.

Initial public offering (IPO): The first-time sale of shares to public investors by a company that previously was not listed on a public stock exchange. An IPO is often the preferred method of exit for a private equity fund investment, as it provides liquidity for any remaining shares in the company and generally, but not always, generates the highest financial returns.

Internal rate of return (IRR): The discount rate that makes the net present value of all future cash flows from an investment equal to zero. Generally speaking, the higher the investment's internal rate of return, the more desirable it is. As such, IRR is often used by private equity investors to rank prospective investments they are considering. IRR is also used as a means of measuring the real financial returns on an investment at the time of exit.

Institutional Limited Partners Association (ILPA): A global member-driven not-for-profit organization that represents the interests of limited partner investors in the global private equity industry by conducting research, engaging in advocacy and education campaigns, and fostering networking and collaboration opportunities for LPs engaged in private equity investing.

Institutional Limited Partners Association (ILPA) Private Equity Principles: A detailed list of suggested guidelines and best practices published by ILPA (see above) to clarify the terms and conditions governing the relationships between general partners and limited partners in a private equity fund. The Principles focus on such key

issues as the alignment of interests between LPs and GPs, governance of the private equity funds, and disclosure and transparency.

Leveraged buyout (LBO): A controlling private equity investment financed predominately with debt (often as much as 80–90 percent). The debt is then repaid from the cash flow generated by the acquired company. This form of acquisition is common in developed markets private equity, particularly in the United States, but rare in developing countries due to limited access to this form of debt financing.

Limited liability partnership (LLP): A business partnership in which some partners (the LPs) have limited liability, meaning they can only lose as much capital as they have invested, rather than being liable for losses in excess of their capital investment. Most private equity funds are structured as LLPs, with the fund manager (GP) assuming unlimited liability.

Limited partner (LP): A partner in a LLP (see above). In private equity funds, limited partners are passive investors, while the general partners are responsible for the day-to-day management of the fund. Limited partners in private equity funds tend to be major institutional investors, such as pension funds, university endowments, family offices, development finance institutions, and insurance companies.

Limited partnership agreement (LPA): A legal document that sets forth the terms and conditions governing the relationship and responsibilities of the LPs and GP in a private equity fund, including, for example, the fee structure, hurdle rates, carried interest, methods used to value portfolio companies prior to exit, and disclosure requirements.

Management fee: The annual fee that limited partners in a private equity fund pay to the general partner to compensate the latter for actively managing the fund. The management fee is usually calculated as a percentage of the committed capital to the fund, with each LP paying in proportion to its investment.

Placement agent: A firm that specializes in assisting GPs (fund managers) in raising capital from institutional investors (LPs) during the fundraising stage.

Portfolio company: A company in which a private equity firm invests.

Prudent man rule: A section of the United States Employee Retirement Income Security Act of 1974, which forbade pension fund managers from investing in alternative and riskier assets such as private equity. In 1979, the Department of Labor clarified the Act in such a way as to permit pension funds to invest a portion of their capital in private equity and other relatively high-risk asset classes. This government action is largely credited with the explosive increase in the volume of private equity fundraising beginning in the early 1980s.

Secondaries market: The market for limited partner commitments to private equity funds; secondaries funds purchase unwanted LP commitments, usually at a discount, and then sell them to other investors.

Strategic buyer: The acquirer of a private equity fund's stake in a portfolio company that is in the same or similar business and has a long-term strategic interest in the company.

Supermajority voting rights (protective provisions or affirmative conditions): Provisions in a term sheet that provide a private equity fund with specified rights to approve major decisions made by the management of a portfolio company even though the private equity fund is a minority investor.

Term sheet: A preliminary, non-legally binding document that outlines the terms and conditions of a proposed investment by a private equity fund in a company. Term sheets also serve the same purpose in defining the structure of the relationship between the GP and LPs in a proposed new private equity fund.

Trade sale: A private equity exit in which the fund's stake in a portfolio company is sold to a strategic buyer, as opposed to an initial public offering or a sale back to the company's management (i.e., management buyout).

Venture capital: A subset of private equity that involves equity investments by a fund in early-stage companies with the potential for exceptionally rapid growth, profitability, and high financial returns. Traditionally venture capital was associated with promising new companies in such high-growth sectors as technology and biotechnology, but in emerging market countries these investments occur in a broad range of sectors.

Introduction

Discovering private equity—a personal odyssey

I have been thinking about this book, perhaps subconsciously, ever since I disembarked in Brazil about 40 years ago as a wide-eyed, naïve Peace Corps volunteer. Fresh out of college, I was assigned to work as a rural agricultural extension agent in one of the country's poorest and most remote regions. This initial grass-roots immersion in the problems of underdevelopment was then followed by a career path that zigged and zagged after graduate school from a Wall Street investment bank to the International Finance Corporation at the World Bank, back to the private financial sector, including a stint at a private equity firm, and finally academia, where I have been privileged to teach graduate students what I had practiced for decades.

* Throughout this book, the term “developing countries” will be used interchangeably with “emerging markets,” a label first coined in the early 1980s by Antoine van Agtmael, then with the International Finance Corporation (IFC), to define a small subset of relatively prosperous developing countries that attracted the interest of international investors because of the size of their public equity markets. Mr. van Agtmael later acknowledged that his intention was to attach a certain prestige factor to this special category of countries. “I... came up with a term that sounded more positive and invigorating. ‘Third World’ suggested stagnation; ‘emerging markets’ suggested progress, uplift and dynamism.” From this modest beginning, the term gradually gained broader acceptance with international investors and the media, becoming a convenient shorthand to describe virtually all developing countries rather than the few that have relatively well-developed domestic equity markets. For the purpose of this book, developing countries or emerging markets refer to all markets outside of Western Europe, the United States, Canada, Israel, Japan, Australia, and New Zealand.

Although at first glance this career path may seem disjointed, a common thread runs through my decades of experience in the public and private sectors, as well as academia: a primary focus on business practices, financing tools, and public policies designed to strengthen the private sector's role as a constructive contributor to economic growth and poverty alleviation in developing countries. As my career advanced, my interests narrowed. Why, I asked myself, had the private sector underperformed by every measure in virtually all of the more than 100 emerging markets where I traveled, worked, and observed in comparison to developed countries? For example, World Bank studies have estimated that the contribution to gross domestic product (GDP) of small- and medium-size companies in developed economies average 51.5 percent compared to only 15.6 percent in low-income countries. Other commonly used metrics of private sector contributions to economic growth, such as new job creation, export generation, and commercialization of research and development (R&D) initiatives, revealed a similar pattern of marked underperformance. Although explanations for the performance gap were numerous, in the course of my professional odyssey I became convinced that limited access to capital and relevant business expertise topped the list of reasons why the growth and competitiveness of so many emerging market companies was stunted. This belief led me to private equity, the subject of this book.

Private equity, I learned, had a proven track record as a significant contributor to business performance in developed countries, but was largely nonexistent in those countries where I had spent a professional lifetime. Although by no means a silver bullet that would solve all the problems of worthy firms, this particular type of financing, I came to recognize, was endowed with a unique set of attributes that makes it especially appropriate for a wide range of companies in developing countries. In fact, my experiences as both a practitioner and an academic have convinced me that the case for private equity is even more compelling in developing countries, where alternative sources of capital and business expertise are relatively scarce. To be sure, as this book will argue, the investment risks in these countries are higher, but so are the opportunities, both for investors and local businesses. And yet, many of the

stakeholders who should be its most forceful advocates don't know what private equity is, how it works, or why it is exceptionally well suited for many of the company owners with limited or no access to the capital they need to grow their businesses.

My views on the untapped potential of private equity in developing countries stem from years of interactions with a broad spectrum of those who have a direct stake in building a stronger, more competitive private sector. For starters, I have talked and worked with hundreds of entrepreneurs, managers, and owners of a broad range of small, medium, and even large businesses: shrimp farmers in Ecuador, sausage makers in Bulgaria, marble cutters in Uzbekistan, snack food entrepreneurs in China, packaging materials manufacturers in Brazil, fitness center chain operators in Colombia, and telecom operators in Nigeria. Regardless of the country, the sector, the business size, or the track record, our conversations invariably got around to the subject of money, and I kept hearing more or less the same story: "I cannot take my business to the next level because I am unable to get capital on affordable terms." As the conversations drilled down on the details, again the story was *always* the same: "The banks won't lend beyond six months, the domestic stock market is off limits because my business is too young, too small or growing too slowly, and attracting foreign capital is a non-starter for the same reasons."

Private equity in emerging markets—underutilized and underappreciated

Part of the problem, I learned, was of the entrepreneurs' own making. The vast majority of business owners in developing countries were unfamiliar with even the most rudimentary ABCs of raising capital. Moreover, they often compound their financing problems by being mistrustful, even fearful, of "outsiders" who routinely demanded company information that they either did not have or were unwilling to share. As the owner of a capital-starved Bolivian wood processing company explained to me following an initial meeting with a prospective private equity investor, "I had no reason to trust these people. Why should I believe they would be any different from the last so-called investors who walked through my door, raised my hopes, and then disappeared, wasting my time?"

No matter the country or the company, I repeatedly witnessed one or another version of this defeatist, suspicious attitude about the prospects of attracting third-party capital.

The investment professionals on the other side of the table who were just beginning to explore private equity opportunities in developing countries were facing their own set of challenges. In the mid-1990s, as an embryonic private equity industry was beginning to take off, some of these pioneering investors shared with me their personal stories of success as well as miserable failure. For the most part, they recounted tales of bitter disappointment and frustration as they learned from painful experience that private equity investing in developing countries is fundamentally different from what they had experienced in the United States and Europe. From conducting due diligence before making an investment to monitoring the performance of portfolio companies after the capital was committed, they begrudgingly acknowledged how ill-prepared they were to deal with the pitfalls. "The legally binding shareholders agreement we signed with the company owner was not worth the paper it was written on," explained one disappointed investor who learned about the futility of seeking legal recourse in Nigeria when he was unable to resolve a serious dispute with the majority shareholder. And another who had a long track record of private equity success in the United States conceded that he was out of his league when he launched a fund in Latin America. "Finding the right skill set in emerging markets is tricky," he recounted. "We learned the hard way that to build company value we had to be able to say to the founder, 'Your brother has to go, or you must sell this subsidiary.'"

By the start of the new millennium, the initial results from this first generation of private equity investors began to trickle in, and the results were not pretty! Although at this early stage there was virtually no data on the nascent asset class, anecdotal evidence revealed that the vast majority of these early pioneers were producing miserable results. Predictably, many first-mover investors concluded that private equity had no future in these high-risk environments, and they retreated to the sidelines. Although I continued to believe that private equity's unique characteristics were tailor-made to bridge the financing gap for many companies in

underserved developing markets, it became increasingly evident that this early performance would have to be explained and corrected if the asset class was to have a future.

My work also brought me in regular contact with a third set of stakeholders alongside business owners and private equity investors—government policymakers and development finance experts with responsibilities for strengthening the role of the private sector in developing countries. I was struck that with a few notable exceptions, such as the International Finance Corporation (IFC), a member of the World Bank Group, the term “private equity” was not even on their radar screen. My questions to these experts about this financing mechanism that had made a significant difference in the performance of countless businesses in developed countries were usually met with blank stares or, even worse, glaring misperceptions based on headlines in the press about job-destroying, asset-stripping Western leveraged buyout firms. Surprisingly, I learned firsthand that most experts in the development financial institutions (DFIs) displayed little interest in private equity, even as they advocated and advised on the most appropriate policies and programs to stimulate private sector development. As one critic observed about economists more generally, “There is so much inbredness in this profession. They all read the same sources. They all use the same data sets. They all talk to the same people. There is endless extrapolation on extrapolation on extrapolation, and for years that has been what has been rewarded.”¹

This “inbredness” came to mind when I asked a senior World Bank official a few years ago why his institution had not published a single report on private equity, despite voluminous research conducted by Bank staff on private sector development. The disingenuous response was simply, “We don’t have anyone who knows enough about the subject.” He might just as well have said, “We have enough to do without exploring beyond our traditional comfort zone.” But perhaps I should not have been so taken aback. Judging from the academic literature, private equity in developing countries has also been largely ignored by economists and others in academia specializing in international development. Even in the most prestigious Master of Business Administration (MBA) programs, as I have learned firsthand, the curricula reveal a disturbing

lack of attention to why private companies in these markets underperform relative to their counterparts in more developed countries—although student bodies are increasingly demanding more courses that address emerging markets subjects.

This inattention to addressing the financing problems of companies across the developing world was all the more vexing in view of the seismic shift occurring in development strategies. By the early 1990s, a global consensus had taken hold among government policymakers, economists, and development finance specialists that the private sector, not the state, should serve as the primary engine of growth and development. But if these experts and stakeholders truly believed in the superiority of market economies and private enterprise over central planning and state-dominated development models, why did private sector underperformance persist unabated? Despite the supportive rhetoric and seemingly endless stream of DFI technical assistance and financing to promote private sector growth, the pattern remained the same.

In virtually every developing country I visited, the private sector was sharply bifurcated, with a tiny handful of the largest firms dominating access to financial resources, especially the medium- and long-term capital that *all* companies need sooner or later in order to grow and compete. For example, the privatization programs that gained momentum in country after country in the 1990s as a way to boost the private sector's contribution to growth were characterized predominantly by large multinational corporations and banks purchasing huge state-owned enterprises (SOEs), sometimes through joint ventures with equally large local companies. Similarly, the surge in foreign direct investment that was flowing into developing countries revealed a comparable pattern of large on large. Reinforcing this trend, notoriously weak domestic financial markets in most developing countries were dominated by the capital raising activities of a few of the largest local companies and the insatiable appetites for credit of deficit-plagued governments. As a practitioner working in many of these countries, I believed that private equity was one way to bridge this private sector financing gap, especially for small and midsize firms, if only more of these thought leaders, policymakers, and financiers would take notice of its potential and support its wider use.

Just as private equity activity in developing countries was beginning to gain some momentum, I was leaving the world of practice for academia. I used my new perch at the Johns Hopkins School of Advanced International Studies (SAIS) to organize a study group comprising about a dozen seasoned private equity investors and development finance specialists. As I wrote in my invitation letter to these leading figures in the industry, “The purpose of the seminar series is to provide an independent forum that allows you to share experiences with a group of your professional peers, learn from one another, and generate useful lessons about private equity investing in emerging markets.”

In 2001, we began to meet monthly for dinner at SAIS, with structured discussions led by one of the participants, focusing on one or another of the specific obstacles that was impeding private equity success in developing countries. What, we persistently asked, must be done to nurture private equity investing for deserving firms in these countries? And why had the first generation of emerging markets funds failed to deliver the financial returns investors were expecting? As word spread about the SAIS dinner-seminar series, my phone began to ring with requests to attend the monthly sessions from others in the private equity community, and the group quickly expanded. What began as a one-year experiment, continued into a second year, and then a third.

The surprising interest in the private equity seminars revealed something important that in hindsight should have been obvious. Prior to this initiative, no independent forum existed where members of the fledgling developing country private equity community could gather, exchange views, and learn from one another. We also discovered that there was virtually no data, analysis, or commentary of emerging markets private equity, an unfortunate reality that explained why there was such widespread misunderstanding about its potential benefits to bridge the financing gap. We came to recognize that this impediment to expanding the use of private equity in developing countries could be overcome by producing more thoughtful, credible information about the asset class.

This led us to the idea of creating an independent, member-driven industry association, and in 2004 the Emerging Markets Private Equity Association (EMPEA) was launched (I served as Founding

Chairman until 2011).² In addition, numerous regional- and country-specific private equity and venture capital associations across the emerging markets began to spring up, complementing EMPEA's efforts to collect, analyze, and disseminate information about the asset class in their respective spheres.

However, despite these encouraging initiatives, private equity investments in developing countries still remain a fraction of what takes place in developed markets, and far too many businesses with exceptional growth potential continue to be starved of capital and business expertise. In sub-Saharan Africa, for example, although private equity investments have grown in recent years, they represented a miniscule 0.12 percent of the region's GDP in 2013—and this metric was even lower in Latin America, the Middle East, and parts of Asia.³ If the asset class is to be used more widely, as I believe it should, someone must make a persuasive case. With 40 years of experience as both a practitioner and academic, I immodestly believe that I am well placed to take up the challenge. This book is the result.

The Absence of Data: No Excuse!

Ever since developing countries became a subject of serious intellectual inquiry, researchers have been plagued by the absence of reliable, robust data. More than half a century ago, for example, the highly respected authors of one of the first books on the subject of development economics cautioned readers that due to their lack of confidence in the available data, “we use statistics only sparingly.” Nonetheless, they went on to explain, this frustrating reality was insufficient cause to abandon their work: “The difficulty or impossibility of submitting certain economic phenomena to quantitative treatment or the insufficiency of statistical information, does not mean the phenomena cannot be understood or analyzed.”⁴ More recently, another prominent development economist provided a realistic and sympathetic perspective on the persistence of the problem by observing that when a country is poor and governments are underfunded at so many levels, “it is hard to keep statistical offices running.”⁵

If reliable developing country data is generally hard to come by, the problem is immeasurably worse when dealing with this book's two core subjects: private firms that are not publicly listed on a stock exchange

and private equity. For example, virtually every published analysis of the severe financing problems encountered by small- and medium-size companies includes the caveat that credible data to substantiate the claim is either inconsistent or unreliable.⁶ There is not even a consensus among the leading DFIs, such as the World Bank and International Monetary Fund (IMF), or within individual country governments, about what constitutes a “small” or “medium” or “large” company. Moreover, despite the voluminous information published annually on financial flows to developing countries by DFIs, the data is not disaggregated to reveal how much is directed to very large companies compared to small- and medium-size ones. As for private equity, it merits hardly a mention from any of these authoritative sources reporting on developing country financial flows.

And it gets worse. Private equity is far more difficult to track and analyze than other financial assets for the simple reason that it is “private.” Unlike publicly listed companies and financial institutions that are subject to relatively intense regulatory oversight and stringent disclosure requirements, most private equity funds are not legally required to disclose information that would shed light on their performance, or even the companies that are recipients of their investments. This information deficit exists in all countries, but it is significantly compounded by the very short history of private equity in emerging markets. Prior to the early 2000s, for example, virtually no quantitative data trail exists that would illuminate the amounts of private equity capital raised and invested in emerging markets, much less how individual funds performed. And even today it is difficult to benchmark the financial returns generated by private equity investors in emerging markets against the same asset class in developed countries; the data is simply too sparse and unreliable.⁷ Although a number of private equity and venture capital industry associations and other private research firms⁸ have begun to compile useful information on the asset class, there are significant methodological differences among them that result in major disparities in what is reported and how.⁹

This statistical conundrum, however, no matter how uncomfortable and frustrating, is hardly a justification for shying away from a serious analysis of the subject. On the contrary, these formidable data gaps provide additional motivation for writing this book, which hopefully illuminates the potential of private equity to overcome some of the most formidable obstacles encountered by most firms in developing countries. In doing so, I hope that this book serves as a catalyst for better data collection and encourages others to pursue similar research.

Three premises at the core of this book

This book's purpose is to narrow the knowledge gap by illuminating the distinctive attributes, as well as the risks, of private equity investing as compared to other types of financing available to worthy companies in developing countries. Although others have written books about private equity, no one has explored the proposition that private equity investing in developing country environments comprises an asset class with unique risk/return characteristics compared to developed countries. Ultimately, the intent of this book is to illuminate these key distinctions and present a persuasive case for why this particular financing mechanism, with a long history of success in more advanced countries, merits wider attention and application in developing nations. With this in mind, the content of subsequent chapters is driven by three themes.

First, while private equity has historically been an important financing tool for companies in developed markets, even when the heightened risks are taken into consideration, the case for private equity in emerging markets is more compelling than in developed countries for a number of specific reasons. Most importantly,

- alternative sources of long-term financing and value-creating business skills are scarce or nonexistent for countless growth-oriented companies. This reality is a defining feature of virtually every developing country.
- as a consequence of this pervasive gap in financing and business skills, the universe of companies able to satisfy the investment criteria of private equity practitioners is large. The bulk of these potential targets resides in what is loosely defined as the middle market—an extraordinarily diverse range of growth-oriented companies that operate in an endless array of industries, such as basic manufacturing, technology and communications, financial services, tourism, energy, environmental services, infrastructure, health care, education, and even real estate. They also comprise the core of the productive private sector, serving as the primary source of job creation, income generation, tax revenues, and other indicators of economic development and poverty alleviation.¹⁰ And unlike advanced countries where highly devel-

oped financial sectors provide these middle market firms with access to a diverse range of affordable financing options to spur their growth and profitability, this is rarely the case in developing countries.

- the very weaknesses and inefficiencies that characterize many developing countries, industries, and individual companies are sources of opportunity for discerning private equity investors who are equipped with both the financial resources and skill sets required to bridge the gaps and bolster performance.

Second, private equity is unique compared to any other financing mechanism available to private companies. In addition to serving as a source of long-term capital, private equity investors are highly incentivized to be active, hands-on participants with company owners and management to enhance enterprise value—the prerequisite for a profitable exit. Moreover, this ongoing, sharply focused involvement mitigates many of the risks typically associated with investing in developing countries.

And third, private equity investing in developing countries is embryonic relative to its potential to benefit a broad range of stakeholders—private and public investors from both developed and developing countries seeking new opportunities to generate high financial returns and achieve diversification of their portfolios; countless private companies in developing countries seeking scarce long-term capital on affordable terms and operating expertise designed to strengthen their competitiveness and profitability; and governments across the globe that are committed to enhancing the capacity of the private sector to fulfill its role as the primary engine of economic growth and poverty alleviation.

The SME Misnomer

In this volume, the middle market is loosely defined because there is no widely accepted consensus on the appropriate demarcation separating “small” from “medium-”size firms. The literature and policy-related discussions about the severity and consequences of the financing gap in developing countries, for example, invariably utilize the term “small and

medium enterprises” (SMEs). But this term is disturbingly broad, imprecise, and unhelpful from an investor’s perspective for a number of reasons. First, despite the enormous attention devoted to SMEs by scholars, policy-makers, and the development finance community, there is no agreement on how to define or classify this universe of firms that comprise the bulk of every country’s private sector. Even different entities within the World Bank Group do not agree on a common set of definitions, and individual countries use a confusing array of different metrics that often do not coincide with the metrics used by the World Bank or other DFIs. Second, from a private equity investor’s perspective, the convention of classifying firms on the basis of the number of employees or annual revenues has limited usefulness as a metric for decision-making. Although company size may enter into their calculus, they are more likely to focus on employee productivity or revenue growth (e.g., revenue generated per employee) compared to other businesses in the same sector, rather than absolute numbers. Finally, notwithstanding these disparities regarding what constitutes a “small” versus a “medium-size” firm, there is general agreement that the outer boundary for SME analysis is 250 employees. But what about larger firms? Are firms with more than 250 employees as likely to be victims of the financing gap as those with 50, 150, 200, or 249?

Unfortunately, it is literally impossible to address this question with even minimal precision because neither governments nor DFIs collect data on firms that break through the SME 250-employee barrier. They may be unimportant to analysts and policymakers, but anyone who has spent time observing private sector activities in developing countries can empirically attest that they are (i) numerous and (ii) often victims of the very same financing constraints as firms with fewer than 250 employees. And finally, it is worth noting that, although rarely acknowledged, the term “SME” is a misnomer.

Who should read this book?

This book is intended for a broad audience of specialists and non-specialists alike. They need only share an interest in learning how and why private equity is a particularly compelling tool to provide long-term capital and business expertise to a broad range of growth-oriented firms in developing countries. More specifically, the book is designed to reach four reader categories:

- Entrepreneurs and company managers in developing countries who are struggling to gain access to the type of investment capital and expertise they need to grow their businesses and compete. Many are either unaware of private equity, misunderstand its benefits, or have serious reservations about the prospect of allowing “outsiders” into their company. And those who are potentially interested in a private equity partner may not know how best to market themselves to investors.
- Professional private equity practitioners, including fund managers, institutional investors, and those who provide direct support services to investors, such as attorneys, consultants, and accountants. All have a direct stake in raising the profile of private equity in emerging market countries, dispelling the misperceptions, and expanding its use.
- Government officials and professional staff in international financial institutions, like the World Bank, who are engaged in stimulating additional private investment as a means of catalyzing economic growth and development and who undervalue or misunderstand the role that private equity can play in this process.
- Finally, an increasingly large universe of students around the world, including my own, who are seeking stimulating career opportunities that allow them not only to make a good living financially but also be engaged professionally in an activity that will better the lives of the underserved in developing countries.

Except for the practitioners themselves, it is no small irony that many of these prospective readers are strong advocates of an expanded private sector role in developing countries, but are largely unaware of private equity. I hope, therefore, that this book will remedy both the inattention to and misunderstanding of the asset class.

How this book is organized

As briefly described below, the book is structured in two parts. The first section, comprising chapters 1–5, provides readers with a detailed examination of the book’s principal themes. These include

explaining step-by-step the private equity investment process and why the skills required for success differ from other types of financing options; exploring the evolution of the asset class in developed markets; identifying the building blocks that serve as the foundation for a thriving private equity industry, taken for granted in developed countries but largely absent in emerging markets; highlighting the nonfinancial value-creation attributes that make private equity an especially compelling financing tool in developing countries where business expertise is often as scarce as capital; and tracing the history and performance of emerging markets private equity from its origins in the 1990s to the present day, highlighting the lessons learned along the way. The second part of the book illustrates the challenges and opportunities described in the first five chapters by profiling in greater detail the private equity industry in three distinct developing countries—China, Brazil, and Kenya. More specifically, the book is organized as follows:

Chapter 1: A Private Equity Primer: The reader is introduced to the distinctive characteristics of private equity that separate it from all other financing mechanisms available to private companies. The specifics of the private equity investment cycle are traced, highlighting how the skills required of successful private equity practitioners and the tasks they perform differ markedly from those of other, more conventional finance professionals such as investment and commercial bankers. The narrative then proceeds to build the case for why private equity is an especially relevant financing tool in higher-risk developing country environments by highlighting three interconnected features that set it apart: active ownership, illiquidity, and financial incentives to create long-term value. The chapter concludes by arguing that these unique features that define private equity are particularly relevant to a vast universe of growth-oriented firms in developing countries, but stakeholders must recognize that *both* the risks and opportunities are fundamentally different from its application in advanced economies. Readers who are already familiar with the distinctive features and investment mechanics of private equity may wish to proceed directly to chapter 2.

Chapter 2: Private Equity Ecosystems: A Stark Contrast between Developed and Developing Countries: To reinforce the

premise that private equity in developing countries bears little resemblance to its counterpart in more advanced economies, this chapter briefly traces its gradual evolution over more than half a century in developed countries, where it benefited from an ecosystem that facilitated and encouraged its growth. The building blocks that serve as the foundation for a thriving private equity industry include, for example, supportive government policies; confidence-inducing legal frameworks that enforce contracts and protect investors; efficient financial markets that offer firms affordable access to diverse sources of capital; a range of viable exit options; relatively stable macroeconomic and political conditions; business adherence to internationally accepted best practices, such as standards of accounting, financial reporting, and corporate governance; and deep pools of entrepreneurial, operational, and managerial talent. These critically important private equity success factors are markedly less robust and dependable in virtually every developing country, heightening the challenges and risks at every stage of the investment cycle described in the previous chapter. Paradoxically, however, it is precisely these shortcomings that are the source of private equity investment opportunities that have largely disappeared in most developed countries.

Chapter 3: The Private Equity Advantage: Operational Value Creation: This chapter expands on the premise that the deep reservoir of expertise focused on nonfinancial value creation provided by private equity professionals is as important or more so for company owners in developing countries as the injections of scarce long-term capital. These investors have accumulated this highly specialized value-creating expertise from working with countless firms that have experienced similar problems. It may take the form of improving products and marketing strategies, strengthening corporate governance practices, expanding access to new markets, implementing a financial reporting system to increase the company's access to additional sources of finance, or introducing training programs to boost worker productivity. It may also include other performance-enhancing measures that at first glance may have a more tenuous correlation with the bottom line, such as compliance with internationally accepted environmental standards. Regardless of the carefully tailored value-creation strategy that is agreed upon

between the private equity firm and management, the overriding objective is to strengthen long-term company performance—the prerequisite for a profitable exit.

Chapter 4: Private Equity Performance before the Global Financial Crisis: This chapter traces the dramatic ups and downs of the relatively nascent industry in emerging markets through two distinct phases leading up to the 2008–2009 global financial crisis. The first generation of emerging market private equity funds was created in the mid-1990s, and investment rapidly accelerated for a few years. But by the early part of the new millennium, these pioneering funds were registering disappointing results in both absolute terms and relative to their counterparts in developed countries. As a result, many early investors retreated to the sidelines, concluding that private equity was simply too risky in these environments, and some even predicted the asset class was too discredited to survive. The naysayers were proven wrong, however, and in 2004 the industry began a surprisingly robust recovery. Institutional investors began to take a second look, new emerging market funds proliferated, more developing countries were targeted by investors, and results began to markedly improve. An examination of this history illuminates for practitioners and policymakers alike the specific reasons why the first generation of funds performed poorly, the lessons learned by various stakeholders, and the changes that led to the resurgence in many, but by no means all, developing countries.

Chapter 5: A Post-crisis Assessment: New Challenges and Opportunities: Although not completely immune from the disruptive consequences of the 2008–2009 global financial crisis, the asset class was by then sufficiently well established and credible to carry on. Unlike previous episodes of global financial instability, developing country economies proved to be surprisingly more resilient than their developed market counterparts in the immediate aftermath of the crisis, reaffirming for many investors that emerging markets private equity should be a critical component of their portfolios. In contrast to earlier in the decade when the industry nearly disappeared due to subpar performance, a more mature emerging markets private equity industry not only survived the crisis but was also attracting an increasingly

greater percentage of global private equity fundraising compared to developed markets. Moreover, the deepening of the industry has been accompanied by several other encouraging developments, such as diversifying interest among institutional investors and an uptick in private equity activity beyond the so-called BRICs (Brazil, Russia, India, and China) into more nascent markets across sub-Saharan Africa, Latin America, and Southeast Asia. Nevertheless, as this chapter explores, the industry now faces new challenges that must be addressed if it is to sustain and build upon the pre-crisis momentum. For example, overall fundraising has declined, at least temporarily, as many Western institutional investors face cash pressures, and the exit environment continues to be problematic. And most notably, even though the asset class is more credible than ever, the financing gap persists for a majority of small- and medium-size firms in emerging markets. This shortfall represents both an enormous challenge—as well as an opportunity—for the next stage of the industry's growth and development.

Chapters 6–8: Country Case Studies—China, Brazil, and Kenya: Each chapter presents a country-specific private equity profile for the purpose of empirically illustrating through specific examples the trajectories private equity have taken in three very different emerging market countries. These differences include, for example, geography and business culture, stages of private sector development, historical evolution and performance of private equity, and the role of the government as a facilitator or impediment to development of the asset class. Each country chapter also profiles individual private equity transactions for the purpose of providing readers with realistic insights into the challenges investors encounter at every stage of the process, including screening and selecting prospective firms, conducting due diligence and agreeing on a valuation, developing and implementing customized nonfinancial value-creation strategies, and carrying out exits.

Chapter 9: Looking through a Hazy Crystal Ball: The asset class is unrecognizable today compared to when it first took off in the mid-1990s, and in all likelihood will bear little resemblance to its present profile ten years from now. With a combination of

optimism and concern, this concluding chapter offers a perspective on some of the formidable challenges the industry is likely to face in the years ahead, and what needs to change among all of the stakeholders showcased in the preceding chapters in order for private equity to play an increasingly significant and constructive role in developing countries. Ultimately, a broader and deeper use of private equity in these underserved countries will benefit not only the owners of increasing numbers of individual companies and their investors but also the overall performance of the private sector—the primary driver of robust macroeconomic growth and poverty alleviation.

1

A Private Equity Primer*

Private equity offers a compelling business model with significant potential to enhance the efficiency of companies both in terms of their operations and financial structure. This has the potential to deliver substantial rewards both for the companies' owners and for the economy as a whole.

—Financial Services Authority of the United Kingdom,
*Private Equity: A Discussion of Risk and Regulatory
Engagement*, November 2006

On the outskirts of Rio de Janeiro, far from the pristine beaches and luxury apartments of Copacabana and Ipanema, Claudio, the owner of a midsize company that provides scaffolding equipment for large construction projects, was reflecting on the turbulent history of his 40-year-old business.¹ “We had a fantastic reputation! The company had a steady stream of reliable clients, a great brand name, and gradually we became a leader in our market. But no matter how fast we grew our revenues, the company was always encountering financial difficulties because we took on too much short-term debt. We never made any money.” This paradox

* The objective of this chapter is to provide readers who are unfamiliar with private equity with a clear understanding of the distinctive features and investment mechanics that set the asset class apart from all other financing mechanisms available for private companies. Grasping these fundamentals is essential for readers to understand why this particular investment tool is uniquely suited to boost the growth and performance of companies across the emerging markets. Private equity practitioners and others who already have a basic understanding of private equity's fundamentals may wish to proceed directly to chapter 2.

of growth without profitability is a frustrating pattern repeated by “successful” entrepreneurs throughout the developing world. And for those who survive, the story usually gets even worse.

“By 2002–2003,” he continued, “the Brazilian economy was beginning a period of explosive economic growth, creating unprecedented opportunities for the construction industry. Although we had been the market leader in our specialized niche, I realized the company would quickly lose market share unless we could rapidly expand and respond to the huge increases in demand for our products. The construction materials sector in Brazil was highly fragmented, and I knew consolidation was inevitable as the building boom picked up momentum. Only those companies with access to the capital required to make new investments, achieve scale, and grow quickly would endure. I had learned from experience that the banks were useless. Even for a well-established company with a good track record in a booming market, they only offered short-term loans with crippling collateral requirements at sky-high interest rates. We even tried the government-owned development bank, and although they claimed to be interested in SMEs like us, I quickly realized they would be too slow and bureaucratic to solve our problem.

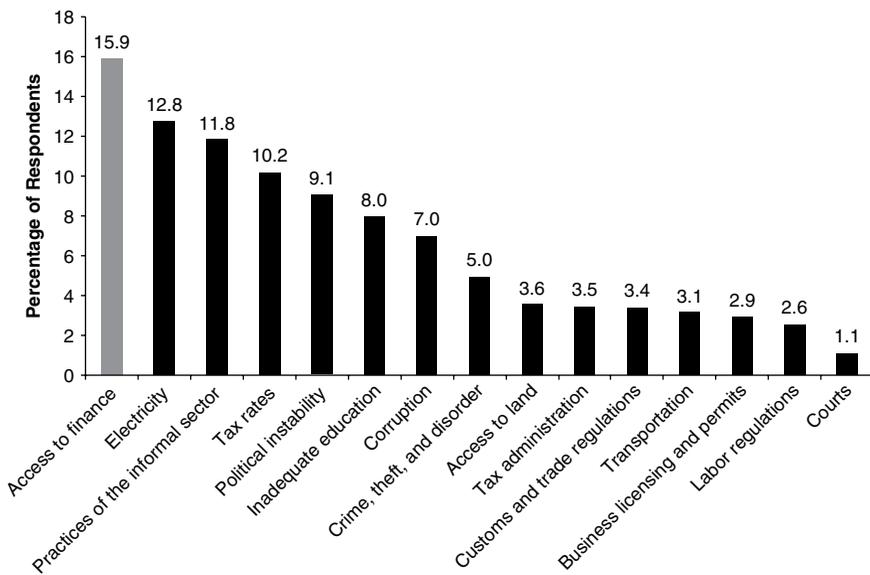
“In order to survive, we needed to attract an investor who recognized our company’s potential and would be willing to make a long-term commitment. Luckily, a friend of a friend introduced me to a private equity fund manager who specialized in making investments in small Brazilian companies with rapid growth potential. During our initial meetings, the prospective investor was extremely demanding, and I became skeptical that we’d ever strike a deal. But after an extended period of time and some very tough negotiations, we reached an agreement for the firm to invest a significant amount of capital for a 15 percent equity stake in the company.

“Our entire mind-set changed once these private equity investors were on our Board. From day one, they were active, hands-on, and sharply focused on specific improvements that would strengthen our performance. For example, although we already had reasonably good corporate governance standards, they offered wisdom we simply did not have, and we were able to strengthen our accounting and financial disclosure practices in line with international best practices. They also gave us more credibility with banks, and suddenly we were getting longer-maturity loans. And with their additional capital and expertise, we were able to

execute a more aggressive acquisitions strategy, which accelerated our growth trajectory.”

The financing problems experienced by this Brazilian entrepreneur are painfully familiar to owners of companies across the developing world. No matter how hardworking and successful, sooner or later they hit the same wall: limited or nonexistent access to medium- and long-term financing, which they require to grow and compete. As a result, these firms underperform relative to their potential. This linkage between access to capital and firm performance is indisputable, and is reinforced by countless surveys of business owners in a broad range of developing countries who consistently assert that the difficulty of obtaining financing ranks is one of their biggest problems (see Exhibit 1.1).² According to one World Bank study, in low-income countries, 43 percent of small enterprises and 38 percent of medium-sized firms report access to finance as a major obstacle to their business operations; in high-income countries, only 17 percent and 14 percent, respectively, of

Exhibit 1.1 Growth Constraints Reported by SMEs



Source: Adapted from The World Bank (2014), *Enterprise Surveys*, www.enterprisesurveys.org, The World Bank.

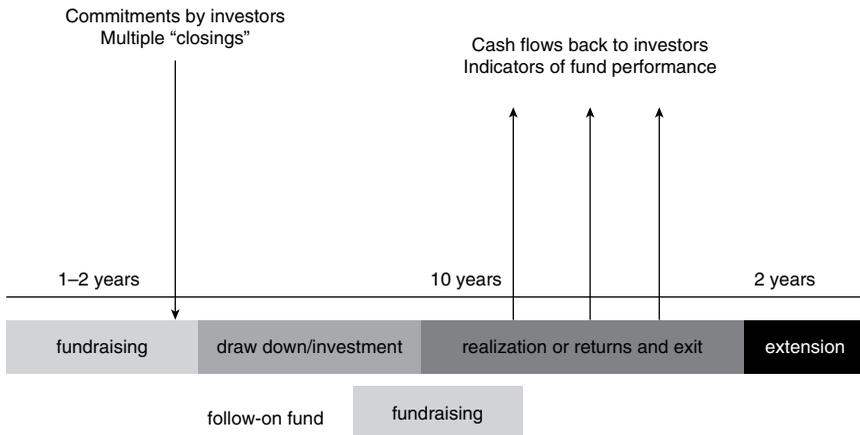
firms report this as a constraint.³ In addition, numerous companies similar to Claudio's do not reach their full potential because their owners or management teams lack the necessary business know-how—whether operational, financial, marketing, corporate governance, or otherwise. Just as capital is scarce and difficult to come by, so is value-creating operating expertise.

A special breed of investors is attracted to companies throughout the developing world that are underperforming for reasons similar to Claudio's firm. Private equity investors are in the business of providing a combination of scarce capital and performance-enhancing expertise for the purpose of strengthening the competitiveness and profitability of individual companies that meet their rigorous investment criteria. When these efforts are successful, company value is significantly enhanced, eventually generating attractive financial returns both for the investors and the owners of the target companies. Moreover, this private equity investment approach has the potential to create a virtuous circle: reams of research validate the proposition that, regardless of the country circumstances, a more productive, competitive private sector generates higher rates of economic growth and lower levels of poverty.

To grasp the full potential impact of private equity in developing countries, however, first requires a clear understanding of what private equity is, and how this particular financing tool is uniquely endowed with characteristics that make it different from all other such mechanisms available to private companies. In addition as will be argued in subsequent chapters, it is particularly well suited for a diversified range of businesses in developing countries worldwide.

Understanding the unique fundamentals of private equity

Traditionally, the term “private equity” has been used to describe an equity investment in a firm that is “private,” meaning not listed on a public stock exchange. In developed countries, private equity also refers to the buyout of a public company, which then results in its delisting from an exchange.⁴ Aside from buyouts, these transactions are commonly large enough for an investor to gain a significant, but not necessarily a controlling, equity ownership

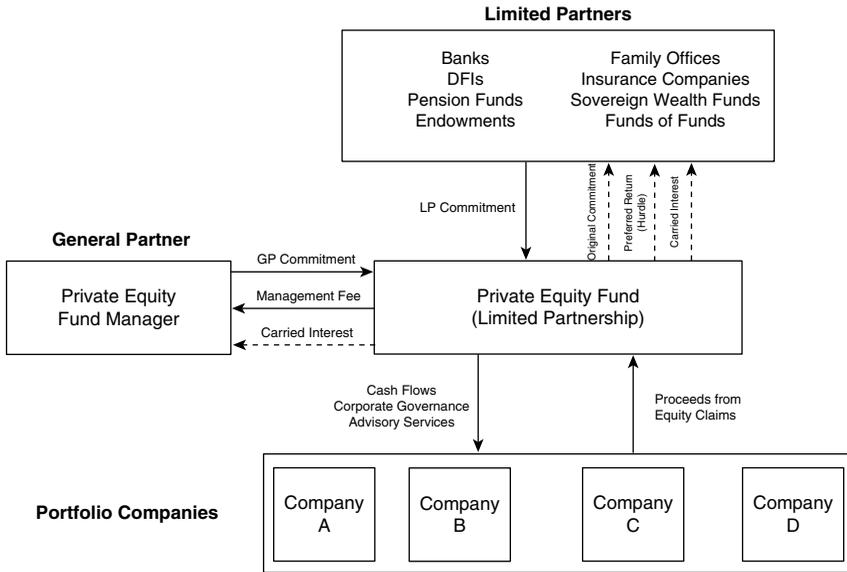
Exhibit 1.2 The Private Equity Timeline⁵

stake in the company. The investor's goal is to carefully select firms with exceptionally high growth potential, work closely with management once the capital has been invested to build value and strengthen performance (typically over a period of three to five years), and then "exit" by selling the shares at a significantly higher price than was originally paid, generally either through an initial public offering (IPO) or via a sale to a strategic investor or corporation (see Exhibit 1.2). Less frequently, fund managers may sell their stake to another private equity fund, or back to the management, known as a management buyout (MBO).

From the early stages of marketing a fund to prospective investors and the initial screening of deals, to the final exit of the last portfolio company, the life of a private equity fund typically lasts about eight to ten years. However, private equity fund managers often begin fundraising for a follow-on fund before the final exits have occurred in the previous one.⁶ This ensures an ongoing continuity of operations.

The private equity organizational structure (see Exhibit 1.3) and means of compensation are distinct from that of other financial intermediaries. Whether well-established multibillion-dollar global asset managers such as The Carlyle Group, Blackstone, KKR, or Warburg Pincus, or small venture capital funds targeting entrepreneurial start-ups, typically, these entities are legally structured

Exhibit 1.3 Basic Organization of the Private Equity LLP Fund Structure



as limited liability partnerships (LLPs).⁷ The private equity fund manager, also known as the general partner (GP), raises a pool of capital primarily from institutional investors and other accredited investors, called limited partners (LP).⁸ Once LPs commit their capital, all responsibility is delegated to the GP, from deal origination to the exiting process. In other words, the LP is a *passive* investor in the designated fund, with no decision-making authority on individual investments.

Although a range of investors potentially falls into the LP category, the most prominent are large financial intermediaries such as public and corporate pension funds, banks and insurance companies, university endowments, some family offices, and state-owned sovereign wealth funds.⁹ These fiduciary institutions are entrusted with the responsibility to manage and invest large pools of capital in a diversified portfolio of financial assets representing different risk profiles, from low-risk government bonds on one end of the spectrum to so-called alternative investments, such as private equity, on the other. Significantly, these institutions tend to have an investment philosophy that allows them to be less concerned with short-term market volatility than many other investors (such

as hedge funds) and, as a result, they are more tolerant of the illiquidity associated with private equity.

Placing Private Equity within an Asset Allocation Bucket—an Illustrative Portfolio

The term “asset class” conveniently distinguishes between different financial assets based on assumptions about their risk, return, and liquidity characteristics. Although there is no universally accepted classification system, institutional investors managing large pools of capital tend to make allocations across a diversified spectrum of financial assets with similar characteristics according to their risk/return preferences. For example, a US university endowment might make investments on the basis of the following allocation:

	Allocation	Expected Return	Standard Deviation
Fixed Income	30%	3%	12%
<i>Government bonds</i>	<i>50%</i>	<i>2%</i>	<i>8%</i>
<i>Corporate bonds</i>	<i>50%</i>	<i>4%</i>	<i>14%</i>
Equity	50%	7%	22%
<i>Domestic</i>	<i>60%</i>	<i>6%</i>	<i>20%</i>
<i>Global</i>	<i>40%</i>	<i>8%</i>	<i>25%</i>
Alternative assets (less liquidity)	20%	14%	30%
<i>Real estate</i>	<i>30%</i>	<i>12%</i>	<i>25%</i>
<i>Infrastructure</i>	<i>20%</i>	<i>12%</i>	<i>25%</i>
<i>Domestic private equity</i>	<i>40%</i>	<i>14%</i>	<i>25%</i>
<i>Emerging markets private equity</i>	<i>10%</i>	<i>20%</i>	<i>35%</i>

According to convention, therefore, private equity is categorized as a distinct asset class because it is perceived by investors to offer higher returns, but also higher risks and volatility (based on standard

deviation calculations). But this book contends that an additional distinction should be made by investors: emerging markets private equity should be viewed as a distinct asset class, endowed with a set of risk/return characteristics different from that of private equity in developed countries.

These institutions are attracted to the LLP structure because of their preference to rely on specialized intermediaries or GPs, especially in the complex and opaque world of private equity. As one pension fund manager acknowledged, direct investing in individual companies [for us] is time consuming and “inherently awkward.” Investing in a private equity fund, therefore, is far more efficient in terms of time allocation, not to mention the higher probability of generating attractive financial results by relying on the expertise of specialized professionals. As an alternative to investing directly in GPs, LPs also have the option of committing their capital to a “fund of funds,” which makes investments in a number of different GPs. Some LPs prefer this approach as it offers the opportunity to diversify their investment risk across a broader spectrum of GPs in terms of geography, strategy, track record, and sector-specific skills. On the flip side, a handful of LPs are bolstering their teams in order to do direct private equity investing, thus bypassing the GP and investing directly in private businesses. However, by and large, these institutional investors have been committing capital to the asset class for decades and believe they have built up the required skill sets to implement such a strategy.

The ILPA Private Equity Principles—a Guide for the LP-GP Relationship

The Institutional Limited Partners Association (ILPA)—a trade association representing the interests of institutional limited partners invested in or considering investing in private equity—established the Private Equity Principles in September 2009 (updated in 2011) to assist LPs and GPs in clarifying the terms of their relationship. The Principles reflect the LP point of view on the terms and conditions that should constitute best practices,

with particular attention to promoting enhanced GP governance and transparency, as well as fee structures that better reflect LP financial interests. While not intended to be a “one size fits all” approach, the Principles provide LPs a set of specific guidelines for their negotiations with GPs.

A sampling of key topics addressed in the Principles includes:

<i>Alignment of Interest</i>	<ul style="list-style-type: none"> • <i>Strengthened clawbacks (or the right of the LP to reclaim a portion of the GP’s carried interest in the event that losses incurred during later investments result in the GP receiving more than originally agreed upon)</i> • <i>Management commitment to the fund</i>
<i>Governance</i>	<ul style="list-style-type: none"> • <i>Stronger role for Limited Partner Advisory Committees</i> • <i>Key person event triggers investment period suspension</i> • <i>GPs as true fiduciaries, avoidance of conflicts of interest</i> • <i>No-fault divorce</i>
<i>Fees</i>	<ul style="list-style-type: none"> • <i>European waterfall (i.e., distributing carry at the close of the fund rather than on a deal-by-deal basis)</i> • <i>A significant “step down” on management fees after the investment period</i> • <i>Carried interest calculated on basis of net, not gross, profits (after-tax)</i> • <i>Placement agent fees paid entirely by the GP</i>
<i>Transparency</i>	<ul style="list-style-type: none"> • <i>“Time and attention standard”—full disclosure to LPs of any significant changes</i> • <i>Financial reports available quarterly; valuations reported at lower of cost or market</i> • <i>Use of independent auditor</i> • <i>Proprietary information protected from public disclosure</i>

Compensation structures represent one of the most distinctive features of private equity compared to other financial intermediaries. The GP receives two primary forms of remuneration: an annual “management fee,” calculated as a fixed percentage of the

total amount of capital in the fund (usually between 1 percent and 2.5 percent, depending on the total fund size), and “carried interest,” which is performance compensation based on the net capital gain generated at the time of exit in excess of a minimal “hurdle rate of return” paid to the LPs (typically 6 to 8 percent). The standard practice in the industry is to pay 80 percent of the carried interest to the LPs and 20 percent to the GP, often referred to as an 80/20 split. Thus, the largest portion of compensation for private equity investors is received only at the end of the process, usually many years after the original capital commitment, and it depends entirely on how well or poorly the fund manager performs in terms of creating value during the interim. In some cases, GPs also generate additional fees for services rendered to their portfolio companies, such as through consulting services or assisting in additional fundraising.

This private equity compensation structure is virtually the opposite of common practice for other financial intermediaries. For example, incentives at investment and commercial banks are skewed in favor of short-term performance as bonuses are granted to employees on an annual basis. When it is time for a loan officer’s yearly performance review, she will be judged and compensated based on the volume of loans *originated*, not on how well the transactions ultimately performed. Naturally, therefore, in both cases financial self-interest is best served by focusing on these short-term metrics.

The term “private equity” encompasses a range of subcategories that can be delineated roughly by target company size, growth prospects, and financing needs (see Exhibit 1.4). The spectrum begins with “angel” and venture capital investors who focus on start-ups—new, small companies that may not even have reached the stage when they are generating revenue. “Growth capital,” the primary focus of subsequent chapters of this book, refers to investments in more established small to midsize firms that have proven business models and demonstrate a capability for significant future growth. And finally, the spectrum ends with buyouts, in which investors purchase a majority ownership stake in a typically well-established large company. Private equity also encompasses some

Exhibit 1.4 The Private Equity Spectrum

Angel	Venture Capital		Growth / Expansion		Buyouts / Distressed	
Seed (idea)	Start-up (product development)	Early Stage (e.g., Series A Round) (sales, working capital)	Growth Capital	Mezzanine	Leveraged Buyout	Corporate Restructuring

Exhibit 1.5 General Characteristics of Growth Capital vs. Buyout Firms

	Growth Capital	Buyout
Equity Stake	<ul style="list-style-type: none"> Usually the purchase of a significant equity stake (typically minority but can be control) 	<ul style="list-style-type: none"> The purchase of all or a majority of a target company's shares, giving the investor control
Fund Size	<ul style="list-style-type: none"> Typically in the hundreds of millions of USD or smaller 	<ul style="list-style-type: none"> Typically in the billions of USD
Target Companies	<ul style="list-style-type: none"> Private small- and medium-sized firms with potential for exceptional growth 	<ul style="list-style-type: none"> Large, mature firms that are either private or publicly listed and become private as a result of the transaction
Transaction Size	<ul style="list-style-type: none"> Tens to hundreds of millions of USD or smaller 	<ul style="list-style-type: none"> Typically larger than growth capital deals; in the hundreds of millions or billions of USD
Use of Debt	<ul style="list-style-type: none"> Little to no debt financing 	<ul style="list-style-type: none"> Usually highly leveraged; debt financing of 60%–90% of deal
Value Added	<ul style="list-style-type: none"> Both financial and non-financial (e.g., operational, strategic, etc.) 	<ul style="list-style-type: none"> Usually financial restructuring

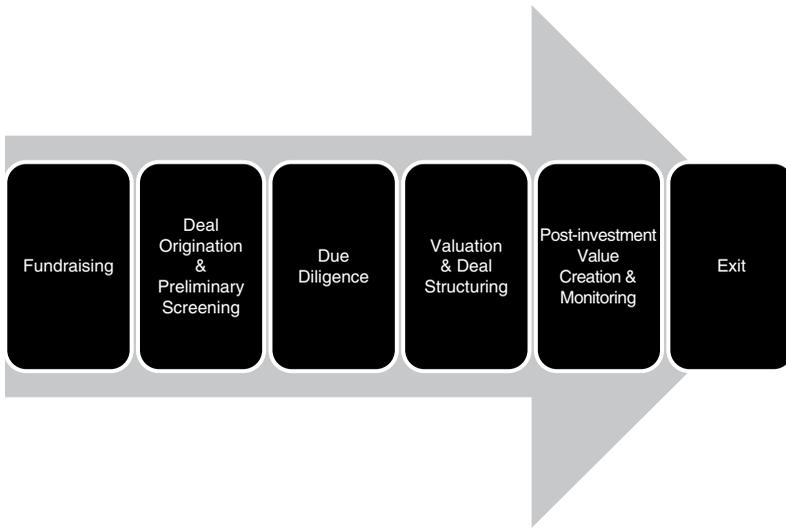
niche strategies such as mezzanine (a form of financing that sits between senior debt and equity).

Notwithstanding these important differences that distinguish private equity subcategories, considerable confusion is sowed because the term “private equity” is often used interchangeably with buyouts, especially in the press, among unknowing policymakers, and even academic experts. However, there are several important differences between buyouts and growth capital investments that are especially relevant in emerging markets (see Exhibit 1.5).

These distinctions are not trivial. Buyout firms have control over the companies they purchase, and therefore have the ability to quickly change management, sell off unproductive assets or entire operating units, and undertake major balance sheet restructuring designed to allow for relatively fast exits that are expected to generate outsized financial returns. In contrast, growth capital and venture capital are more likely to entail significant minority equity investments that are more labor intensive, and in which exits may take longer to materialize. They depend on forging effective long-term relationships between the investor and management with an eye on significantly strengthening company performance. The distinctions lead some to conclude, although not always justifiably, that buyouts focus on the quick fix through financing engineering/restructuring, while growth capital investments appreciate more gradually through hands-on value creation. Stereotypes aside, significant confusion is fomented by the media, government officials, and even well-informed scholars by concentrating their attention almost exclusively on buyouts, as if these highly publicized transactions represented the entire private equity industry.¹⁰ One explanation for their disproportionate attention is the sheer size of the funds and their investments.

However, as further explained in chapter 2, buyouts are *not* the core subject of this book. Although there are notable exceptions, private equity investing in developing countries has historically been primarily about growth capital. Partnerships are forged with the owners of small and midsize businesses operating within the broad middle market, and private equity investors tend to encompass many traditional growth capital characteristics: the owners often retain significant equity stakes, transaction sizes tend to be in

Exhibit 1.6 The Private Equity Cycle



the tens to hundreds of millions (or smaller), little to no leverage is employed, and a value-creation strategy is often critical to success.

The private equity cycle

Whether the transaction is a multibillion dollar buyout in the United States or a small company operating in a low-income developing country, the step-by-step private equity process does not vary significantly, nor do the basic analytical skills required to successfully “do a deal” (see Exhibit 1.6). Once the basic parameters of a fund’s strategy are clearly defined (e.g., stage of the business, geographic region, deal size, and industry sector), the fund manager begins the private equity cycle with the task of fundraising. Often alongside this step, the team will identify and preliminarily screen potential investment targets. Those companies determined to be most promising will then be subjected to an intense due diligence process to evaluate the viability of the firm’s future prospects and its value. If both parties agree that a partnership would be mutually beneficial, they will then enter into negotiations to reach a final agreement on the valuation and structure of the investment.¹¹ Post-investment, the GP will be an active participant alongside

the company to improve operations and create additional value so that when the time comes to exit, it can sell its stake at a higher price point than what was originally paid. Each of these steps is discussed in greater detail below.

Fundraising: When asked to identify the least favorite part of their job, the response of senior private equity practitioners is most likely to be “fundraising!” No matter the country or the fund size, the response is predictable and unsurprising. After all, the DNA of every successful private equity investor is “doing deals,” not asking for money—even though the latter is the prerequisite for the former. Seasoned general partners understand that the fundraising process, often described as “my worst nightmare,” involves endless road shows, exhausting travel schedules, and multiple unceremonious rejections, and with the exception of a few privileged brand name firms at the top of the rankings, the process invariably takes far longer than anticipated. As the Brazilian founder of one fund explained, “Even though we have an excellent track record, including multiple exits, for a mid-market fund like ours everything about fundraising takes longer.” Nevertheless, fundraising is the essential first step of the private equity cycle.

Deal origination and preliminary screening: Among the sharp distinctions separating private equity from all other forms of financing is the common refrain expressed by practitioners everywhere as they describe the highly time-consuming, labor-intensive screening process that occurs even before serious due diligence

Exhibit 1.7 Key Considerations for Sourcing Successful Deals

Investment Fit	Firm Prospects
<ul style="list-style-type: none"> • Target geography/industry • Promising market growth (solid customer base) • Target company stage/size • Access to/experience with expertise necessary to add value 	<ul style="list-style-type: none"> • Market leader or potential to become one • Strong management team • Strong EBITDA and operating margins, cash conversion cycle • Potential for growth (organic or inorganic) • Value-added product/service • Attractive exit strategy

gets underway: “For every 100 investment opportunities that come across our desk, we end up conducting due diligence on about 10, and ultimately agree to finance one.”

Based on extensive research, good market intelligence through a strong local network, and word-of-mouth tips, investment candidates are systematically identified and screened, using a carefully defined set of selection criteria based on the fund’s investment strategy. For example, although there is no one-size-fits-all template, a fund manager might begin the screening process by evaluating prospective deals against a number of metrics—including the fit with their strategy, firm prospects, specific transaction details, and overall alignment of interests. But finding the right fit can be very difficult. As one fund manager noted, “Some people think that you can arrive on the shores of Africa and easily find tons of quality companies looking for capital, and that is simply not true. Although there is a large universe of companies, most are not going to be targets for private equity.”

No matter how rigorous and systematic the screening process, however, even the most seasoned private equity investors acknowledge that this critical first step in the investment cycle involves an uncomfortable but inevitable amount of subjectivity, especially when reliable information is scarce. “Deal origination is always more art than science,” explains one investor, “but never more so than when I venture into developing countries where the quality of information is notoriously unreliable.”

Although the selection criteria vary enormously depending on the investor’s strategy, one ingredient never changes: a company perceived to being undervalued relative to its growth potential for identifiable reasons that can be rectified by a combination of additional financial resources and value creating expertise. This may involve an opportunity to outpace competitors by financing a new plant, purchasing an expensive piece of equipment, expanding into a new market, or acquiring one or more competitors. Or perhaps performance will be enhanced by a major overhaul of the company’s corporate governance practices, new financial controls, or a restructured marketing strategy. Regardless of the circumstances or intended use of proceeds, the initial litmus test centers around a preliminary judgment that participation by the private equity

Exhibit 1.8 Sample Simplified Due Diligence Checklist

Market

- Customers
- Drivers of growth
- Competitive dynamics (market share, nature of competition)
- Regulations
- Distribution channels
- Suppliers

Financials, Operations, and Ethics

- Annual and quarterly financial statements; tax filings
- Capital structure, including shares outstanding, options, debt instruments, etc.
- Bank accounts and depository arrangements; assets
- Financial projections, budgets, business plans, and expected capital expenditures
- Articles of incorporation; bylaws and Board minutes
- Organizational chart
- Strategic partnerships
- Licenses and permits
- Pending litigation
- Compliance with local laws/ international standards
- Business integrity
- Resource management

Management

- Alignment of interests
- Backgrounds—experience and expertise
- Team chemistry
- Track record
- Access to resources
- Potential to evaluate risk
- Capacity for sustained effort
- Openness to third-party intervention

Business Model

- Value added for consumer
- Sales strategy
- Potential for revenue/margins
- Uniqueness/proprietary nature of product/ service
- Performance/quality versus the competition
- Potential benchmark companies
- Scalability
- Attractive exit strategy

Environmental, Social, and Governance

- Compliance with international environmental standards
 - Resource use and management; mitigation of pollutants
 - Labor and working conditions
 - Health and safety track record
 - Community impact
-

investor will propel the company to a new, more competitive level of performance within a prescribed period of time.

Due diligence: Once the fund manager reaches a reasonable level of confidence that the company passes this initial screening test, and arrives at a preliminary agreement with management on a possible investment, the deal team begins extensive due diligence to assess the operational, managerial, and financial strengths and weaknesses of the company. Based on detailed information gathered and analyzed on the company, as well as an assessment of the competitive dynamics of its market, the team creates a set of assumptions about its *future* performance. This is the “what if” stage of the analysis that results in a financial model building exercise designed to forecast how the company is likely to perform over time. The model then generates a range of values for the company that will serve as the basis for negotiations with management about the amount to be invested, the percentage of ownership granted, and the terms and conditions of the private equity investor’s role in the company once the funds are disbursed.

Compared to industrialized countries, as will be discussed in chapter 2, the due diligence process in developing countries tends to be far more time consuming and fraught with additional risks. Critically important operational and financial information is often either unavailable or unreliable, disclosure standards are not well established, and company managers are often unaccustomed to dealing with the rigorous, time-consuming information demands from prospective investors. But regardless of the country or business, the due diligence process requires careful review of voluminous documentation about the company, as well as numerous site visits to evaluate firsthand the company’s facilities and conduct lengthy interviews with key employees, customers, suppliers, and others who may have access to important information about the competitive strengths and weaknesses of the company and its markets.

The Conflicted Investment Officers

The investment officers in a private equity fund that invests in small, growth-oriented Brazilian businesses had completed preliminary due

diligence on a company located on a remote island at the mouth of the Amazon River that produces hearts of palm using environmentally-friendly farming methods. On the basis of their favorable preliminary assessment, the investment officers recommended that the fund proceed with an investment, subject to a second round of on-site due diligence. But when they returned to complete the final evaluation, their deeper investigation uncovered major accounting discrepancies and large hidden tax liabilities that had not been disclosed either to the investment officers or the government. Despite the new, unsettling information, the investment officers were still attracted to the fundamental strengths of the company and the rapidly expanding hearts of palm market. The officers were conflicted: should they reverse their earlier recommendation and cut off negotiations with management of the company, or make a new offer with a much lower valuation and a secure agreement from management to revise accounting practices while reaching a settlement with the government on the outstanding tax liabilities? Either way, how would they justify their recommendation to the fund's investment committee?

The common perception of due diligence as simply a financial exercise falls well short of reality. Although a key goal is to produce financials of projected future performance, these calculations typically involve input from a broad range of nonfinancial specialists. Attorneys, for example, must conduct legal due diligence to identify and assess the likelihood of pending suits against the company or other legal liabilities that might impact the company. Depending on the sector, it is commonplace to bring in consultants to assess whether the company needs to undertake costly investments to comply with environmental, health, and safety regulations. And highly specialized industry experts are often asked to evaluate the quality and condition of the company's plant and equipment in order to determine the level of future investment required to enhance performance.

Although much of the due diligence process is based on well-defined, objective metrics, savvy private equity investors know that the most important factor for the success of every transaction is the most difficult to measure: an assessment of the owner's competence, integrity, and genuine receptivity to open, transparent

collaboration with a third-party investor. No matter how rigorous and careful this evaluation, an uncomfortable quotient of subjectivity is inevitable. One global emerging markets investor outlined their process: “During due diligence we often spend months evaluating the founder to ensure he or she will meet our key criteria: do they have integrity, do we share a common view on where to take the business within a prescribed period of time, is there openness to change (e.g., can we bring in a new CFO [chief financial officer], COO [chief operating officer], or implement new governance practices), and is there a willingness to delegate responsibility?”

And it is not just the investor who is struggling to take the measure of his prospective partner. More often than not there is *mutual* suspicion when the due diligence process gets underway, as both sides weigh the pros and cons of forging a long-term relationship with someone unknown. Both company owner and investor must exhibit a willingness to enter into a trusting relationship; otherwise, the transaction is a nonstarter, no matter how attractive the company’s growth prospects. “When we make a bad investment,” explained one fund manager with decades of experience, “more often than not the root cause was our misjudgment of the senior management.”

Valuation and deal structuring: If the due diligence exercise is generally challenging and time consuming, it is even more so for small and midsize companies that have never been subjected to such rigorous outside scrutiny. This unfamiliarity is likely to compound the tensions between investors and management that often arise, especially when it comes to negotiations about company valuation.

Arguably the most critically important objective of the due diligence process is to arrive at a mutually acceptable agreement on company value. The entrepreneur may feel shortchanged when the investor’s proposed valuation comes in far below expectations—either “sweat equity” is undervalued or perhaps there is a perception that the “outsider” simply does not understand the business model. But on the other side of the table, private equity investors are trained to be skeptical and persistent in the quest for information that might reveal previously undetected risks (e.g., unpaid taxes, overly optimistic sales projections, faulty equipment, or environmental hazards), and then incorporate them into the valuation.

Typical of the impasse that often arises, an Argentine private equity investor explained why he was unable to reach a final agreement with the founding entrepreneur of a successful company with excellent growth prospects: “It was very difficult to convince Felipe [the entrepreneur] that he should focus on his company’s *future* value and his own residual stake in a more profitable company, rather than on the past and the value of his sweat equity.” Felipe, on the other hand, complained bitterly that the prospective investor badly undervalued his company: “He doesn’t understand what we have done for the past ten years.” But later, reflecting on why the exasperated private equity investor had walked away from the deal, a disappointed Felipe acknowledged, “I had no idea what the value of my company should be.”

Once agreement is reached on company value and the investment amount, the final step prior to disbursing the funds is executing the legal shareholders’ agreement that officially binds the two parties and defines their respective obligations, rights, and responsibilities. Typically the new investor will be designated a number of seats on the Board of Directors proportionate to the ownership stake, which is determined by the valuation and the amount of equity injected. Regardless of the number of Board seats, however, the new investors have strong incentives to be explicit about the level of involvement in monitoring the company and participating in key decisions likely to affect performance.

Even when the private equity investor is a minority shareholder, it is customary to negotiate “super majority rights”¹² that specify management decisions that will require the investor’s approval, such as hiring key senior management personnel, making new investments that exceed a specified amount, or selling all or a portion of the company to a third party. As one global fund manager notes, “Even as a minority investor, you could have outsized influence on a company, depending on the leverage you have and the congruence of interest with the majority shareholder—for instance, they may want to implement some changes, such as shaking up the senior management team, and you coming on board could be the catalyst for that change.”

To ensure a productive collaboration post-investment, differences between the investor and investee should be fully addressed

and amicably resolved during this deal structuring process. “There must be a clear agreement pre-investment on the post-investment value-creation strategy,” explains the Managing Partner of a private equity fund with long experience in emerging markets, “and this requires trust and a clear alignment of interests between us and management about how to grow the company.”

Post-investment value creation and monitoring: “In the simplest terms, we are a company builder,” explained the head of one Chinese private equity fund. “The key success factor in our business is post-investment execution.”¹³ This statement reflects the indisputable maxim that distinguishes private equity from other financing mechanisms: “the real work begins *after* the money is disbursed.” Once the shareholder agreement is signed and capital is disbursed, the private equity investor’s roles and responsibilities dramatically change. Now they are company owners and begin to act accordingly, working with management to implement a series of value-enhancing changes that will result in a stronger, more competitive company.

Buttressed by the binding shareholder rights embedded in the executed investment agreement, the investor is *legally entitled* to be actively involved, including participation in key management decisions. The investors are not only usually granted seats on the Board of Directors to ensure their shareholder rights are well protected, but their roles also often extend well beyond attendance at Board meetings to include hands-on involvement in key operational and financial decisions that affect company performance. Emblematic of this hands-on approach, one investor explained, “Not only did we put ourselves on the Board [of our portfolio company], we were able to assemble a first rate group of former industry professionals, whose networks and knowledge allowed the company to secure customers, become more efficient with receivables...all of which contributed to earnings growth.”

The early days are often considered to be the most crucial in terms of establishing a good working relationship with management and solidifying a revised path forward for the business. With this in mind, standard practice for many private equity professionals begins with a post-investment 100-day plan that identifies the near-term tasks required to begin the value-creating process.¹⁴ This

plan, mutually agreed upon by the investors and management, serves as the initial blueprint for longer-term changes, and allows management to systematically begin tracking progress and implementing specific changes designed to enhance performance. The value-creation focus of any investment will vary depending on the unique circumstances of each company, but the 100-day plan is a good place to start. For example, it may focus on addressing specific operational issues, recruiting new senior management personnel, strengthening corporate governance practices, improving environmental compliance, or a combination of the above.

Unleashing the Power of Human Capital: Global Forest Products and the Global Environment Fund¹⁵

Global Forest Products (GFP), a South African company with over 56,000 hectares of forest land, three saw mills, a plywood plant, and a value-added wood processing plant, was acquired in the early 2000s by a consortium of investors led by the Global Environment Fund (GEF), a global private equity firm. At the time of the investment, the company was drastically underperforming and operating at a loss. From GEF's perspective, however, the growth prospects for the forestry sector were attractive, and GFP offered a complex but rich menu of value-creating opportunities. At the top of GEF's list of post-investment priorities was to significantly improve the productivity of the company's underperforming workforce.

From 1948 until 1994, the South African government operated under an apartheid regime that heavily discriminated against the country's black majority, limiting their access to education, health care, work opportunities, and the right to vote. Scott MacLeod, GEF Managing Partner, says that when GEF made its investment, the workforce was largely illiterate, 25–30 percent of employees tested positive for HIV, and many had 20 or so dependents that they supported on their paychecks of a few dollars a day. As the new company owners, GEF Managing Partner Jeff Leonard recalled, "We basically were responsible for supporting a small town, inclusive of providing the workers and their families with schooling, clean water, health care and nutrition."

These workforce problems were compounded by plummeting morale, stimulated in part by a dysfunctional corporate culture. Leonard explained, "There were rumors everywhere that when we acquired this thing we were

just going to close the mills. There had been heavy layoffs prior to our acquisition, so there was a lot of anxiety.” Productivity was further undermined by poor worker training and egregious inattention to quality control in the mills. For example, the company systematically ignored basic maintenance, such as sharpening saw blades. As a result, wood was going through the mill at a rate of about 3 meters a minute, compared to a rate of 100 meters a minute seen in modern mills in the United States or Canada.

Finally, as Leonard recounted, “We also discovered shortly after completing the transaction that there was considerable theft and embezzlement at all of our mills. Members of the management team had an elaborate scheme that we just happened to uncover because two of us were attending a meeting at a mill on a Sunday, and we noticed a truck parked in the far corner of the mill, where product was going over the fence.”

Thus, any prospect of turning GFP into a successful investment would require GEF to undertake a top-to-bottom overhaul of the company’s human resource practices, a challenge that fell to MacLeod to oversee. He recalled that the first task was to conduct an intensive worldwide search for a new, experienced chief executive officer (CEO), and several members of the senior management team. In an immediate setback, within two weeks of recruiting a Canadian CEO, GEF found itself back to square one when the CEO was arrested by the local authorities on the pretext that his work permit had been incorrectly approved. According to Leonard, “A competitor spread a rumor that he was in the country illegally and that we were going to replace the entire management team with expats.” Once this obstacle was resolved, GEF recruited more than a dozen skilled expatriate lumber mill workers to spearhead workforce training. Leonard explained, “One guy was there to teach workers how to sharpen saw blades, another helped create a rational log-sorting yard, and a third worked on sorting out logistics problems. All the knowledge they had learned in the rough-and-tumble Canadian side of the forestry industry was transferred to the GFP workforce.”

In addition to upgrading hard skills, the training programs focused on instilling an attitude of accountability and a sense of pride among the workers, helping them appreciate their involvement in producing a high quality, competitive product. Before GEF’s newfound emphasis on worker training and morale, as Leonard explained, “Nobody thought about the end use of the product, and therefore quality control was not a priority. For example, if a long, wide board comes off of a tree that has been pruned every year to prevent knots, its value is high and it commands a premium

price in the market. But if workers ignore this fact and saw the tree in a careless manner, leaving a knot in the middle of the board, a potentially Grade A board becomes a so-called XXX Grade, which lowers the selling price by an order of magnitude."

GEF's MacLeod and the new management team began to focus on extensive workforce training. With an eye to upgrading productivity and quality control, they discovered a wealth of unexploited talent, particularly among laborers who were formerly subject to discriminatory apartheid policies. Leonard elaborated, "We started doing basic aptitude testing on some of our employees who had been with the company for many years, but had never been considered for promotion. The test results were stunning. For example, some of the best lumber graders turned out to be poorly educated black laborers. To see these guys wielding a grease pan and circling bad product that needed to be sent back to their white coworkers for resawing because of their earlier mistakes was changing everyone's post-apartheid worldview. Within a year, most of our top South African management guys, even those I had predicted would stay, left the company, unable to adjust to the new merit-oriented culture." This sharp GEF focus on transforming both the skills and attitudes of the workforce generated immediate, tangible results. At one mill, for example, GFP doubled productivity within one year without any additional capital expenditures. Looking back, MacLeod says with some satisfaction, "We learned that with new leadership and organization the workforce in a rural South African region can be highly productive." This enabled both increased employment and higher enterprise value during GEF's time as majority owner of GFP.

The private equity investor is well positioned to wield considerable influence over key decisions affecting the investee's performance and strategic direction for reasons that extend beyond its significant ownership stake. In addition to becoming knowledgeable about the company as a result of extensive due diligence conducted prior to making the investment, these specialized investors invariably draw on their cumulative experience with countless other companies from the same sector or country. As will be discussed in chapter 3, this deep reservoir of expertise is one of the hallmarks of successful private equity investors. Their ultimate success hinges on adding value along a broad spectrum of company

functions that is largely based on previous experience, such as expanding access to new markets, tapping into additional financing sources, recommending more cost-effective production methods, or a variety of other performance-enhancing measures that will contribute to long-term performance and a profitable exit.

Exit: No matter how successful a fund manager is at each stage of the private equity investment cycle, it is all for naught unless the investor is able to monetize “paper” financial gains with a profitable exit, be it via an IPO, a sale to a strategic investor, a management buyout, or some other route. From the very first look at a prospective portfolio company, a private equity investor is thinking about the exit, even though the event is years away. As one fund manager puts it, “You have to start planning for the divorce before you get married.” Throughout the investment cycle, the GP is singularly focused on what has to be achieved during the intervening years to strengthen performance in order to profitably divest of its ownership stake. The financial incentive to take this long-term value-creating perspective ranks high on the list of key factors that differentiate private equity investors from all other financiers.

Private equity investors in developed countries have historically preferred to exit via IPO, as a well-received public listing is likely to provide continued access to capital by creating a liquid market for the firm’s securities. However, prelisting requirements for an IPO can be extremely rigorous and demanding (e.g., meeting established standards of disclosure, financial reporting, and corporate governance). In addition, volatile capital markets have made this route undependable, causing most investors to evaluate a range of exit options. This is particularly true in developing countries, where public equity markets are notoriously thin and IPO exits by private equity investors are the exception rather than the rule.

The private equity distinction

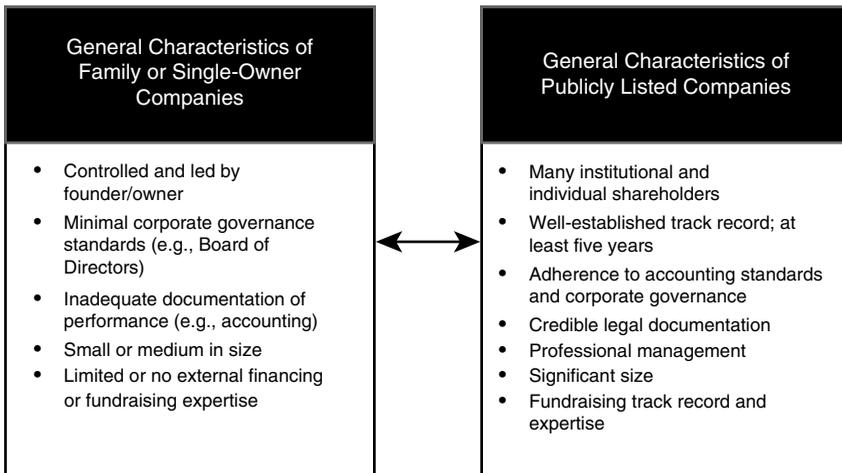
For companies seeking medium- and long-term capital, alternatives to private equity financing include raising capital by borrowing from banks, or issuing shares and bonds on public securities markets. However, the critical difference that separates private equity investors from these other suppliers of capital is their

value-creation expertise and strong incentive to be *active* investors. It is this continuous hands-on involvement with portfolio companies that allows them to mitigate many of the risks that escape the attention of other, more passive investors and undermine performance. Drawing on experience accumulated from working with countless companies, private equity investors are incentivized to focus sharply on collaborating closely with management to strengthen performance. “Our entire mind-set changed,” explained Claudio, the Brazilian entrepreneur portrayed at the beginning of this chapter, as he described his company’s experience with a private equity investor. It is this combination of long-term funding, active engagement, and financial incentives to strengthen portfolio company performance that sets private equity apart from other, more conventional sources of business finance. More specifically, the asset class has three interconnected distinctive features: concentrated ownership, illiquidity, and incentives to create value.

Concentrated Ownership: Before the advent of private equity, there were basically two forms of company ownership in a market economy. At one extreme were publicly held companies that listed their shares on a stock exchange. In this case, company ownership tended to be widely dispersed among a large number of shareholders who individually exercised little or no influence over how the company was run. For well-established companies with a reasonably good track record, the primary advantage of this model was access to a much deeper pool of equity capital than was available from other sources. The main disadvantage for publicly listed firms was intense government regulatory scrutiny and the costly burden of complying with rigorous stock exchange listing requirements, such as independent audits, standard accounting practices, and independent directors. As is sometimes still the case today, company managers knew full well that dissatisfied shareholders would sell their shares, and therefore had a tendency to be sharply focused on short-term results that were likely to boost the stock price.

At the other end of the spectrum, as depicted in Exhibit 1.9, stood family-owned or closely held firms with no outside shareholders. This ownership structure, especially prevalent in developing countries where stock markets either don’t exist or are closed as a source of capital to all but a handful of very large companies,

Exhibit 1.9 Private Equity Falls between Two Extremes



allowed the owners to maintain tight control of the company and avoid regulatory scrutiny or oversight by an independent Board of Directors. This model may work well for a period of time, but eventually all growing firms reach a stage when they are unable to sustain and build upon their early success by relying solely on their own personal financial resources (so-called family and friends) or retained earnings (undistributed company profits). At that point, outside financing becomes imperative in order to sustain growth and competitiveness. But often lacking transparency, accountability, and other prerequisites for raising long-term capital from banks or listing shares on a public stock market, these companies sooner or later hit the proverbial financing wall.

As elaborated in chapter 2, the initial foundations of private equity began to take hold in the 1940s and 1950s, thus paving the way for a third ownership model that stands squarely between these two extremes. Regardless of whether the investors control a significant minority of the company's shares or 100 percent, their ownership stake is typically sufficiently large enough to give them the right to exercise a high degree of influence over key decisions that determine how the company will be run, and to hold management accountable for achieving specified performance benchmarks. In other words, they are owners in the true sense of the

word. With a significant financial stake in how well or poorly the company performs, they are highly motivated to play an *active* role in building company value over time.

Illiquidity: Once a private equity investor commits capital to a company, there is no turning back until the ownership stake is sold. In other words, the investment is illiquid for an extended period of time.¹⁶ This illiquidity feature contrasts sharply with investments in the shares of publicly owned companies that can be bought and sold at will on a stock exchange. Absent liquidity, private equity is quintessentially long-term “patient” capital, eliminating the investor’s option of suddenly disappearing at the first hint of crisis. In fact, some observers have even suggested relabeling the term from private equity to “long-term equity” in order to more accurately capture this unique attribute. This reality also explains why private equity investors have a much-deserved reputation for being tough, analytically rigorous, and disciplined from the beginning of the investment cycle until the day of exit. Their compensation depends on it.

Illiquidity heightens the investor’s risk compared to most other financial assets but, as noted earlier, it also creates strong incentives to be especially vigilant, first in selecting each investment and then working closely with management to significantly enhance enterprise value as the prerequisite for a profitable exit. Thus, both sets of stakeholders are highly motivated to achieve the same objective.

The long-term, illiquid nature of private equity is especially attractive for firms in developing countries, where macroeconomic volatility has historically been more prevalent and financial crises deeper and more prolonged. Even in the worst of times, private equity provides firms with a level of financial stability that often is missing with other types of funding. Illiquidity also drives the underlying rationale for investor expectations of generating higher financial returns than most other investments (i.e., the illiquidity premium).

Value creation: These two distinctive features—concentrated ownership and illiquidity—provide the foundation for understanding a third attribute of private equity that distinguishes it from all other financing mechanisms. The bulk of private equity investors’ financial rewards depends on how well they succeed in creating additional value in their portfolio companies after they have

committed their capital. This contrasts sharply, for example, with investment bankers, who are paid handsome fees to raise capital or provide financial advice to a corporate client, and then, once their task is completed, move on. Their job is done, their fee is in the bank, and they are free to focus on the next client. Thus, they have no long-term financial stake in how well or poorly their corporate client performs. Similarly, commercial bankers are content so long as borrowers generate sufficient cash flow to meet their debt service obligations in full and on time; they are satisfied so long as company performance remains above the bankruptcy threshold. As for shareholders in publicly listed companies, their ownership stake is usually too small to effectively influence firm performance. If dissatisfied with performance, they simply sell their shares. Private equity investors, on the other hand, enjoy no such luxury. They are singularly fixated on the company's *long-term performance* simply because, unlike the investment or commercial banker, the bulk of their compensation is *directly* linked to the value of the company at the time of exit rather than when the original investment is made.

The private equity investors' activist role is usually perceived by company management as an important benefit, especially in developing countries where the expertise provided by these new shareholders is extremely hard to come by. Explaining the lure of private equity, the owner of a Brazilian software company voiced a commonly expressed view:

"It wasn't just their money that we needed. We were performing extremely well, but could not expand our business as rapidly as we wanted because bank credit was virtually unavailable to a high-risk, young technology company like ours, even though our annual sales were increasing at a rate of 45 percent. Once the decision was made to accept a private equity investor, everything changed. Our new investor orchestrated all our bank relationships, and suddenly doors began to open. Within a year of forging the new partnership, growth accelerated, a new, expanded Board of Directors was operating, the first independent audit was completed, and management had acquiesced to completely revamp corporate governance practices. We couldn't believe how the tables had turned so quickly. We had been completely ignored by outside suppliers of capital, and now we were being targeted by investors who wanted to be shareholders, including the

International Finance Corporation and others with a strategic interest in our business.”

In the jargon of economists, private equity investors and business owners are driven to collaborate because their interests are closely aligned: stronger company performance leads to higher value and ultimately to more attractive personal financial gains. This profile contrasts sharply with virtually all other financiers—passive investors who have no incentives to provide anything more than the money itself.

A closer look at private equity in developing countries

This brief overview has highlighted some of the key features of private equity that distinguish it from all other forms of financing, wherever practiced. Moreover, the description of the private equity investment cycle—the step-by-step mechanics of “doing a deal”—suggests a process that is generic. Regardless of whether the prospective transaction is large or small, in the United States or Nigeria, in the consumer sector or energy, these generalizations about the tasks performed by private equity practitioners hold true. However, scratch beneath the surface of this private equity ecosystem and vast differences are revealed in terms of the challenges and risks encountered at every stage of the cycle depending on the market.

The following chapter takes a closer look at the characteristics that typically distinguish private equity in developed and developing countries—highlighting that the opportunities and risks in these markets are fundamentally different. In particular, the chapter examines the key building blocks that provide the foundation for a thriving private equity industry in advanced economies—from supportive government policies and enforcement of the rule of law to well-developed capital markets and the widespread implementation of acceptable corporate governance practices—all of which are largely absent in developing countries. However, it is the lack of these success factors in emerging markets that opens the door wide for the skilled private equity investor who is able to capitalize on these opportunities while mitigating many of the risks.

2

Private Equity Ecosystems: A Stark Contrast between Developed and Developing Countries

Private equity in emerging markets is a relatively small but vital part of our portfolio. In addition to the arguments for diversification and performance, we believe that experienced fund managers are playing an important role in building local economies—they are generating growth, creating jobs, strengthening corporate governance and raising the overall standards for business across the board.

—Institutional limited partner

A principal theme of this book is that private equity in developing countries bears little resemblance to its counterpart in more advanced countries, where it benefits from a supporting ecosystem, which includes, for example, enabling government policies; confidence-inducing legal frameworks that enforce contracts and protect investors; efficient financial markets that offer firms affordable access to diverse sources of capital; a range of viable exit options; relatively stable macroeconomic and political conditions; business adherence to internationally accepted best practices, such as standards of accounting, financial reporting, and corporate governance; and deep pools of entrepreneurial, managerial, and operational talent. However, it is important to keep in mind that it took more than half a century for this foundation to develop and evolve.

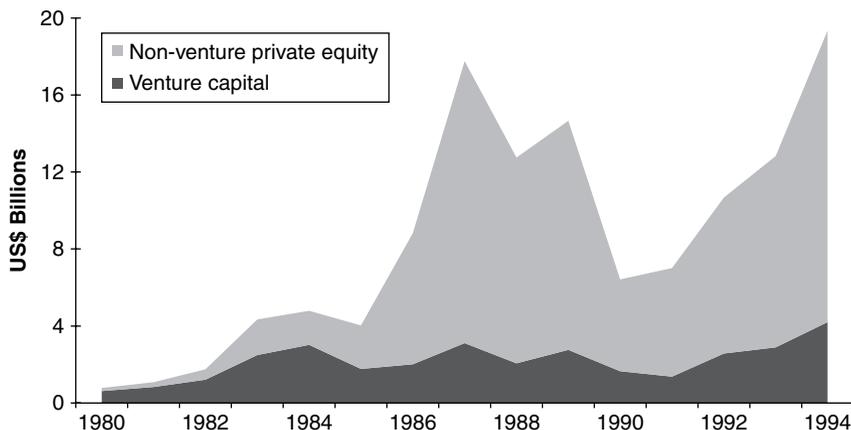
Building a private equity industry in developed countries: over half a century of gradual evolution

Private equity was a relatively obscure slice of the international financial landscape until the late 1980s and early 1990s, when a few mega-buyout funds such as Blackstone, KKR, and The Carlyle Group came to dominate the headlines. But private equity existed long before these firms became household names; its origins trace back to 1946, when the first formal venture capital firm, American Research and Development Corporation (ARDC), was formed by leaders at the Massachusetts Institute of Technology (MIT), Harvard Business School, and the Boston business community. Originally established to channel private investments into businesses run by soldiers returning from the battlefields of World War II, ARDC marked the first legal structure that could raise capital from sources beyond wealthy families, who had previously dominated the private investment landscape.

The gradual transformation of the private equity landscape in developed countries

In its infancy, the term “private equity” was synonymous with venture capital: a type of equity financing aimed at fostering entrepreneurial activity in start-ups or early-stage firms that exhibit the potential for rapid growth. From the beginning, venture capital investing grew at a sluggish pace and was relatively insignificant as a financing vehicle. During the first three decades of its existence, the amount of capital flowing annually into the industry, which was rooted in the United States, never exceeded a miniscule few hundred million dollars.¹ This changed dramatically in the late 1970s, however, following two important regulatory modifications. First, the 1978 Revenue Act decreased the capital gains tax from 49.5 percent to 28 percent, giving individuals greater incentive to invest in venture capital funds. Second, and more importantly, in 1979 the US Department of Labor modified an obscure regulation called the Employee Retirement Income Security Act (ERISA), which governed what was and was not a permissible investment for pension funds. Previously, according to ERISA, pension funds were not considered to be fulfilling their fiduciary responsibility to

Exhibit 2.1 New Commitments to Private Equity Partnerships, 1980–1994



Source: George W. Fenn, Nellie Liang, and Stephen Prowse. *The Economics of the Private Equity Market*. Washington, DC: Board of Governors of the Federal Reserve System, 1995.

be “prudent” investors if they invested in high-risk assets such as venture capital. When the Department of Labor liberalized this so-called prudent man rule, pension funds were permitted for the first time to allocate a small portion of their assets (up to 10 percent) to relatively high-risk “alternative investments.”

The result was transformative (see Exhibit 2.1). Commitments to US venture capital and private equity funds increased dramatically in just a few years, reaching nearly US\$4.5 billion by 1983—more than two and a half times the total amount of capital committed during the entire previous decade.² Venture capital activity continued to soar, with investment increasing almost twentyfold between 1980 and 1994. Thus, a seemingly insignificant regulatory adjustment became the principal catalyst for the industry’s rapid expansion.

Venture capital lays the foundation

The pioneering venture capital investors in the United States focused primarily on a limited number of sectors, such as technology and biotechnology, which were relatively new and untested but demonstrated the potential for exceptionally rapid growth.

Such companies often faced several years of operating losses in the early stages and had limited assets available to pledge as collateral, which explained why they were unattractive candidates for bank financing. As venture capital funds increasingly stepped in to fill this financing gap, the United States experienced a renaissance in innovation and job creation. Between 1972 and 1999, venture capitalists were responsible for nearly 1,000 firms joining the public market.

Many of the earliest venture capital firms were based in New York and Boston. However, the West Coast, and Silicon Valley in particular, began to emerge as a hub in the early 1970s, with firms such as Kleiner Perkins Caufield & Byers and Sequoia Capital setting up offices along Sand Hill Road in Menlo Park to take advantage of the proximity to Stanford University and a number of nearby technology companies, particularly those in the semiconductor space.

Since then, activity has mushroomed: in the past 40 years or so, venture capitalists have provided the initial funding for almost every successful information technology company in the United States, including Google, Netscape, Oracle, Intel, 3M, ADM, Sun Microsystems, Yahoo, Cisco, My Space, YouTube, and Facebook. Its impact has been similarly far reaching in the biotechnology industry, with venture capitalists providing early-stage financing for such success stories as Amgen, Biogen, Cetus, Centocor, and Genentech. Eventually, venture capital also played a significant role in supporting prominent companies outside of the tech space with the potential for exceptional growth, including Starbucks, Home Depot, Staples, Federal Express, Zipcar, and Pinkberry. According to one estimate, venture capital in the United States alone had directly created about 8 million new jobs by the year 2000. If indirect employment generation is included, the number soars to 27 million.³ To paraphrase Apple founder and former CEO Steve Jobs, these capital suppliers “changed the world” by providing long-term equity financing to promising firms when other financial intermediaries were unwilling to take the risk.

Along with the United States, the United Kingdom was also developing a venture capital industry, and eventually it began to gain traction in a few other European countries as well. In 2001, the British government commissioned a review of institutional

investment in unlisted companies, also known as the Myners Report, which is largely credited with encouraging pension fund investments in private equity. In 2003, the European Union (EU) adopted a directive embracing the “prudent man rule,” more than 30 years after it was adopted in the United States. Gradually, as the venture capital industry gained credibility and scale, it expanded globally. By 2013, more than 60 countries had venture capital funds that were financing local businesses in much the same way as the original US firms began investing more than half a century ago.⁴

Investors eventually began to broaden their market focus by targeting not only early-stage entrepreneurial ventures in a few high-growth sectors but also larger, more established companies with verifiable track records. While many of these larger firms had an easier time securing bank loans than their smaller cousins, some were struggling on the operational side to maximize their profits, and others were outright distressed. As a result, access to long-term capital from more conventional sources was sometimes limited because investors were put off by the risk/reward calculus relative to other, less-risky financing opportunities. As transactions became larger and more investors got involved, the “venture capital” label no longer captured the increasing diversity of the business. Thus the term “private equity” was coined. Then, beginning in the late 1980s, further ambiguity was added to the lexicon. In order to reflect the growing use of large pools of debt in transactions, along came leveraged buyouts (LBOs), commonly called “buyouts.”

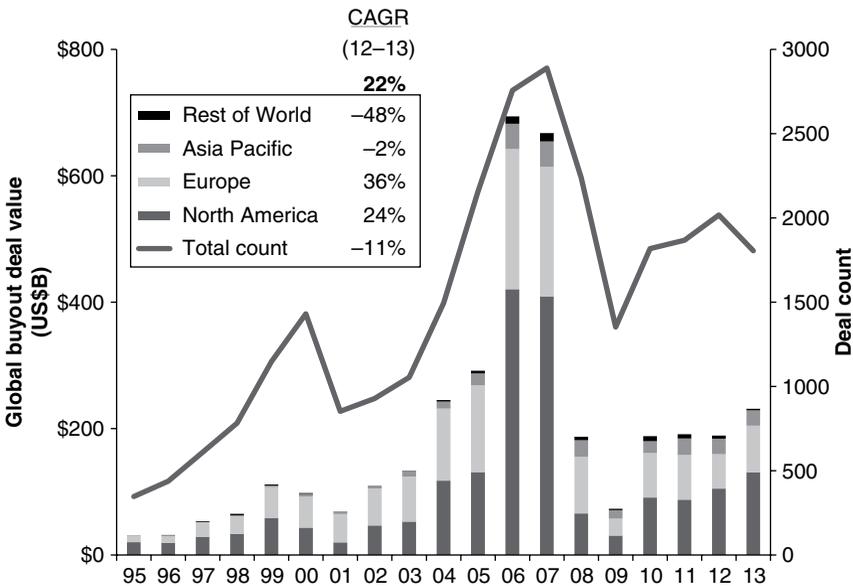
The industry consolidates; LBOs dominate

When corporate financiers Jerome Kohlberg, Henry Kravis, and George Roberts—then employed by Bear Stearns—led the modern private equity revolution in the 1960s, they invested in a series of family-owned businesses, many of which were founded during World War II and at the time were facing succession issues. These early transactions, referred to as “bootstrap investments,” were too small to go public, and the owners were too invested in the businesses to sell them outright to a competitor. In 1976, Kohlberg, Kravis, and Roberts split from Bear Stearns due to a disagreement

over the establishment of a dedicated private equity fund within the organization. They went on to form KKR, one of the first modern private equity firms. Several other firms were established shortly thereafter, including Thomas H. Lee Partners, Cinven, Candover, Apax Partners, Permira, and Forstmann Little & Company.

In the last 15 to 20 years, LBO firms have distanced themselves from the traditional growth capital model of targeting promising opportunities and applying a hands-on value-added approach to developing a business. Instead, the LBO segment has become less diversified and more concentrated in fewer mega-firms executing ever-larger (and more expensive) transactions (see Exhibit 2.2). By the mid-2000s, for example, there were multiple LBO deals valued in the range of US\$10–25 billion, an unimaginable sum for a single transaction just a few years earlier, with 65–70 percent or more of the purchase price financed with debt. As the size of individual transactions has ballooned, so too has the size of LBO firms. Whereas a billion dollar fund was rare in the 1990s, by the

Exhibit 2.2 Global Buyout Deal Value, 1995–2013



Source: Used with permission from Bain & Company, Inc. *Global Private Equity Report 2014*, www.bain.com. Data from Dealogic.

mid-2000s Blackstone had raised US\$21.7 billion for its Blackstone Capital Partners V fund, and a number of other mega-funds were not far behind.

Following the 2008–2009 global financial crisis, with the debt markets in turmoil and investors more risk averse due to heavy losses across all asset classes, fundraising and investing by LBO firms sharply declined. However, by 2012, with interest rates at record low levels and US equity markets steadily regaining their pre-crisis momentum, LBO funds were back in fashion and attracting massive amounts of institutional capital. In 2012 and 2013, for example, at least a half dozen of these mega-LBO firms successfully raised new funds of more than US\$10 billion, including The Carlyle Group, Advent International, CVC Partners, Warburg Pincus, and Silver Lake. Then, in late 2013, Apollo Global Management raised the largest buyout fund post-financial crisis, securing US\$18.4 billion for its flagship buyout fund Apollo Investment Fund VIII.⁵

Private equity firms rushed to put this capital to work, particularly in North America, resulting in 2013 being the most active year for deal-making activity since the global financial crisis.⁶ In addition to the historically low interest rates, the resurgent stock markets fueled an exits boom, with an estimated 255 private equity-backed IPOs, another record since 2006. But increasing fund sizes did not necessarily correlate with success for all. Many of these mega-funds continued to compete for a shrinking universe of multibillion-dollar deals, with the predictable result of higher entry valuations and lower exit multiples compared to times past. By July 2013, for example, average exit multiples had shrunk to 11.5x—a level not seen since 2004 at 11.1x.⁷

These tougher LBO market conditions led many of the largest, most dominant firms to transform themselves from pure private equity funds into diversified asset managers. This new strategy placed a premium on increasing the volume of assets under management (AUM), which would generate outsized revenue streams from management fees and make them less dependent on performance-based carried interest. As explained by an attorney at a leading New York-based law firm with a large private equity practice, “The game is now to grow assets under management, rather than to grow carried interest. It’s all about fees and asset size now.”

By 2013, for example, Blackstone had more than US\$250 billion AUM, but private equity accounted for only about 25 percent of the total. Similarly, The Carlyle Group, with roughly US\$200 billion AUM and a private equity business that accounts for less than 50 percent of assets,⁸ had begun to market itself as an “asset management company” rather than a private equity fund. This new branding more accurately describes a firm with 118 separate funds and 81 fund-of-fund vehicles under its corporate umbrella, as well as investments in a diverse range of financial asset classes, including real estate, public equities, and distressed debt.

Finally, in an ironic departure from the traditional private equity model, many LBO firms are no longer private. In an effort to secure permanent financing, they have opted to become publicly listed companies, raising large amounts of capital from a deeper, more diversified pool of investors by executing IPOs. Blackstone was one of the first with a US\$4.1 billion IPO in 2007, followed by KKR in 2010 (US\$1.93 billion) and Carlyle in 2012 (US\$671 million). A number of others have followed these market leaders, or are considering following suit.

The private equity industry in the United States and a few other developed countries has matured and diversified to an unimaginable degree when compared to its venture capital–focused origins of more than half a century ago. Venture capital remains an important bridge across the financing gap for small, rapidly growing high-tech and biotechnology companies, and at the other end of the spectrum buyout firms provide financing for companies that are large and mature but may be plagued by financial and operational inefficiencies. In between these two extremes, a smaller mid-market buyout industry also continues to find attractive opportunities. Far less prevalent is the dominant form of private equity in developing countries discussed later in this chapter: minority equity investments in rapidly growing small and midsize firms.

Over the last 50 years, growth capital investing of this kind has declined in developed countries as financial sectors have matured, providing relatively easy, affordable access to financing for middle-market companies. Banks regularly extend medium-term credit to these firms, and they have a far easier time raising capital through public listings on exchanges, such as the NASDAQ in the United

States or AIM in England, or via the corporate bond market. As a result, private equity now has less of a role to play in helping these companies reach the next stage of their development. Thus, as companies of all sizes and track records in developed countries have gradually gained access to diversified sources of medium- and long-term capital, the role of private equity has adapted to the changing financial landscape. This reality reinforces one of the main contentions of the book: emerging markets private equity bears little resemblance to its counterpart in developed countries.

Building blocks for a thriving private equity industry

Private equity in developed countries, as described above, gradually evolved from an industry concentrated around small venture capital funds to one dominated by outsized LBO firms over more than half a century. Critical to this process of steady growth was the capacity of these countries to put in place a support system that encouraged the maturation of the asset class. These building blocks include:

- government policies that support the industry without impeding the essential role of market forces;
- confidence-inducing legal frameworks that enforce contracts and protect investors;
- efficient financial markets that offer firms affordable access to diverse sources of capital as well as a range of viable exit options;
- relatively stable macroeconomic and political conditions;
- business acceptance of international best practices, such as standards of accounting, financial reporting, and corporate governance; and
- deep pools of skilled human capital, both within the portfolio companies and the private equity funds.

These features serve as the foundation for a thriving private equity industry and are sometimes taken for granted by investors operating in advanced economies. In contrast, they are largely absent in developing countries, which explains why the

challenges and risks are exponentially more formidable at every stage of the private equity investment cycle. In most emerging market countries, for example, government support is limited; contract enforcement mechanisms and legal protections for investors are weak; financial markets are nascent and/or inaccessible; company owners are less likely to maintain accurate and complete accounting records and adhere to acceptable corporate governance practices; and there is an acute shortage of skilled managers and other key professionals. The remainder of this chapter elaborates on the most striking features that differentiate the private equity investment climate in emerging markets compared to developed countries.

Supportive government policies

Today it is almost universally accepted that private sector performance is a key factor driving economic growth, poverty alleviation, entrepreneurship, job creation, productivity, and other indicators of development. In the same vein, few dispute the proposition that the efficacy of government policies and programs either stimulates or inhibits the private sector's ability to achieve these goals. In other words, recognizing that market forces should be the primary driver for determining how resources are allocated within an economy in no way obviates the imperative for a supporting public policy environment.

Paradoxically, in the advanced economies where the financing gap is exponentially less severe and the pool of skilled human capital immeasurably deeper than in developing countries, governments have been far more willing to design and implement programs that create incentives to induce domestic private financial intermediaries to increase their allocations to small and midsize companies. Perhaps surprisingly, nations that boast the strongest private sectors and the most liberal market economies have recognized that *market forces alone are not sufficient to ensure an adequate flow of investment capital to these firms*. Or, as MIT economic historian Charles Kindleberger observed with striking simplicity many years ago, these governments recognize that "markets generally work well, but not always."⁹ When the "not always" occurs and a desirable public policy objective is at stake, such as stimulating

private sector development, some form of government intervention may be deemed justifiable to compensate for the market failure.

Countries within the Organisation for Economic Co-operation and Development (OECD), by their own admission, “are convinced that there are still enough instances of market failure in SME finance to justify government intervention.”¹⁰ With this simple pronouncement, therefore, these advanced countries are explicitly acknowledging that (i) access to capital for these small and midsize firms ranks as a high public policy priority because of their importance to economic growth and prosperity, and (ii) the absence of a level playing field justifies government intervention of one sort or another to mitigate the persistent inability of market mechanisms to provide reasonable access to capital for deserving companies. This recognition has led to various programs designed to address this failure, something that is far less common in developing countries.

These government programs in developed countries provide an important explanation for why private equity has grown steadily and served as a constructive force for private sector development. For example, as noted earlier in this chapter, venture capital and private equity investing took off first in the United States and later in the United Kingdom and Western Europe largely because government policies allowed pension funds and other large fiduciary saving institutions to allocate a portion of their capital to the asset class. In addition to facilitating capital flows from large savings institutions, over the years, many developed country governments created financing programs with the objective of encouraging a higher level of private financing for start-ups and small- and medium-size companies that otherwise would have limited or no access to medium- and long-term capital.¹¹ In Western Europe, for example, governments support venture capital in multiple ways. Some have programs that allow them to invest directly in start-up companies, such as Germany’s High-Tech *Gründerfonds*, which funds new technology firms, and others, such as the European Investment Fund (EIF),¹² finance government initiatives aimed at venture capital funds that specifically target small- and medium-sized companies. In the United States, the Small Business Administration (SBA) manages a program that offers a partial guarantee to private investors

who provide capital to specially licensed private equity funds called Small Business Investment Companies. And in Israel, the government created a highly successful public-private partnership called Yozma, which allowed public funds to be co-invested with private investors to create specially licensed private equity funds (see box below). This innovative program is credited with launching the world-class venture capital industry in Israel, which boasts per capita venture capital investments that are roughly 2.5 times greater than those in the United States and 30 times greater than those in Europe.¹³

Jumpstarting a Venture Capital Industry: Yozma Venture Capital¹⁴

Recognizing that promising Israeli entrepreneurs in high-tech start-ups were struggling to attract capital from banks or the local stock market, in 1993 the Ministry of Finance established Yozma Venture Capital, a US\$100 million fund. The government's objective was for the fund to serve as a catalyst for the creation of a domestic venture capital industry by using its own seed capital to attract funding and specialized expertise from foreign venture capitalists who would invest in promising early-stage Israeli companies. The designer of the program envisioned the creation of about ten Yozma funds, each with approximately US\$20 million in AUM financed by a combination of 40 percent government funding and 60 percent private capital. Each fund comprised three parties: a foreign venture capital firm, aspiring Israeli venture capitalists in training, and an Israeli financial institution. From the outset the government planned to divest its stakes in the Yozma funds as soon as they were able to demonstrate self-sufficiency. The private investors were granted the right to buy back the government's stake (principal + 5–7 percent interest) within five years of becoming operational. This provided the private investors with an attractive incentive by allowing them to capture the financial gains if their investments proved successful. Thus, the government resisted the temptation to retain control for longer than necessary or attempt to micromanage the newly created funds. Instead, the government's job was simply to provide seed funding, establish the criteria for licensing the new funds, and monitor their performance during the

initial years of operation. As one of the original Israeli fund managers explained, “This was a rare government program that had a built-in get-in and get-out provision.”¹⁵

The Yozma initiative exceeded the government’s expectations and successfully served as the catalyst for the establishment of a thriving domestic venture capital industry. As envisioned by its creators, each of the ten Yozma funds was managed by experienced venture capitalists from the United States, Europe, and Japan, and many went on to generate spectacular returns, after repaying the government. More importantly, they served as precursors to a larger, more diversified Israeli venture capital industry. Most of the original foreign-led Yozma funds recruited Israeli partners who eventually spun off and established their own funds that proved to be equally successful. A decade after the Yozma program was launched with a government outlay of just US\$100 million, the original ten funds were managing almost US\$3 billion in capital, and the Israeli venture capital industry comprised 60 funds with about US\$10 billion in AUM. By 2007, the ratio of Israeli venture capital investment to GDP was exponentially larger than that of any other country in the world.

Although the scope and mechanics of the most successful government programs vary widely, there are a number of common denominators. Perhaps least recognized and most difficult to document is the intangible but essential prerequisite of political will—acknowledgment by political leadership that providing affordable financing to small and midsize firms is an integral component of private sector development, and that modest expenditures of public funds may be required in order to achieve this public policy objective. Second, the most successful government programs display a preference for crafting incentives that encourage higher levels of private sector participation in financing, rather than burdening the government itself with direct operating responsibility for making investments. The goal of most government-sponsored programs is to take full advantage of the existing private financial sector capabilities and avoid “crowding out” or competing with these financial intermediaries. This practice allows governments to minimize market distortions and serve as a catalyst for private sector development.

In contrast to these successful government-sponsored programs in advanced economies, most developing country governments have been slow to elevate private equity investment on their list of public policy priorities, and therefore few government-instigated programs exist that are designed explicitly to encourage the flow of additional private capital and expertise into the asset class. However, as awareness of private equity spreads, this has gradually begun to change as some emerging market governments have initiated programs designed to encourage additional financing. As illustrated in the chapters on Brazil and China, for example, governments are capable of exercising influence on the pace and direction of private equity investing, and the chapter on Kenya notes that the government is at the beginning stages of thinking through a strategy to encourage participation by local investors in private equity.

Confidence-inducing legal frameworks

The bedrock for conducting all financial transactions in any country is a carefully constructed and enforceable legal contract that clearly defines the terms and conditions of the obligations and rights of both the provider and the user of the funds. With private equity transactions, the standard procedure is to sign a legally binding shareholder agreement that defines the responsibilities and rights of both shareholders and the company. These include, for example, the timing and content of reporting requirements; details of Board representation; and, mechanisms for protecting, enforcing, and resolving disputes that may arise between majority and minority shareholders. Leaving aside the endless stereotypes about exceedingly greedy and litigious attorneys, investors in developed countries have a relatively high level of confidence in their legal systems. Most importantly, investors can usually depend on a transparent, reasonably timely, and impartial judicial process in the event of intractable disputes.

In developing countries, on the other hand, virtually every seasoned private equity investor can recount horror stories attributed directly to weak and inefficient legal systems. Although many developing countries have established a body of corporate and business law that would be worthy of any well-regarded textbook,

when it comes to enforcement, the gap between theory and reality is glaring. As one Africa-focused lawyer declared, “We try to get international best practices adopted from a legal point of view. That being said, it is absolutely true that the documentation is not worth the paper it is signed on if you have to go to court. By the time legal action is required, it is probably too late.” A law firm opining on the legal risks associated with private equity investing in Latin America, echoes these sentiments, “There are significant issues of ‘enforceability’ of key contractual rights and statutory protection for minority rights, [which] collectively act as an unintended disincentive to private equity investors.”¹⁶

Even relatively attractive developing countries from a private equity investment perspective, such as Brazil, India, China, Mexico, Indonesia, and Turkey, all garner dismal rankings on the World Bank’s *Doing Business 2013* report when it comes to protecting investors and enforcing contracts.¹⁷ Of the 189 countries included in the survey, only Turkey scores within the top 50 countries on both indicators (see Exhibit 2.3).

Even the most seasoned foreign investors are at a loss when disputes arise, and they are matched against local business owners who are highly skilled at navigating the ins and outs of the local

Exhibit 2.3 Emerging Market Country Ranking on Key Doing Business Indicators

	Protecting Investors	Enforcing Contracts
Brazil	80	121
China	98	19
India	34	186
Indonesia	52	147
Kenya	98	151
Mexico	68	71
Russia	115	10
South Africa	10	80
Turkey	34	38
United States	6	11

Source: *Doing Business 2013*—World Bank Group.

legal system by adeptly prolonging judicial proceedings with an eye to exhausting the patience and resources of “outsiders.” As one analysis noted, for example, “It may be difficult for the outside provider of financing to determine whether the entrepreneur is making erroneous decisions or . . . [is motivated] to remain opaque, not only in dealings with financiers, but also with other outsiders such as government regulators and tax authorities.”¹⁸ Compared to the relative reliability of laws and enforcement capabilities in developed countries, therefore, inadequate legal protection serves as one of the most formidable deterrents for many private equity investors in emerging markets.

Minority Shareholder Rights

In developing countries, where most private equity transactions involve minority investments, few issues are more important than enforcement of shareholder legal protection, especially when there is high potential for abusive treatment of one class of shareholders by another. For example, a private equity shareholder may discover that the proceeds allocated to a portfolio company are being used by the majority shareholder for a purpose other than what was stipulated in the legal shareholders agreement, or that material facts about company performance may have been misrepresented or withheld during due diligence. Given the potential for abuse of minority shareholders, investors understandably gravitate to countries with legal systems that provide reliable, predictable, and timely mechanisms for dispute resolution. But these conditions are rarely the norm in developing countries.¹⁹ As one investor remarked, referring to the glacially slow judicial process in India, “If you need to go to court to resolve a dispute, it’s too late.” Halfway around the world, the same sentiment was echoed by a frustrated Latin American fund manager explaining why he turned down an attractive opportunity: “I recognized that the fund would have little recourse if disputes arose with the company [due to] the notorious weakness of minority shareholder rights.”

Efficient financial markets

Well-developed financial sectors offer firms of all sizes and performance levels access to a range of capital-raising alternatives

provided by a broad spectrum of financial institutions, from commercial banks extending loans of various maturities to investment banks willing to underwrite and distribute a company's shares and/or bonds on public securities markets. In developed countries, as noted earlier in this chapter, private equity practitioners and their portfolio companies have good reason to assume that deep, broad, and liquid financial markets will be responsive to their funding requirements at every stage of the investment cycle. The rapid growth of the LBO market in the United States, for example, has been made possible by the existence of deep, liquid credit markets that allow GPs to finance a significant portion of their acquisitions with relatively inexpensive loans from banks and other intermediaries. LBOs are rare in developing countries because of the almost complete absence of debt financing of this type.

During the post-investment phase, investors supplement their own capital injections by assisting their portfolio companies in accessing additional debt and equity financing, for example, to acquire a competitor firm. And, of course, the capital markets—and especially the depth and breadth of domestic stock markets that facilitate IPOs—heavily influence the timing, method, and profitability of exits. As one investor emphasized, “Private equity is not about what you can buy, but what you can sell,” an axiom that is obvious but too often forgotten.

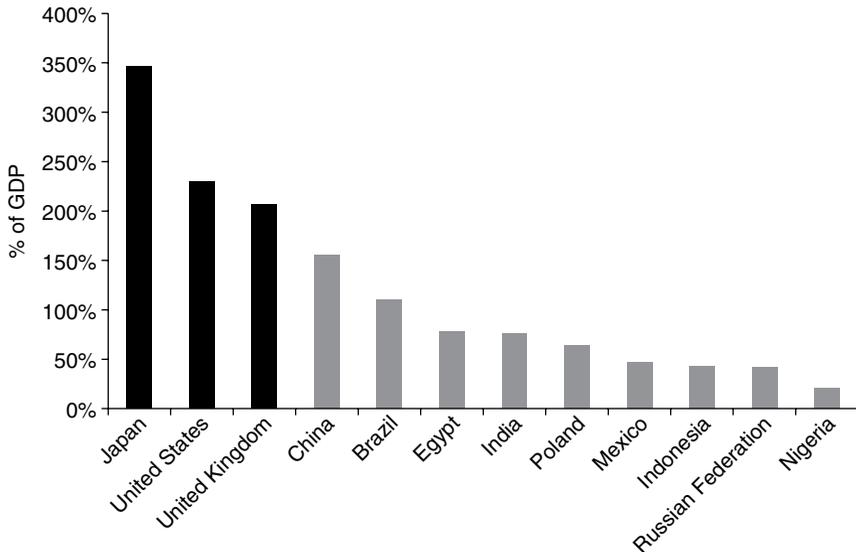
In sharp contrast to this profile of reasonably efficient, responsive markets and institutions that characterize well-developed financial sectors, most company owners and their private equity investors in developing countries—no matter how hardworking and successful—eventually run into the same impenetrable barrier: the financing they require to grow and compete is limited or nonexistent. As noted in chapter 1, countless surveys conducted by the World Bank and others confirm that business owners in developing countries consistently assert that the difficulty of obtaining financing ranks at the top of their list of obstacles to enhanced performance.

In some countries the financing shortfall is less severe when firms seek short-term bank credit (i.e., generally less than six months' duration), which may be available for a wide range of businesses that are legally registered and meet a minimal threshold

of profitability and transparency.²⁰ However, for the vast majority of firms, even when they are profitable and growing at a healthy rate in a dynamic sector, the financing hurdle arises when they seek the longer-term capital that is required to take the business to a higher level. Domestic credit provided by the banking sector, on average, in emerging market countries is a fraction of what it is in developed countries, as is access to a well-functioning banking system (see Exhibit 2.4).

In many developing countries, the main cause of weak, inefficient financial markets is an overbearing state sector that absorbs the lion's share of domestic savings, either to finance public sector deficits or by directing large state-owned banks to lend to equally large, often inefficient state-owned enterprises. As will be discussed in chapter 6, nowhere does this syndrome create an uneven playing field for private companies than in China. But China is not unique. State dominance of the financial sector is the norm rather than the exception in many developing countries, creating insurmountable financing obstacles for countless businesses as they struggle to

*Exhibit 2.4*²¹ Domestic Credit Provided by Financial Sector (% of GDP, 2012)



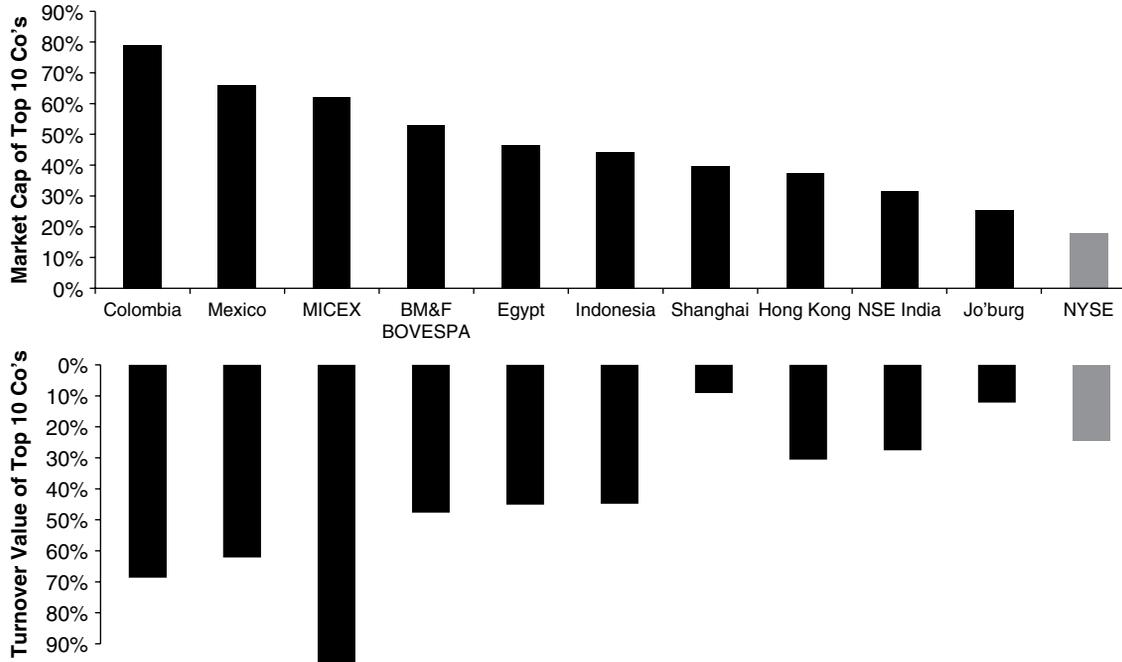
Source: The World Bank: World Development Indicators, accessed June 2014.

compete for financial resources. This leads to scarce capital being allocated not on the basis of creditworthiness or performance, but rather noncommercial purposes, such as senior management jobs for individuals in political favor but lacking the requisite experience. If there is an upside to this portrait of financial sector inefficiency, at least theoretically, it is the opportunities created for astute private equity investors to fill the void.

In addition to facing challenges in accessing medium- and long-term credit, emerging market companies also are likely to struggle in terms of raising capital through local stock exchanges, as most lack depth and liquidity. In 2012, for example, stock market capitalization as a percentage of GDP was 54.7 percent in Brazil, 44.9 percent in China, and 36.7 percent in Kenya, compared to about 122.7 percent in the United Kingdom and 114.9 percent in the United States.²² Even in developing countries that boast fairly well-functioning stock markets, the capital raising needs of middle-market firms are rarely met. With few exceptions, emerging market exchanges are dominated by a small number of the country's largest companies. In Colombia, Mexico, and Russia, for example, the ten largest listed companies represent well over 60 percent of each exchange's total market capitalization (see Exhibit 2.5). And in sub-Saharan Africa, excluding South Africa, the 16 functioning stock exchanges in 2012 had just over 500 listed companies with a combined market capitalization of about US\$150 billion, less than a third the market cap of Apple.²³ Thus, for the vast majority of emerging market companies that comprise the middle market and are the likely targets of private equity investors, domestic equity markets are typically not accessible as a means of raising capital.

This sharp contrast between emerging market and developed country financial markets becomes even starker when the time comes to exit. IPOs represent an insignificant proportion of private equity exits in most developing countries due to the small size and lack of liquidity in domestic stock markets.²⁴ Of the 181 private equity-backed IPOs valued at approximately US\$57 billion that took place in 2013, 60 percent were issued in the Americas, led by the United States, and 30 percent in Europe.²⁵ Among 118 exits in Africa executed between 2007 and 2012, on the other hand, over half were done through trade sales, 23 percent were

Exhibit 2.5 Market Cap and Turnover Value of Top 10 Companies (% of Total)



Note: RTS and MICEX merged in 2011; Colombia, Lima, and Santiago became the MILA in 2012.

Source: The World Federation of Exchanges Limited, as of 2011.

through secondary sales (sales to other private equity firms),²⁶ and only 9 percent were executed through a stock sale on the public markets. And this pattern prevails in other major emerging markets as well. “You are going to be discouraged,” explained one fund manager, “if you think the only way to exit is to go public.” This limitation on IPOs as a potential exit strategy is often cited by GPs accustomed to investing in developed countries as a major deterrent for entering emerging markets.

Redefining the Middle Market

Ask five experienced emerging markets fund managers to define the middle market and you are likely to get five different answers. One private equity investor correctly observed that “middle market” is “a lazy term.” It not only ignores vast differences between developed and developing countries but even more significantly, the term blurs important distinctions within the emerging markets universe itself, such as country size (e.g., Brazil vs. Botswana), sector (retail and consumer products vs. capital intensive infrastructure), and the overall size and investment strategy of the GP (e.g., global Western funds vs. local country-specific vehicles in sub-Saharan Africa). An average mid-market private equity investment in Brazil or Russia would likely fall roughly within the range of US\$20–\$50 million, whereas in parts of Africa, middle-market deals may be as small as US\$2–\$5 million and rarely exceed US\$20 million.²⁷ However, even taking into account these fundamental differences and the inevitable imprecision embedded in the middle-market label, few private equity investors would disagree that a number of distinctions sharply separate middle-market firms in developing countries from their counterparts in developed countries. Most significantly, these distinctions are as follows:

- **Company size:** *Although there is no common size metric that fits all companies in developed countries, the middle-market definition in the United States is loosely defined as encompassing firms with revenues of up to US\$1 billion.²⁸ In Europe, the category differs from country to country. According to one study, the United Kingdom’s and Germany’s middle market entail companies with annual revenues of up to US\$1.3 billion, while France’s comprise companies that are generating revenues up to US\$650 million.²⁹*

In emerging markets, middle-market companies are usually much smaller in comparison to developed markets. In Brazil, for example, with almost 22,000 companies listed on the S&P Capital IQ research database in 2012, only 6 percent reported revenues of US\$200 million or greater, and in India only about 3 percent of the 46,000 companies in the database reported sales of at least US\$200 million. In the smaller, less developed countries, of course, there are far fewer companies that reach this size threshold.

- **Access to capital:** *In developed countries, where financial markets are reasonably well developed, most middle-market firms that are performing at a profitable level do not rank lack of access to medium- and long-term capital among their major concerns. For example, one study conducted in 2012 found that only 13 percent of middle-market firms in the United States listed limited access to capital as a factor hampering growth, much lower than other reported growth constraints such as pricing pressures, regulatory and legislative pressures, new technologies, and customer demand.³⁰*

In emerging markets, in sharp contrast, as noted in Exhibit 1.1 in Chapter 1, surveys of business owners rank limited access to affordable finance at the top of their list of constraints to growth and profitability. As will be elaborated in Chapters 6, 7, and 8, entrepreneurs operating middle-market businesses in countries as vastly different as China, Brazil, and Kenya consistently repeat the identical refrain: lack of access to medium-term capital on affordable terms is their most formidable obstacle to success.

- **Value-creation opportunities:** *Middle-market firms in developed countries tend to be well established, have a demonstrable track record, and are managed by relatively skilled senior and midlevel professionals. When acquired by private equity investors, often in a buyout, the primary focus of post-investment “value added” is on financial engineering (e.g., balance sheet restructuring). If dissatisfied with the quality of management, the most common strategy of the new owners is to find replacements from a deep pool of experienced human capital residing in these countries. Absent the need for labor-intensive, time-consuming value-creation tasks, private equity investors anticipate exiting these middle-market deals in three to five years from the time of the initial investment.*

Middle-market companies in developing countries tend to be less established, and senior managers frequently lack the skills and know-how to maximize performance and competitiveness. Whereas these characteristics are likely to be viewed by private equity investors as deterrents in developed countries, they may stand out as opportunities in developing countries. But implementing value-creation strategies takes longer, requires more hands-on attention, and therefore the path to exit is likely to take several years more than in developed countries. "Private equity investors [in emerging markets] have principally provided their target companies with infusions of growth capital," according to one analysis by an international consulting firm, "which require far longer holding periods than the buyout investments more typical of private equity in developed markets."³¹

Relatively stable macroeconomic and political conditions

In the eyes of many investors, macroeconomic performance tends to be closely correlated with country risk. It is axiomatic that the greater the incidence of macroeconomic and political volatility in a country, the higher the level of uncertainty for investors when it comes to calculating future outcomes for their portfolio companies. Of course, political and economic instability is not the exclusive domain of developing countries, as investors everywhere learned painfully in the aftermath of the 2008–2009 global financial crisis when they experienced the aftereffects of plummeting stock market indexes around the world.

Nonetheless, even accounting for the major disruptions caused by the global financial crisis and the subsequent fallout from the Euro crisis that began in 2011, historically the more advanced countries have been spared frequent bouts of disruptive macroeconomic volatility that heighten perceptions of country risk and deter investors. Indeed, in the post-war period prior to 2008, although the United States and Europe experienced periodic economic downturns and financial disruptions, they were typically short-lived and recoveries occurred reasonably quickly. This half-century of relative financial stability has been reflected in the sovereign credit ratings of developed countries. This measure of

a country's macroeconomic profile and relative creditworthiness serves as one of the cornerstones for investor confidence and resides at the very foundation of the private equity ecosystem. These credit ratings measure in absolute and relative terms a country's willingness and ability to repay its foreign debt obligations in full and on time. Year after year, with few exceptions, the credit rating agencies attach their highest grades to developed countries. The same can hardly be said for developing countries (see Exhibit 2.6).

Financiers of all stripes are affected when markets collapse, exchange rates abruptly deteriorate, or regulations become unpredictable due to sudden political regime changes. But these risks are exponentially elevated for private equity investors due to their long-term, illiquid exposure. This illiquidity that defines private equity makes macroeconomic and financial market volatility all the more painful, as such disruptions have the potential to dramatically extend the projected

Exhibit 2.6 Standard & Poor's Country Credit Ratings (March 2014)

Country	Rating
Australia	AAA
United Kingdom	AAA
United States*	AA+
Japan	AA-
Poland	A-
Brazil	BBB-
India	BBB-
Indonesia	BB+
Turkey	BB+
Nigeria	BB-
Argentina	CCC+

*In mid-2011, Standard & Poor's downgraded the previous "AAA" credit rating of the United States to "AA+" following a prolonged controversy over raising the country's statutory debt ceiling.

Source: Standard & Poor's.

timeline of an investment from entry to exit, not to mention the likelihood of seeing depressed exit valuations. Once invested, there is no escape route for a private equity investor when unexpected economic downturns disrupt his or her best-laid plans.

From their earliest days in emerging markets, investors have been buffeted by the consequences of disruptive economic and currency crises. Ironically, however, high levels of country risk based on perceptions of macroeconomic fundamentals do not enter as prominently into the calculus of most emerging markets private equity fund managers as might be expected when they are considering where to invest. “It goes with the territory! I pay far less attention to country risk factors than I used to,” commented a senior partner from a global emerging markets fund. “Some risks such as currency are greater than in developed countries, but on the other hand, the lack of leverage in our emerging market deals lowers the risk profile.” Another private equity investor notes, “You can be in the best sector in the best country and still lose money. Private equity investing is ultimately about micro factors—you back companies and management teams.”

Some sectors may actually benefit from negative macroeconomic indicators, such as rising inflation that may generate higher operating margins for some consumer products companies. Without diminishing the self-evident preference for stable, predictable macroeconomic fundamentals, therefore, private equity investors are likely to focus far more intensively on the risk profile of individual companies and sectors than on uncontrollable, exogenous country risk factors. How else to explain, for example, the surge of investor interest in lower-income countries across sub-Saharan Africa, Latin America, and Southeast Asia in the past five years (see chapter 5)?

Even if most private equity professionals are resigned to the emerging markets reality of “it goes with the territory,” their best-laid plans can be turned upside down when sharp local currency depreciations erode US dollar financial returns. Making matters worse, when currency values plummet, the first line of defense for local governments is often to raise interest rates, which further undermines the earnings of portfolio companies by increasing borrowing costs. Whether anticipated or not, therefore, when economic conditions deteriorate and exchange rates fluctuate, even the most methodical and careful investor projections on company

performance count for little. Assumptions about future revenues, expenses, and earnings are rendered obsolete when the prices of inputs and final products change dramatically. As a consequence of these realities, even high-performing companies that register strong revenue growth, higher margins, and increased profitability are likely to generate unsatisfactory or even negative financial returns for unhedged dollar-denominated investors. This is what happened to many private equity funds with investments in some of the best performing emerging market economies in the 2002–2012 period, including Brazil, India, Russia, and Turkey. At various points between 2012 and 2014, each of these favored countries experienced a sharp downturn in macroeconomic performance and protracted currency devaluations impacting numerous portfolio companies.

But as one seasoned emerging market investor concedes, “We don’t like it of course, but there’s very little you can do about it. Currency hedges can be prohibitively expensive due to the long-term nature of private equity investments, and attempts to predict future currency values are a fool’s errand.” Another battle-tested investor in developing countries reflected the painful reality: “Currency predictions by so-called foreign exchange analysts are less reliable than weather forecasters.”

As will be described in chapter 4, the first generation of private equity investors in emerging markets was particularly hard hit by unanticipated severe economic crises in various regions of the developing world in the late 1990s, just as the asset class was beginning to gain a foothold. Nowhere was this more surprising, or damaging, than in Southeast Asia, which just before the crisis erupted in the summer of 1997 had been triumphantly labeled by the World Bank and others as “the Asian Miracle” (see box).

The 1997 Asian Financial Crisis

In the 1990s, many Asian economies were experiencing what the World Bank labeled the “Asian economic miracle,” achieving growth rates of 8–12 percent per annum and attracting the attention of international investors. But many of the region’s rising stars, such as Thailand, Malaysia, South Korea, and Indonesia, began to accumulate large current

account deficits, which often is a precursor to currency devaluations. Once international investors foresaw this possibility and began to question the capacity of local governments to defend the value of their currencies, they predictably raced to exits, each trying to get ahead of the stampeding herd. This became an unfortunate trend in the summer of 1997 when the Thai Baht collapsed, devaluing by almost 40 percent in a matter of weeks, triggering a contagious investor reaction that quickly spread to almost every other country in the region with similarly damaging consequences for domestic currencies. Compounding the challenges facing long-term illiquid investors, governments throughout the region sought to defend their currencies by sharply increasing short-term interest rates, further aggravating the problems for domestic businesses. Even more surprising, the crisis rapidly spread to other regions of the developing world even though their economies had not been suffering from similar macroeconomic problems. What had started as a localized crisis in Thailand, a relatively obscure developing country at the time, triggered a global financial crisis that, as US Treasury Secretary Robert Rubin warned at the time, threatened “the whole international financial credit system to freeze.”³² But private equity fund managers with portfolios of dollar-denominated investments could not simply divest and join the herd. They were caught in this maelstrom along with their portfolio companies, and even the best performers suffered major losses that took years to recover.

**Internationally accepted best business practices:
it begins with the quality of information**

If the lifeblood of every financial decision-maker is access to reliable and timely information, nowhere along the financial spectrum is it more imperative than with private equity, where investments are long term and illiquid. No matter the country, company size, or length of time invested in a business, a fundamental litmus test for whether a company deserves a second look is an assessment of the management’s willingness to adhere to well-established and widely accepted standards of financial accounting and reporting. At the pre-investment stage, the prospective investor expects a high level of comfort that due diligence can be performed and valuations calculated based on the financial information provided by the company in accordance with generally accepted accounting standards.

Moreover, even when not required by law, investors are unlikely to move forward with due diligence unless a targeted company agrees to an independent audit that verifies the accuracy of its accounts and identifies any divergence from standard accounting principles.

When one senior partner of a fund with decades of experience investing in China and other Asian countries was asked what happens if the founder of a targeted company resists an independent audit as a precondition for moving forward, his response was unambiguous and adamant: “We walk away!” These practices are no less essential post-investment, when effective monitoring of portfolio company performance depends on regular access to timely and accurate financial information presented in a standardized format.

Notwithstanding occasional, widely publicized accounting scandals, such as those that occurred within a number of large corporations in the early 2000s, in developed countries following accounting and reporting standards are the rule rather than the exception for businesses. For instance, in the United States, public companies are required by the Securities and Exchange Commission (SEC) to prepare financial statements in line with the US Generally Accepted Accounting Principles (GAAP), and most private companies do the same in order to satisfy their lenders or private stakeholders. Compliance with such practices provides investors with a reasonable level of confidence that they are making investment decisions based on accurate, fully disclosed information in accordance with widely accepted reporting standards.

In emerging markets, the prototypical small or mid-sized company is highly dependent on a single individual, most often the founder and CEO, who has built a successful business with virtually no shareholders beyond his immediate family and close friends. Absent the necessity of accountability to a Board of independent directors or outside shareholders, the financial interests of the owner and the firm are sometimes intermingled. In addition, some emerging market companies embrace a deeply embedded business culture that places a high premium on privacy, and little attention is paid to accounting standards that are commonplace in developed countries. However, as explained in the next chapter, these substandard practices are not necessarily “deal breakers,” and may actually present opportunities for value creation, provided that the investor

has confidence that the entrepreneur is willing to abandon customary practices, and understands that implementing widely accepted best practices is an essential part of long-term value creation.

Combating Corruption: The Private Equity Advantage

Enron, WorldCom, Bernie L. Madoff Investment Securities, and countless other corporate scandals in the United States and other developed countries are reminders that business-related fraud occurs everywhere. Regardless of the country, such fraud can take the form of various scams designed by management or other employees to surreptitiously divert company resources for personal gain, or as bribes to public officials in order to win contracts. But especially in developing countries, where woefully deficient legal codes and enforcement mechanisms are the norm, corruption is systemic. Compared to developed countries, it tends to be pervasive at every level of society, in every sector, and in both government and the private sector.

Even though corruption indexes are imperfect and only serve as a crude barometer of relative levels of malfeasance, all tell a similar story. For example, in the 2013 edition of Transparency International's ranking of corruption in 177 countries, Uruguay was the only developing country ranked among the top 20 least corrupt markets. Almost 70 percent of the surveyed countries received a score below 50 (out of 100), indicating "serious corruption problems," including 66 percent of countries in Latin America, 64 percent in Asia, 84 percent in the Middle East and North Africa, more than 90 percent in sub-Saharan Africa, and 95 percent in Eastern Europe and Central Asia.³³

This unfortunate reality comes as no surprise to investors who have had even minimal experience in emerging markets. Less appreciated, however, is an awareness that private equity investors rank among the most effective combatants against corruption, one deal at a time. Other financiers can turn a blind eye to malfeasance, such as underreporting taxable earnings, bribing customs officials, or simply diverting cash receipts to personal bank accounts, so long as they continue to collect their interest payments, dividends, and fees. Not so with private equity investors. Whether minority or control shareholders, as owners they are stakeholders in the truest sense of the word. They have especially strong incentives to be vigilant, hands-on stewards of their investments, knowing that the bulk of their financial rewards will be realized many years after their initial investment, at the time of exit. It is well understood that prospective buyers will always undertake their own rigorous due diligence and will either walk

away or heavily discount enterprise value if they uncover or even suspect illegal activity.

Whether driven by financial self-interest or some higher motivation, private equity investors are highly incentivized to accumulate the necessary expertise and devote considerable time to ferreting out corrupt practices. From the first meetings with senior management of a prospective investee company, through the due diligence process, during the post-investment value-creation phase, until the time of exit, experienced investors are practiced corruption combatants. This explains their sharp focus on company practices that strengthen transparency and disclosure, such as accounting standards and corporate governance, as well as continuous on-site interaction with management and other Board members. Although there is no silver bullet to mitigating systemic corruption that is the scourge of developing countries, few are more incentivized to promote a corporate culture that takes integrity and transparency seriously.

As many investors acknowledge, this problem of substandard business practices may have less to do with the controlling shareholder's calculated deception than a simple skills deficit. Although the landscape is changing, the historical profile of most entrepreneurs in developing countries who have built successful companies does not often include an MBA degree or formal training in finance and accounting. Prior to deciding to attract third-party financing, many of these successful business owners have neither the motivation nor the skills to devote their attention and firm resources to proper accounting procedures. It is unsurprising, therefore, as revealed in one World Bank Enterprise Survey, that only 37 percent of small firms have their annual financial statement reviewed by an external auditor, compared to 58 percent of medium-sized firms and 79 percent of large firms.³⁴ This may be due to deeply embedded traditions of autonomy, secrecy, and independence that run deep within the business culture, but it may also be simply a function of a knowledge gap.

Moreover, the problem in almost all developing countries is further aggravated by a similarly severe human capital deficit within governments, characterized by underpaid and poorly trained public officials who are charged with enforcing accounting and disclosure regulations even when they do exist. As many entrepreneurs

are well aware that government enforcement of tax and other regulations is weak, it is hardly surprising that such a large number of them attach a low priority to regulatory compliance.

Deep pools of entrepreneurial, managerial, and operational talent

It is axiomatic that the performance of every business enterprise depends upon skilled managerial and technical professionals. In developed countries, businesses that encounter human resource issues, no matter how serious, typically enjoy the luxury of drawing on a deep and diverse pool of qualified professionals. Whether they face the sudden departure of a CEO or chief technical officer, specialized machine operators or marketing analysts, the odds are high that an ample supply of replacements is available, thus mitigating any serious disruption to performance.

Without exception, the empirical and anecdotal evidence overwhelmingly suggests that emerging market countries suffer from a shallow pool of skilled professionals in almost every category compared to their developed country counterparts. Ask any private equity fund manager who has worked virtually anywhere in the developing world to identify the most challenging and persistent obstacle to long-term success within her portfolio companies and the odds are very high that at the top of her list will be the scarcity of talent at all levels of the business, from senior management to midlevel technical professionals to junior workers. “After the price paid for a deal, it’s all about management,” explained one emerging market investor. “When we get it wrong, people mistakes are the single biggest reason.”

Reinforcing this oft-repeated observation, in a 2011 survey of over 150 US and Canadian firms operating in developing countries, 59 percent cited a scarcity of local employees with the required technical skills as the most critical human resources challenge.³⁵ Some of these human resource constraints may offer private equity investors value-creation opportunities, such as through the recruitment of new senior managers with the requisite skill sets, the introduction of technical training programs, or the revamping of employee benefit packages to increase worker productivity and boost morale. But no matter how well intentioned, the talent

draught in developing countries is a problem not easily solved. This human resource scarcity is a generational constraint; it will likely take years or even decades before the professional management pools in these markets approach the levels that exist in most developed countries.

The private equity value-creation opportunity: capitalizing on a substandard investment climate

As described in this chapter, the sharp differences in the private equity ecosystems that separate emerging markets from developed countries unquestionably create a complex labyrinth of challenges and risks that understandably deter many investors. At the same time, however, these riskier environments hold the *potential* to generate an abundance of private equity investment opportunities by capitalizing on inefficiencies and information asymmetries that have largely disappeared in developed countries. Lack of supportive government policies, inadequate legal protection, weak financial markets, poor adherence to standard business practices, and shortages of talent are not necessarily insurmountable obstacles for experienced private equity practitioners. Indeed, the hands-on modus operandi that is the hallmark of all successful private equity professionals, combined with their value-creating expertise accumulated from dealing time and again with companies hamstrung by similar problems, makes them uniquely qualified to mitigate many of the risks that deter most other financiers. This is especially the case among the vast universe of underperforming small and mid-sized businesses, representing the middle market of virtually all developing countries, which struggle to gain access to the two vital resources they require to grow, compete, and make a healthy profit: affordable medium- and long-term capital, and value-creating expertise. It is the scarcity of both these resources that opens the door and provides unparalleled opportunities for a growing corps of skilled emerging market private equity investors. The next chapter elaborates more specifically on how this breed of professional investors applies their expertise to create value and strengthen long-term performance for emerging market businesses.

3

The Private Equity Advantage: Operational Value Creation

You find a lot of entrepreneurs in emerging markets that have produced a great service or product but don't know that it can be improved upon. Or perhaps they have perfected their product but don't know how to brand and sell it. Or perhaps a company is doing well and moving up the value chain but doesn't know how to handle competition, which it is now facing for the first time. All of these scenarios inhibit growth, which is why the entrepreneur needs a private equity partner—it is our job to identify the gaps and help a company reach its full potential.

—Emerging market private equity investor

In the years following the 2007 investment in the Brazilian scaffolding equipment business described at the beginning of chapter 1, the company performed at an extremely high level. In addition to seeing accelerated growth within its core business of supplying the heavy construction industry, the company used the proceeds from the private equity injection to launch an equipment rental business that deepened its relationship with its core client base and additionally acquired a major competitor. The expansion strategy was fueled by booming activity in the Brazilian construction sector at a time when the economy was in the midst of a period of sustained growth. As a result, the company benefited from unprecedented demand for large-scale investments in physical infrastructure, as well as commercial and residential real estate. These favorable external factors, coupled with internal improvements fostered by close collaboration between Claudio and his new private equity partner,

generated enviable financial results between 2007 and 2009: revenues increased at a compound annual rate of 45 percent and net earnings soared 155 percent during the period.

Capitalizing on this strong performance, in early 2010 the stakeholders agreed to solidify their gains by orchestrating an IPO exit. As the company prepared for a share listing on the São Paulo stock exchange (BOVESPA), a major component of the marketing strategy for new investors focused attention on the company's value-creating achievements since partnering with a private equity investor. In addition to the internal operational improvements and expansion activities, these included, for example, the implementation of world-class corporate governance standards, a reconstituted Board with independent directors, regular independent audits of all financial statements, and a new profit-sharing plan that created equity-based incentives for senior management and other employees.

Shortly thereafter, the company proceeded with a successful IPO, selling a substantial portion of the company's shares at a price of about six times 2009 EBITDA. As this was the only construction equipment company listed on the BOVESPA, investor interest in the offering was strong. Agreement was reached to conduct both a primary and a secondary share offering that allowed existing shareholders to sell a substantial portion of their equity stake, while simultaneously providing the company with a capital injection to sustain its growth trajectory. The US\$390 million IPO enabled Claudio and his team to purchase new equipment and support additional operational expansion. "I'm thankful that we stayed at the negotiating table with the private equity team—even when it felt as though they were being too demanding. We would not have achieved the results we did without their money and, more importantly, their expertise."

The levers of value creation

Unlike most financiers, private equity investors are preternaturally attracted to underperforming companies. While their role as providers of capital is undoubtedly essential in supporting the growth of companies victimized by the financing gap, every private equity professional knows that capital alone rarely suffices to significantly boost performance—especially in developing countries. If the

objective is to generate a quantum leap in a company's profitability and competitiveness—as measured by such metrics as accelerated revenue growth, improved EBITDA margins, and higher levels of worker productivity—the distinct private equity advantage resides in the fund manager's role as an *active, hands-on* investor endowed with the specialized value-creation expertise that complements any capital injection. As the head of an African private equity firm recounted when discussing a portfolio company, "It wasn't just our capital that was required to generate a strong return. It was putting the company in touch with the market opportunity in Nigeria, including helping them to recruit locally, obtain a license, and deal with all the other local factors. It is not just about the capital, but what comes with the capital."

Although the circumstances of the country, sector, and business heavily influence the specific components of any strategy, a typical GP "to-do" list for portfolio company transformation includes addressing a range of issues.

- *Operational*: enhancing products and services, improving production and supply chain management processes, restructuring internal operations, and expanding marketing and distribution channels;
- *Human capital*: recruiting experienced and/or skilled senior managers, professional training for workers, and ensuring compensation structures are competitive in order to attract and retain key personnel;
- *Corporate governance*: establishing an independent Board, introducing acceptable accounting and financial reporting practices, and codifying best practices for the Board of Directors;
- *Environmental*: implementing environmental practices, which in recent years have been recognized as having a high degree of correlation with overall firm competitiveness; and
- *Financial*: advising management on an efficient capital structure, assisting in raising additional debt and equity, and providing input during negotiations to secure attractive financing terms.

The sharply focused attention on the nonfinancial dimensions of value creation in order to strengthen portfolio company

performance is at the core of the case for private equity as an attractive financing tool, especially in developing countries. As noted in the previous chapter, private equity has flourished and matured in industrialized countries, where highly skilled human capital is relatively abundant and best business practices are taken for granted. In sharp contrast, the root cause of company underperformance in developing countries can often be traced to an absence of operational and governance standards, especially in the vast universe of middle-market firms that comprise the bulk of the productive private sector. Just as these firms underperform due to their lack of access to medium- and long-term capital, they also fall short of their potential as a result of subpar business processes and procedures. However, as every experienced private equity investor recognizes, many of these shortcomings can be corrected with access by management to the relevant know-how and incentives to adopt best practices.

The tale of Claudio, the Brazilian scaffolding entrepreneur, illustrates some of the benefits derived from a private equity investor's expertise: advice on product improvements, training on more effective financial and accounting procedures, and support in the execution of an acquisitions strategy to achieve economies of scale. Like Claudio, business owners across the globe have increasingly come to realize that although selling a significant ownership stake to a private equity investor often invites disruptive changes to traditional business routines, the net improvements to the overall value of the company ultimately make this tough decision worthwhile.

Various studies have empirically validated this correlation between operational value creation and bottom-line performance. In Latin America, for example, according to one survey, operational improvements fueled 80 percent of EBITDA growth in private equity deals compared to cost reductions or financial restructurings, which is almost twice as high as its contribution in the United States and Europe.¹ In Africa, private equity's focus on nonfinancial value creation—and especially on strengthening environmental, social, and governance (ESG)² practices—has contributed to 66 percent of EBITDA growth.³

LPs also recognize the centrality of the GP's nonfinancial expertise as a critical determinant of their own financial returns. Just as

GPs evaluate target investee companies based on clearly defined selection criteria, LPs utilize their own checklists to determine which fund managers will be the recipients of their capital (see Exhibit 3.1).⁴ Particularly in developing countries, GPs increasingly recognize that a primary driver of their fundraising competitiveness hinges upon the possession of a demonstrable value-creation skill set. Affirming a common view, one LP investment officer with a long track record of selecting GPs active in developing countries stated emphatically, “Operational value creation is the key element in private equity that will distinguish the winners from those that disappear... the time to bet on financial levers is over.”⁵ In other words, GPs can no longer expect to attract funding from institutional investors solely by demonstrating that they can identify good companies and apply financial engineering skills, such as debt restructuring and asset sales.

A well-known exemplar of this LP focus on value creation is Yale University Endowment, a strong advocate of what they call a “value-added approach” to investing. With a large portfolio of private equity investments that has consistently outperformed other large university endowments for more than two decades, the Endowment’s investment team subscribes to a rigorous fund manager selection process that places a higher premium on operational experience than financial engineering expertise. When selecting GPs, it views the former skill set as the essential ingredient: “We seek [private equity] funds that build fundamentally better businesses,” explains David Swensen, the Chief Investment Officer of the Endowment.⁶ Several funds of funds have taken a similar approach. One emerging market-focused portfolio manager notes, “Ultimately, we look for GPs who see themselves as partners to help build businesses, rather than ‘company pickers.’ Being in the latter category was a viable strategy several years ago, but as the market matures, GPs need to be able to drive value creation beyond the basic organic growth of the company. Those GPs who have such a mind-set and have had the time to cultivate their expertise stand to generate superior performance.”

This essential GP skill set is acquired cumulatively. It deepens as a result of repeated experiences over many years in assisting company after company with similar problems. Proudly recounting a

Exhibit 3.1 Sample LP Due Diligence Checklist

Alignment of Interest	<ul style="list-style-type: none"> • Do the GP principals have a significant cash investment in the fund? • Does the agreement stipulate that LPs receive their original financial contribution plus a preferred return (hurdle rate) before carried interest distributions to the GP? • Is carried interest calculated on net rather than gross profits? • Are all transaction, monitoring, and advisory fees charged by the GP to portfolio companies distributed proportionately to the LPs?
Investment Strategy/Value Creation	<ul style="list-style-type: none"> • Does the investment team have the experience/expertise necessary to contribute significant value to the GP's portfolio companies? • Does the GP have a verifiable track record of successful exits? • Does the GP demonstrate a commitment to environmental, social, and governance principles in its selection of portfolio companies and investment strategy?
Governance	<ul style="list-style-type: none"> • Is the GP subjected to periodic independent audits and willing to regularly provide LPs with standardized financial reports? • Are portfolio company valuations regularly reported at the lower of original cost or market value? • Does the GP agree not to commence raising a new fund until after completion of the investment period of the current fund? • Does the GP agree to subject any changes to the Limited Partner Agreement (LPA) to a vote of the majority of LPs?
Transparency	<ul style="list-style-type: none"> • Are there clearly defined conflict of interest clauses in the LPA? Are projections for capital calls and distributions regularly disclosed? • Is the GP willing to disclose any legal issues, breach of LPA provisions, or liabilities to the fund? • Does the GP have a strong and transparent risk management plan? • Does the GP provide quarterly and annual reports on the fund's performance? <hr/>

key ingredient underpinning his successful track record as a private equity investor, one fund manager acknowledged, "We are . . . shameless about stealing (non-proprietary) best practices from our partner companies and applying them elsewhere. If we don't, we run the risk of leaving the companies stuck with practices that may

be outdated.” This replication of value-creating business practices that have proven successful previously is a pivotal component of the private equity advantage. Providing capital must be combined with clearly recognized opportunities for the investor to contribute something more.

How “contributing something more” works in practice in a developing country context is the focus of this chapter. The value creation tasks profiled on the following pages are emblematic of how private equity investors typically address company underperformance once they have committed their capital.

The keys to the kingdom: ensuring an alignment of interests

Helping a great business realize its potential takes a lot more than just capital. It is ultimately about the people, and thus your relationship with the management team is essential to the support you can provide—whether through facilitating introductions to key industry expertise, strengthening corporate governance, or introducing relevant operational best practice.

—Chinese private equity investor

Before any private equity investor can implement performance-enhancing improvements, they must first get management buy-in. This means ensuring that the firm’s owners are in sync with their new investor on the crucial elements of the value-creation plan needed to achieve long-term profitability and competitiveness. Successful implementation of the strategy requires the formation of a genuine partnership, ideally based on mutual trust and respect. One Indian private equity investor explains, “Whether we have a 10 percent or 30 percent stake is not the issue. We don’t invest in a company unless we believe the entrepreneur has a predisposition to work with us.” It is axiomatic, then, that *before* a fund moves forward with an investment, the entrepreneur must recognize the importance of making a series of unfamiliar and perhaps unsettling changes, all of which are geared toward improving the business. The two sides must also have the personal “chemistry” needed to work as partners to implement the agreed-upon changes. In other words, a shared vision of what needs to be done

is far more important to investors than the strength or weakness of the company's current practices.

As noted in chapter 1, building an acceptable level of trust between investor and entrepreneur often does not come easily. Especially in developing countries, deeply embedded traditions of autonomy and secrecy are frequently put to the test once an entrepreneur comes to the realization that her company's future cannot be assured without more capital. At first she may be attracted by the prospect of partnering with a private equity investor who can provide the needed financing, but hesitancy and even fear can set in once confronted with the uncomfortable reality that the quid pro quo for the funds is an ownership stake that typically includes influence over how the company will be run, including new standards of accountability and transparency. Prior to closing a transaction, for example, a GP often seeks management buy-in on a number of conditions designed to facilitate proposed changes, such as an independent financial and legal audit, Board representation roughly proportionate to the investor's equity stake, and binding bylaws that prescribe how the Board will operate (e.g., regularly scheduled meetings, election of independent directors, and operating procedures for Board committees, such as audit and compensation). For owners of many emerging market companies who are unaccustomed to this level of scrutiny, there is sometimes an understandable discomfort with these conditions for investment.

The challenge of convincing an entrepreneur to accept an outside equity partner is magnified because private equity remains relatively new and unknown in developing countries, especially among the small and midsize firms that are the prime targets. As one investment professional at an Africa-focused development finance institution noted, "As a fund manager, you are very unlikely to find a situation where you can just walk into a meeting with a potential investee and say, 'Here is our private equity product—would you like some?' As in other parts of the developing world, a significant amount of patience and education is required for the people involved, especially with smaller-scale businesses."

Indeed, unfamiliarity often breeds suspicion. "At first I was very frightened about bringing in an outside investor," acknowledged

the Chinese owner of a small but growing provincial manufacturer of customized industrial valves for oil and gas wells. “But my opinion changed,” he continued, “once I learned how the investor intended to introduce new business practices designed to help the company grow and become more profitable, such as creating our first strategic plan that gave us a much clearer idea of where the company was going and what we needed to do to get there. He also explained how the local banks would be more responsive to our financing needs if we adopted more acceptable financial reporting and corporate governance practices.” The private equity investor’s initial challenge, therefore, is to make a convincing case that even though the process of abandoning traditional business practices may be uncomfortable in the short term, the long-term benefits will more than compensate for the disruption.

An investor’s task can often be facilitated by the time-tested appeal to the owner’s self-interest. Once the very survivability of a business is threatened and it becomes increasingly apparent that a “business as usual” approach is no longer tenable, even the most hidebound entrepreneur becomes more willing to consider alternatives. Whatever the reason, this is the moment when the private equity door swings open. Examples of drivers include the following:

- *The need to access additional capital:* The primary reason most entrepreneurs consider private equity is because they need capital in order to accelerate growth. Whether a bank loan, a strategic investor, a private equity partner, or any other outside source of capital, invariably a company will be required to meet customary standards of disclosure, transparency, and financial reporting. Once management reconciles itself to the consequences of refusing to comply with these preconditions to virtually any type of third-party financing, acceptance of a private equity partner becomes more palatable.
- *New competitive threats:* Changing circumstances within a particular industry that have caused significant erosion of a firm’s market share and/or profitability may entice a business owner to explore a potential private equity partnership. As governments almost everywhere have embraced policies more conducive to

open markets and lower protective barriers, many companies that once thrived are ill-prepared for new, more intense competitive pressures. The partner of a successful Latin American private equity fund commented on the correlation between increasing competitive pressures within a specific sector and their deal flow: "Very few family groups had taken the steps . . . to professionalize the management of their companies and were now under threat [from new competitors]. As a private equity firm, we were able to offer the outside expertise and capital necessary to allow them to maintain a strong position within their market."⁷

- *Succession issues:* A founder of a family-owned business who is nearing retirement age may not have sons or daughters interested in or capable of taking over the business. As this reality draws nearer, the founder is forced to consider alternative ownership structures to ensure the company's viability going forward. "We knew that family owners were increasingly facing succession issues and the need for liquidity," explained a Latin American private equity investor, "at a time when their companies were experiencing performance problems."⁸ Private equity firms have the networks and knowledge necessary to solve such succession issues.
- *Distress:* The threat of bankruptcy or liquidation due to a prolonged period of underperformance typically forces the founder to choose between accepting new shareholders, however reluctantly, and closing down the business.

Even though private equity remains relatively unknown to many entrepreneurs in emerging markets, this is changing rapidly. As the asset class has gradually gained a credible foothold, especially in the BRIC markets and a few other large developing countries, the so-called demonstration effect has attracted some business owners to private equity. Perhaps nothing more persuasively breaks down an entrepreneur's resistance than learning about the owners of other companies who have reaped outsized financial rewards from partnering with private equity investors. Whether transmitted by newspaper articles or word of mouth, success stories have the power to change entrepreneurial attitudes. The Brazilian managing partner of a mid-market private equity fund recounted with amazement what happened in the aftermath of a highly publicized

IPO on the domestic stock exchange by one of its portfolio companies: “We received more than 50 unsolicited calls from companies that had read about the IPO results of this relatively obscure company, and the role we had played to assist the firm to meet all of the stock exchange listing requirements.” When it comes to getting the attention of emerging market companies, private equity investors know that it is a game of show, not tell.

The operational improvements lever

Although there is no one-size-fits-all value-creation strategy, a handful of tasks tend to be at the top of most emerging market private equity investors’ list of priorities. The process typically begins with a 100-day plan clearly defining the operational changes to be undertaken to help a company get on track to achieve its long-term goals.

Exhibit 3.2 Sample 100-Day Plan

	Action Item
Personnel	<ul style="list-style-type: none"> – Replace CFO – Identify and fill gaps in sales and marketing team
Governance and Compliance	<ul style="list-style-type: none"> – Adopt internationally accepted accounting standards – Introduce annual and multi-year budgeting processes – Establish Board bylaws and create new Board committees, including audit, compensation, and compliance
Operations	<ul style="list-style-type: none"> – Purchase and implement information management systems – Identify and implement environmentally friendly practices – Survey potential acquisition targets
Finance	<ul style="list-style-type: none"> – Assess options for refinancing/rescheduling existing liabilities
Product	<ul style="list-style-type: none"> – Obtain quality assurance certification – Upgrade antiquated equipment – Launch marketing campaign to increase brand recognition

A well-conceived 100-day plan helps avoid downstream misunderstandings, manage expectations, and most importantly, ensure that there is an alignment of interest between the private equity investor and the management team on the specific value creation strategy. Few practitioners would disagree with the view expressed by one private equity investor: “Creating a 100-day plan is more than a suggestion—it’s a necessity! That means operational changes must be defined and undertaken early, or they may not get done at all...if change doesn’t happen within the first 100 days, typically it dissipates and people go back to business as usual.”⁹

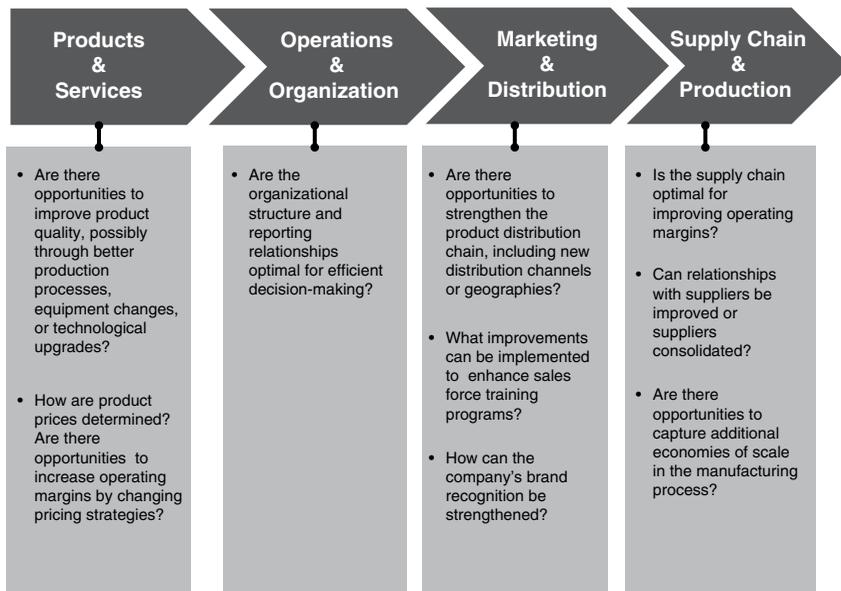
Generally, the 100-day plan begins to crystallize during the due diligence stage, when the GP team is learning details about the strengths and weaknesses of the company and what will need to be done if and when the investment closes. While the strategy may vary depending on the private equity investor’s position as either a majority or minority stakeholder, typically the GP will discuss the plan and reach agreement on the specifics before signing the shareholder agreement. “One objective of the 100-day plan is to signal to management that things are going to change,” one investor explained.

The arsenal of skills a GP brings to bear to create operational value added is largely a function of the deep industry-specific knowledge acquired from countless years of experience in a particular sector, such as telecommunications, health care, financial services, or consumer goods. Based on this expertise and historical/comparative perspective, the GP team is able to identify operational inefficiencies within a portfolio company and draw up a plan with the goal of accelerating company growth, either organically or through acquisitions.

Improving the bottom line by focusing on internal changes

Stronger overall performance can often be achieved by concentrating on internal improvements, such as the expansion of a product portfolio, the streamlining of production processes, the restructuring of management roles and responsibilities, and/or the implementation of a new marketing campaign focused on building brand awareness. A sampling of the questions a private equity investor might ask is included in Exhibit 3.3.

Exhibit 3.3 Framework for Identifying Potential Operational Improvements



Preserving the Hungarian Confectionery Tradition: Bonbonetti and EMSA Capital

Bonbonetti was founded in 1868 by a master chocolatier who was the first to introduce steam-driven technology and large-scale chocolate production to Hungary. With a tumultuous history that included being nationalized in 1948, and privatized and sold to a German conglomerate in 1992, Bonbonetti in 2006 found itself in the portfolio of EMSA Capital, a private equity firm focused on underperforming, distressed, or special situation companies across Central and Eastern Europe. EMSA Capital identified Bonbonetti as a company wherein it could implement significant improvements.

At the time, the company was struggling with unsustainable debt levels, uncompetitive products, unappealing packaging designs and inventory losses stemming from a failure to drop dead-weight products. EMSA Capital worked with Bonbonetti management to reduce inefficient and costly production processes, and cut administrative expenses. Shortly after closing the investment, EMSA Capital undertook a product profitability analysis with the goal of eliminating underperforming products and assisting

management to develop an operating strategy that focused more sharply on the best-selling core chocolate offerings. EMSA Capital also assisted management in crafting a new product development plan based on the results of market research findings, modernizing product packaging and branding, and upgrading the quality of raw ingredients. As a result, the company became debt free and cash flow positive within two years of EMSA Capital's investment, all while preserving the company's culture and heritage.

Source: EMPEA. "The Impact of Private Equity in Emerging Markets Case Study: Bonbonetti," October 2011.

Achieving scale through acquisitions

Although companies may achieve greater efficiency and higher profitability by focusing on organic growth, these objectives may also be accomplished with a quantum leap in scale by acquiring one or more competitor firms, often called "roll-ups." Although growth-through-acquisition strategies are practiced worldwide, many developing countries offer unusually attractive opportunities that have largely disappeared in the West due to a pattern that is similar in a broad range of sectors: highly fragmented and inefficient industries, cluttered with hundreds or even thousands of relatively small firms that are unable to grow to a size that allows them to capture the operating efficiencies achieved with scale. The underlying causes of this omnipresent problem vary somewhat by country and sector, but often the explanations include a number of common denominators, such as government regulations that protect small firms and limit the entry of larger competitors, poor infrastructure that makes it difficult to transport goods and services beyond one local market, or simply a pervasive lack of financing and operational expertise to fund and execute acquisitions. This private sector reality obstructs the creation of larger firms and foments inefficiency and underperformance in a multitude of industries, be it food distribution in rural China, construction materials in Brazil, consumer products in India, or health care in Nigeria.

This profile of sector inefficiency is tailor-made for astute private equity investors. Invariably, some of these small and midsize firms are endowed with qualities that enable them to take advantage

of overcrowded, fragmented markets and accelerate growth, provided they gain access to necessary capital and operating expertise. Reflecting on a theme repeated time and again, regardless of the emerging market country or region, one Asia-focused GP explained the rationale for his fund's investment strategy:

“Most of the industries within Asia, including China, are less than 20 years old, and they are still very fragmented. There are a lot of players, so the typical market leader might have, say, only a 5 percent market share. As a result, there hasn't been much consolidation taking place where you have a clearly defined market leader. I think one attractive opportunity over the next 5–10 years is going to be to identify and back these emerging champions to help them become the undeniable #1 player via industry consolidation. . . . The goal is to help companies accelerate their development to enable them to pull away and take market share from other players, and therefore gain a competitive advantage.”

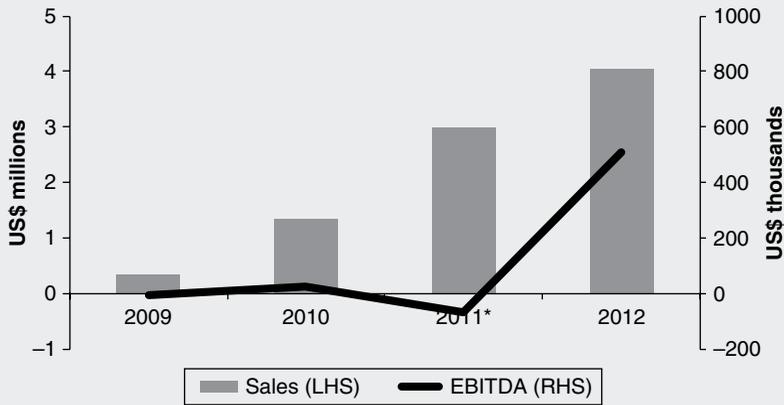
The private equity challenge therefore is to sift through the large population of companies within a chosen sector, and carefully select those that have the greatest potential to grow rapidly and become market leaders, either organically or through acquisitions.

Rolling Up in Rwanda: Consolidation in the Coffee Industry

Although Rwanda produces some of the highest quality coffee in the world, the coffee sector was in distress in 2011, plagued by mismanagement, a lack of access to financing, subpar productivity, and fragmented local processing facilities. Kaizen Venture Partners (KVP), a sub-Saharan private equity fund, viewed these sector-specific problems as a potentially attractive investment opportunity, provided that they could capture cost-saving economies of scale through one large, consolidated coffee processing company.

This strategic vision was realized in 2011 when KVP formed a holding company, KZ Noir, to acquire a 75 percent stake in Socor Ltd., a Rwandan coffee processing company on the brink of insolvency (see Exhibit 3.4).

Exhibit 3.4 KVP Portfolio Companies' Sales and EBITDA, 2009–2012



*KVP acquired the portfolio companies in early 2011.

Shortly after the transaction closed, KVP's new portfolio company acquired two other similarly distressed Rwandan processing firms and created one consolidated holding company. Capitalizing on the injection of KVP's capital and expertise, the new holding company was able to capture economies of scale and introduce a range of value-enhancing changes.

The creation of the larger, consolidated coffee processing company generated striking benefits. For example, KZ Noir had more negotiating power with local banks and, with KVP's assistance, the company renegotiated its medium- and long-term debt obligations on more favorable terms and gained regular access to essential working capital. Larger scale also allowed the company to introduce changes designed to reduce operating costs, such as centralizing back office functions (e.g., accounting and quality control) and negotiating lower prices from suppliers. KVP also worked closely with management to implement other internal changes that resulted in stronger financial performance, such as tighter internal financial controls, and new, productivity-enhancing worker training programs that introduced agronomy best practices focused on land maintenance, fertilizer application, tree pruning, and other practices that resulted in significantly higher yields. KVP also advised management on how to upgrade and professionalize the marketing function, which generated higher export sales to major international coffee roasters, such as Peet's Coffee and Whole Foods, as well as some of the world's largest commodities trading houses.

The combination of KVP's capital injection and value-creating expertise immediately reversed the company's performance and profitability. Production volumes increased, operating margins widened as a result of lower unit production costs, and revenues soared at a compound annual growth rate (CAGR) of 73 percent between 2010 and 2012. In addition to the dramatic improvements in KZ Noir's financial performance, KVP's training initiatives impacted the lives of hundreds of Rwandan coffee processing employees, as well as thousands of poor rural coffee growers by boosting their incomes and standard of living.

Source: EMPEA. "The Impact of Private Equity in Emerging Markets Case Study: KZ Noir Ltd.," May 2013.

The talent management lever

In addition to evaluating a portfolio company's business model, operations, and growth potential, private equity investors invariably take a hard look at the management team and the workforce to identify changes needed to ensure implementation of their value-creation strategy. "It's easier to fix power plants than people," explained the head of a private equity team struggling to restructure a Pakistani electricity generation plant that was massively underperforming.¹⁰ The same admonition is echoed by private equity investors virtually everywhere in the developing world, regardless of the sector or company size. Their single greatest value creation challenge is the same: finding and training good people. Although hard data substantiating the severity of the human capital deficit is scarce, the consensus among emerging market private equity practitioners is virtually unanimous that the overall success of any value-creation strategy, especially when they are minority shareholders, is heavily dependent on the most important assessment of all: the quality of the management team and workforce.

When asked about the most costly lessons learned from his recent investment in a Nigerian telecom company, one private equity investor lamented, "We badly underestimated the difficulty of attracting and retaining a competent CFO for the company. We were forced to change the CFO multiple times, which was a major reason why our exit was delayed by a number of years." But a weak

member of the senior management team may be a problem waiting to be solved. Drawing on experiences and relationships with other portfolio companies, for example, private equity professionals are well positioned to recruit new talent, introduce skills-based training programs, and revamp personnel policies to increase productivity and improve morale. As with so many other obstacles to competitive business performance, private equity investors often view these people-related challenges as an opportunity.

Although scarce human capital capabilities are to be expected in the smallest and least developed emerging markets, such as in many African and Central American countries, the same problem persists even in the larger countries that have attracted the most attention from private equity investors, such as Brazil, India, and China. For example, an investor with a long track record of doing deals in China commented, "The biggest lesson [for me] is that private equity investment above all is a people business, and it's more important to look at the quality of the entrepreneur than the projected financial returns. One of the biggest challenges we are currently facing [in China] is a lack of qualified talent in the portfolio companies themselves."¹¹ A similar conclusion was highlighted in a 2013 research report ranking countries based on human capital indicators, such as education, health, and training. China, Brazil, and India are placed forty-third, fifty-seventh, and seventy-eighth, respectively, among 122 graded countries.¹²

Due to the scarcity of management talent, a common obstacle is poaching by competing firms. As one pan-emerging market fund manager explained, "It's a war for talent in the emerging markets right now."¹³ Confronted with the challenge of not only attracting but retaining top managers, therefore, experienced private equity investors often advocate new compensation packages for highly valued senior executives that are designed to provide attractive financial incentives tied to achieving clearly defined performance benchmarks (e.g., stock options). Although these incentive-based compensation schemes have long been common in advanced economies, they have been introduced only recently in most developing countries.

Depending on the severity of the senior management deficit within a particular industry, the remedy may include recruiting experienced professionals from outside the country. An investor in

South Asia declared, “In some cases we have had to take an active role in sourcing managers from outside of the country to run one of our portfolio companies. For example, retail is a very specialized business, so for our supermarket chain investment, we used our network to find two French citizens who had previously worked for [a large supermarket chain] in Malaysia.”

The second human resource deficiency resides below the senior management level, where there also may be an acute shortage of professionals with the requisite technical skills, especially in sectors such as telecommunications, health care, and electricity generation. As with senior managers, these critically important technical personnel are in extremely short supply and highly susceptible to poaching by competitors. Complaining about one of the most disruptive problems in his Nigerian telecom company, the exasperated owner explained, “We hire a trainee engineer for US\$400 per month and spend US\$40,000 to US\$50,000 to train him over a period of three years...after that he can command a salary of US\$1,000 per month, so a lot of our good people are poached. It’s very hard for us to keep people after sinking a lot of money into their training.”

There is no quick fix for these deep-seated human resource problems. Experienced private equity investors encounter the same patterns time and again in virtually every developing country, but they are well placed by dint of experience to introduce time-tested solutions by, for example, crafting programs designed to boost worker productivity and reduce costly turnover. Initiatives may be as straightforward as introducing better skills training, but may also entail performance-based compensation, employment contracts that include “non-compete” provisions and more attractive worker benefits, such as improved health care, better housing, schooling for dependent children, or other quality-of-life benefits that are likely to improve worker morale and boost productivity.

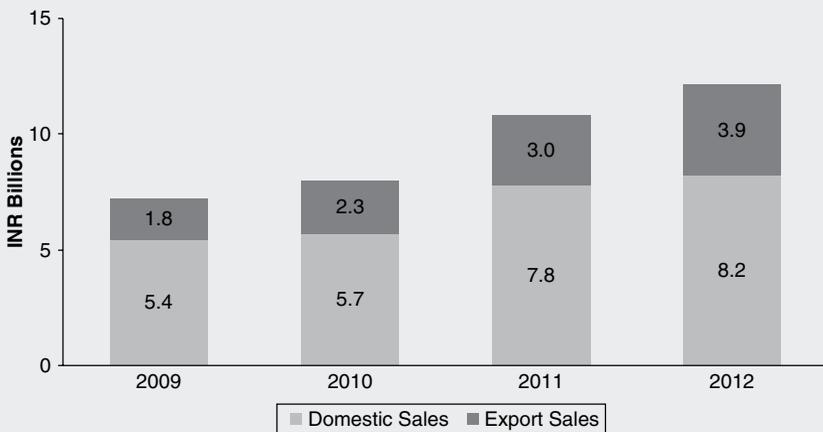
Attracting and Retaining Key Talent: Blue River Capital & KPR Mill

In 1984, India's KPR Mill Limited, a textiles and apparel company founded by three brothers, was operating out of a converted barn in Coimbatore,

a town in the southern textile belt. In 1995, when the World Trade Organization (WTO) dismantled worldwide textile quotas and the domestic textile market seemed poised for consolidation, Blue River Capital, an India-based private equity firm, saw significant potential in KPR's growth prospects and made an investment in the company. Though Blue River was only a minority shareholder, the two firms developed a high level of mutual trust, allowing Blue River to play a leading role in transforming KPR's culture and performance through major hiring, procurement, operational, and financial decisions.

Perhaps the most significant and innovative change that Blue River brought to KPR was the unusual approach for attracting and retaining talented workers. By recruiting young women from rural villages, KPR was able to offer a safe and fulfilling environment for these new workers with secure housing, access to amenities like swimming pools and yoga classes, and opportunities for further education through the company's relationships with two local universities. As a result, almost 40 percent of KPR's employees have earned vocational training certificates, or college or business degrees. Due to these dramatic cultural changes, morale has skyrocketed, and increases in worker productivity have more than offset the cost of the additional employee benefits. Whereas worker turnover in the Indian textile industry averages 30–50 percent, in KPR the number is in the single digits. Commenting on the overall success of the partnership,

Exhibit 3.5 KPR Mill Sales, 2009–2012



a senior member of the Blue River team noted, “KPR’s best practices really set them apart in terms of their core beliefs and ethos [and] in how they treat people. A very satisfied and high-morale workforce—that’s the magic of this formula.”

Source: EMPEA. “The Impact of Private Equity in Emerging Markets Case Study: KPR Mill Limited,” September 2012.

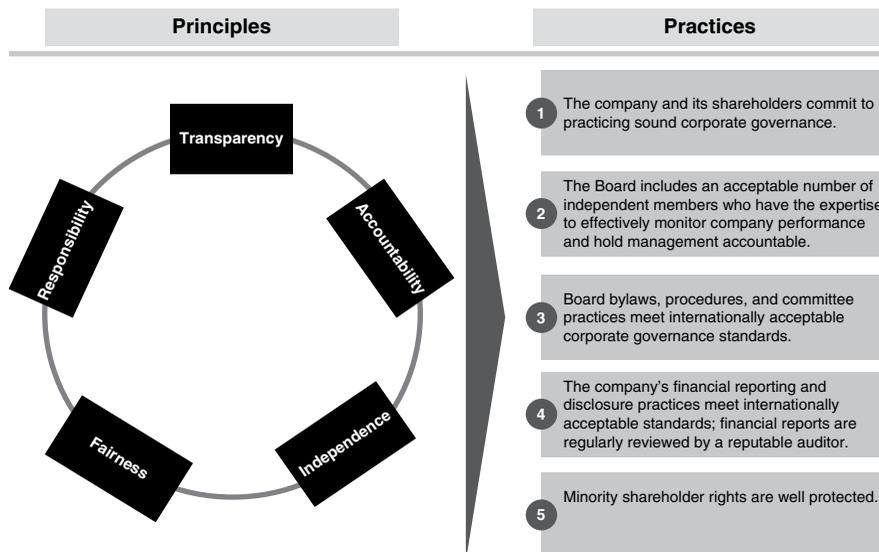
The corporate governance lever

Corporate governance is an imprecise and easily misunderstood term, but it generally refers to the standards and practices established by a company to ensure (i) an accurate, timely, and transparent flow of operating and financial information to relevant decision-makers; (ii) well-defined procedures designed to hold senior management accountable to a Board of Directors that includes a number of independent members; and (iii) the Board is vested with the authority to deliberate and decide on key decisions affecting the company’s operating and financial performance. Although opinions differ regarding what constitutes sound corporate governance, and standards may vary somewhat among countries, the most commonly agreed-upon principles and practices are summarized in the exhibit below.

In all countries, firms wishing to raise capital through a public offering must first demonstrate compliance with established corporate governance standards. Moreover, once shares are listed, companies are subjected to ongoing requirements to publicly disclose detailed information in a standard format about the firm’s financial performance, including notice of any material changes that may affect future performance. In addition to government-imposed regulations, virtually every stock exchange in the world has its own corporate governance standards and internal requirements stipulating the conditions that every listed company must satisfy.¹⁴

In sharp contrast to these corporate governance practices for publicly listed companies, unlisted firms—the principal targets for private equity investors—are subject to far less government

Exhibit 3.6 Features of Sound Corporate Governance



oversight.¹⁵ As a result, management has less incentive than their public company counterparts to proactively take steps to establish and practice sound corporate governance, and weak corporate governance is more often the rule than the exception—particularly in developing countries. Company founders may view such practices as unnecessarily costly and/or provide competitors with a potential advantage by publicly revealing privileged company information. A Brazilian private equity investor who first began screening companies in the early 2000s explained, “The term ‘corporate governance’ was not in anyone’s vocabulary back then.”

Most financiers consider weak or nonexistent corporate governance as a major deterrent; they have neither the incentives nor the skills to cope with these company deficiencies. Private equity investors, on the other hand, are likely to view this as a value-creating opportunity. Their litmus test is not whether acceptable standards are already established and consistently practiced, but management’s recognition that effective corporate governance is fundamental to improving performance, coupled with a genuine willingness to collaborate with their new private equity partners to implement the necessary changes.

Nowhere is this corporate governance issue more challenging than with family-owned small- and medium-size firms. The prototypical founder/entrepreneur has built a successful business with virtually no capital or shareholders other than immediate family and close friends. He is accustomed to retaining complete control over who sees what information; two or even three sets of financial accounts is not unusual, and an independent Board of Directors is viewed as neither necessary nor desirable. Many are understandably threatened by financial transparency and disclosure practices that may attract unwanted attention by tax collectors. Unaccountable to outside scrutiny, then, the owner has little incentive to draw sharp distinctions between his personal financial interests and the firm's. As one small business owner acknowledged about the absence of accountability, "Before we had a private equity investor, my Board consisted of two members: me and my mother."

Unburdened by oversight from independent directors or the government, company founders are often skilled at obfuscating financial reality. There is little likelihood that the company has undergone an independent audit or implemented standard accounting practices. As one frustrated financial consultant observed after attempting to value a company in China, "The gymnastics they do with revenues and costs are so impressive that the Beijing Olympics should have added an event especially for accountants." But China is hardly alone when it comes to poor levels of financial reporting and transparency. A fund manager with long experience in Latin America explained, "Our big problem is skeletons in the closet. We conduct due diligence on many great companies, but often they have hidden subsidiaries, offshore sales, and other tax avoidance schemes."

This is not to imply that all emerging market businesses employ shady practices. On the contrary, awareness of the importance of sound corporate governance practices among nonpublic firms has become increasingly prevalent, if not commonplace. Nevertheless, many company owners have little motivation to adopt sound governance policies. Explained one global private equity investor, "Many simply do not have the same perception of good governance as in developed countries. We refer to this as innocent dishonesty."

This resistance to accountability and transparency is likely to evaporate once a company owner learns of the unmistakable correlation between acceptable corporate governance practices and easier, less-costly access to third-party financing. Banks, for example, are more willing to lend once a company adopts standard accounting and financial reporting practices that facilitate their own due diligence and monitoring. Recounting the unanticipated advantage of partnering with a private equity investor, the founder of a successful midsize Brazilian information technology company acknowledged, “Even though our company had been registering annual revenue increases of about 45 percent, we had no experience with corporate governance, nor an understanding of the difference it could make. Once we had a private equity partner, suddenly the same bankers who previously had no interest in our high-tech company were lining up to extend credit, and even IFC was knocking on our door.”

Numerous studies confirm that, in addition to gaining access to new capital providers, once companies decide to become publicly listed, investors are likely to pay a premium for companies with strong corporate governance practices. A survey of publicly listed companies in South Korea, for example, revealed that the shares of firms with strong governance traded at a 160 percent premium compared to poorly governed firms.¹⁶ A study in Brazil generated similar results, confirming that firms listed on the São Paulo stock exchange with the best corporate governance ratings had price-to-earnings ratios 20 percent higher than those with poor ratings.¹⁷ Not surprisingly, the same conclusion has been reached by the independent credit rating firms that include the quality of a company’s corporate governance as a criteria for their ranking. For example, an important determinant of S&P’s credit ratings is their “Corporate Governance Score,” which applies four core principles: fairness, transparency, accountability, and responsibility, when evaluating a firm’s ownership structure, financial stakeholder rights, financial transparency, information disclosure, and Board structure and processes.¹⁸ Moody’s has gone one step further, categorizing companies’ governance practices on a spectrum from “credit strength” to “credit challenge” that could restrain future ratings improvements.¹⁹

Ultimately, from a private equity investor's perspective, the value-creating benefits derived from implementing acceptable corporate governance practices are realized at the very end of the investment cycle: the exit. Whether the sale is to a strategic investor or via an IPO, every private equity investor knows that exit values are heavily influenced by the quality of corporate governance. Strategic buyers take comfort in seeing strong corporate governance policies in a company that they are about to acquire and, as noted above, achievement of an IPO hinges on the company's ability to convincingly demonstrate that it has fully satisfied the listing requirements of the stock exchange. Private equity professionals are endowed with both the expertise and the incentives to work closely with management to achieve this objective.

Better Board, Easier Exit: Transforming Corporate Governance in Chinese Manufacturing²⁰

“Prior to the involvement of the private equity investor, our Board was a mere rubber stamp that provided virtually no meaningful oversight or governance of the enterprise,” acknowledged the CEO of a Chinese flat glass manufacturing company. But with an eye toward an eventual IPO, the CEO and other members of senior management enthusiastically supported the fund manager’s recommendation to dramatically transform the company’s corporate governance standards and practices—especially once it became clear that this was a prerequisite for fulfilling the listing requirements of the Hong Kong Stock Exchange (HKSE). These corporate governance changes included:

- *a new Board of Directors comprising three senior members of management, two representatives from the private equity fund, and three independent directors unrelated to the company; the independent directors had to satisfy qualifications specified by the HKSE;*
- *a new Chairman of the Board;*
- *the creation of new Board committees, including audit, compensation, and compliance, and bylaws stipulating committee responsibilities and reporting requirements;*

- *new bylaws defining Board responsibilities, including a stipulation that Board meetings would be scheduled at approximately one-month intervals;*
- *a requirement that management provide all Board members with monthly financial and operating reports, using a newly created standard format; and*
- *implementation of new accounting standards in order to fully comply with GAAP, and performance of an annual independent audit.*

These major changes were implemented relatively smoothly due to the close, trusting relationship and alignment of interest that was gradually forged between the private equity investors and senior management. One year after the corporate governance changes were in place, the company successfully completed an IPO on the HKSE, raising over US\$20 million in an offering that was eight times oversubscribed. Two years later, reflecting back on the successful transaction, the CEO readily acknowledged the pivotal role of his private equity partner in transforming the company's corporate governance practices and allowing his firm to gain access to crucial additional funding sources.

The environmental sustainability lever

“We are not motivated to focus on the environment simply because it is a ‘nice to have,’ or enhances the company’s reputation. Whatever changes we implement from an environmental perspective have to drive value in the partner company—and they often do.”

—Emerging market private equity investor

Not too many years ago there was widespread skepticism about the correlation between environment-related operating practices and company financial performance. Textbook concepts about how to maximize shareholder value within the mainstream investment community left little room for factors that appeared to be ambiguous and difficult to quantify. It was considered relatively straightforward to measure the progress of post-investment value-creation initiatives by tracking standard financial benchmarks such as revenue growth, better operating margins, and improvements

in EBITDA. Far more difficult to quantify is the contribution to stronger financial performance made by an expenditure of time and resources to upgrading company compliance with internationally accepted environmental and safety standards. Even when concerns about environmental issues began to appear more prominently on investors' radar screens in the mid-2000s, there continued to be confusion and imprecision among both advocates and opponents of environmental principles about how to define, much less measure, the connection between bottom-line performance and environmental practices.

But times change. Just as "corporate governance" gradually transitioned from being a nonsubject to an imperative for many developing country firms and their investors, in the mid-2000s another term rapidly entered the mainstream and gained widespread acceptance as being linked directly to corporate performance: "environmental governance."²¹ Global awareness gained momentum, on the one hand, by headlines around the world reporting the damaging environmental consequences of industries that were subject to lax or nonexistent regulations and willfully ignored environmental regulations. Scandals exposing systemic contamination of everything from rice and baby formula to pharmaceuticals and drinking water began to catch the attention of government officials, development finance institutions, and corporate executives.

If enhanced public scrutiny and severe penalties dispensed by regulators were not motivation enough to change behavior, company owners themselves began to recognize the link between improved environmental best practices and performance. For instance, Walmart, the world's largest retailer, has been striving for years to make its operations more environment friendly, including putting pressure on thousands of companies in its global supply chain that sell products valued at billions of dollars to the company. In addition, influential thought leaders have fueled a change in perception regarding traditional, narrowly defined concepts of shareholder value. McKinsey & Company opined that business managers who hold fast to a short-term perspective on shareholder maximization are likely to neglect less tangible but equally (or more) important opportunities that will enhance company performance over the

long term, such as gaining the trust of customers or investing in equipment that reduces harmful greenhouse emissions.²²

For private equity, the elevation of environmental issues on the value-creating agenda is not solely driven by some lofty, politically correct premise that this is simply “the right thing to do.” “We don’t invest in guilt trips and green businesses just because they’re green,” explained the Managing Partner of one fund. “We’re looking for the intersection of greater efficiency, innovation, and a lesser environmental footprint. By focusing on those areas on a long-term basis, we can achieve attractive risk-adjusted returns that can benchmark with institutional investor expectations for private equity.” In other words, just as with other components of a value-creation strategy, developing an expertise in compliance with environmental best practice is driven by pragmatic considerations of what it takes to strengthen overall company performance, which eventually translates into higher exit values.

Greening Screening: KKR’s Focus on ESG

Emblematic of the seriousness with which private equity investors incorporate ESG into their business, the global private equity firm KKR has an internal template used by all their deal teams to identify and monitor issues within their portfolio companies considered to carry both the greatest environmental and business impact. To develop their customized methodology, labeled the Green Portfolio Approach, the firm solicited advice from a number of environmental advocacy groups, including the Environmental Defense Fund and the National Resource Defense Counsel. The result of this collaborative effort, summarized below, established a disciplined approach that allows the KKR deal teams to identify and address specific environmental issues with each portfolio company with an eye to creating additional firm value.

By late 2013, KKR estimated that the companies participating in its Green Portfolio Program had realized an estimated US\$917 million in cost savings and added revenue, as well as avoided 1.8 million metric tons of greenhouse gas emissions, 19.5 million cubic meters of water, and 4.7 million tons of waste since 2008. Henry Kravis, Co-Chairman and

Co-CEO of KKR noted, “Environmental management has become a core part of KKR’s investment model and is taking root as a new best practice for value creation across the private equity industry.”

Exhibit 3.7 Overview of KKR’s Green Portfolio Approach

GREEN PORTFOLIO APPROACH



Note: KEPA stands for Key Environmental Performance Areas.

Source: EMPEA. “Beyond Standards: Integrating Responsible Investment into Your Portfolio.” *Emerging Markets Private Equity Quarterly Review—Volume VI, Issue 3* (2010).

The importance of adopting environmental best practices becomes evident when viewed at the sector and the company levels. For example, a high priority for poultry producers is waste disposal practices that are environmentally compliant; the owners of forestry companies must focus on sustainable harvesting practices for long-term competitiveness; and power plant operators must prioritize installation of modern equipment to reduce carbon emissions. In each of these sector-specific examples, the firm’s ability to strengthen compliance with widely accepted industry standards has direct consequences for company performance. Other businesses are motivated to upgrade environmental practices as a marketing tool to attract new customers. In Bolivia, for example, a small family-owned company that produces flooring materials from indigenous tropical woods succeeded in expanding its customer base by obtaining a coveted certification from the

internationally recognized Forest Stewardship Council, an indication to customers that all of the firm's wood products complied with rigorous internationally approved environmental standards. Similarly, hotels catering to international tourists aspire to an endorsement from Green Globe, an association that promotes environmentally sustainable tourism.

GPs also are increasingly motivated to pay close attention to ESG standards because their fundraising competitiveness depends on it. In a remarkably short time span this dimension of value creation expertise has become deeply embedded in every LP's due diligence checklist when assessing which emerging markets fund managers will be the beneficiaries of their financial support. According to a 2013 EMPEA survey of LP views on emerging markets private equity, 53 percent of LPs categorized a GP's active management of and reporting on environmental, social, and governance concerns as "important" or "very important."

Particularly in low-income countries, where the vast majority of GPs are heavily dependent on the DFIs as a funding source, attention to ESG is an essential prerequisite. The International Finance Corporation, the largest investor in emerging market private equity funds, uses a rigorous screening process to assess the capability of a fund manager to apply ESG best practices before agreeing to an investment, and then monitors compliance throughout the life of the fund. An IFC representative notes, "Our staff specialists apply an 'Environmental and Social Diagnostic' to a fund's first three deals to ensure compliance with our standards. We then check the fund's portfolio annually to ensure they are continuing to follow our approach to environmental compliance." Other DFIs have followed suit both by screening GPs before agreeing to invest, and by providing ESG toolkits post-investment that they expect their funds to use. As a result, not surprisingly, environmental considerations have become a mainstream component of every private equity investor's skill set. In Africa, for example, where it is a virtual imperative for a private equity fund to attract DFI support in order to operate, it is widely recognized that portfolio companies, encouraged by the DFIs and their private equity partners, are ahead of the curve when it comes to ESG.²³

It also is noteworthy that in sharp contrast to just a few years ago, private equity investors are encountering less pushback from the business owners themselves. They too have begun to exhibit a growing awareness of the correlation between their company's long-term performance, including access to growth capital, and compliance with globally accepted environmental standards. Just as with LPs, they also evaluate prospective private equity partners in part on their demonstrable ESG skill set. Acknowledging this newfound expectation among business owners, one fund manager explained, "We are frequently expected to take an *active* role in identifying possible shortcomings in environmental compliance and working with the portfolio company to rectify them."²⁴

Adding to the pressure exerted on fund managers by LPs and business owners to demonstrate ESG capability as part of their value-creating expertise, virtually all emerging market governments now recognize the centrality of environment friendly practices in promoting private sector development. With strong support and encouragement from international institutions like the World Bank and the United Nations, this governmental awareness has been accompanied by a flood of new domestic environmental regulations.

However, a credible enforcement capability invariably lags far behind in many developing country governments due to a severe shortage of skilled public servants with the technical expertise to monitor and enforce the new laws. But just as a country's inefficient financial sector creates opportunities for astute private equity investors to bridge the funding gap, so too does weak public sector environmental enforcement capability. Private equity investors, working closely with the management of their portfolio companies, have strong incentives to strengthen environmental governance as an integral component of an overall value-creation strategy, regardless of whether local governments are effective enforcers of the law.

Like other aspects of nonfinancial value creation, therefore, environmental expertise has become an important barometer for measuring the relative competitiveness of emerging market private equity fund managers. It is no longer sufficient to pay lip service to the broad goals espoused by environmental advocates. Rather, fund

managers everywhere have had to rethink their own skill requirements and credibly demonstrate an ability to address company- and sector-specific tasks. Both LPs and business owners routinely expect fund managers, regardless of their country or sector focus, to include professionals with the requisite hands-on experience and skills to assess and monitor a portfolio company's willingness and ability to comply with relevant environmental practices, and to assist management in upgrading their capabilities when they are substandard. Some funds now recruit environmental specialists with sector-specific skills (e.g., power plants, mining, agribusiness), and others have even created dedicated teams of specialists who are assigned to work on all deals.

An Environment of Sustainability: Transforming the Environmental Practices of a Tunisian Packaging Manufacturer

TunInvest,²⁵ a well-established middle-market private equity fund focused on North and sub-Saharan Africa, invested in Cogitel, a small family-owned Tunisian manufacturer of flexible packaging in 2006. Soon after closing the investment, the TunInvest team agreed with the management of the portfolio company to undertake a number of new investments and operating practices designed to improve health, safety, and environmental conditions at the company's plants. This focus on environmental sustainability was strongly encouraged by IFC, an LP investor in TunInvest. For Cogitel, IFC provided environmental and sustainability training for relevant company personnel. One consequence of the specialized training was that employees began to view themselves as environmental stakeholders, and they became committed to revolutionizing the sustainability practices of Cogitel.

Examples of the impact on the company's operating efficiency and profitability are summarized in Exhibit 3.8.

In addition to improving operational efficiency and worker safety, Cogitel successfully obtained several international health, safety, and quality assurance certifications, which enabled the company to gain new customers by exporting to European markets. The ISO certifications, for example, allowed the company to more effectively differentiate itself from competitors and build stronger relationships with multinational clients, such as Danone and Coca-Cola.

Exhibit 3.8 Impacts of Environmental and Sustainability Value Creation at Cogitel

Activity	Impact on Revenues, Costs, Savings
Installation of a new device to supply fresh air to employees and extract solvent-laden hot air from the plant	Reduced employee respiratory, liver, and kidney, problems, causing reductions in absenteeism and increases in productivity, more than offsetting the capital cost of the equipment
Introduction of recycling solvents emitted during the accessories cleaning process	75% annual reduction in solvent usage and significant cost savings
New recycling plan for waste products generated from manufacturing processes, such as plastics, paper, and wood	Waste products were collected and sold for recycling, generating additional revenue of more than US\$50,000 annually
Reduction of waste rate (defined by amount of waste as a percentage of production capacity) from 13.8% to 9.8%	Improved margins by an estimated US\$290,000 (roughly 1% of revenues) in 2010

In the five years following TunInvest's investment in Cogitel, the company's revenues doubled and exports increased to 51 percent of total sales. Moreover, TunInvest's success with Cogitel created a positive demonstration effect with their other portfolio companies. Reflecting on the importance of these ESG initiatives, a TunInvest Partner observed, "We use our Cogitel experience in conversations with other investee companies, and we say, 'Look at this Tunisian company making environmental enhancements in difficult operating conditions like yours. If they can do it, you can too.'"

Source: EMPEA and IFC. "The Impact of Private Equity in Emerging Markets: Sustainability Case Study: Cogitel," 2011.

Private equity in emerging markets: A historical perspective

The impact of skilled private equity investors on both flourishing and struggling businesses by introducing and implementing value-creation enhancements cannot be underestimated. As illustrated in this chapter, these professional investors are endowed with a unique combination of expertise and incentives that can dramatically strengthen the competitiveness and profitability

of companies, so long as owners are willing to accept change to their traditional ways of doing business. By providing sector and market expertise, broad industry networks, knowledge of best practices, and an outside perspective—in addition to serving as a source of “patient capital”—private equity can drive transformational results. This nonfinancial value creation expertise is scarce in emerging markets, and has proven to be especially invaluable when applied to growth-oriented small and medium-sized firms that are critically important drivers of a country’s overall private sector performance. As explained by a senior IFC official with deep private equity experience, “We know extensive knowledge transfer is taking place even though you can’t always measure it.”

Since its beginnings as an obscure, rarely used investment vehicle in emerging markets more than a quarter-century ago, private equity has benefited from a slow but growing recognition among all stakeholders that it has the potential to make a significant contribution to company performance, and in turn, a country’s overall economic growth and development. But since the first generation of emerging market private equity funds ventured into this new territory, the road traveled has been far from straight and smooth. The next chapter traces the uneven evolution of the asset class from its genesis in the 1990s to the seminal events surrounding the 2008–2009 global financial crisis. Chapter 5 will then examine the asset class’s more recent history, with an emphasis on important lessons learned by all the stakeholders as the industry has begun to mature.

4

Private Equity Performance before the Global Financial Crisis

Our private equity business was focused exclusively on the United States and a handful of Western European markets, and that model had served us very well. However, by the mid-1990s it was becoming increasingly clear that we needed to think through a strategy that would enable us to tap into a number of new, high-growth markets, such as China and India. But we had no experience in these countries, knew very little about the local business cultures, and our contacts on the ground were limited. It was quite a daunting undertaking.

—Global private equity fund manager

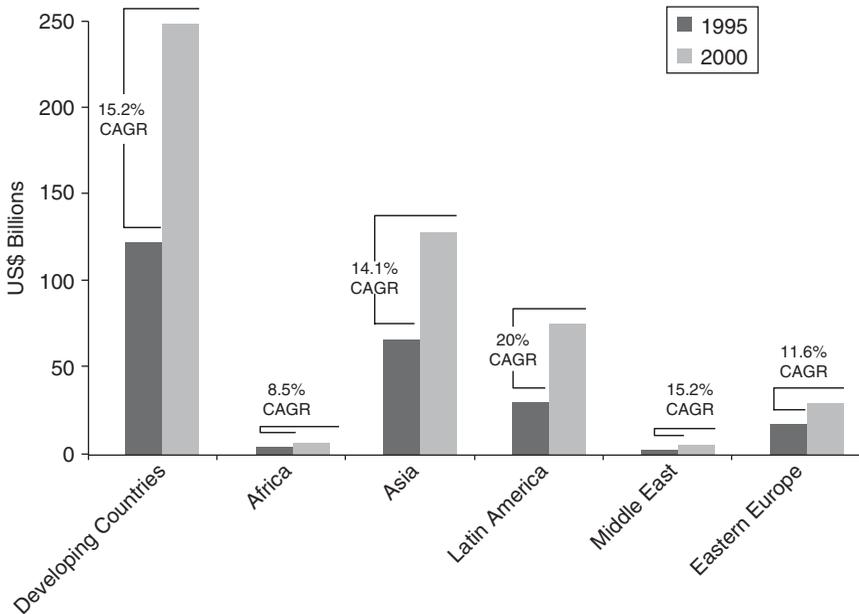
The 1990s: The genesis of emerging markets private equity¹

By the 1990s, a global consensus had emerged among policymakers, development finance specialists, and academics that the private sector, rather than the state, should be the primary catalyst for economic growth and development. A number of encouraging events had begun to unfold across many emerging markets: the 1980s debt crisis that had crippled the growth prospects of so many middle-income countries, particularly in Latin America, was largely resolved; the November 1989 crumbling of the Berlin Wall had led to the sudden opening of an entirely new group of countries that were enthusiastically embracing a transition to capitalism; privatization of state-owned enterprises was becoming a high

priority for many countries; and leaders such as Deng Xiaoping in China and Manmohan Singh in India had begun the process of opening up their countries to foreign trade and investment. It seemed that in every region of the developing world a new, more receptive attitude toward private investors, both domestic and foreign, was in full swing.

With growth beginning to pick up, inflation and interest rates declining, and political and regulatory regimes gradually shifting in favor of open markets and lower barriers to competition, investors began to sense newfound opportunities in emerging markets. From 1995 to 2000, the amount of annual foreign direct investment (FDI) targeted at developing countries nearly doubled from US\$122.4 billion to US\$248.3 billion, growing at a compound annual growth rate (CAGR) of 15 percent.² At the regional level, FDI increased at a CAGR of 14 percent in Asia, 12 percent in Eastern Europe, and 20 percent in Latin America (see Exhibit 4.1).

Exhibit 4.1 Foreign Direct Investment in Developing Countries, 1995–2000 (US\$ Billions)



Source: International Monetary Fund, 2003.

While this influx of funds was a welcome development for a number of emerging markets, the capital was not necessarily trickling down to each country's most productive companies. Several governments were heavily dependent on domestic savings to finance public sector deficits, crowding out access to capital by most private firms. Those that did benefit from the surge in FDI were primarily a handful of the largest, most well-established domestic firms in each market. Conversely, the other 95 percent or so of private companies were not participating in the investment boom, largely because little progress had been achieved in strengthening domestic financial sectors. Raising capital through public securities markets or banks continued to be off-limits to all but the very largest, most creditworthy corporate clients, and there was little evidence of government policy shifts that would encourage private providers of medium- and long-term capital to go "down market" to address the financing needs of other firms, including the burgeoning number of small- and medium-sized companies operating in these economies.

Against this backdrop, the potential of private equity in emerging markets looked promising. The number of companies in critical need of capital that were operating in an increasingly favorable macroeconomic environment appeared to present a tailor-made opportunity for savvy private equity investors. If financing patterns continued to be heavily biased in favor of a small number of large firms, and everyone agreed that something had to be done to bridge the financing gap persisting for the rest of the private sector, who better to fill the void? After all, private equity investors were in for the long haul and would not head for the exits at the first sign of crisis. Moreover, they were less reluctant than more conventional suppliers of capital, such as commercial bankers, to take the risks associated with companies that were smaller and less well established. These ingredients appeared to validate the premise that demand for private equity financing would be strong, governments would be receptive, and skilled investors with the expertise needed to create significant value in their portfolio companies would have opportunities to make attractive returns.

Although still a relatively nascent industry, private equity appeared poised to offer many attractive advantages to both the

providers and users of capital. On the supply side of the equation, a new generation of Western fund managers, buoyed by the track records they had achieved in the United States and Western Europe, began to recognize the opportunities created by these severe capital shortages in many emerging markets, which implied low valuations for the expanding number of companies hoping to raise capital, and hence an opportunity to generate substantial profits.

Many of these fund managers' prospective LPs were equally optimistic. Flush with funds due to the booming performance of global financial markets during the mid- to late 1990s, many of these investors were willing to allocate a percentage of their gains to emerging markets, encouraged by the improving macroeconomic conditions, the new receptivity of governments to foreign investors, the diversification benefits to their portfolios, and, most importantly, the prospects of earning high returns commensurate with the risks associated with these countries. As with many GPs, their calculus about emerging markets private equity was also influenced by growing concerns that in Western markets too much money was chasing too few attractive deals, driving valuations to unacceptably high levels. The time had come, many investors believed, to look further afield for new opportunities.

With so many factors pointing in a favorable direction, the number of emerging market private equity funds proliferated. By the end of 1999, more than 100 funds were investing in Latin America, where virtually none had existed earlier in the decade. Between 1992 and 1997 the amount of new capital raised for private equity in the region increased by a compound annual growth rate of 114 percent, from just over US\$100 million to over US\$5 billion. In Asia, the numbers were even larger and growth more dramatic, with about 500 funds raising more than US\$50 billion in new capital between 1992 and 1999.³ Following the sudden collapse of the former Soviet Union and the emergence of 15 new republics in Central and Eastern Europe in the early 1990s, private equity growth in these transition economies also began to take hold. Although the volume of private equity investing was small compared to the total flow of direct foreign investment, the high growth rates pointed to an encouraging future for an asset class that had barely existed a few years earlier.

During these early years most of the GPs were headquartered in developed countries, primarily the United States. Amid the encouraging signs of rapid growth, most of these fund managers seemed to ignore the reality that, as discussed in chapter 2, conditions in developing countries were vastly different from their experiences as investors in the West. In their minds, the analytical skills required to find the right opportunities through good market intelligence, networking and word of mouth were the same, as was the step-by-step process of “doing a deal,” from conducting due diligence and building financial models that would forecast future company performance and value ranges, to negotiating with entrepreneurs and preparing the necessary documentation needed to close the deal. They also assumed that the similarities would carry over to the post-investment phase, allowing them to forge effective working relationships with company owners to build value and lay the foundations for a profitable exit within a reasonable time period. As discussed later in this chapter, these blanket assumptions proved ill-founded.

The indispensable role of the DFIs

This early surge of private equity activity was facilitated by the support of a small number of DFIs with a mandate to promote private sector development. Recognizing the broader impact that private equity could have on developing countries via the transfer of both capital and expertise, these organizations were among the first movers to back private equity funds in emerging markets.

Bilaterally, for example, in the United States, the Overseas Private Investment Corporation (OPIC) and the United States Agency for International Development (USAID) became actively involved as direct investors in private equity funds that targeted specific countries and regions, and additionally created incentives designed to encourage other institutional investors to allocate capital to private equity funds. OPIC, for example, pioneered the concept of debt-leveraged private equity funds that were designed to attract LP investors by leveraging their equity investment with OPIC-backed debt financing. Meanwhile, in 1999, USAID established the Development Credit Authority in order to mobilize local private

financing sources—including private equity—by guaranteeing 50 percent of each investment in a local business. Both of these innovative initiatives induced private investors to allocate a portion of their capital to an asset class that previously had been off-limits.⁴

A number of the multilateral DFIs took a different tack. Rather than guaranteeing some of the private investors' downside risk, they took a more direct approach by becoming LPs in carefully selected country and region-specific private equity funds. These were a handful of pioneering DFIs with an explicit mandate to provide both financing and technical assistance for private companies in developing countries, such as IFC (the private sector arm of the World Bank),⁵ the European Bank for Reconstruction and Development (EBRD),⁶ and the United Kingdom's Commonwealth Development Corporation (CDC). Gradually, as private equity began to gain traction, other DFIs also became more actively involved, such as the African Development Bank, the Asian Development Bank, Germany's Investitions- und Entwicklungsgesellschaft (DEG), the European Investment Bank, Export Development Canada, FMO of the Netherlands, France's PROPARCO, and the Development Bank of Southern Africa.

This flurry of activity was evidence of a surprising turnaround by the development finance community. Whereas "private equity" was not even in the DFI lexicon in the early 1990s, by the end of the decade, organizations like the IFC and the EBRD had created entire departments dedicated to promoting the asset class. By 1998, they had committed about US\$15 billion to some 220 emerging market private equity funds,⁷ sending a strong positive signal to other potential investors.

In these early years, when most private investors were still hesitant to commit capital to countries with unfamiliar local conditions and unknown risk/return trade-offs, this DFI role was pivotal. Given the DFIs' well-deserved reputation for conducting exhaustive due diligence, their investment in a fund would often make the difference on whether other private sector LPs were willing to participate. As one fund manager reflected at the time, "IFC is highly prestigious, and having them as an investor in our fund provided important assurance to other LP investors."

It is no exaggeration to claim that the private equity industry in emerging markets would not be where it is today without the leadership and support of the DFI community. Although often criticized for slow, cumbersome bureaucratic procedures, the DFIs have played a crucial role in nearly every emerging market region—from supporting the fund managers with capital to offering guidance on various operational concerns, such as implementing broader environmental, social, and governance initiatives. Their participation, especially during this early period, also attracted the attention of commercial LPs that otherwise would have shied away from developing countries. They additionally provided support to local, regional, and global associations that were beginning to promote the asset class, and served as a credible advocate with developing country governments and regulators that had little familiarity with this underutilized private sector financing tool.

Although the DFIs' role, especially in poorer countries, is widely viewed as indispensable, GPs that are the beneficiaries of these organizations' funding almost universally view the experience as a double-edged sword. On the one hand, especially for small and midsize funds, these sources of funding have proven to be critically important because they also serve as a "Good Housekeeping Seal of Approval" that is needed to attract other DFIs and commercial LPs. But on the other, it is the rare GP who does not voice strenuous frustration about exceedingly bureaucratic procedures in these organizations, which invariably cause long, costly fundraising delays. Reflecting the views of many DFI-supported fund managers, one exasperated GP summed up his experience: "We can't survive without the DFIs, but working with them is an absolute nightmare."

International Finance Corporation: The Transition from Undisciplined Private Equity Investor to Indispensable LP

IFC, established in 1956 as the World Bank's "private sector investing arm," was the first development finance institution with an explicit

mandate to provide financing and technical assistance directly to private companies rather than government projects. Long before becoming involved in private equity in the early 1990s, IFC was by far the largest and most experienced DFI focused on private sector development. Although initially permitted to serve only as a creditor, IFC in the 1980s became in effect the very first emerging market private equity investor when it was granted authority to make equity investments in developing country businesses. This experience making equity investments in the first decades of IFC's existence provided a solid institutional foundation for the next step in its evolution.

IFC's exposure to private equity first gained momentum in the early 1990s with a series of investments as an LP in some first-generation regional emerging market funds. These early capital commitments, however, were carried out in an uncoordinated fashion by IFC's 12 geographic investment departments, each with its own priorities and investment criteria. As one former staff member recalled, investing in private equity funds during this early period was considered by many investment officers as an expedient way to disburse funds and enhance their reputations:

All you needed was a guy to come in and say, 'I am a great person to set up a fund in country X—I just need IFC to provide the seed capital.' This was viewed as an opportunity to get US\$20 million out the door with almost no due diligence because we were investing in a blind pool, and people in the various investment departments started doing these deals right and left. We called it the Christmas tree and the funds were known as 'stocking stuffers'—you could hang them on the tree and make it look beautiful while not having to do much work.

Not surprisingly, these first-time funds badly underperformed, both in absolute terms and relative to IFC's portfolio of direct investments in individual companies. These disappointing early results fomented a vigorous internal debate about the advisability of the Corporation devoting any attention and resources to private equity. Nevertheless, IFC's management eventually decided to revamp its strategy by creating a new centralized department to take responsibility for overseeing existing and future private equity investments, and in 2000 the Private Equity and Investment Funds Group was born. Reflecting on the early internal struggle to recognize private equity as an integral component of IFC's mandate, one senior member of the new department, noted,

In 2000, our group was launched; we had US\$1 billion of investments in 100 funds across the emerging markets. The first thing we had to do was organize the files, which the staff referred to as the compost heap. The legal documents were a mess—we were missing LPAs, subscription agreements, histories on capital calls, etc. We spent the first year creating a filing system and organizing the documents for each fund.

During these initial years, the new department dramatically overhauled IFC's private equity practice in an effort to improve the performance of both its existing portfolio and new fund investments. For example, it focused on enhancing due diligence efforts by tracking, measuring, and rating funds and fund managers; strengthening shareholder agreements with its GPs by establishing an Ideal Term Sheet to ensure Corporation-wide consistency; and creating a standardized approach to assessing the private equity environment within industries in different countries.

Gradually, the new strategy succeeded in reversing the disorder that had marked its approach in the 1990s, and IFC became widely recognized for its catalytic role in growing the asset class. Between 2000 and 2013, IFC invested over US\$2.7 billion in 153 private equity funds, which in turn supported over 1,100 businesses that have created an average of 584 jobs per company.⁸ In addition, there is the harder-to-quantify but equally important knowledge transfer taking place, especially in countries that are off the radar screen for most investors. For example, the bulk of IFC's investments are directed toward frontier markets that many LPs consider too risky and, as a result, attract little private equity activity.⁹ The results of this ramped-up focus on private equity are reflected in IFC's impressive financial performance: during the 13-year period beginning in 2000, the portfolio registered an average internal rate of return of 18.3 percent, with returns from its "first-time-manager" funds averaging 24 percent.

The late 1990s and early 2000s: unmet expectations and a predictable retreat

A shroud of secrecy surrounds the performance of individual GPs, largely because traditionally they have not been subject to the same legal disclosure requirements as publicly traded securities.¹⁰ In fact, virtually no verifiable performance data exists regarding

the first generation of private equity investing in emerging markets. Nevertheless, the highly efficient financial industry grapevine ensures that few secrets endure for long, and once revealed, the well-known herd mentality takes over as investors sprint in unison in one direction or another. And so it was with emerging markets private equity.

Even without legal disclosure requirements, anecdotal evidence began to trickle out, indicating that exits were taking much longer to materialize than fund managers had initially forecast with unbridled optimism when marketing their new funds to LPs, and the returns were disappointing. For example, a 2003 survey of 227 Latin American private equity investments that occurred between 1995 and mid-2000 indicated that only 15 investments, a meager 7 percent of the total, had achieved an exit. Although the volume of private equity investing in Asia during this period was larger, the exit performance was equally discouraging. As these returns became known, investors rightly concluded that, contrary to expectations, they were not realizing a premium for the higher risk levels associated with emerging markets.

The enthusiasm among LPs for the fledgling asset class evaporated almost as quickly as it had materialized a few short years earlier. In Latin America, for example, the anemic US\$417 million raised by private equity funds in 2003 was the lowest level since 1995, when the industry had first begun to take off. In the same year, Central and Eastern Europe and the Commonwealth of Independent States including Russia attracted only US\$406 million, and Emerging Asia saw only US\$2.2 billion in new fundraising, fractions of what had been raised a few years earlier.¹¹ Reflecting the pervasive sentiment of the time, one disenchanted fund manager lamented, "After three or four years of lousy returns in Asia, Latin America, and Russia, it's going to be very difficult to attract new money. Investors do not have any high-profile role models of consistently successful funds to demonstrate that this type of investing works well. The publicity is bad, and it is getting worse." LPs who earlier had embraced the new asset class echoed this pessimistic assessment. "Basically, we don't want to increase our exposure to emerging markets," explained one bruised investor, "and only when money starts coming back will we reinvest."

Perhaps no investor group was more frustrated and disappointed by the sudden downturn than the DFIs that had played such a catalytic role in promoting the first generation of emerging market private equity funds. Although they were as secretive about financial returns as their private sector counterparts, an IFC official acknowledged that cumulative returns on its private equity portfolio were in single digits in the late 1990s, and descended into negative territory between 2000 and 2003.¹² As a result, some senior decision-makers began to ask whether the DFIs should withdraw altogether from financing private equity funds, and concentrate exclusively on their more traditional investment activities, providing debt and equity financing directly to firms on a case-by-case basis. Although the internal debate continued at IFC as well as some other discouraged DFIs, eventually they concluded that if they retreated, the effect on the nascent asset class would be devastating. After all, if they were unwilling to take the risk, why should any private investor?

Explaining the poor performance of the first-generation funds

In hindsight, the lofty investor expectations for high returns in the early years were as unrealistic as were their hasty judgments a few years later that the asset class had no future. Most first-generation funds had been in business for only three or four years before the “I told you so” pessimism set in, far too short a time frame to reach definitive judgments, especially for institutional investors. As noted in chapter 1, private equity is a long-term, illiquid asset class, with realizations often not generated until several years after commitments have been made. Even in the United States, private equity funds typically have a lifespan of ten years and are unlikely to generate positive returns until about five years into the investment cycle.

In addition to unrealistic expectations about the timing and the level of returns, the doom and gloom were compounded by the unenviable burden of comparison between these first-generation emerging market funds and their US and European counterparts at a time when macroeconomic conditions in developed countries were fueling exceptionally high returns. In 1999 and 2000, for example, one year rolling returns on the US private equity fund

index were 18.09 percent and 38.82 percent,¹³ respectively. Even public equity markets were booming amid what Federal Reserve Chairman Alan Greenspan famously referred to a few years later as “irrational exuberance,” with the Dow Jones Industrial Average soaring from 9,350 points in January 1999 to 11,720 points one year later, just before the dot-com bubble burst.

The likelihood of acceptable emerging market returns was further torpedoed by a string of unprecedented, globally contagious financial crises that erupted one after another during this period, which further undermined investor confidence in emerging market risk. As mentioned in chapter 2, in the summer of 1997 the so-called Asian miracle¹⁴ came to a surprisingly abrupt halt with a series of precipitous currency devaluations that caused devastating declines in economic performance. Starting with the Thai Baht in July, the contagion quickly spread to the South Korean Won, the Malaysian Ringgit, the Indonesian Rupiah, and a number of other Asian currencies that had registered some of the fastest economic growth rates in the developing world for more than a decade. Many of these currencies suffered devaluations of 40 percent or more before the end of the year. Predictably, private foreign investors headed in unison for the exits, further fueling the currency declines, but due to the illiquidity factor, private equity investors were the exception to this mass exodus, and were severely affected by the plummeting value of their portfolio companies and the sudden evaporation of exit opportunities.

Investors everywhere were caught by surprise when the fallout from the Asian crisis quickly spread, leaving private equity professionals in Latin America and other regions reeling from the unanticipated consequences of events that had occurred halfway around the globe. A year later, investors were again caught unawares on August 26, 1998, when the Russian government defaulted on its short-term debt obligations and the Ruble’s value plummeted 38 percent in one day. Although Russia’s problems were largely unrelated to the economic prospects of other countries, investors acted as if this were part of a larger pattern, and their retreat from emerging markets accelerated. Finally, as if to confirm investors’ worst fears, a few months later, in January 1999, Brazil, the largest country in Latin America, was forced to abandon its currency peg

to the US dollar, resulting in an almost 300 percent decline in its value, plunging the country into a financial crisis. As in Asia, the crisis spread rapidly throughout the region, impacting Argentina, Bolivia, Ecuador, Uruguay, and Chile, among other countries.

Although the poor performance of emerging market private equity funds during this early period could rightfully be attributed in part to exogenous macroeconomic events beyond the control of individual investors, other factors also played a role. Most importantly, the new breed of private equity funds targeting developing countries was primarily a clone of their US predecessor, driven by the assumption that the mechanics and skills required to invest in emerging markets were more or less the same as those needed in developed countries. The approach taken, therefore, was strikingly similar in terms of the fundraising strategy, organizational structure, staffing, and exit expectations of the fund. Most funds, headquartered in the United States or the United Kingdom, recruited professionals from large international investment banks who had backgrounds and skills that equipped them to assess risk and do deals primarily in developed countries. They had minimal experience, however, with the hands-on post-investment value creation tasks that were critical to private equity success in developing countries. In addition, funds believed they could generate returns through US-style IPO exits. As one veteran emerging market investor acknowledged, "The idea was to adapt the U.S. venture capital model to promote private sector development in these countries." Highly experienced Western private equity practitioners assumed that they could take this well-proven structure, perhaps tinker about the edges to account for emerging market differences, and the results would be either the same or better. As time passed, it became increasingly apparent that these basic assumptions would prove to be the Achilles heel for the new industry.

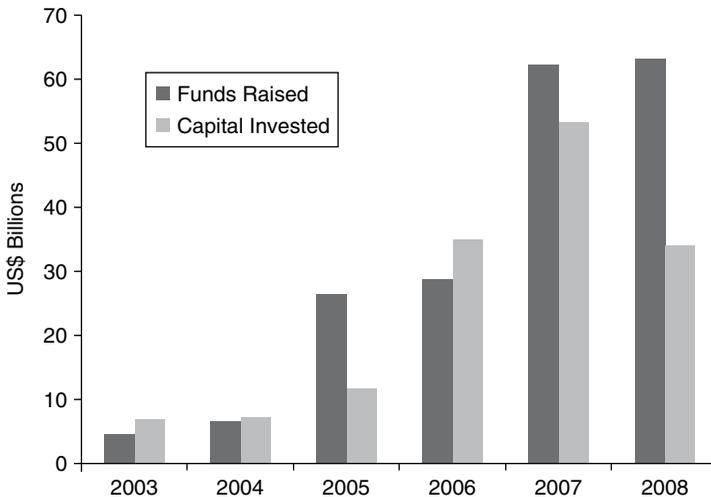
Notwithstanding decades of investment experience in developing countries, even the DFIs specializing in private investment, such as IFC and the EBRD, adhered closely to the Western private equity model. Reflecting on the private equity lessons learned during this early period, one senior IFC official commented, "We relied almost exclusively on Western fund managers, but their prior experience as investment bankers or running funds in their home country

did not translate well to emerging markets. Moreover, the most well-known and successful Western private equity brand names counted for little when they went to emerging markets where they had limited or no experience.”

The mid-2000s: recovery and growth

Mark Twain famously remarked after reading of his demise in a London newspaper, “Reports of my death are greatly exaggerated.” Similarly, after emerging markets private equity had been discredited and written off by many investors, the asset class defied its detractors and began a remarkable and unexpected recovery in 2003. As demonstrated in Exhibit 4.2, total private equity fundraising for emerging markets increased over 1,300 percent between 2003 and 2008, from US\$4.6 billion to almost US\$63 billion, and the amounts invested subsequently soared. What had once subsisted primarily as a DFI-backed experiment with subpar performance was transformed in a few short years into a credible commercial asset class attracting a broad range of well-established, sophisticated institutional investors from around the world.

Exhibit 4.2 Emerging Markets Private Equity Fundraising and Investment, 2003–2008 (US\$ Billions)



Source: EMPEA.

Not only did emerging market private equity activity soar in absolute terms but it also grew relative to total private capital flows to developing countries. Between 2003 and 2008, for example, private equity fundraising increased annually at an average rate of 94 percent compared to 57 percent for total net private capital flows during the same period. Moreover, although private equity investing represented a relatively small portion of total private capital flowing to developing countries, each year it accounted for a larger slice of the pie, increasing from 4 percent in 2003, to 17.6 percent in 2006 and 43.7 percent in 2008.¹⁵

Although not all regions benefited equally from this resurgence, an increasingly diverse range of developing countries attracted larger capital inflows. Emerging Asia's relative dominance was driven by a combination of outsized populations, rapidly expanding middle classes with disposable income, and exceptionally rapid economic growth, especially in China and India. But equally noteworthy, between 2005 and 2008, fundraising increased almost threefold in Latin America and the Middle East, and by more than 400 percent in sub-Saharan Africa. This represented a startling turnaround from the discouraging performance witnessed earlier in the decade.

The resurgence also spread geographically beyond a handful of very large emerging market countries. In the early years of the millennium, only the BRIC countries—with a combined population of about 2.7 billion—and South Africa were considered sufficiently attractive to support country-specific private equity funds. By 2008, however, single-country funds began to proliferate in such markets as Thailand, Cambodia, Morocco, Vietnam, Poland, Egypt, Kazakhstan, Peru, Nigeria, and Mexico, and each year the number increased.

Even more significant than this sharp reversal of fortune in terms of fundraising and investment was the encouraging change in the one metric that matters most to investors: financial returns. After the abysmal early performance that drove most investors to the sidelines, in 2007 and 2008, returns finally started to meet—and in some cases exceed—investor expectations. As Exhibit 4.3 demonstrates, emerging market private equity results were outpacing the performance of US public equities and, for the first time, were

Exhibit 4.3 Emerging Market vs. US and Europe Average Returns (as of end-September 2008)

Index	1-year	3-year	5-year	10-year
Global Emerging Markets PE & VC	(6.9)	14.4	17.0	7.0
Latin America & Caribbean PE	6.7	21.8	18.5	1.1
Asia/Pacific Emerging Markets PE	(10.3)	13.0	15.7	7.3
Europe Emerging PE	(4.6)	31.7	37.1	18.8
MSCI Emerging Markets Index	(33.0)	8.7	19.0	14.8
US VC	(1.1)	9.7	9.9	36.7
US PE	(6.3)	13.1	18.8	12.8
Europe Developed	(13.0)	29.3	29.7	21.4
S&P 500	(22.0)	0.2	5.2	3.1

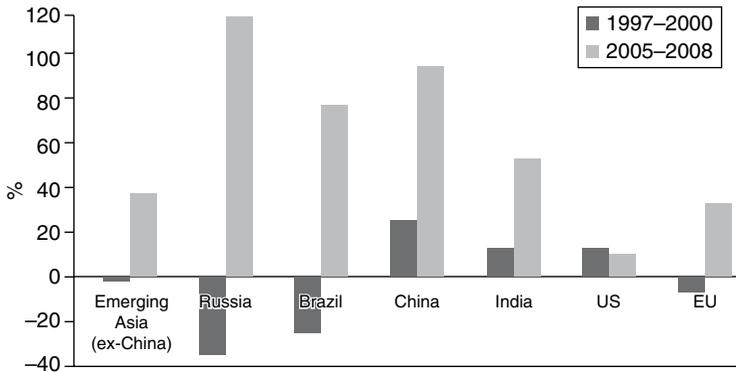
Source: Cambridge Associates LLC Private Investments Database. Data as of Q4 2013 for the period ending September 30, 2008; pooled end-to-end returns, net of fees, expenses and carried interest.

competitive with private equity returns generated in Europe and the United States. For example, five-year net returns for emerging market private equity and venture capital funds in late 2008 were 17 percent, compared to 18.8 percent for private equity funds in the United States and 5.2 percent for the S&P 500 Index.

Explaining the turnaround: what changed?

Just as the disappointing performance during the industry's start-up years stemmed from a complex combination of both exogenous factors and miscalculations by overly optimistic and inexperienced private equity practitioners, the dramatic recovery that began in 2004 could also be traced to a confluence of external events and internal adjustments by the key stakeholders. Perhaps most importantly, many of the emerging markets that had been hard hit throughout the financial crises of the late 1990s entered a period of sustained economic growth, propelled partly by internal reforms favorable to private sector activity. Russia rebounded beyond all expectations from the disastrous consequences of its 1998 sovereign

Exhibit 4.4 GDP Growth Rates, 1997–2000 and 2005–2008



Source: The World Bank: World Development Indicators, April 2014.

debt default; Brazil entered a period of sustained economic growth and currency stability that continued for more than ten years; and, the two largest countries of all, China and India, were generating annual economic growth rates as much as three times the pace being achieved in developed countries.

Along with investor-friendly government-led reforms, many emerging markets were beginning to take advantage of their competitive strengths, including a lower cost manufacturing base and rising demand for oil and other natural resources and commodities. These markets also began to capitalize on inherent positive demographic trends, including younger and growing workforces, and as economic growth rates accelerated, so did the size of middle-class populations with higher income levels. Indicative of this strong economic performance, the share of global GDP generated by emerging markets steadily increased from 15.9 percent in 1999 to 23.5 percent ten years later.¹⁶

Global liquidity was also expanding during this period due in part to low interest rates in developed countries and an increase in foreign exchange reserves and domestic liquidity in several emerging markets. In August 2005, *The Economist* reported that “global liquidity has expanded at its fastest pace for three decades.” As a result, the age-old maxim of “too much money chasing too few deals” benefited emerging markets. As the volume of capital seeking investment opportunities in relatively low-risk developed country

environments began to outpace the availability of attractive deal flow, competition intensified—especially among large buyout firms—and valuations became inflated. As a result, investors were willing to explore opportunities further afield just at a time when many developing countries were performing better than ever.

But strong macroeconomic performance in many developing countries and expanding global liquidity were not the only explanations for the dramatic private equity rebound. Even though capital flows to emerging markets increased rapidly across the board during this period, private equity investing grew at a far faster pace than other asset classes. Nor could the turnaround be attributed primarily to the magnitude of the emerging market financing gap affecting a broad swath of growth-oriented small- and medium-sized companies, as this was hardly a new phenomenon. Instead, there were clear signs that the embryonic industry was beginning to gradually mature, similar to the path taken in the country where it started.

As discussed in chapter 2, the private equity industry in the United States evolved in fits and starts over a 40- to 50-year period, successively learning from and building upon the mistakes made in prior fund cycles. This historical perspective is critical to understanding the gradual evolution of the industry in developing countries. Specifically, fund managers had begun to move rapidly up the learning curve, correcting many of the errors committed by first-generation GPs. They began to recognize that the US venture capital model did not work well in emerging markets and therefore they needed a fundamentally different approach. At the same time, company owners were gradually shedding their distrust of “outsiders,” recognizing the financial and nonfinancial benefits offered by a private equity investor. Finally, some domestic policymakers were beginning to take notice of the potential of this neglected financing tool and started to craft government policies to encourage rather than deter private equity investors.

Building off the lessons learned from earlier missteps, private equity investors began to align their business model more closely to emerging market realities, starting with a belated acknowledgment of the imperative of establishing a permanent local presence. Just as a vibrant venture capital presence mushroomed along Silicon Valley’s Sand Hill Road in response to the proliferation of a cluster of new technology clients located there, many fund

managers began to expand their base of operations from New York and London to the countries in which they invested in order to be closer to their clients.

Although not everyone reacted in lockstep, a local presence became increasingly recognized as essential in order to effectively generate market intelligence about the competitive landscape, understand the nuances of the local regulatory environment, investigate new investment opportunities, conduct due diligence, and maintain ongoing direct involvement with portfolio companies. As one fund manager commented, "We will no longer do an investment in a country where we do not have permanent eyes and ears on the ground." By 2008, for example, a survey revealed that 125 of 127 private equity funds investing in Brazil maintained an office in-country.¹⁷

An additional motive for establishing a local presence was the economics of doing business. Even in Africa, where private equity activity was negligible compared to other emerging market regions, the logic was compelling: "Execution and post-deal engagement costs in Africa are still relatively high," explained one GP. "While many investors choose to locate in London and partner with African companies, this model is unlikely to attract funding in the future. The need to find a cost-effective way of keeping 'boots on the ground' through leveraging flexible operating models and local networks is becoming more vital than ever."¹⁸

An obvious accompaniment to this newfound commitment to "go local" was a different recruitment strategy. "We need people who live there," explained one fund manager operating in Brazil, "people who have the passport, and are committed to the community. That is the only way we will gain the critical sixth sense about what is going on, where are the good deals, and who are the people we want to work with." In-country offices began to proliferate, and new investment teams were recruited that had the analytical skill set and sensitivity to be effective in environments that bore little resemblance to "back home."

Over time, these local offices would be staffed by fewer foreign nationals and more local professionals who could understand and cope with the nuances of the local business culture, speak the language, and network effectively with local business elites and government officials. Fortunately, the rapid growth of private equity fundraising and investment was attracting an expanding pool of

talented professionals who were born and raised across the emerging markets. Although many had been educated in Western universities and worked initially for developed country financial institutions and companies, they were keen to return home and capitalize on opportunities created by the nascent private equity boom.

But it was not only Western fund managers who were turning to local professionals. In contrast to the first generation of emerging market funds in the 1990s that were staffed primarily by professionals from the United States and Western Europe, the competitive landscape changed dramatically during the following decade. As explained by one Western LP, “The ‘localization’ of the industry over the past decade—including more local GPs, portfolio company managers and institutional investors—has been a big step in the maturation process of the ecosystem.”¹⁹ The significance of this trend was reinforced by an emerging markets private equity investors’ survey conducted in 2009 that noted, “There is a broad consensus of opinion among GPs that domestic players will be the dominant investor type in the medium term.”²⁰

A second key driver contributing to the resurgence was the dramatic transformation in the attitudes and behavior of the potential recipients of private equity investments in emerging markets. As discussed in chapter 3, success breeds success, and a positive demonstration effect spread among business owners who began to take notice of the mounting numbers of firms that were gaining access to this expanding pool of capital. The stereotype of the founder of a family-owned company, resistant to change and wary of any interference in traditional business practices by third-party providers of capital, began to crumble as word spread about private equity success stories. “Even the owners of fairly small companies are becoming more receptive to outsiders,” explained one fund manager in Latin America, “and increasingly they recognize the value of professionalizing corporate governance, transparency, accounting, etc. In the old days, a business owner was ridiculed if he actively sought outside help. Now it’s the opposite—to attract a private equity investor is a sign of great prestige and status.”

Private equity also began to catch the attention of local government officials in some countries, as they started to recognize the potential benefits of encouraging the development of the asset class. It became apparent that rapidly growing local companies that had

partnered with private equity investors often created additional jobs, improved worker productivity, complied with environmental best practices, and generated higher tax revenues. In many countries, regulators began to implement policies that reduced barriers for foreign fund managers to invest in local companies. One LP who had retreated to the sidelines after large emerging market private equity losses in the earlier period commented, “Liberalization policies in countries like Brazil, China, and India were as important as any other factor in igniting higher quality deal flow.”

A handful of policymakers also began to rethink policies that restricted the ability of local institutional investors, such as pension funds, to allocate a portion of their assets to alternative investments like private equity. Just as the regulatory shift in the “prudent man” rule had catalyzed the growth of private equity in the United States, some emerging market governments started down a similar path. For example, in the early 1990s, Chile was a pioneer in liberalizing regulations to encourage higher levels of local investor participation by permitting pension funds to invest in local GPs, while in 1997 the Brazilian government also began to allow pension funds to invest in domestic private equity funds.

Meanwhile, the DFIs continued to be a key factor in spurring the growth of the asset class, especially in so-called frontier markets where private equity activity lagged far behind the larger emerging market countries. They, too, had learned valuable lessons. “For one thing, we got smarter,” explained an IFC staff member. “We learned a lot from our unfortunate mistakes during the first phase of investing in the 1990s.” This included, for example, a far more rigorous process of due diligence on prospective emerging market fund managers and more post-investment monitoring of fund performance. As important as the capital injections themselves, or perhaps more so, the renewed interest in private equity by these private sector-oriented DFIs had an enormously catalytic effect on attracting other LPs.

CDC Group: Catalyzing an Industry²¹

Wholly owned by the UK government's Department for International Development (DFID), CDC Group is widely regarded as the world's oldest development finance institution. CDC was established in 1948 as a

statutory organization with a mission to “do good without losing money.” While its portfolio through the first several decades of its existence was primarily dominated by loans, the organization’s philosophy changed in the mid-1990s with the appointment of Dr. Roy Reynolds as Chief Executive. Reynolds was an advocate for private equity, believing that good management and value creation were as important as investing capital. By focusing more on private equity, he believed, CDC could achieve both a high development impact as well as strong returns.

In the early 2000s, CDC initiated a number of additional strategic changes, including the decision to spin off the ownership and management of its private equity portfolio, by creating two new companies: Aureos Capital and Actis. Aureos, with additional financial backing from the Norwegian development finance organization Norfund, took over the management of CDC’s private equity country-focused funds that were primarily targeting SMEs, while Actis spun off from CDC and assumed responsibility for all the remaining private equity investments in its portfolio, as well as a number of regional-specific funds. Once Aureos and Actis were separated from CDC, they were incentivized to diversify their sources of capital for any follow-on funds, while CDC also diversified by investing into other fund managers. The combination of these initiatives had a catalytic effect on private equity investment in emerging markets.

As of the end of 2012, CDC’s portfolio was valued at over US\$3.6 billion, and included 1,250 investee businesses. While the organization invested primarily in private equity funds up until 2011, CDC has more recently broadened its interests to include direct equity investments and debt instruments. The organization has also recently shifted its focus to concentrate on supporting businesses in Africa and South Asia, yet its ultimate goal remains the same: to support private businesses in its targeted countries as a means of creating jobs and stimulating the economic development of the world’s poorest countries.

Exhibit 4.5 CDC Historical Fund of Funds Returns

	2004	2005	2006	2007	2008	2009	2010	2011	2012
Annualized Portfolio Return (%)	15.0	41.3	36.0	55.9	-35.9	24.4	18.3	-3.4	13.1
# of Investments	36	47	69	100	127	134	143	152	155

Source: CDC Group plc.

Pre-financial crisis: a highpoint before the downturn

By 2008, as illustrated in Exhibit 4.2, fundraising for emerging markets private equity had reached a record-breaking US\$63 billion, an increase of over 2,000 percent from 2003. Fund managers focusing on developing countries had begun to proliferate and build reputable track records; a larger, more diversified universe of institutional investors was paying attention to emerging markets and therefore targeting higher allocations to the asset class; business owners seeking medium- and long-term capital were becoming more aware and less suspicious of this financing alternative; and local government officials were beginning to craft policies and regulations designed to encourage greater use of private equity, which a few years earlier had not even been on their radar screen. With this newfound credibility and acceptance, the asset class was poised for additional growth and success. However, the confidence generated by this high point was about to face its greatest test: the 2008–2009 global financial crisis.

The following chapter explores the challenges the industry encountered during and in the aftermath of the global financial crisis, including sharp declines in fundraising as Western institutional investors faced cash pressures; mismatched return expectations between buyers and sellers; an increasingly tough exit environment; and, economic downturns in the emerging market countries that had been the largest recipients of private equity investing during the pre-crisis years. However, unlike earlier in the decade, when the asset class nearly disappeared, this time it proved surprisingly resilient despite the disruptions caused by the financial downturn. Nevertheless, even as the industry has begun to rebuild, it has had to contend with a number of new challenges.

5

A Post-crisis Assessment: New Challenges and Opportunities

Most emerging markets have exhibited surprising resilience in the aftermath of the global financial crisis. Perhaps this will lead institutional investors to reconsider investing in emerging markets private equity.

—CEO of a global emerging markets firm

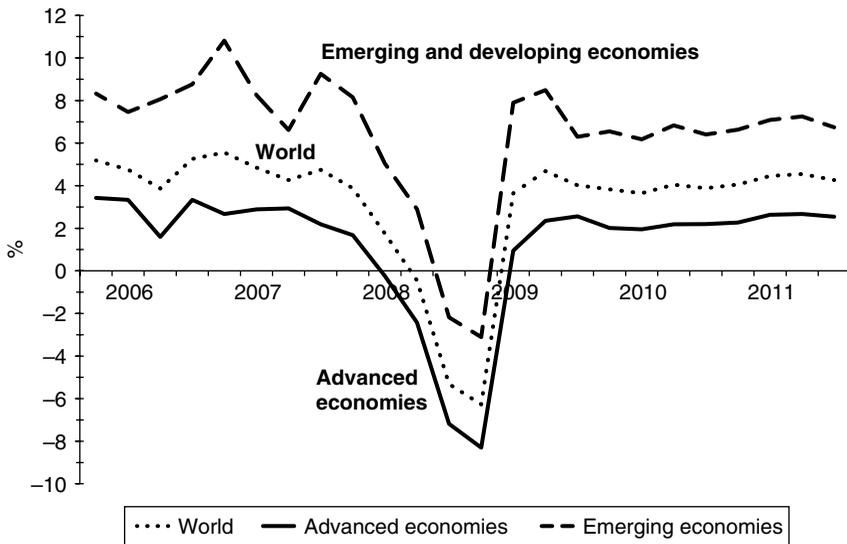
The onslaught of the global financial crisis

Nearly every asset class was severely tested in the wake of the global financial crisis that erupted in the fall of 2008, and emerging markets private equity was no exception. The crisis that began in the United States rapidly spread around the world, causing global economic output to drop precipitously. The result was the worst financial downturn since the Great Depression, with an estimated US\$14.5 trillion—or 33 percent of the value of the world's publicly listed companies combined—erased between September 2008 and February 2009.¹ As stock markets across the globe plummeted, the interrelated collapse of large US financial institutions such as Northern Rock, Countrywide Financial, Bear Stearns, Lehman Brothers, AIG, Fannie Mae, and Freddie Mac generated contagious aftershocks almost everywhere. Following close on the heels of this damaging global calamity, a sovereign debt crisis unfolded in the Eurozone beginning in 2011, further straining liquidity and undermining investor confidence.

The surprising resilience of emerging markets

When the global financial crisis hit, emerging markets were enjoying a sustained period of strong economic growth that had attracted increasing attention by investors across the globe. As noted in the previous chapter, between 2005 and 2008, economic growth in emerging markets rapidly accelerated and many of these countries were registering much faster rates of annual GDP growth than in virtually all developed countries (see Exhibit 4.4). Some economists even forecast optimistically that over the long term the economic performance of developing countries would continue to outpace the more developed countries. They coined yet another new term in their lexicon, “decoupling,” suggesting that economic performance in emerging markets was no longer dependent on what happened in developed countries. To substantiate the claim, they pointed to data indicating that the macroeconomic damage following the crises appeared to be deeper and more protracted in the West, with GDP rates declining faster and further. Many, including

Exhibit 5.1 Especially Post-Global Financial Crisis, Emerging Market Economic Recovery Was Projected to Be More Rapid than OECD Countries



Source: IMF staff estimates. IMF, *World Economic Outlook Update: A Policy-Driven, Multispeed Recovery*. Washington, DC: IMF, 2010.

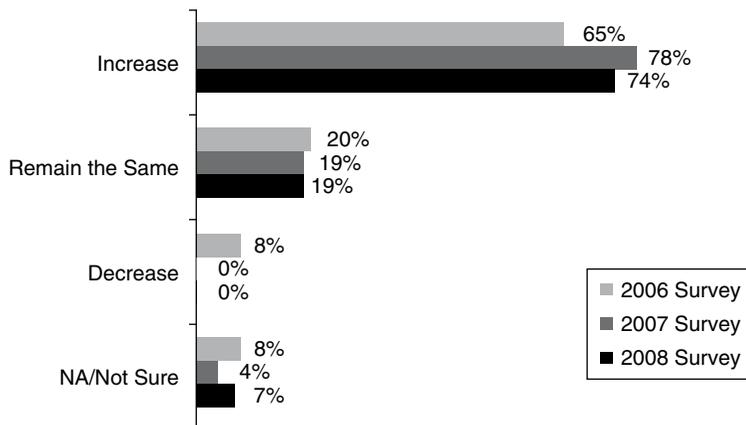
the IMF, lent credence to the decoupling thesis by projecting that the growth gap between developed countries and emerging markets was likely to continue well into the future (see Exhibit 5.1).

The BRIC economies in particular had posted impressive growth rates before the crisis, and then demonstrated remarkable resilience immediately afterward. But it was not just these large countries that had been registering notable economic gains. Between 2001 and 2010, for example, six of the world's ten fastest-growing economies were in sub-Saharan Africa.² This encouraging emerging markets performance was attributed to a confluence of factors, including stabilizing governments, macroeconomic reforms, trade liberalization, rising commodity prices, increased urbanization, and a rapidly growing (and consuming) middle class.

The emerging markets private equity industry was a major beneficiary of this economic resurgence across much of the developing country universe both before the crisis and in the initial post-crisis years. Emerging markets private equity fundraising reached a record-breaking US\$63 billion in 2008, representing a 120 percent increase from the US\$28.5 billion raised in 2006 (see Exhibit 4.2), and the expansion was dispersed across nearly all developing country regions. Although the majority of funds were targeting China, India, and middle-income Southeast Asian countries, fundraising was also beginning to accelerate for Central and Eastern Europe, Russia and the republics of the former Soviet Union, Latin America, the Middle East, and Africa. In a further encouraging sign, approximately 25 percent of the funds that closed in 2008 were raised by first-time GPs.³

Adding to the optimism, Western LPs were increasing their exposure to private equity in emerging markets. In a survey of institutional investors conducted just before the onset of the global financial crisis (see Exhibit 5.2), 74 percent indicated they planned to grow their commitments to the asset class over the following three to five years, largely in search of attractive risk-adjusted returns.⁴ The survey suggested that LPs were becoming more comfortable with the political and economic environments in many emerging markets as a result of the sustained economic growth story, and they were also encouraged by ongoing reforms in many countries geared to strengthening the investment climates for private investors. In addition, there were promising signs in many emerging market countries that the industry was maturing, providing LP investors

Exhibit 5.2 Expected Change in Emerging Market Commitments as a Percentage of Private Equity Portfolio Over the Following Three to Five Years



Source: EMPEA Limited Partners Survey, 2008.

with an opportunity to choose from a deeper, more diversified universe of experienced fund managers. Just prior to the fall 2008 onset of the global financial crisis, one investor at a US public pension fund noted, “We believe in the long-term potential of emerging markets private equity and its diversifying benefits—particularly in the face of slowing private equity returns in developed markets.”

Even more encouraging, the profile of international LPs interested in private equity in emerging markets was diversifying. By 2008, although DFIs continued to be an important source of funding, especially in the smaller, less developed countries, the asset class was now attracting new institutional investors, such as public pension funds. For example, by 2008, the California Public Employee’s Retirement System (CalPERS), one of the first and largest public pension funds in the United States to invest in the asset class, had approximately 30 emerging market-focused private equity or venture capital funds in its portfolio, up from fewer than 10 in 2003.⁵

Emerging markets, resilience proves short-lived

The optimism about emerging market economic performance generally, and private equity in particular, in the aftermath of the global

financial crisis proved to be short lived. By late 2009 it was evident that the crisis was beginning to take its toll across all regions of the world, and emerging markets private equity was not immune. In a clear indication that investors were scurrying for safe havens, fundraising for the asset class plummeted 65 percent in 2009 from the previous year's peak to US\$22.2 billion, a level last seen prior to 2005, while investment fell from US\$34 billion in 2008 to US\$22 billion, a drop of 35 percent. In sharp contrast to the outlook a year earlier, one US corporate pension fund representative summed up the mood of international investors: "I see everyone becoming much more risk averse and far less willing to do new things."

Western LPs, the primary source of capital for emerging markets private equity in the years preceding the crisis, were suffering significant losses in their portfolios. For example, some of the US endowments that had among the largest allocations to private equity of their peer group suffered unprecedented losses. For the year ended June 2009, the endowments of Harvard University, Yale University, and Princeton University, all with relatively high allocations to private equity, realized losses of 24 percent, 27 percent, and 25 percent, respectively.⁶ Not only had the overall values of portfolios plummeted, but many LPs that had invested heavily in private equity were struggling to meet previously agreed capital calls, and even fewer were contemplating making new commitments to the asset class. As one fund manager noted, "For many LPs, the crisis and resulting liquidity crunch called into question the appropriate allocation to private equity. The easy response was to say 'no' to most new commitments."

Emerging market private equity returns from the final quarter of 2008 dragged down one-year net IRRs across the board, as evidenced by Cambridge's Global Emerging Markets Private Equity and Venture Capital Index dropping to -31.4 percent by the end of December (see Exhibit 5.3).⁷ This dramatic fall reflected large year-end write-downs in the values of LPs' unrealized portfolios. Faced with the specter of LPs defaulting on their capital commitments due to the liquidity squeeze, some GPs came up with creative ways to ensure their LPs stayed in the game. In some cases, LPs were permitted to downsize their capital commitments, which of course resulted in a reduction in the overall size of the fund and its management fees. Other LPs renegotiated fee structures or

Exhibit 5.3 Emerging Market vs. US and Europe Average Returns (as of end-December 2008)

Index	1-year	3-year	5-year	10-year
Global Emerging Markets PE & VC	(31.4)	1.6	8.0	2.9
Latin America and Caribbean PE	(19.2)	9.9	13.7	(0.6)
Asia/Pacific Emerging Markets PE	(34.9)	(1.1)	4.3	2.0
Europe Emerging PE	(38.4)	10.7	25.2	14.2
MSCI Emerging Markets Index	(53.2)	(4.6)	8.0	9.3
U.S. VC	(16.5)	3.6	6.3	29.7
U.S. PE	(23.2)	2.9	11.5	9.5
Europe Developed	(37.3)	11.2	18.8	17.5
S&P 500	(37.0)	(8.4)	(2.2)	(1.4)

Source: Cambridge Associates LLC Private Investments Database. Data as of Q4 2013 for the period ending December 31, 2008; pooled end-to-end returns, net of fees, expenses, and carried interest.

slowed down the pace of their capital calls—but such tactics were painful for both sides, and did not bode well for future fundraising prospects.

In stark contrast to investor sentiment a year earlier, LPs were scaling back their commitments to emerging market private equity funds; 65 percent of LP respondents participating in a 2009 survey cited less cash to deploy as a key factor for their withdrawal from the asset class, while 37 percent cited a need to reduce their overall exposure to private equity, also known as the “denominator effect.”⁸ As public equity markets collapsed following the global financial crisis, LPs were required to immediately mark down the value of their portfolios, using the widely accepted valuation methodology for publicly listed securities known as “mark-to-market.” Even worse, unlisted companies in private equity portfolios had to be valued at original cost. As a consequence of this common practice, the reported value of private equity investments changed less frequently than public equities, and in the aftermath of the crisis

many LPs found themselves with private equity holdings that represented a disproportionately large percentage of their total portfolio. This imbalance forced many LPs to prematurely divest large portions of their private equity portfolios at deeply discounted prices, and any plans for additional investments were put on indefinite hold.⁹ Commenting on the consequences of this denominator effect, one United States public pension fund portfolio manager explained, "These were [private equity] deals which were never executed or finalized, and we decided not to fund them... the decision has nothing to do with the quality of the funds and we would still consider them if they were still open when the situation changes."

In addition to the diminishing prospects for new fundraising and growing pressures from some LPs to be released from commitments made pre-crisis, many fund managers were dealing with the underperformance of portfolio companies that were severely impacted by the downturn. Compounding GP problems, depressed and volatile public equity markets caused the IPO exit route to slam shut. Even for portfolio companies that were relatively unscathed by the crisis, divestments to strategic investors were also becoming more challenging to execute.

Weathering the storm

Despite the unprecedented stress caused by the global crisis, emerging market private equity practitioners had some cause for optimism. In contrast to the early 2000s when the embryonic asset class nearly disappeared due to subpar performance and diminishing credibility among LPs, now a larger, more mature asset class was proving to be considerably more resilient even as the crisis took a heavy toll. To be sure, the downturn in fundraising and investment activity was significant but, unlike the earlier period, most investors viewed the setback as temporary and no one questioned the long-term durability of emerging markets private equity.

Most fund managers took a "hunker-down" approach and concentrated on carefully stewarding their portfolio companies through the downturn. One Middle East-focused GP noted, "We spent a good deal of 2008 and part of 2009 nurturing our portfolio companies to ensure they would not just weather the global storm, but thrive. [Three years later], all of our investments are still standing strong."

Regulatory Reaction: The Alternative Investment Fund Managers Directive (AIFMD)

Before the financial crisis, alternative investment funds, including private equity, were not subject to the same rigorous regulatory reporting requirements as traditional banks and financial institutions in most developed countries. After the crisis, however, regulators attempted to correct for the lack of transparency that was viewed as one of the underlying causes of the crisis that led to the taxpayer bailouts of so many large financial institutions. Across the developed world, regulators responded by subjecting large alternative investment funds, including private equity, to more intense scrutiny by imposing new public disclosure and reporting requirements.

One driver of this new public disclosure push by regulators was their concern about the practice of many large private equity funds to use outsized amounts of leverage to purchase struggling companies. Even David Rubenstein, the CEO and founder of The Carlyle Group, conceded that by gaining easy access to inexpensive credit, private equity played a role in fomenting the instability that eventually plagued the financial system: “Clearly we contributed a little by paying higher prices [for distressed companies]...It was intoxicating to get [very cheap] debt with no covenants,” he said. “People wanted to do more and more deals, and there was a greater focus on very large deals.”¹⁰

The European Union’s Alternative Investment Fund Managers Directive (AIFMD), approved in 2012, was one result of the regulatory backlash. It had potentially far-reaching consequences for the fundraising activities of emerging markets-focused GPs that were either domiciled in Europe and/or raising capital from European-based LPs. The Directive’s new regulations include requirements that private equity funds marketing their funds within the EU, regardless of their size or country of origin, must

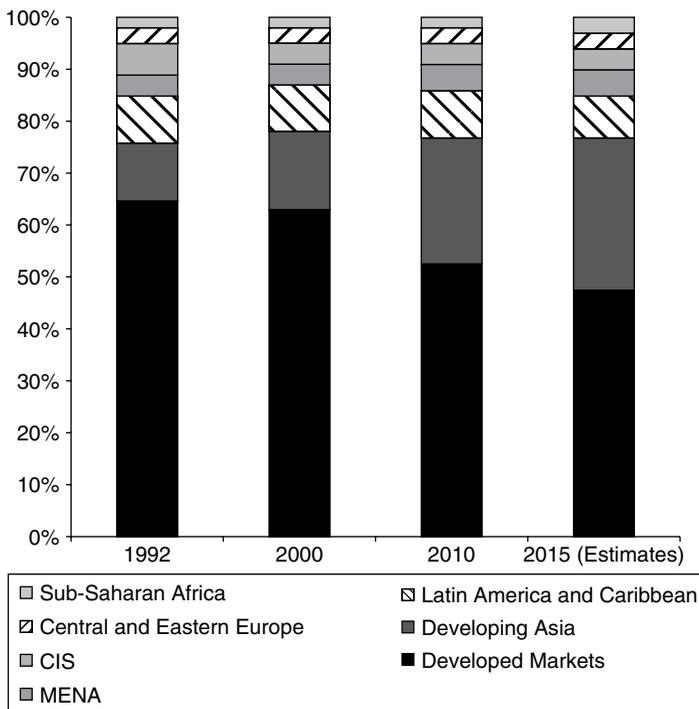
- *seek authorization by the European Union,*
- *adhere to new levels of transparency, disclosure, conduct, remuneration, leverage and reporting,*
- *hire an independent custodian for each fund they manage, and*
- *separate their risk management and valuation functions.*

Private equity firms and industry associations reacted strongly to the legislation, pointing out that the costs of complying with the new Directive would be inordinately high, particularly for smaller funds, such as those focused on developing countries. Those emerging market funds based

outside of the EU began to scramble to determine the extent to which they planned to market themselves in Europe, calculating the additional fund-raising costs resulting from the tighter regulations.

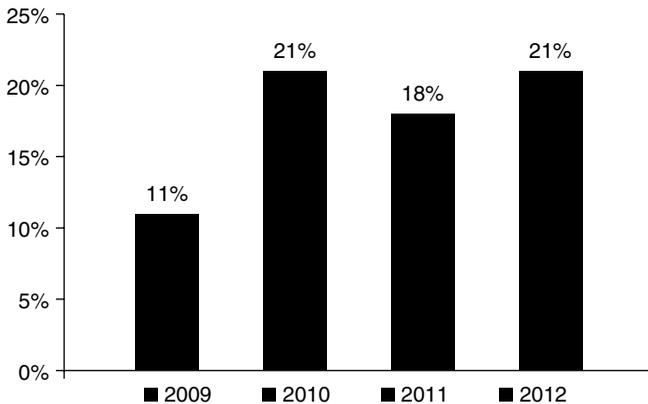
Despite the consequences for emerging markets of a precipitous economic downturn triggered by the global financial crisis, the United States, Western Europe, and Japan were faring even worse. For the first time, by 2010 the combined output of developing countries accounted for a larger share of world output than the economically advanced countries (see Exhibit 5.4).¹¹ “Investors recognize that emerging economies are the only ones still growing,” commented one fund manager at the height of the crisis. Another slightly more cautious LP noted during this period, “There has been a crest of interest

Exhibit 5.4 Developed Market Share of World Output, 1992–2015



Source: International Monetary Fund, World Economic Outlook Database, April 2011.

Exhibit 5.5 Emerging Markets Private Equity Fundraising as a % of Global Total, 2009–2012



Source: EMPEA.

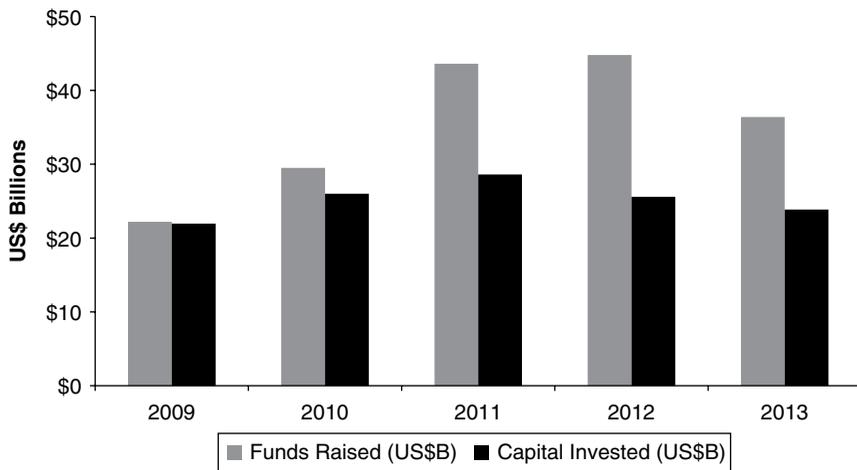
in emerging markets and that may recede. But there has also been a lot of knowledge and familiarity gained and that won't disappear."¹²

Even though the volumes of fundraising for emerging markets private equity were declining after the crisis, the asset class showed clear signs that it was holding its own. Compared to developed countries, for example, it was attracting an increasingly greater percentage of global private equity fundraising year over year—rising from 11 percent in 2009 to 21 percent in 2012 (see Exhibit 5.5). As one fund manager noted at the height of the fallout from the crisis, “Emerging markets private equity continues to have a compelling value proposition—growth capital for growth companies in high-growth markets.” By the spring of 2009, one LP survey revealed that approximately 75 percent of investors had indicated their intention to increase their commitments to the asset class over the following five years, noting that most were undeterred by the fallout from the global financial crisis. This positive trend continued in subsequent years, with the majority of LPs signaling their intention to increase new commitments to emerging markets private equity funds in 2010 and 2011.¹³

Post-global financial crisis: the new normal

Even as the industry began to bounce back after the financial crisis (see Exhibit 5.6), fundamental changes were underway. Three

Exhibit 5.6 Emerging Markets Private Equity Fundraising and Investment, 2009–2013



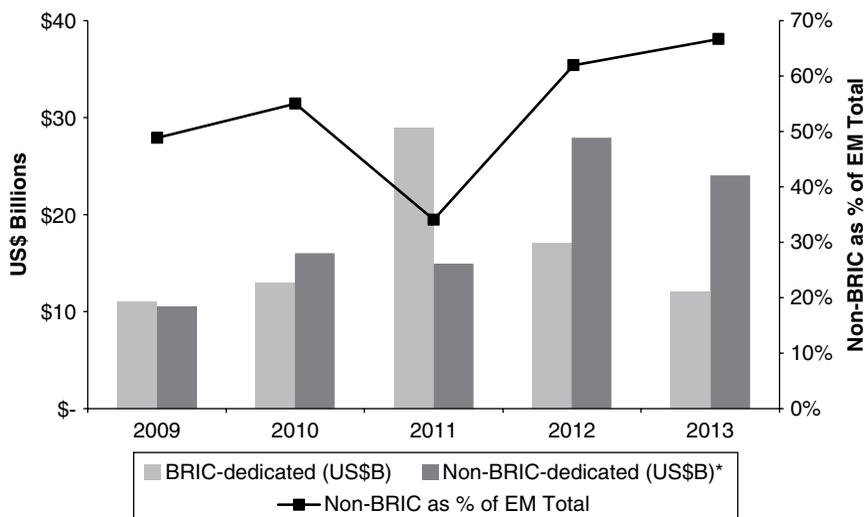
Source: EMPEA.

significant new trends emerged, each representing its own unique set of challenges and opportunities: (1) private equity activity began to expand significantly beyond the BRICs into smaller countries in Sub-Saharan Africa, Latin America, and Southeast Asia; (2) emerging market GPs that were underperforming relative to their peer group were either closing or struggling to raise follow-on funds; and (3) partially as a result of this second trend, the industry began to consolidate around fewer, larger GPs as many Western LPs opted to favor a strategy of investing in a smaller number of sizable fund managers.

Diversifying into new markets

The global financial crisis provided a stark reminder for investors of the importance of diversification. While China, India, and Brazil continued to anchor most Western LPs' emerging market private equity portfolios, countries that were once viewed as either too risky or small, such as many of those within sub-Saharan Africa, Southeast Asia, and the Andean region increasingly garnered investor attention. In contrast to the asset class's first decade of growth, both GPs and LPs began to seek diversification not just via exposure *to* emerging markets but also *within* the vast universe of countries (see Exhibit 5.7). Between 2011 and 2013, for example, funds

Exhibit 5.7 BRIC- vs. Non-BRIC-dedicated Funds as a % of Fundraising



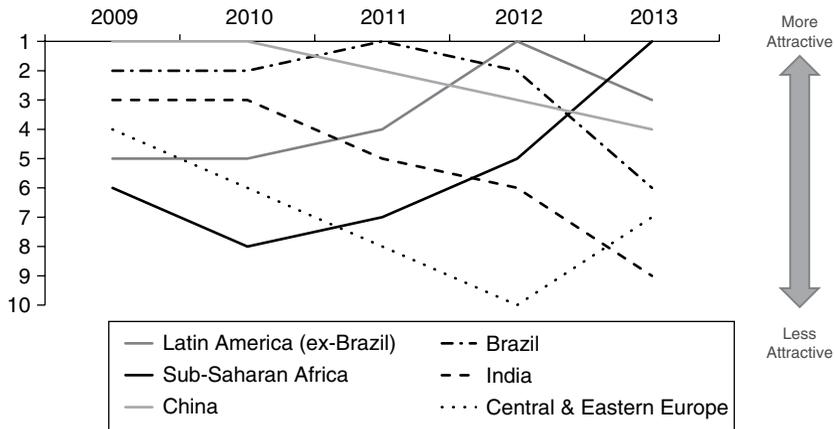
Source: EMPEA.

dedicated to countries such as Turkey, Indonesia, Nigeria, Peru, and Mexico were fully subscribed, and in some cases oversubscribed.

Geographic diversification also could be seen by the increasing number of global and regional funds that expanded their network of local offices in new countries. For example, breaking with the tradition of running sub-Saharan African operations from South Africa, GPs began opening additional offices in Ghana, Nigeria, and Kenya, and the focus in Asia expanded beyond China and India into some Southeast Asian countries, such as Indonesia and Vietnam. By 2012 this diversification trend resulted in about 36 percent of emerging market private equity transactions executed in non-BRIC markets, 16 percent higher than the prior year, and the pattern continued to accelerate sharply in 2013 to 44 percent. Even countries with a relatively shallow history of private equity investing, such as Malaysia, Colombia, the United Arab Emirates, Tanzania, Croatia, Pakistan, and Madagascar, were attracting sizeable transactions.

Over the same post-crisis period, the BRIC markets experienced a notable decline in new private equity investments, including sharp drops of 50 percent and 46 percent, respectively, in China and India between 2011 and 2013. One reason for this dramatic falloff in the two most favored destinations for emerging markets private equity

Exhibit 5.8 Market Attractiveness Rankings, Greatest Shifts



Source: EMPEA Global Limited Partners Survey, 2013.

in the years preceding the financial crisis was a growing perception among LPs that these countries had fallen victim to an unsustainable glut of “too much money chasing too few deals.” Whether a temporary slowdown limited to these largest countries or the onset of a longer-term trend, the newfound investor attention on smaller countries suggested that the asset class was diversifying.

Nowhere was this geographic diversification more striking than in sub-Saharan Africa. A 2013 LP survey indicated the region that had been completely ignored by investors a few years earlier (with the exception of South Africa) now ranked as the most attractive emerging market for private equity investment—the first time in the survey’s nine-year history that a non-BRIC market had ascended to the number one ranking (see Exhibit 5.8).¹⁴ In a comment that would have been inconceivable a few years earlier, one survey respondent observed: “These markets are very attractive because of their [economic] growth and greater pool of managerial talent, the development of local capital markets, and the ability [for GPs] to build on lessons learned.”

The GP shake-up

Juxtaposed to the encouraging resilience and geographic diversification in the post-crisis years, other, more worrisome trends

surfaced that clouded the industry's future. Most troubling, new capital flowing to many emerging market GPs was declining from its pre-crisis levels. Even though fundraising increased to US\$45 billion in 2012, a 102 percent jump from 2009, the level remained well below the 2008 peak of US\$63 billion.¹⁵

In addition, anecdotal evidence suggested that the population of emerging market GPs was contracting. During the five years prior to the global financial crisis there was an exponential increase in the number of international and domestic GPs investing in emerging markets, especially in some of the largest countries, such as China and India. As would be expected with such explosive growth, many of these entrants were first-time fund managers with little or no private equity experience, and they sorely lacked the value creation skills that are the hallmark of successful GPs and a prerequisite for generating profitable exits. Eventually, the inexperience of these outliers led to poor results, and their prospects of raising a follow-on fund evaporated. As one LP commented, "Ultimately, we look for GPs who see themselves as partners to help build businesses, rather than 'company pickers'. Being in the latter category may have been a viable strategy several years ago, but as the market matures, GPs need to be able to drive value creation beyond the basic organic growth of the company."

An Unconventional Partnership: Aureos and Abraaj

From initial appearances, Abraaj Capital's July 2012 acquisition of Aureos Capital—a former spin-off of the United Kingdom's CDC Group—may have seemed unlikely, and even potentially unwieldy. Abraaj was a large private equity firm with over US\$6 billion in assets under management in 2011,¹⁶ focused mostly on the Middle East, Turkey, North Africa, and South Asia. Aureos, in contrast, had a network of offices in Asia, sub-Saharan Africa, and Latin America that invested in small- and medium-sized enterprises. Thus, the two were significantly different in terms of geographic focus, strategy (i.e., buyout vs. minority) and company size.

However, the two firms had more in common than appeared on the surface, and the potential synergies were significant. Both firms were highly entrepreneurial, focused exclusively on growth markets and companies

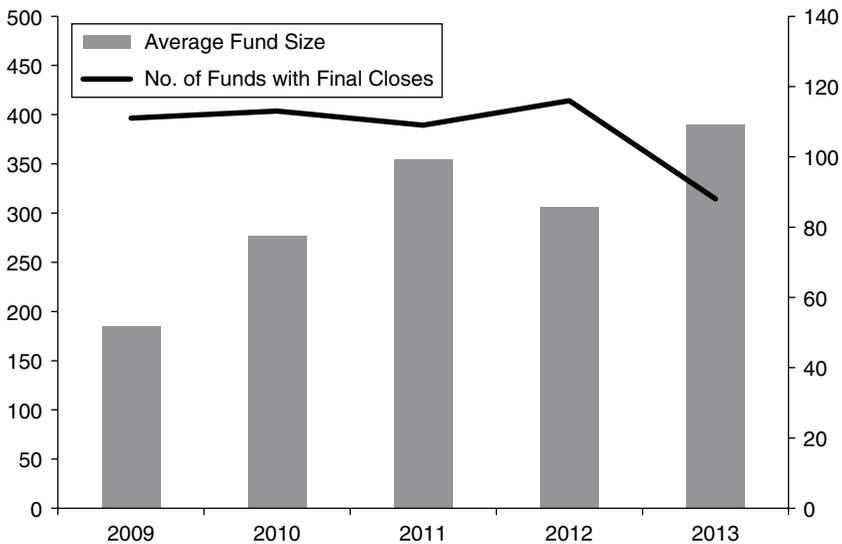
with significant value creation opportunities, and believed local presence was critical to accessing attractive deals and maximizing returns. Moreover, Abraaj was seeking to expand into Southeast Asia and sub-Saharan Africa in order to create a more robust global investment platform with the capacity to provide a range of differentiated private equity products across all growth market regions. As Abraaj Founder and Group Chief Executive, Arif Naqvi, explained, “The [Aureos] acquisition is a significant step in executing the vision we set ourselves just over a decade ago of creating a dedicated global growth markets private equity firm. We share a common philosophy with Aureos, combining a track record of strong investor returns with an appreciation of the long-term social and economic benefits that our model of investing in growth markets can deliver.”¹⁷

Leaving aside potential synergies that derive from operating across similar sectors in diverse countries, the merger created a private equity firm with more than 25 offices that span almost the entire developing world.¹⁸ By 2014 the new combined firm had about US\$7.5 billion in assets under management, managed distinct funds across six regions, had invested in more than 200 companies, and completed more than 70 exits. Sev Vettivetpillai, the CEO of Aureos preacquisition who became an Abraaj Group Partner, explained the rationale for the merger: “Because of the scale we’ve created, we can support the local investment teams with higher-level execution and operational capabilities from our regional centers.”¹⁹ According to Group CEO Naqvi, the merger will also prove attractive to LPs seeking a diversified emerging markets private equity exposure: “We believe we can be a proxy to how LPs think they want their money invested. If an investor says to us, ‘I’m interested in Sub-Saharan real estate, and I want Asia but not India,’ then we can probably help with that.”

Short shrift for the middle market

Even as post-crisis fundraising began to show some signs of recovery by 2013, another serious challenge was descending with the potential to significantly alter the emerging market private equity landscape. Although increasing numbers of LPs were investing in the asset class and deploying significant amounts of capital, many were writing larger checks to a smaller number of the largest

Exhibit 5.9 Average Final Emerging Market Private Equity Fund Sizes, 2009–2013



Source: EMPEA.

fund managers. The result has been a ballooning of the average fund size but a contraction in the number of funds holding final closes. As demonstrated in Exhibit 5.9, for example, 111 funds held final closes in 2009 with an average fund size of US\$185 million, compared to 88 fund closings in 2013 with an average size of just under US\$390 million. If this trend continues, the industry could be caught in a cycle of fewer, larger funds, which in turn would compel them to target large emerging market companies that can absorb sizable amounts of capital.

Emblematic of private equity activity coalescing around fewer, larger funds, a record-breaking US\$7.1 billion was raised in 2011 for private equity investing in Brazil, but a staggering 99 percent of the total was captured by just five GPs, each with a fund size in excess of US\$1 billion. This trend continued in 2012 and 2013, as the top five GPs captured nearly 75 percent and 88 percent, respectively, of all Brazil-dedicated funds raised. In sub-Saharan Africa, one GP accounted for US\$900 million of the US\$1.1 billion raised for private equity investing in the entire region in 2011.²⁰ The same narrative has also played out globally, with the ten largest funds in

2013 accounting for 70 percent of all capital raised for emerging markets private equity, compared to 48 percent four years prior.²¹

It remains unclear whether this not-so-virtuous circle represents a temporary trend or a more permanent structural change toward ever-larger funds investing at the very top of the pyramid of private sector firms. If the latter, the consequences would be ominous for the future of growth capital private equity investing in small and midsize firms that drive much of the economic growth in developing countries. The arithmetic is straightforward and revealing: with emerging market GPs averaging a portfolio of about 10 to 15 companies, the larger the fund size, the larger the individual investments that must be made in order to manage a reasonable portfolio of firms.²² A US\$1 billion fund, therefore, would need to target investments in the range of US\$50 million to US\$100 million per company, and even the largest emerging market countries have only a handful of firms at the very top of the private sector pyramid in this investment range. “Almost no developing country has a sizable number of companies capable of absorbing such large investments by a private equity fund,” remarked one frustrated investor in response to the shrinkage of middle-market opportunities.

Conclusion

The post-global financial crisis landscape for the emerging markets private equity asset class is a portrait of contrasts. On the one hand the industry has emerged from the 2008–2009 turmoil more resilient and credible than ever. But on the other, the industry now faces worrisome challenges, especially for fund managers focused on investing in middle-market companies that stand to benefit most from injection of the capital and value-creating expertise that define private equity. Like all broadly defined trends, however, these generalizations obscure significant differences that distinguish the challenges and opportunities within individual emerging market countries. The next three chapters aim to highlight just how varied private equity is in the developing world by examining more closely three very different countries: China, Brazil, and Kenya.

6

China: Private Equity with Chinese Characteristics¹

*We must do this business the China way, and not impose Western standards on China.*²

—*Chinese private equity fund manager*

The main contours of China's private equity history bear a striking resemblance to the road map the country has carefully followed for more than 30 years during its remarkable transformation from a tightly controlled, centrally planned economic model to one driven increasingly by market forces and an expanding private sector. But even as the role of private equity has steadily evolved in China, it has done so under the watchful eye and steady guidance of a constellation of omnipresent government actors. Some private equity practices have been carefully and selectively emulated from the West, providing much-needed capital and expertise to select portfolio companies. But in many respects the industry has evolved in ways that are distinct from any other country, developed or developing, reflecting the country's unique circumstances and approach to economic development.

Perhaps most significantly, in no other country has government played a more active role as a catalyst for the development of an institutionalized domestic private equity market. The Chinese government has been as hands on in its approach to striking what it views as a balance between market forces and government oversight in guiding and regulating the private equity industry as in other sectors of the economy. "For a dynamic private equity market to

develop in China,” explained a senior regulator, “we believe there must be ongoing, close collaboration between the relevant government officials and practitioners.” As this chapter will illustrate, although there have been missteps and continuous regulatory confusion along the way—due in part to the multiplicity of government actors and the rapid pace of industry growth—the Chinese government is peerless among developing countries in its awareness and activism, promoting the asset class as a positive force for private sector development.

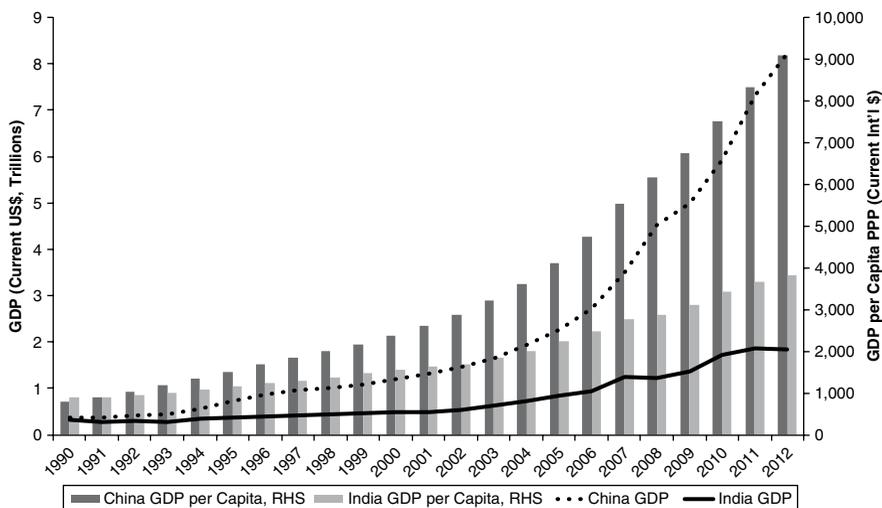
The government has also been an astute observer of how the private equity industry has developed elsewhere, most notably in the West, making calculated adjustments to the Chinese model that take into account its own priorities. After spending considerable time and resources investing in China, one veteran US venture capitalist explained, “The government has carefully studied private equity best practices from around the globe, and is meticulously crafting a policy and regulatory framework that meets China’s needs.” But, he continued with undisguised frustration, “this includes making a premeditated, carefully orchestrated effort to provide as many incentives as possible to local fund managers and LPs.” In other words, as both foreign and Chinese practitioners acknowledge, the private equity competitive landscape bears no resemblance to a level playing field.

The paradox of China’s private equity development from the very beginning, therefore, is that it has followed a trajectory of reforms geared toward strengthening the role of market forces and private sector participation, but always controlled by a vigilant government determined, if not always successfully, to orchestrate the pace and direction of every aspect of the asset class’ activity, whether local or foreign. Viewed in this light, the evolution and profile of private equity in China conforms to a pattern that crops up time and again to describe so many developments in the country: “private equity with Chinese characteristics.”

Taking stock of China’s unparalleled economic transformation

Notwithstanding its unique features, a balanced portrait of private equity’s brief history in China first requires dispensing with some

Exhibit 6.1 China's Economic Performance vis-à-vis India (as of year-end 2012)



Source: World Development Indicators, The World Bank. Author's analysis, 2014.

of the hyperbole that seems to accompany, and often distort, so many descriptions of the country's meteoric rise to prominence. Admittedly, China *is* different; it defies comparison with every other emerging market on various levels. Most obviously, China's sheer demographic and economic size has proven to be irresistible for investors. Although India's population is fast approaching China's 1.3 billion inhabitants, for example, its GDP (as of 2012) is approximately one-quarter and less than one-half on a per capita basis (see Exhibit 6.1).³

This widening gap is explained by China's incomparable *sustained* economic performance, with annual GDP growth averaging more than 9 percent between 1980 and 2012. Personal incomes increased more than eightfold between 1978 and 2012, leading to the emergence of an estimated 300 million middle-class consumers with incomes of at least US\$10,000, and an 80 percent reduction in the number of people living in poverty.⁴ Equally unprecedented, this economic track record has been achieved while successfully orchestrating an extraordinary transition from state dominance of all aspects of economic life to a system

increasingly reliant on private enterprise. It is worth recalling, for example, that ownership of private property in China was illegal just over a generation ago. Now, under the watchful guidance of government, the private sector generates roughly two-thirds of total economic output.⁵

These much-trumpeted distinctive features of China's overall economic and demographic profile are a helpful point of departure for understanding the allure of private equity, and why the industry has grown exponentially faster and become larger by an astonishing margin compared to any other developing country (see Exhibit 6.2).

Similarities with other emerging markets

But set aside the sheer size, dramatic economic growth, and wealth creation that differentiates China, and the contours of the private equity landscape bear a striking resemblance to the other countries profiled in this book. Three characteristics, in particular, stand out: a private sector financing gap that persists due to an inefficient

Exhibit 6.2 Top 10 Countries for Fundraising, 2008–2013 (US\$ millions)

Country	2008	2009	2010	2011	2012	2013	Total
China	14,104	6,933	8,079	19,185	11,024	9,626	68,951
India	6,876	2,673	3,225	2,198	2,586	1,187	18,745
Brazil	2,995	1,298	2,076	7,109	2,843	1,024	17,345
Russia	1,068	327	75	97	678	601	2,846
Mexico	152	169	316	430	798	805	2,670
Turkey	–	103	50	307	1,990	49	2,499
South Korea	344	316	154	765	213	500	2,292
Indonesia	55	7	285	890	757	188	2,182
South Africa	217	32	448	307	861	50	1,915
Peru	351	–	92	455	50	962	1,910

Note: Figures are only for country-dedicated funds.

Source: EMPEA.

financial sector; severe human capital constraints; and weak investor protections. While a distinctive Chinese flavor permeates these dynamics, these similarities merit further consideration.

Private sector financing gap caused by a weak financial sector

If generally true that a weak, unresponsive financial sector is one of the driving forces underlying the private equity “opportunity” in emerging markets, then China is the quintessential example. Finance is the one sector that has continuously lagged behind the extraordinary accomplishments of the Chinese economy.⁶ According to one analysis, the financial sector “plays a relatively small role in mobilizing and allocating the nation’s savings” and when it does serve this fundamental purpose it does so inefficiently.”⁷ Although endowed with the largest pool of domestic savings in the world—approximately US\$4.3 trillion in 2012⁸—which theoretically is available to be mobilized and directed toward productive investment—more than 50 percent of these financial resources are intermediated through the huge, inefficient state-owned banks that dominate the financial sector and allocate the bulk of their financings to SOEs.⁹ One unsurprising consequence of these state-to-state financial transactions is the high likelihood that lending decisions often are made on the basis of criteria unrelated to commercial considerations. As former Federal Reserve Bank chairman Alan Greenspan observed after an official visit, “Chinese banks have not been banks as we know them in the West...no bank loan officers make loans that would be expected to be repaid...they function primarily as ‘transfer agents.’”¹⁰

Surveys of Chinese business executives confirm precisely the same story reported in country after country: access to financing ranks first among their list of problems—ahead of government red tape, corruption, high taxes, and a number of other obstacles to success.¹¹ One survey of Chinese enterprises revealed that 90 percent of participating firms’ investments were self-financed. Business owners recount that borrowing from banks is simply untenable—interest rates are too high, loan procedures are too complicated, and/or collateral and guarantee requirements are too onerous.¹² As one analyst put it, “Banks regard their own

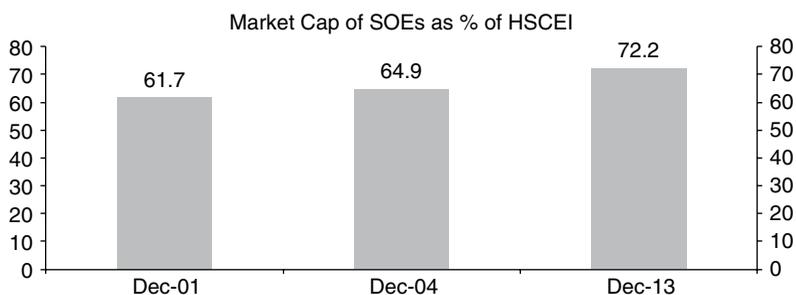
loan documentation as a work of fiction [while] Chinese companies get the worst of all worlds: they have to tie up all their collateral to secure overpriced loans, while also paying an additional 2 to 3 percent a year to the third-party credit guarantee company for a guarantee the bank requires but treats as basically worthless.”¹³

A similar pattern of SOE dominance at the expense of private companies prevails in the raising of equity capital on the domestic stock market. SOEs account for nearly 75 percent of the market capitalization of companies included in the Hang Seng China Enterprises Index, despite the fact that non-SOEs have notably outperformed SOEs since the global financial crisis (see Exhibit 6.3).¹⁴

The debt capital markets tell a parallel story. In 2013, the number of bonds issued by small- and medium-sized enterprises in China constituted an infinitesimally small 0.012 percent of bonds issued by the government/state sector. Even when adding in firms in the so-called hybrid sector—an amalgam of SOEs and other large corporations—the bonds issued reached merely 23 percent of the value of government issues (see Exhibit 6.4).

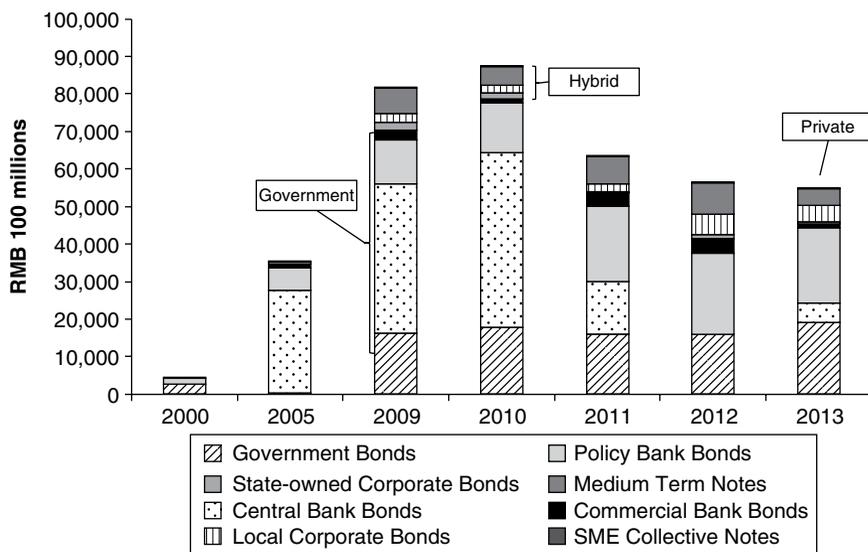
Thus, a weak, inefficient, sharply bifurcated financial sector that heavily favors a limited number of the largest firms has resulted in a financing gap in China that is no different or less severe than elsewhere in the developing world. The only other financing alternatives for private companies are in the shadow financial system—a murky conglomeration of financial institutions, including some

Exhibit 6.3 SOEs Dominate the Hang Seng China Enterprise Index



Source: KKR, “China Repositioning Now Required.” February 2014.

Exhibit 6.4 Composition of Chinese Bond Market, Annual Issuance by Type



Source: China Central Depository & Clearing Co. March 2014.

traditional banks, off-balance-sheet lending institutions, and insurance firms—and the underground market, which includes pawnbrokers and other informal lenders. On the one hand, shadow banks have played an important private sector role by bridging the financing gap for companies not able to obtain financing from traditional banks, but on the other, they typically charge extremely high interest rates, attach unreasonable covenants and conditions, and are largely unregulated.¹⁵

Severe human capital deficit

At virtually every professional skills level considered important to a well-developed private equity industry, China resembles nearly every other developing country. Indeed, China's remarkable transition makes it easy to forget that there was virtually no private sector—or even the rudiments of a market economy—until the early 1980s. With no private businesses, there was no need for standardized accounting principles or corporate governance, or the countless other basic building blocks described in chapter 2.

As a result, China had hardly any trained accountants, attorneys, bankers, or professional managers accustomed to running companies according to market principles.

Although remarkable progress has been achieved in the last quarter century, the human capital deficit remains a key challenge for both companies and private equity investors alike. As one professional put it, "What China lacks are professional managers, both at the portfolio company level and the private equity fund level."¹⁶ At the same time, however, herein lies a major source of the private equity opportunity: creating value by bridging the skills deficit that holds back so many Chinese businesses.

Paradoxically, the exceptionally rapid rise of private equity activity in such a short time period may actually have made the industry worse off, with the massive inflow of capital outpacing the development of an adequate pool of skilled professionals to manage the industry's growth. Although there are allegedly thousands of so-called Chinese private equity GPs,¹⁷ from all accounts only a handful are endowed with professional teams that have the experience and skill set required to conduct rigorous pre-investment due diligence or perform the vital value creation tasks once a deal is consummated and the real work begins.

Unclear investor protections and the rule of law

The rule of law is no more reliable or confidence inducing in China than elsewhere in the developing world. "The legal framework for private equity is simply not yet in place," one Chinese attorney cautioned in 2012, although even the most experienced investors seemed undeterred. The irresistible allure of an enormous domestic market and high rates of economic growth immunized investors against the inevitable risks associated with a legal system that is manifestly unreliable and seemingly in constant flux. As one analyst observed, even as China has become the number one emerging market destination for private equity investment, "it has gained a reputation as a market where contracts are often treated as vague notions rather than bona fide agreements."¹⁸ As in other emerging markets, because most growth capital investments involve minority positions, private equity investors are unlikely to have even minimal confidence in legal recourse.

These significant shortcomings with the private equity ecosystem reveal that China is not as unique as it might first appear, at least from a private equity perspective. Demographics, economic performance, and strong government guidance and support may explain why China has outpaced every other developing country as a private equity destination. But as the asset class experienced explosive expansion over a prolonged period of time, investors became intoxicated by the China growth story, and for many years were inured to the inescapable risks that characterize private equity investing in emerging markets, regardless of the country.

To grasp how the asset class grew so quickly in spite of these weaknesses requires an understanding of the country's private equity transition from a cottage industry populated by a smattering of state-owned so-called venture capital funds in the 1990s to a dynamic, multidimensional industry that has attracted an increasingly large and diverse universe of foreign and local players. As the asset class grew relentlessly, even the most sophisticated foreign and domestic practitioners tended to ignore or gloss over the market's fragile underlying fundamentals. There was a sense that somehow China was indeed different. But this historically unprecedented private equity growth story ground—at least temporarily—to a halt in 2011–2012. China, as it turns out, is no different: fundamentals matter!

The genesis of Chinese private equity

Chinese private equity had its beginnings during the same period in which the government was embarking on its far-reaching transition from a centrally planned economy. Although this historic shift began hesitantly in the initial years following the death of Mao Zedong in 1976, a decisive turning point was reached in the early nineties when his successor, Deng Xiaoping, first advocated the establishment of a “socialist market economy.” This pronouncement triggered the onset of a blizzard of uncharacteristically market-friendly reforms by the world's largest communist country, and then in 1997 the Chinese constitution officially recognized for the first time that the private sector should play a pivotal role as “an important component of the economy.”¹⁹ Although this shift

did not diminish the paramount role of government, a carefully orchestrated progression of liberalization measures began to take shape, opening large swaths of the economy to both domestic and foreign private investors.

One small but significant part of this complex nationwide transition was a willingness by the government to permit the first private equity transactions. Whereas a number of other emerging market countries were starting to experiment with private equity during this period, few had less of the basic institutional infrastructure in place than China. "We not only had to learn experiences from industrial countries," reflected a Chinese analyst when describing this pioneering period, "but we also had to find our way in terms of the overall development strategy, legal framework and standard of business practices by taking into account China's political and economic reality of the time."²⁰ In other words, China was starting from scratch. Just as investors would have to climb a very steep learning curve, so too would government policymakers, the managers of companies seeking outside capital, and a broad range of other professionals who serve a thriving business community, such as accountants and attorneys.

Despite the rudimentary business and financial infrastructure, every private equity indicator moved inexorably higher, uninterrupted by the cycles that plagued other countries. Fundraising, for example, increased from an insignificant US\$16 million in 1991 to more than US\$580 million the following year, a thirtyfold increase,²¹ and by 2000 China had attracted more than US\$5 billion for private equity investment.²² At the same time, not only did the number of fund managers investing in China increase steadily but so did the size of the individual funds and the average size of their investments.²³

Similar to the pattern in other developing countries, during these early years the industry was dominated by international rather than local fund managers.²⁴ Even though the country was a virtual unknown to these first-generation investors and they were compelled to maneuver through a mind-boggling labyrinth of onerous government restrictions, the opportunity to penetrate this huge, if enigmatic, virgin market proved irresistible. The prevailing mood

of unbridled optimism was captured by one early private equity investor who exclaimed, "You can put toilet seats in China and earn a good return."²⁵

Although there was some logic driving this euphoria, it led many of the most disciplined and sophisticated international investors to give short shrift to their own well-established standard operating procedures in order to gain a foothold. If the Chinese government violated many conventional Western prescriptions of how to develop a market economy, international private equity investors were equally iconoclastic as they marched forward despite the glaring absence of the most basic information requirements that are the lifeblood of all financial decision-making. At every stage of the investment cycle, investors made uncomfortable compromises that would have been unimaginable closer to home, or in any other country. For example, decisions often were made without access to reliable financial and operating information about the company's performance, nor could investors be confident that the information flow would markedly improve post-investment. During this early period, independent audits were little more than a vague theoretical concept.

Nor had the term "corporate governance" entered the Chinese lexicon, much less exist as standard practice. Few, if any, Chinese companies had a board of directors with true independence, and even if private equity investors succeeded in gaining board representation, their leverage over decisions was negligible. Perhaps most discomfiting of all, during these early years before there was even a semblance of corporate or securities law, investors had no meaningful legal recourse in the event disputes arose with management or other shareholders. Even among signs that the government was slowly establishing the fundamental institutional building blocks of a market economy, these early private equity investors moved forward on the basis of faith as opposed to making decisions based on their time-tested due diligence practices. They were willing to disregard a range of risk factors that would have sent them scurrying for the exit in any other country.

At the same time that Deng Xiaoping was extolling the virtues of a market economy, the government strictly controlled who could invest, in what, and on what terms. The price of entry to

the Chinese market was an almost blind willingness to adapt to a series of restrictions that tested investors' ingenuity and required acquiescence to investment conditions that would have been unthinkable elsewhere. For example, in this early phase foreign funds were not permitted to raise capital in-country, nor did the legal framework provide for the creation of the limited liability partnership structure as was customary in the West. Instead, the only option for non-Chinese fund managers was to incorporate offshore, raise capital overseas, and then establish a joint venture with a Chinese counterpart that was invariably state owned. Moreover, in a complete departure from traditional private equity practice, most investments during these early years were in SOEs, not private companies. Thus, in contrast to a defining feature of private equity practice elsewhere in the world, investors were so keen to gain a foothold in the Chinese market that they acquiesced to invest in "companies" in which both the majority shareholder and management were one and the same: the government.

Despite this unprecedented array of unfamiliar restrictions, controls, and risks, this first generation of international investors adapted and thrived as they moved up the learning curve. Not only did the amount of capital raised and invested by China-focused international funds grow steadily during the decade but there also were an increasing number of private equity-backed IPOs by SOEs on both mainland stock exchanges and the red hot Hong Kong Stock Exchange (HKSE).²⁶ Gradually, as the industry became larger and more established, conditions began to improve, the role of the private sector as a driver of economic growth accelerated, and investor attention shifted from state-owned companies to private firms.²⁷ Thus, the initial optimism displayed by these early investors who were willing to adapt to this unfamiliar, high-risk environment appeared to have been warranted.

The early dominance by international fund managers and institutional investors was not unlike most other emerging markets that were experiencing the first wave of private equity investment during the 1990s. The asset class was new, untested, and completely unfamiliar to the relevant in-country stakeholders, including government officials, investors, and the company owners. The reliance

on international investors was understandable: absent their early participation, the industry would likely have developed far more haltingly due to the lack of indigenous institutions, knowledge, and practical experience.

But as the door slowly opened to international investors, the government was also taking the lead in expanding opportunities for domestic private equity funds, albeit on a much smaller scale. Contrary to conventional wisdom in the West that state-owned private equity funds are a self-defeating oxymoron, the Chinese government played an important role from the outset in developing the private equity industry, not only as a regulator and policy maker but as a fund manager and LP. Its experience doing so in the 1990s would prove instrumental in the subsequent decade.

As the pace accelerates, local fund managers emerge on the scene

As the Chinese economy continued its relentless pace of growth—driven increasingly by an ever-expanding private sector—the one industry that continued to lag behind was financial services. In fact, the financing gap was actually widening as more and more private firms were created and struggled to raise medium- and long-term funding to grow their businesses. Moreover, nearly all of these new businesses suffered from a paucity of management talent.

By the mid-2000s the importance of the enormous, rapidly expanding universe of small and midsize private companies was recognized by investors and government alike as undeniably important to the country's economic performance. Official government statistics estimated a mind-numbing 42 *million* small- and medium-size companies were the primary drivers of the accelerating private sector growth story in China. According to government estimates, these firms had grown to account for 80 percent of private sector jobs, 65 percent of all patent approvals, 50 percent of tax revenues, and more than 90 percent of labor-intensive exports (such as clothing, textiles toys, and shoes), and they absorbed 80 percent of the labor force laid off by poorly performing SOEs.²⁸

Even more striking than the size and increasing importance of these private firms was the fact that their prominence and achievements were being generated with almost no access to conventional sources of debt and equity financing. As noted earlier in this chapter, even as these firms contributed ever-larger proportions to the country's GDP growth, investment capital flows were directed predominantly toward SOEs, and the financing difficulties for the overwhelming number of private firms did not perceptibly diminish. As an adviser to one provincial government explained, "Money in China is like a powerful hose that flows from state-owned banks to SOEs, with just the little bit that drips down going to private enterprises."²⁹

Bridging the Financing Gap and Creating Value for Chinese Entrepreneurs

Zhang arrived in Chengdu from his rural village in Sichuan Province at the age of 20 with no money and no job. Endowed with an abundance of ambition and energy, he quickly gained employment as a delivery truck driver for a small but growing local food distribution company. Based on strong performance, he quickly earned a string of promotions, and within five years Zhang ascended from driver to the marketing department, and finally became manager of the marketing and sales department. "I was very grateful to my boss," Zhang explained, "but I was very ambitious, and I was determined to go out and start my own business. I saw that in the 1990s, China was passing through a historical moment; this was an opportunity to be an entrepreneur, make money, and build something of my own." Capitalizing on the rapid growth of China's middle class, Zhang launched his food distribution company at a time when processed food manufacturers were vying for shelf space in small and midsize retail stores that were proliferating in large urban centers like Chengdu, a city with 10 million inhabitants. He correctly calculated that as incomes continued to grow among this new class of consumers, demand for processed and snack foods would grow apace. Reflecting on this early experience as a budding entrepreneur, Zhang proudly explained, "my revenues doubled between the first and second year, and doubled again in year three; within five years of starting my company, I'd become the owner of the largest food distribution

company in Chengdu. Based on the success of my distribution business, I decided to launch a second company to manufacture and package sunflower seeds.”

By the early 2000s, with both companies enjoying strong profitability and prospects for continued growth, Zhang encountered a problem familiar to successful entrepreneurs throughout the developing world: “Until this time I had financed company growth by reinvesting my profits and taking short-term loans from a local bank. But to keep up with increasing consumer demand, I needed outside financing to construct a new plant with additional production capacity. But there’s almost no long-term capital in China for companies like mine, even when we are successful and have a track record with strong profits. The big state-owned banks only care about big companies and government projects.”

Introduced “by the friend of a friend” to the local representative of a private equity fund that was investing in promising small and midsize companies, Zhang conceded, “I was very frightened about bringing in an outside investor.” After repeated meetings, however, not only did he begin to feel more comfortable with the proposed arrangement but he learned that the prospective investor had more to offer than just the financing. Recounting what happened after reaching agreement for a minority stake in his company, Zhang ticked off the nonfinancial value his new partner contributed to building the business:

- “We professionalized our accounting and purchased new software that have helped make me a better CEO by getting me more accurate and timely information.
- “Attracting investment from a foreign private equity fund was very prestigious and immediately boosted our reputation. Our employees were reassured, and staff turnover decreased. And banks that previously had been unwilling to consider extending credit to the company were suddenly cooperative.
- “We created our first Board of Directors. Although the board was very demanding and sometimes I became frustrated, the directors give me very good advice and feedback.”

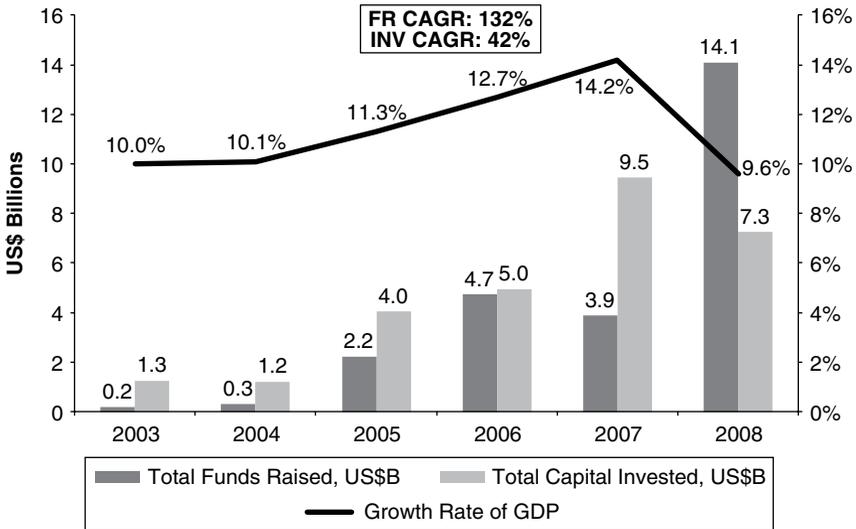
During the period of private equity investment, the company used its new-found long-term capital to improve its input sourcing and the quality of its products. Headcount increased from 520 to 1,240 employees, while average annual wages nearly doubled, and the number of suppliers more than

tripled. Having achieved scale, Zhang realized that even greater economies of scale could be accomplished through merging his two companies. Both companies' boards agreed to the merger, and in 2009, two well-known local private equity funds invested in the newly merged company, facilitating the exit of the initial investor and financing the company's next stage of growth.

On the surface, therefore, the stars seemed to be aligned, allowing for a continuous expansion of private equity as a means of addressing both the financing and human capital constraints. In fact, the growth of private equity fundraising and investment continued to trend higher at a pace that exceeded even the torrid rate of economic growth (see Exhibit 6.5).

As the industry continued to grow larger and more mature, it mirrored the development of China's economy, expanding into an increasingly diverse range of sectors. Unlike the nineties, when

Exhibit 6.5 Growth in Private Equity Fundraising and Investment Eclipsed GDP Growth Rate

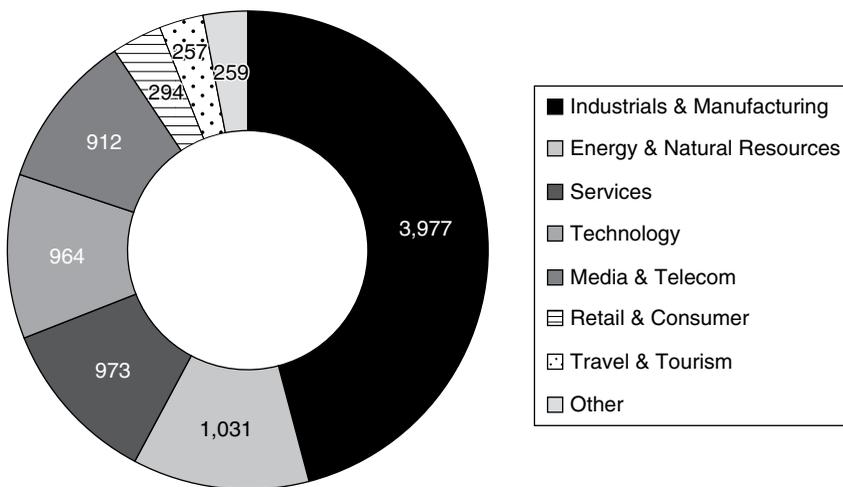


Sources: APER, EMPEA, World Bank. Author's analysis, 2014.

most private equity financing was directed to SOEs, investors were now reaching into every corner of the growth-oriented private sector. Although investments in dynamic industries such as information technology and telecommunications were obvious targets of opportunity, there also was a major expansion into health care, basic manufacturing, consumer goods, and professional services. In response to the explosive growth of tourism and business travel, hotel chains also became a prime target, as well as restaurant chains, catering companies, and other businesses that capitalized on the booming travel and leisure sector.³⁰ With the combination of explosive economic growth, a rapidly expanding consumer class, and tens of thousands of private companies with insatiable appetites for financing and expertise, no sector seemed off-limits (see Exhibit 6.6).

But not all sectors were open to all GPs on an equal basis. As would happen time and again, foreign fund managers faced legal and regulatory hurdles that hindered their operations in the country. One challenge was circumventing the prohibition on investing directly in Chinese companies. Foreign GPs were first required to

Exhibit 6.6 Private Equity Investments by Sector, 2008 (US\$ millions)



Source: EMPEA.

set up a legal offshore holding company that would be the recipient of dollar-denominated capital. Onshore, the foreign GP was only permitted to establish a “representative” office, officially called a Wholly Owned Foreign Enterprise (WOFE) to manage the portfolio of Chinese investments. Nevertheless, because these WOFEs raised dollar funds, they were treated as foreign investors and certain sectors remained off-limits.

This cumbersome and expensive legal arrangement, however, had one advantage: when it came time to exit, IPOs were easier to consummate on an offshore stock exchange, usually Hong Kong, rather than one of the two Chinese stock exchanges that were just beginning to gain traction. Listing requirements on the offshore exchanges were less opaque, issuing companies did not have to compete with the mammoth SOEs dominating the domestic exchanges, and offshore exchanges provided access to a deeper, more diversified pool of international investment capital.

Private Equity with Chinese Characteristics—Tale of a Deal Gone Wrong³¹

Although we were well aware of the stories about the lack of transparency in many Chinese companies, we were looking to make our first deal and spent a lot of time seeking a quality firm. We identified a company in an agribusiness sector with potential for explosive growth: its product market was rapidly expanding, it was a market leader, its clients included the likes of Walmart and Carrefour, and it had firmly established its competitiveness in the Beijing market. We also were attracted to the company because a number of DFIs had already extended financing to the company based on their own extensive due diligence. In sum, everything on paper looked great.

We invested alongside an established Chinese fund manager that had raised capital from foreign LPs and that we believed was highly reputable. As significant minority equity investors, both the Chinese GP and our firm received seats on the company’s Board.

Fast-forward a few years, and we began to discover serious problems. The company was having significant cost overruns on the construction of new facilities, there were production and marketing issues, and the founder/CEO, who was the majority shareholder, clearly did

not know what he was doing. At first we raised our concerns at board meetings without success. We then brought in an industry expert from the United States at our own expense, and he identified 96 changes the company could implement to strengthen performance. But the owner was uninterested in the recommendations.

Shortly thereafter, an independent person on the Board was appointed CFO and it was quickly discovered that a number of sales contracts in fact did not exist, and that products were being sold “out the back door.” We also learned that revenues were no longer growing anywhere near our projections. While the CEO was telling us that it was a difficult environment for all companies in the sector, Nielsen scanner data revealed competitors were reporting 20 to 30 percent increases in revenue. We concluded at this point that we needed to mobilize support from other Board members to replace the head of marketing and remove the founder as CEO—the company had reached a level of size and sophistication beyond his expertise.

Our efforts were strongly resisted. The founder refused to leave, one of the Board members whom we thought was our ally balked at supporting our proposal, another was a friend and staunch ally of the founder, and the local fund manager who had invested alongside us did not want to create problems at a time when they were in the middle of raising a new fund. We were even threatened by one Board member, who said, “We know how to treat foreign wolves in China. We meet them at the door with guns.”

We finally realized the futility of our efforts when one of the shareholders took our Board representative aside and said, “I’m so glad I caught you alone. We all thought you were creating trouble, but the more you talk, the more I realize we are never going to get our money back.” When we pushed this shareholder to support our recommendations for change, she replied, “Oh no, we do not want to make waves with someone as important and influential as the founder.”

What’s interesting is that I don’t know what we could have done differently to achieve a better outcome. The underlying investment thesis for the company remains valid today, but despite our decades of experience vetting founders of emerging market companies, we backed the wrong guy. The company was a market leader in a rapidly growing sector, but it was still the wrong guy. His level of competence for a small-scale operation was quickly surpassed. On the marketing

side, there was an employee who turned out to be his mistress, so no wonder he wouldn't fire her. And who knows what sort of corrupt practices were taking place? He had a view of the company as a piggy bank, and "face" and glory were his motivations.

Amid the legal uncertainty and confusion, the bias favoring domestic over foreign private equity investors was becoming increasingly obvious. For example, a new mergers and acquisitions law passed in 2006 formally authorized the government to approve all investments funded with foreign capital that included "key industries, famous Chinese trademarks and old China trade names," although there was no definition of what constituted a "key industry" or any of the other terms.³² And although a major step forward was taken in 2007 with the approval of a new "Partnership Enterprise Law" that allowed the formation of limited liability partnerships similar to the structure and legal protection applied to private equity funds in many Western countries, the law applied only to domestic partnerships.

Foreign GPs also were subjected to thinly veiled bias in the attractive privatization market. Even the largest, most prestigious international private equity funds that by now had a significant presence and track record in China, such as Blackstone, The Carlyle Group, KKR, TPG, and others, were at a distinct competitive disadvantage that was carefully orchestrated by the government. Much to their mounting frustration, many of these privatization transactions were off-limits. As one local fund manager conceded, "the privatization 'auctions' have always been something of a charade. The Chinese GPs rarely compete against one another. We're friends and talk regularly, and the government [seller] has a strong preference for Chinese rather than foreign GPs when it comes to meting out the privatization deal flow."

Amid this environment—for the first time—a few private equity funds that were managed and staffed 100 percent by Chinese professionals were proving to be competitive with the very best international firms at raising US dollar funds. Prototypical of this new breed was a GP called Hony Capital [*See Sidebar*].

*Hony Capital.*³³

Hony Capital was founded in 2003 with an investment of US\$38 million from a single investor: Legend Holdings, a personal computer business established by the government-owned Chinese Academy of Sciences.³⁴ Legend's influential and politically well-connected founder, Liu Chuanzhi, launched his pioneering first-of-a-kind private equity fund after successfully navigating a daunting maze of government regulatory approvals and political hurdles. With his experience building Legend, Liu understood what the government was trying to achieve during the transition to a market economy. He believed China was at a critical juncture that was likely to create untold opportunities for the nascent private equity industry:

"First, China's traditional industries all have huge room for growth, so the returns on private equity can be even higher than those on venture capital. In other countries, there are limits to the growth of traditional industries, but in China industries like construction materials, textiles, or food and beverages have limited risk and very fast growth, so they are well suited to private equity investment. Second, because Chinese enterprises lack resources, private equity can act like irrigation, stimulating qualitative change as soon as it enters. Third, private equity serves as a good tool for China to reform state-enterprise ownership and management-incentive systems."

Liu's first challenge was to find a leader for the new fund, no easy task given the paucity of Chinese private equity expertise. He turned to John Zhao, a native of Jiangsu province who had attended Nanjing University, and then worked briefly as an engineer at the state-owned Jiangsu Electronics Company before pursuing graduate studies in the United States. After earning two Masters of Science degrees and an MBA from Northwestern University's Kellogg School of Business, Zhao spent ten years working in a number of high-tech companies and Silicon Valley start-ups. He returned to China in 2002 to work as a senior adviser to Lenovo's CEO. Shortly thereafter, Liu Chuanzhi handpicked him as Hono Capital's first CEO.

Pursuing Liu's vision, Zhao immediately began to build Hono Capital. By 2007, with the exception of one midlevel foreign employee, the team was 100 percent Chinese. According to Zhao, hiring a world-class professional staff ranked among his biggest

challenges. Success in the Chinese private equity market would require a unique professional profile, and he proactively recruited individuals who had in-depth local knowledge and strong operating expertise. Value creation skills were a high priority from the outset.

In addition to building a professional staff, the new CEO began to flesh out Hony's investment strategy. A McKinsey & Company top-down analysis of 99 sectors in the economy led to an investment strategy that focused on a few high-growth sectors, such as pharmaceuticals, heavy equipment, and construction materials. Secondary interests included consumer goods, retail, media, and financial services. Zhao explained that this early exercise with McKinsey gave the Hony team focus and discipline as they began to grow their private equity business.

After relying 100 percent on Legend for the first fund in 2003, the second and third funds attracted some of the world's most prestigious LP investors, including the Stanford University endowment, Goldman Sachs, Singapore's Temasek Holdings, the Gates Foundation, and the Rothschild family. By 2013, a decade after its founding, Hony had built up expertise in SOE restructurings, growth capital opportunities, and crossborder investments, and had raised seven funds—five in US Dollars, two in local currency—and managed roughly US\$7 billion in AUM.

The deepening of the local fund manager landscape and the distinctions between foreign and domestic GPs proved to be critical in the next stage of the industry's development. As China continued to register annual economic growth rates of 9 percent to 10 percent, domestic equity markets were soaring to new heights, and a new set of regulatory reforms gave a significant additional boost to the private equity industry: the introduction of local currency financing for fund managers.

From Dollars to Renminbi, and an explosion in speculative activity

Perhaps nothing has been more transformative in the Chinese private equity industry compared to other emerging market countries

than the 2008 decision by the National State Council to permit a select number of large, reputable state-owned savings institutions such as the National Social Security Fund (NSSF)³⁵ and the China Development Bank to allocate up to 10 percent of their assets for investment as LPs in local currency (RMB) private equity funds. Two years later the China Insurance Regulatory Commission followed suit, allowing local insurance companies to allocate up to 5 percent of their total assets in private equity.

Demonstrating once again a preference for local rather than international managers, the government handpicked two of the largest, most experienced Chinese GPs—Hony Capital and CDH Investments—to be the first licensed firms to raise local currency funds, and NSSF was directed to be the “anchor investor” in each, contributing 40 percent of the total committed capital. However, with no experienced domestic institutional LPs to invest alongside NSSF, notwithstanding the excellent reputations of the two GPs and the strong government support for this pioneering initiative, it took more than a year for CDH and Hony to complete their fundraising.

Following these initial steps, at the government’s direction NSSF took the lead to gradually expand the initiative by encouraging other domestic institutional investors to co-invest in new RMB-denominated private equity funds, such as local and provincial government entities. Eventually, a select number of foreign fund managers was also licensed to raise RMB funds, usually in joint ventures with local governments and (frequently state-owned) corporations, such as the Carlyle Beijing RMB Fund, Shanghai Blackstone Equity Investment Partnership, TPG Western Growth Partners I (Chongqing), and TPG Shanghai RMB Fund.

Thus, between 2008 and early 2012, NSSF served as the anchor investor alongside a gradually expanding number of other domestic LPs. The manner in which the government carefully orchestrated this initiative is yet one more example of its unique, hands-on approach to spurring development of the private equity industry “with Chinese characteristics.” On one level, the government’s promotion of local currency private equity financing made perfect sense. After all, capital was hardly a scarce resource in a country with a deeper pool of domestic savings than any

other in the world; but it was intermediated through an inefficient financial system. The move demonstrated that the government at least tacitly recognized the massive private sector financing gap. If banks and other financial intermediaries were unwilling to allocate a portion of their assets to the growth-oriented private firms that were driving the bulk of the country's economic growth, why not encourage private equity investors to bridge the gap?

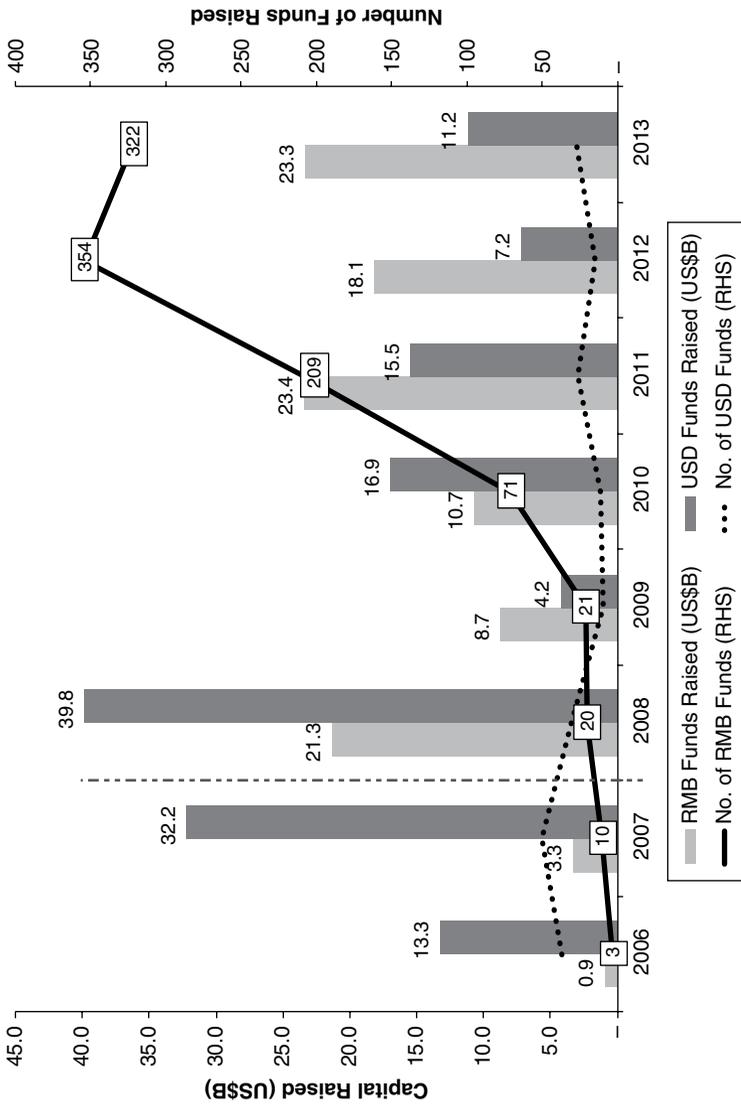
The local currency initiative also signaled the government's acknowledgment that the industry would benefit from less dependence on the dollar financing that had dominated the private equity industry until this time. This was especially relevant from the perspective of the thousands of growth-oriented firms that were active in multiple sectors and were generating RMB revenues. They understandably were uninterested in financing that would unnecessarily expose them to foreign exchange risk.

The consequence of this groundbreaking departure from reliance on dollar financing was immediate and explosive. Within a brief period of four years, RMB fundraising for private equity investing skyrocketed from practically nil to a level that exceeded total US dollar fundraising (see Exhibit 6.7). In the annals of emerging markets private equity, this was an unprecedented development.

But this explosive growth of local currency private equity financing in such a brief time period begot its own problems. Although admirably serving as the catalyst, the government sorely lacked the capacity to regulate or monitor the activities of the flood of new LP and GP entrants to this new, untested market. "No one in government was paying much attention," acknowledged one Chinese attorney. "The CSRC [China Securities Regulatory Commission] had minimal staff capacity to regulate private equity, and understandably focused most of its attention on securities firms and the stock markets. Moreover, the private equity funds lobbied hard and successfully to keep the CSRC at bay at a time when they were profiting from participating in this explosive new domestic market."

So long as the economy continued to expand rapidly year after year and domestic stock exchange indexes were keeping pace, the

Exhibit 6.7 The Rise of RMB Funds



Source: Zero2IPO, 2014.

risks inherent in the local currency market's trajectory was of little concern to government overseers. But as the investment frenzy accelerated, so did the unintended adverse consequences. Many among the avalanche of new local LP and GP investors had limited or no professional investment skills, nor did they have the patience and long-term investment perspective that is imperative for all private equity investors.

Local companies and wealthy individuals who had benefited from the enormous wealth creation in recent years became substantial investors in RMB funds. These investors often had little understanding of the risks associated with committing their capital to a blind pool of illiquid assets managed by private equity fund managers. This mind-set and lack of sophistication caused these investors to have an unrealistically short investment time horizon and inflated expectations of the profitability on their investments. They misunderstood the sharp differences between being a passive (LP) and an active (GP) investor, and therefore tended to be far more likely than more experienced institutional investors to harbor misperceptions about their influence with the GP on how their capital was deployed. When their unrealistic expectations fell short of reality, conflicts began to arise with their GP counterparts, and distrust between the parties escalated.

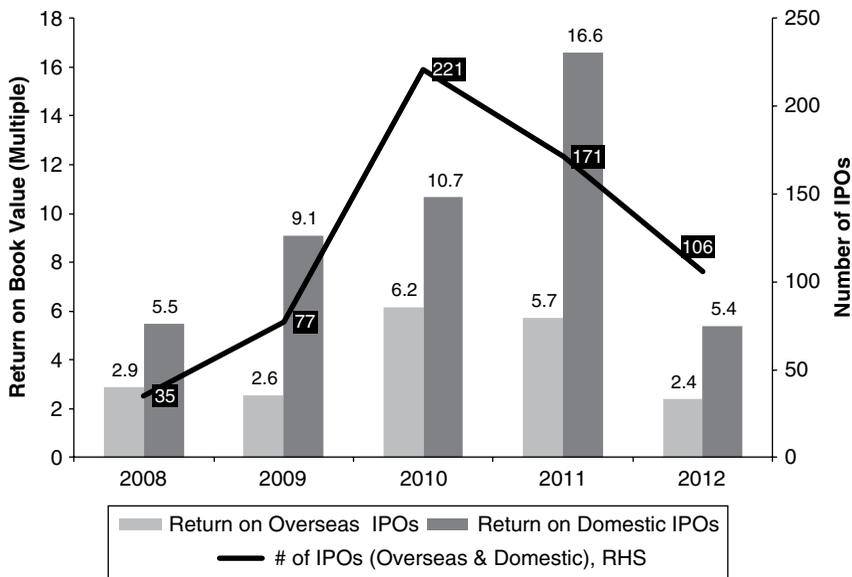
For their part, GPs were loudly complaining about unscrupulous LPs who were refusing to honor their legally required capital call commitments and attempting to meddle in the active management of GPs' portfolios. The crescendo of LP complaints was just as loud once they belatedly began to recognize the risks of investing through GPs that they had failed to properly vet.

Reflecting on the looming reversal of fortunes, the experienced Chinese CEO of one large fund summed up the inevitable consequence: "The huge flood of new local currency private equity funding between 2009 and 2011 was fueled primarily by high net-worth individuals and other unsophisticated speculators with a short-term, get rich mentality. This was the euphoric period when the private equity industry walked on water, and many of these new entrants were dismissive of the concept of risk."

Stakeholders in this booming market—GPs, LPs, portfolio companies—also paid little notice to another problem on the horizon: herd-like investment strategies that focused almost exclusively on companies they believed would be attractive candidates for an IPO within a relatively short period of time. This exceedingly optimistic view was fueled by their belief that the soaring domestic stock market would continue indefinitely. After all, between 2005 and 2008, the Shanghai Stock Exchange index rose about 400 percent,³⁶ and even though the index experienced declines in the wake of the global financial crisis, the market recovered relatively quickly. This created an irresistibly lucrative platform for private equity exits, with valuations reaching astronomical levels compared to those listed on Western stock exchanges (see Exhibit 6.8).³⁷

Between 2008 and 2011 the number of private equity IPO exits was growing at a torrid rate. Presumably, this trajectory contributed to a mind-set among many of the new GP entrants managing

Exhibit 6.8 PE/VC-backed IPOs in China



Source: Zero2IPO, 2014.

local currency funds that virtually ignored basic due diligence before investing or demonstrating a willingness to partake in the essential tasks of value creation once funds were disbursed. Nor did most of the new LPs seem to be any more aware of private equity basics. “It turned out in many cases to be among the blindest forms of blind pool investing ever—a lottery ticket strategy in search of lottery returns,” observed one research report.³⁸ The scenario was unsustainable, and sooner or later a correction seemed certain.

The good times grind to a halt

To paraphrase the famous warning from renowned American economist Herbert Stein, if something cannot go on forever, it will stop. Financial history is replete with boom-bust examples of dire consequences for investors when they ignore this proverbial truth and underappreciate the fundamentals of risk management. As the fallout from the local currency fund initiative demonstrated, despite more than three decades of continuous economic growth and development—accompanied by the inexorable rise of private equity fundraising and investment—China eventually proved no more immune from these dangers than other countries.

As losses began to mount and criticisms grew louder among the entire range of private equity stakeholders, the government became increasingly alarmed by what it had unleashed a few years earlier with the best of intentions. By 2011 it was difficult for government officials to ignore the rampant and increasingly public rumors of insider trading, systemic fraud, and other corrupt practices. The abrupt turning point came in July 2012. A deeply worried CSRC intervened aggressively by abruptly slamming shut the door on new IPOs on both the Shanghai and Shenzhen stock exchanges. For the first time in the asset class’ history, the government’s sudden intervention put an end to the gold rush mentality that had propelled the industry for more than 15 years. As so often in the past, one experienced Chinese fund manager complained, “the government talks about relying more on market forces, but when times get tough the government has proven time and again to be unwilling to allow market forces to play their disciplinary role.”

The result of this government intervention was immediate. By suddenly closing off the IPO exit route, the RMB market was effectively put on hold. By some estimates, more than 760³⁹ private equity-financed Chinese companies discovered that their path to an IPO exit would be delayed indefinitely, and an estimated US\$100 billion or more of LP and GP capital was stranded inside illiquid private equity investments.⁴⁰ In a matter of weeks following the CSRC action, the Shanghai Stock Exchange index descended to levels not experienced since the depths of the global financial crisis, and the government at first gave no signal as to when the IPO market might reopen. Amid the heightened uncertainty, new private equity fundraising and investment also plummeted. In 2013, for example, there was almost a 13 percent year-over-year decline in capital committed to new funds, and a 30 percent reduction in the number of funds achieving a close.⁴¹ Meanwhile, only 18 pre-IPO deals totaling US\$1.8 billion took place in 2013, compared to annual averages of 45 deals totaling US\$3.8 billion between 2009 and 2011.⁴²

In January 2014, the CSRC began to gradually reopen the IPO window, but with more stringent rules governing listing requirements. Forty-eight successful IPOs were completed on domestic exchanges during the first five weeks of 2014, with glimmers of a gradual recovery on the horizon.⁴³

Conclusion

Contrary to the cyclicity that is a hallmark of private equity in virtually every other country, prior to 2012, the trajectory in China traveled in only one direction: up. Fueled by 30 years of robust economic growth and an expanding private sector populated by countless companies starved for capital, the brief history of the asset class in China rarely experienced a period of slow or negative growth. One investor, struggling to come to grips with the losses in his fund in 2013, explained, "No one in China had any experience with anything other than year after year of rapid private equity growth and seemingly endless opportunity. No one had experienced a downturn, so it's not surprising that risk was systematically underappreciated." Unlike every other developed and

developing country where the cyclical nature of private equity has periodically taken its toll, amid the seemingly endless growth trajectory in China it was easy for all the stakeholders to turn a blind eye to the risks.

The events of 2012–2013 put an end to these unrealistic perceptions and triggered a long overdue correction. Industry participants in China learned that their market is no exception to a fundamental truth: private equity is a high-risk asset class subject to cyclical bouts of volatility, as discussed in chapter 1. The other painful, but necessary lesson learned during this tumultuous period was the importance of the fundamental building blocks, constructed gradually over an extended period of time, that lead to a mature private equity industry. Even taking into account that the Chinese private equity industry would develop in its own unique way, according to Chinese characteristics, the underpinnings of a solid ecosystem, as described in chapter 2, still must be put in place.

Despite all its impressive progress, the industry had grown too rapidly, stretching capacity to its breaking point at every level, be it human capital skills, adherence to the rule of law, the importance of corporate governance and transparency, a modicum of credible government oversight, and a range of other factors. The question was less whether the bubble would burst, than when.

If the damage caused by the sudden downturn was unavoidable, it also served as a constructive reminder of a lesson learned by private equity professionals time and again, in country after country: investment success ultimately hinges upon value creation, one company at a time. One long-time China watcher observed, “Looking ahead, successful private equity investing in China will be no different really than anywhere else in the world. To succeed, it takes hard and committed work inside a company. That means focusing far more on operational excellence and how to enhance the value once you’ve invested.”⁴⁴

As noted at the outset of this chapter, the evolution of the Chinese private equity industry bears both striking similarities to and differences from other emerging market countries. On one level, the explosive growth of the asset class in a country that continues to be at least nominally communist defies conventional explanations. Should LPs and GPs be indicted for foolishly succumbing to the

irresistible opportunities created by the world's largest universe of capital-starved companies operating in a pseudo-market economy, even though devoid of the basic safeguards and infrastructure that are taken for granted in more advanced countries? Or should they be applauded for recognizing that with each passing day, China is becoming more capitalist and less communist, and that this will generate untold new investment opportunities?

Notwithstanding the risks and contradictions inherent in a "socialist market economy," most Chinese and foreign private equity practitioners continue to reside in the latter camp. They are reconciled to and reasonably comfortable with the tension inherent in a doctrinaire communist political system gradually orchestrating the transition to a more market-oriented economy. In the aftermath of the damage triggered by the CSRC intervention in the summer of 2012, as the industry began to recover its footing, few were likely to disagree with the admonition of one investor who survived the downturn: "We need to go back to basics. That means focusing on value creation, rather than a short-term time horizon and expectations of executing quick IPOs at very high multiples."

7

Brazil: The Country of the Future

In the old days a Brazilian business owner would be ridiculed if he actively sought outside investors. Now it's the opposite, and is regarded as a sign of great prestige and status. Once we had a private equity partner, our credibility was enhanced enormously with clients and banks. They took us more seriously.

—*Founder and CEO of a São Paulo software company*

With more than a hint of fatalistic resignation, Brazilians have long observed that theirs is the country of the future... and always will be. Geographically immense, with an economy and a population almost twice as large as any other in Latin America, Brazil is also endowed with enviable natural resources. But time and again throughout the country's tumultuous history, one or the other economic or political crisis has undermined the predictions of hopeful optimists and provided rich fodder for cynics. As former president Fernando Henrique Cardoso explained about his country, "this special kind of failure that results when tantalizing potential falls tragically short of expectations. That is the kind of failure that Brazil has always specialized in."¹ The country profile has been marked by endless boom-and-bust cycles of rampant inflation, anemic economic growth, a huge external debt burden, income inequality, systemic corruption, notoriously unreliable legal enforcement, low labor productivity, and abysmal physical infrastructure. As one of the country's leading economists explained in early 2014, even taking into account the relatively strong economic performance

of 2008 to 2010, “the government has failed to undertake many fundamental reforms in the past decade.”

But this seemingly unattractive country profile tells only one side of a more complex story. In fact, notwithstanding the mosaic of contradictions and risks, over the years investors have found ample reason to be attracted to Brazil. The private equity industry in particular stands in sharp contrast to the “special kind of failure” depicted by President Cardoso. For more than two decades, Brazil has ranked near the top of emerging market countries in terms of fundraising and investment activity, as well as the size and diversity of active GPs. Even when recent setbacks are taken into account, few developing countries can claim as mature and diversified a private equity industry as Brazil.

Investors have had good reason to flock to Brazil. If for no other reason, size alone continues to play in the country’s favor. Between 1996 and 2012, GDP per capita increased from about US\$6,500 to US\$11,630, elevating Brazil’s ranking to the world’s seventh-largest economy. With a population approaching 200 million inhabitants, Brazil is by far the largest domestic market in Latin America, while the middle class expanded by more than 35 million people between 2001 and 2012, fueling a surge in consumer spending across a broad spectrum of sectors. “Consumption has structurally shifted up,” remarked the partner of a Brazilian GP,² which explains why consumer-oriented sectors have become the primary focus of many private equity fund managers, regardless of their size. Notwithstanding a disappointing economic downturn beginning in 2011, these factors shed light on why Brazil remains among the most attractive emerging market private equity destinations. Only India and China have registered higher volumes of private equity fundraising than Brazil during the past several years (see Exhibit 6.2), validating the premise that sheer economic and demographic size are important drivers of private equity activity in emerging markets, and that is unlikely to change.

Aside from its size, Brazil shares a number of characteristics with other emerging markets, especially within the vast midsection of the private sector, which generates both challenges and opportunities for private equity practitioners. Investors can choose from tens of thousands of midsize firms, many of which share the same

profile highlighted throughout this book. From information technology to entertainment, retail markets to health care, environmental protection to construction, sector after sector is populated by companies that often perform reasonably well until they reach a certain stage of development. Then they hit the proverbial financial wall. Future growth hinges upon access to additional capital and expertise, and by scaling up either through organic expansion or the acquisition of competing or complementing firms. Echoing a common view among Brazilian private equity investors, the partner of one fund manager commented, "Many markets are still very fragmented, and because of that, economies of scale are a major driver of competitive advantage."³

Then there is the damaging financing gap. One survey of Brazilian SME owners, for example, revealed that more than 70 percent rely exclusively on internal financial resources to fund their growth, and only 4 percent had obtained outside equity financing.⁴ World Bank research on the banking sector concluded that in Brazil, "financial intermediation, in terms of both absolute interest rates and spreads, remains among the highest in the world, and credit is rather scarce for a significant proportion of the economy." Smaller firms, according to the report, are singled out as being especially "credit constrained, with the cost of credit being the most commonly cited reason for not applying for a loan."⁵ As if to verify this conclusion, the owner of one midsize company explained, "Here in Brazil the banks are useless. They demand onerous collateral, interest rates are prohibitive,⁶ and the terms are lousy." This troubling private sector profile, however, creates a potential bonanza for private equity investors.

This chapter first traces Brazil's two-decade private equity history, highlighting periods of impressive growth followed by setbacks that were caused primarily by a combination of foreign and domestic financial crises. Then the country's private equity ecosystem is assessed, demonstrating that many of the features described in chapter 2 are gradually materializing in Brazil, providing the underpinnings to allow the asset class to grow and mature. However, as will be discussed in the final section, the Brazilian private equity industry is sharply bifurcated, leaving the vast Brazilian mid-market badly underserved by investors, for a number of

country-specific reasons. Most notably, Brazil's real interest rates are among the highest in the world, creating perverse disincentives for the country's pension funds and institutional investors, who otherwise would be more inclined to allocate a portion of their capital to private equity. As a result, GPs focused on middle-market companies are severely underfunded even though the country is endowed with a deep pool of domestic savings. If and when the government loosens monetary policy, domestic LPs are likely to look at the asset class more favorably, and the private equity industry will be positioned to play a far more significant role as a provider of financing and value creation to Brazilian companies.

Capitalizing on Fragmented Markets

The private equity investment that led to the IPO of Odontoprev, a Brazilian dental care provider, demonstrates the opportunities generated by inefficient, fragmented markets. "Our approach from the very beginning focused on consolidation opportunities in sectors that were hyper-fragmented," explained a senior partner of TMG Capital, the midsize Brazilian GP that orchestrated one of Brazil's most celebrated private equity success stories in the mid-2000s. "After visiting hundreds of companies in the late 1990s looking for investment opportunities, we discovered dental care almost by accident, and quickly determined that no one was paying attention to the enormous potential of this sector." With more than 700 small and unsophisticated providers, the dental market was a highly fragmented, badly underpenetrated segment of the health-care industry; only 3 million Brazilians out of a population of just under 200 million were covered by dental plans, but the numbers were rapidly increasing.

Odontoprev was founded by an entrepreneurial dentist, Dr. Randal Luiz Zanetti, who foresaw the consolidation opportunities even before being approached by TMG. He was confident that if his company could access capital to begin acquiring other small providers, he could create a nationwide network of dental providers under one corporate umbrella. This shared vision with TMG resulted in a US\$8 million investment in 1998, a time when the company had just 82 employees. As the TMG partner explained, "We were very hands-on from the very beginning. We had weekly meetings with Dr. Zanetti and senior management, and we inserted a TMG partner initially as CFO." In the years following TMG's investment, Odontoprev

acquired a number of competitors and steadily increased its market share. It also implemented a series of internal, value-creating changes, such as installing management and financial information systems and developing a revamped marketing and branding strategy that attracted an impressive portfolio of large national and multinational corporate clients. As the company continued to grow, the gains generated from scale resulted in a steady reduction in unit costs, improved operating margins and higher profitability. Eight years after the initial investment, Odontoprev had grown from a handful of small offices in São Paulo to 14,000 dental providers located throughout the vast country; revenues had grown from about US\$9 million annually at the time of the original investment to more than US\$100 million; EBITDA increased at a 56 percent annual rate; and, the company's market share equaled that of its four largest competitors combined. With the company widely recognized as the country's leading dental health care company, it was time to exit.

In November 2006, riding the crest of a sustained track record of profitability, Odontoprev successfully completed an IPO on BOVESPA's Novo Mercado,⁷ the segment of the domestic stock exchange designed for small- and medium-size local companies. The highly publicized R\$522 million (approximately US\$233 million)⁸ IPO was 13 times oversubscribed, with 40 percent of the net proceeds allocated to the company and 60 percent to the founder, employees, and private equity investors. TMG's return was 40 times its original investment.

A brief history: The stages of Brazilian private equity

An initial spurt of growth and optimism: Until about 1995 there were only a handful of GPs operating in Brazil, and private equity could hardly be labeled as a distinct asset class. There was no government recognition or support for private equity, nor did international private equity investors display more than occasional interest in venturing into this unexplored territory.⁹ But in the mid-1990s the private equity landscape began to change, and there were clear indications of an industry poised for takeoff. Domestically, the Brazilian economy showed signs of recovery and growth in the aftermath of the debilitating external debt crisis of the so-called lost decade of the 1980s. Stronger macroeconomic performance was spurred by a range of new initiatives, including the government's 1994

introduction of a much-heralded new currency, (i.e., *Plano Real*) by Minister of Finance Fernando Henrique Cardoso (who would soon thereafter become president), a series of legal reforms that for the first time established procedures defining how venture capital and private equity funds should be organized and regulated,¹⁰ and the launch of an ambitious privatization program in 1997 that captured the attention of foreign investors.

These favorable developments contributed to a surge of interest in private equity. More than 60 new private equity funds were functioning by 1997 with capital under management totaling more than US\$8 billion, double the amount two years earlier.¹¹ And as a further sign of increasing momentum, some of the major international banks and private equity funds, such as Advent International, were opening offices in the country. Brazil seemed poised to establish itself as a credible private equity market with the capability to finance a broad range of companies at a time when the economy was growing and the private sector was rapidly diversifying.

2000–2003—The “nuclear winter”: As has so often happened in “the country of the future,” progress stalled. A combination of international and domestic factors transpired over the next few years that reversed the trajectory of both the economy and the fledgling private equity industry. Some factors were hardly unique to Brazil, such as the global contagion following the Asian financial crisis in 1997, the Russian government default a year later, and then in 2001 the bursting of the Internet bubble, causing a sudden contraction of the international pool of liquidity that had been flowing to emerging markets. In a pattern that has repeated itself ever since financial markets existed, the investor herd stampeded for the exits in search of less risky assets. As discussed in greater detail in chapter 5, these events inevitably resulted in a serious setback for emerging markets private equity, and Brazil was no exception.

But Brazil was also afflicted by serious domestic problems that further undermined the prospects for the continuation of the early growth spurt of private equity. Most damaging was the severe currency crisis that resulted in the Brazilian Real losing almost two-thirds of its value between mid-January and early March 1999.¹² The consequences for the entire economy were devastating, and

even the most experienced private equity investors were caught unawares by the severity of the downturn. For international fund managers, dollar investments made before the 1999 devaluation were virtually doomed to generate negative returns for their investors unless they could delay exits indefinitely. No matter how well the portfolio companies were performing in local currency terms, the valuations in dollar terms depreciated inexorably once the Brazilian Real plummeted.

By 2001–2002 the first anecdotal results for Brazil’s private equity funds that had been created in the 1990s began to trickle out. Like many other emerging market countries during this period, Brazil’s performance was well below investors’ lofty expectations, and prospects for raising additional capital came to an abrupt halt. Veteran Brazilian private equity investors who lived through those years of massive disappointment refer to this epoch as the industry’s “nuclear winter,” a period of steep financial losses, and more importantly, a mass exodus of dispirited investors. Many even speculated whether the asset class was so badly discredited that perhaps it would not recover.

2004–2010—The boom years: Just when this pessimistic outlook seemed likely to become a self-fulfilling prophecy, another dramatic turn of events led to a private equity resurgence. In 2004 Brazil began to ride the crest of a growing wave of renewed international interest in emerging market private equity that was similar to a decade earlier. This time, however, it was not only strong global economic growth and increasing liquidity that was driving the recovery (see Exhibit 7.1). Much to everyone’s surprise, “the country of the future” appeared to be making a convincing case that “this time will be different.” By almost every macroeconomic indicator, Brazil was demonstrating sustained improvement, along with admirable political stability. GDP increased annually at a rate of 4 percent to 5 percent between 2003 and 2008, the nemesis of debilitating inflation was finally under control, interest rates declined sharply, the currency strengthened, and a series of economic reforms appeared to establish a solid foundation for future gains.

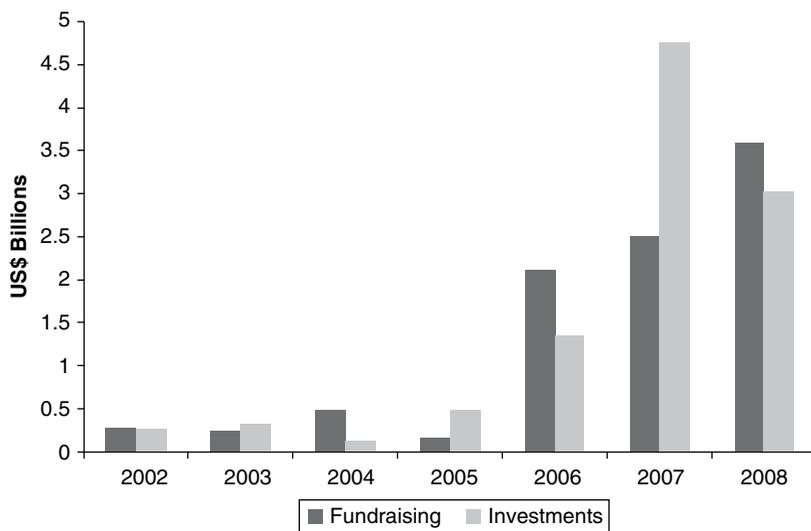
By virtually every metric, the private equity industry’s growth during this period paralleled or exceeded the country’s strong macroeconomic performance. As demonstrated in Exhibit 7.2,

Exhibit 7.1 Brazil Macroeconomic Indicators, 2003–2008

Billions of USD	2003	2004	2005	2006	2007	2008
GDP	552.4	663.7	882.0	1,089.3	1,366.9	1,653.5
Current Account Balance	4.2	11.7	14.0	13.6	1.6	-28.2
FX Reserves		52.9	53.8	85.8	180.3	193.8
Inflation (percent)	14.7	6.6	6.9	4.2	3.6	5.7
Exchange Rate (BRL/USD)		2.9	2.4	2.2	2.0	1.8
GDP per Capita (USD)	3,090	3,665	4,810	5,870	7,284	8,721

Source: International Monetary Fund.

Exhibit 7.2 Brazil Private Equity Fundraising, 2002–2008 (US\$ Billions)



Source: EMPEA.

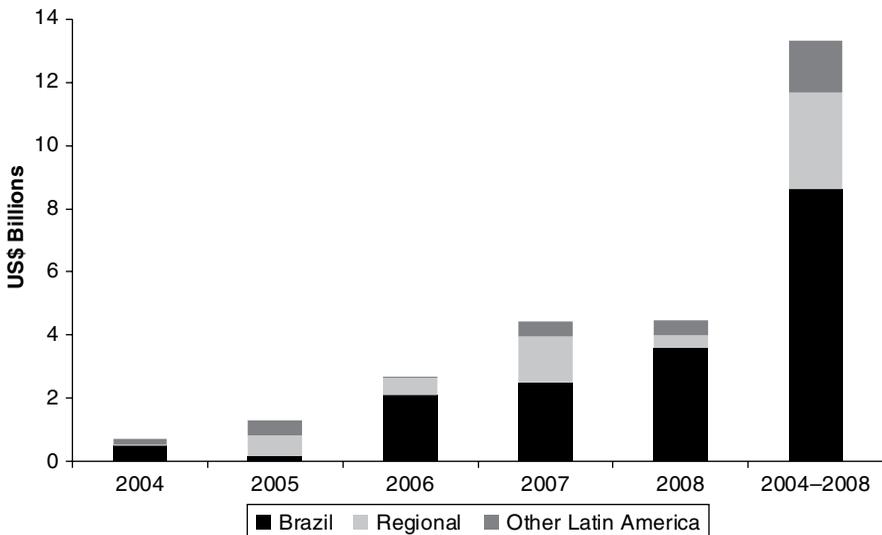
fundraising and investment increased sharply in tandem with the economic recovery. Fundraising, for example, soared more than tenfold between 2004 and 2007, from a negligible US\$500 million to more than US\$5 billion, and private equity

investment increased at a similar pace, benefiting companies across a diverse array of sectors, including agriculture, consumer goods, pharmaceuticals, electricity and power, and software development.

Even accounting for the country's dominant size compared to the rest of Latin America, Brazil's private equity transformation was impressive. Its share of total Latin American private equity activity has long dwarfed the rest of the Southern Hemisphere, and consistently represented 55 percent to 60 percent of total fundraising almost every year from 2002 to 2009, and over 50 percent of total investing (see Exhibits 7.3 and 7.4).¹³

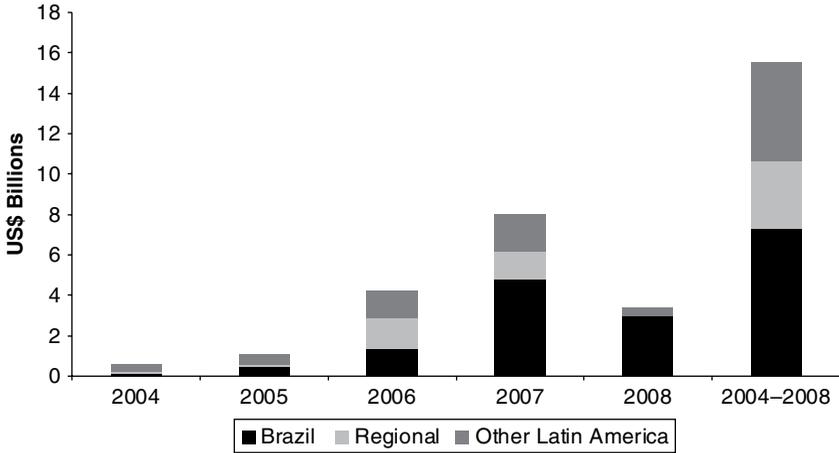
In private equity, the ultimate barometer of success, however, is exit performance, a notoriously difficult factor to assess because private equity funds are not legally required to disclose performance results. The one exception to this conundrum occurs when the exit is achieved by IPO, a public event by definition. The period between 2004 and 2007 was the heyday of Brazilian private equity-backed IPOs executed on BOVESPA, the domestic Brazilian stock exchange (see Exhibit 7.5)—a striking contrast to the period

Exhibit 7.3 Latin America Private Equity Fundraising, 2004–2008 (US\$ Billions)



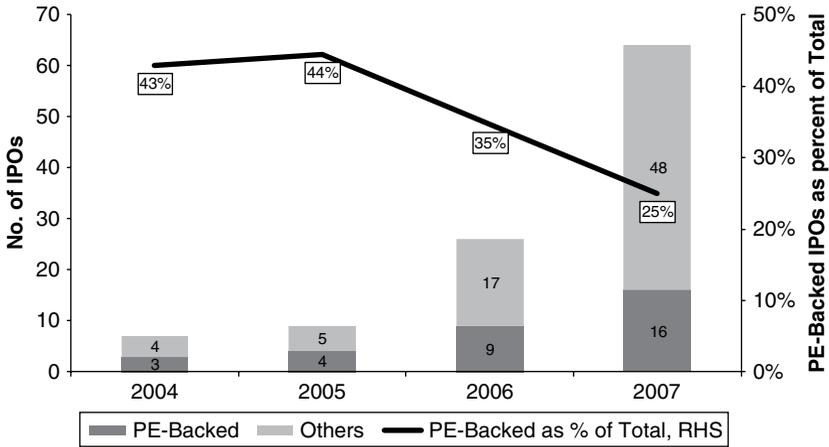
Source: EMPEA

Exhibit 7.4: Latin America Private Equity Investment, 2004–2008 (US\$ Billions)



Source: EMPEA.

Exhibit 7.5 IPO Activity in Brazil, 2004–2007



Source: BM&FBOVESPA.

before 2004 when not a single IPO exit occurred, or in the years between 2008 and 2013 when the domestic IPO market once again became negligible. But during this brief interval, the surge in private equity-backed IPOs significantly raised the profile and reputation of the asset class with investors.

During this period, then, all signs appeared to be favorable for Brazil's private equity industry. The growing volume of fundraising, investments and exits suggested a market that was becoming well established and credible with a broad range of foreign and domestic investors. Even more encouraging, the industry was putting down local roots by attracting more domestic savings, deepening the pool of homegrown skilled practitioners, and building credibility with increasing numbers of entrepreneurs and family-run companies that traditionally had shunned the idea of equity financing.

Even during the immediate aftermath of the 2008–2009 global financial crisis, Brazil's economy demonstrated resilience. Whereas the average OECD country experienced a 2.7 percent decline in GDP in the 12 months following the onset of the crisis, Brazil registered a 4.9 percent increase during same period, and surged 7.5 percent in 2010.¹⁴ This surprisingly robust performance, especially at a time when industrialized countries were reeling from the downturn, predictably created outsized expectations among investors. In early 2011, *The Economist* gushed that international investors' money was "pouring in" to Brazil, and the head of a major international private equity fund confidently exclaimed, Brazil is "absolutely the most attractive emerging market right now."¹⁵

The prevailing sense of unvarnished optimism about future prospects for Brazilian private equity naturally extended to Brazilian fund managers. "If we succeed in raising the capital for our new fund," commented the partner of a local GP, "I am so confident about our prospects for success that it scares me." With the industry growing at a record pace and the economy performing at a level not witnessed in recent memory, it was little wonder that even seasoned industry professionals were in a euphoric mood. Perhaps "the country of the future" was poised to finally live up to its potential.

The repeat of a familiar pattern: Haunted by the familiar prophesy that Brazil would never realize its potential, the economy once again went into reverse beginning in 2011, with all basic economic indicators registering significant declines. Annual GDP growth plummeted from 7.5 percent in 2010 to only 1 percent in 2012, before improving slightly to 2.3 percent in 2013 (see Exhibit 7.6). There were also sharp declines in the value of the Brazilian Real (down about 13 percent against the Dollar in 2013); real interest rates were

Exhibit 7.6 Brazil's Deteriorating Macroeconomic Conditions (2010–2013)

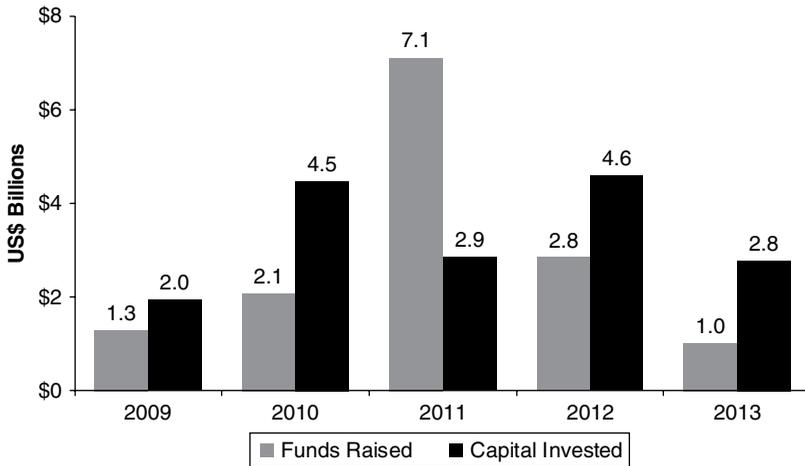
Billions of USD	2010	2011	2012	2013
GDP Growth (%)	7.5%	2.7%	1.0%	2.3%
Inflation (%)	5.0%	6.6%	5.4%	6.2%
Interest Rate (%)	10.8%	11.0%	7.3%	10.0%
Exchange Rate (BRL/USD)	1.76	1.67	1.95	2.16
GDP per Capita (USD)	11,089	12,694	11,437	11,311
BM&FBOVESPA Index	69,305	56,754	60,952	51,507

Source: International Monetary Fund.

among the highest in the world;¹⁶ inflation was beginning to creep up, reaching over 6 percent by late 2013; and the Ibovespa stock market index declined by more than 18 percent between 2010 and 2011, and 15.5 percent during 2012 to 2013.¹⁷ Not only was Brazil registering economic weakness in absolute terms but the slowdown was more pronounced than in other large emerging market countries such as China, India, and Russia, as well as a number of Latin American countries, such as Mexico, Peru, Colombia, and Chile. As had happened so often in the past, these adverse economic developments led to an erosion of investor confidence, which was reinforced by S&P's downgrade of Brazil's sovereign credit rating in March 2014 to BBB-, only one notch above junk bond status.

Predictably, as macroeconomic performance deteriorated, so did private equity fundraising and investment (see Exhibit 7.7). Even during the post-crisis period when the economy at first demonstrated encouraging resilience (2009–2010), private equity fundraising and investment activity remained well below the levels achieved from 2006 to 2008, and there were indications that Brazil was falling out of favor with investors compared to other emerging markets

Although there were encouraging signs in 2011 that private equity activity was beginning to rebound, the optimism proved short lived. Between 2012 and 2013 fundraising and investment declined 64 percent and 39 percent, respectively, and although the comparable numbers for the rest of Latin America were also disappointing during this period (down 38 percent and 22 percent, respectively), Brazil fared considerably worse than its neighbors.

Exhibit 7.7 Private Equity Fundraising and Investment in Brazil, 2009–2013

Source: EMPEA.

The erosion of investor confidence was reflected in one survey of LPs' emerging market private equity preferences, revealing that Brazil had fallen from the number one ranking in terms of attractiveness in 2011 to sixth in 2013.¹⁸

These disappointing numbers made it easy to conclude that once again the asset class appeared to be facing an uncertain future in Brazil. However, such a pessimistic interpretation ignored significant gains made during the previous two decades. Rather than a harbinger of a singularly grim future, a more nuanced assessment of the private equity industry reveals significant strengths in addition to weaknesses.

Brazil's private equity ecosystem: Assessing 20 years of gradual progress

Brazil's 20-year private equity history depicts an industry profile that is arguably as durable and mature as in any emerging market country. Although the Brazilian ecosystem is by no means on a par with developed countries, and the macroeconomic volatility continues to deter some investors, the pillars needed to support a sustainable private equity industry have gradually grown stronger.

Emergence of a diversified range of foreign and domestic GPs: Although it stands to reason that steadily increasing private equity interest in Brazil would be accompanied by a surge in the number of GPs, few would have predicted in the early 2000s that the landscape would be populated by such a diverse group of fund managers, both local and foreign. When the asset class was first gaining momentum in the late 1990s, with a few notable exceptions, foreign fund managers dominated the industry, as was the case in virtually all other emerging markets. A decade later, in contrast, the composition of the GP population was decidedly different, with a diversified population of small, medium, and large fund managers, many launched and managed by Brazilians (see Exhibit 7.8).¹⁹

At one end of the spectrum reside about a dozen multibillion-dollar foreign and Brazilian buyout funds that are indistinguishable in quality from their counterparts in the United States and Europe (except for the Brazilian composition of their professional teams).²⁰ At the other end is a small but growing number of venture capital funds that also resemble their counterparts in developed countries, focusing on start-ups and early-stage local companies. In-between are the midsize growth capital funds that focus on the vast mid-section of the Brazilian private sector where many thousands of established companies operate in diverse sectors.

Deepening pool of Brazilian private equity professionals: The steady increase of Brazilian-managed GPs has been accompanied by an expanding population of qualified local private equity practitioners.

Exhibit 7.8 Composition of Private Equity Fund Managers in Brazil

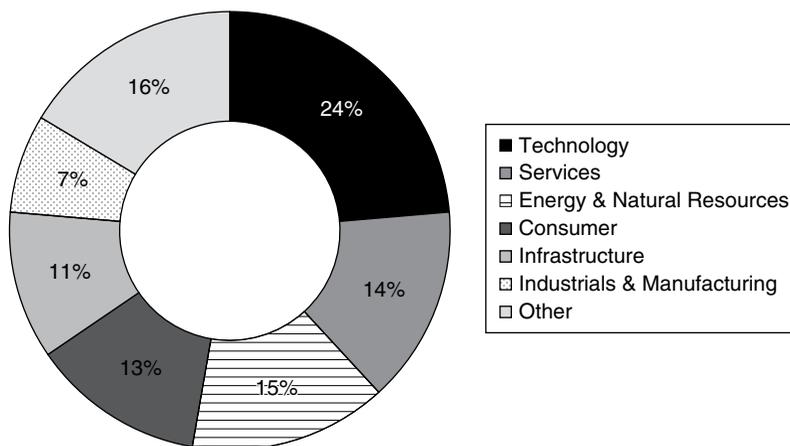
Origin	2004		2009	
	Number	Percentage	Number	Percentage
Brazil	53	74.7%	102	73%
Latin America	–	–	3	2%
United States	10	14.1%	22	16%
Europe	4	5.6%	7	5%
Others	4	5.6%	6	4%
Total	71	100%	140	100%

Source: GVcepe of FGV-EAESP Fundação Getulio Vargas.

Even the foreign GPs with Brazilian offices are staffed almost entirely by Brazilian professionals. The Carlyle Group, for example—one of the world’s largest private equity firms, with more than US\$200 billion in assets under management and a global network of offices across six continents—opened its São Paulo office in 2010 with a team comprising 100 percent Brazilians managing funds denominated in both Brazilian Reals and US Dollars. This transformation has dramatically deepened the pool of skilled indigenous practitioners with hands-on private equity experience, and bodes well for the industry’s long-term future.²¹

Private equity investment penetrates virtually every sector of the economy: As the private equity industry has gradually expanded, hardly any sector has been overlooked by fund managers (see Exhibit 7.9). Replicating a pattern witnessed in other emerging markets, investors have focused especially on deal flow generated by the rapid rise of an urban middle class. As the partner of one GP commented, “What gets us excited is the local domestic consumer market.”²² Despite the ups and downs that have characterized the Brazilian economy in the past 20 years, between 1995 and 2012, GDP per capita (PPP) increased from about US\$6,500 to US\$12,600, while the Gini coefficient fell from about 0.6 to 0.53.²³ In other words, as

Exhibit 7.9 Brazil Private Equity Investments by Sector, 2013



Source: EMPEA.

the middle-class population was becoming larger and wealthier on a per capita basis, income inequality was diminishing.

But the breadth of private equity deal flow in Brazil extends far beyond the opportunities generated by a growing middle class. Unlike earlier periods of the industry's growth, for example, GPs are increasingly specializing in commercial and residential real estate, and the entire spectrum of infrastructure sectors that historically have been neglected by investors.²⁴ Thus the GP landscape in Brazil has all the markings of an increasingly diverse private equity industry that is investing in every corner of the private sector.

Senior Solution's IPO

In the mid-1990s, a Brazilian software engineer with grand ambitions and limited capital launched a company called Senior Solution to design customized software for large banks, insurance companies, and other financial institutions. Bernardo, the company CEO and founder, remembers well that during the start-up years his new company encountered a number of challenges:

Senior Solution started with only myself and one other employee. As software designers we didn't need much capital in the beginning; we financed our operations from personal savings and the cash flow generated from our first clients. By the early 2000s, however, our niche in the software sector was experiencing extremely rapid growth. But the sector was hugely inefficient, with intense competition among hundreds of small, undercapitalized software providers that were unable to gain access to the financing needed to grow to the next level. We believed that the best way to get ahead of our competitors was to quickly achieve scale through acquisitions. Even though we could demonstrate a track record of steady growth and profitability in a dynamic sector, the banks paid no attention to us because of our small size and because, as a service company, we had no fixed assets, real estate, or anything else to offer as collateral for a loan. The sector was ripe for consolidation, but everyone was facing the same financing obstacle. I was confident our company could become a market leader if only I could raise capital, use the proceeds to acquire some of my competitors, and achieve scale."

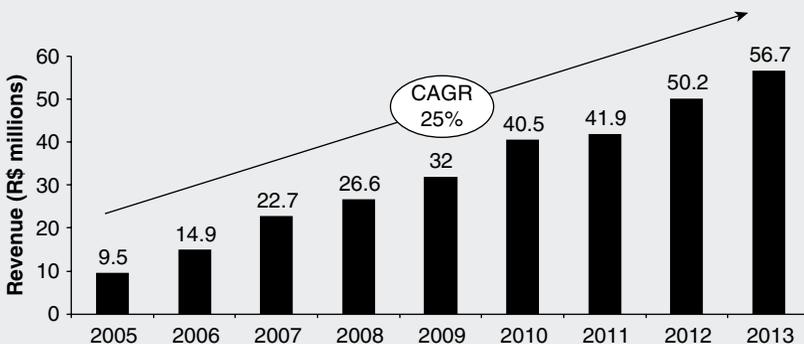
In the early 2000s Bernardo met with more than 15 private equity funds and other investors without success. Then, in 2004, Bernardo finally

entered into serious negotiations with Stratus Group, a midsize private equity fund, and BNDESPar,²⁵ the subsidiary of the Brazilian development bank that specializes in equity financing for small and midsize companies, and which already was a lender to the company. After almost a year of due diligence and tough negotiations over an acceptable valuation, Bernardo finally agreed to sell a 36 percent equity stake to the two outside investors in 2005. Once the company was fortified with its first significant capital injection, the proceeds were used to make three acquisitions in less than two years, followed by two more by 2011. In addition to strengthening the balance sheet, as Bernardo explained, “We benefited from the participation of our new Board members—a Senior Partner from Stratus and the representative from BNDESPar. They actively participated in our monthly Board meetings and played a significant role in mapping out and implementing our growth strategy. The Stratus team also participated actively in our negotiations with each acquisition target, and once we had a reputable private equity firm as a shareholder, our company suddenly caught the attention of clients who previously had ignored us. Stratus provided the company with the credibility and expertise I simply did not have.”

Between 2005 and 2013, Senior Solution’s revenues increased at a CAGR of 25 percent, from R\$9.5 million to R\$56.7 million, and the company built a roster of more than 180 clients, including the ten largest banks in Brazil.

By 2012, although the sector was still highly fragmented and ripe for additional consolidation, Senior Solution was widely viewed as the market leader. As Bernardo explained, “Now we were ready to move to the next level of satisfying all requirements to become a publicly listed company, which would allow us to draw on a deeper pool of capital. With a successful

Exhibit 7.10 Senior Solution’s Growth



Source: Stratus Group.

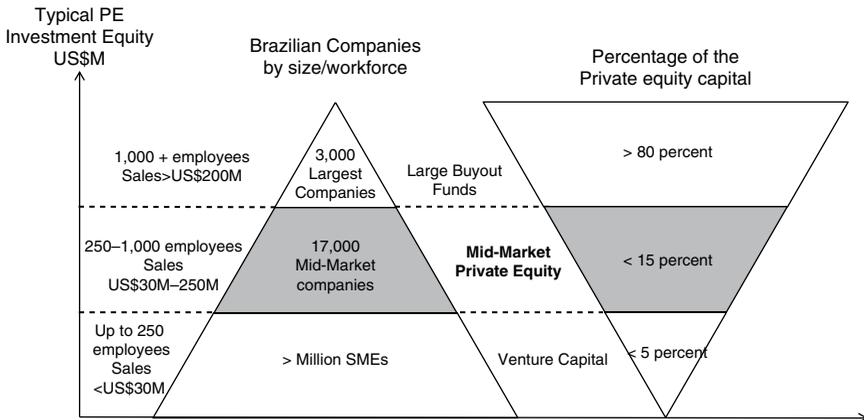
IPO, we could continue making acquisitions, enhance our credibility with both clients and other sources of finance, and sustain our strong growth and bottom-line financial performance.”

With Stratus continuing to play an active advisory role, Senior Solution proceeded to go public in two steps. In 2012, the company met all the stock exchange requirements and was officially listed as a public company. A year later the company successfully raised R\$57 million in one of the smallest IPOs in BOVESPA’s history. About 60 percent of the net proceeds went into the company coffers to finance future expansion, and the balance was allocated to the pre-IPO shareholders (e.g., the founder, company employees, Stratus, and BNDESPar).

The middle market: A private equity opportunity waiting to take off

As much as any emerging market country, Brazil is an exemplar of the intricate mosaic of challenges, risks and, most importantly, opportunities for private equity investors who focus on the vast, highly diverse universe of middle-market companies. As illustrated in Exhibit 7.11, an estimated 17,000 companies with annual revenues in the range of US\$30 million to US\$250 million occupy this broad swath of Brazil’s private sector, more than five times the number

Exhibit 7.11 The Underserved Middle Market in Brazil

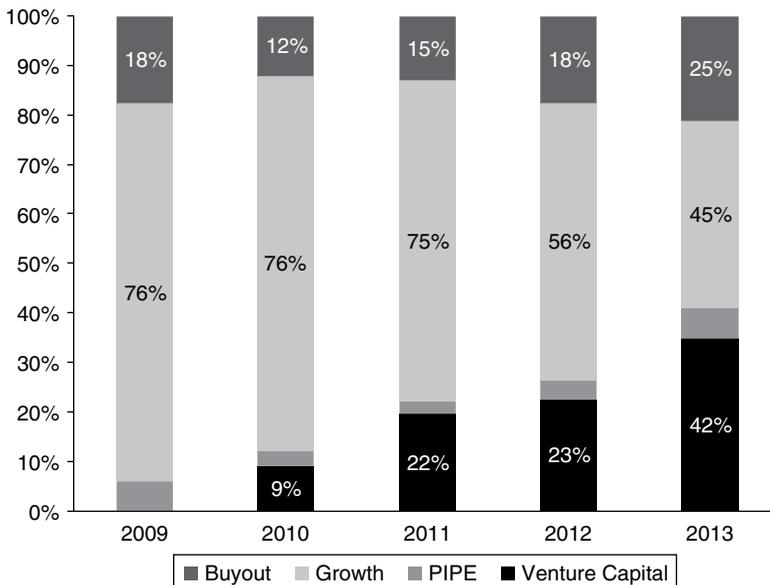


Source: Stratus Group, 2013.

classified as “large.”²⁶ The typical profile of these midsize businesses includes a number of features similar to those in other emerging market countries: owned and managed by the founder or members of her family; limited or no access to medium- or long-term capital to expand the business; and weak management skills that become increasingly apparent as the company grows and is subjected to heightened competitive pressures. Simply put, this universe of middle-market firms provides a quintessential example of the growth capital private equity investment opportunity. As one Brazilian fund manager explained, “There is an ocean of midsize companies that are ready to emerge, but are underserved and without access to alternative sources of capital. It is probably the sweetest spot—adjusted to underlying risks—for investment in the world today.”

Yet between 2010 and 2013, the number of private equity investments directed to this so-called sweet spot ranged from a paltry 50 in 2010 to 25 in 2013, and during the same four-year period mid-market deals as a percentage of total private equity transactions diminished sharply, from 76 percent in 2010 to 45 percent in 2013 (see Exhibit 7.12).²⁷ In a glaring understatement that is revealing if

Exhibit 7.12 Private Equity Investments by Stage in Brazil, 2009–2013



Source: EMPEA.

unsurprising, one Brazilian private equity investor observed, “In a country with thousands of midsize companies that are the primary drivers of the world’s seventh-largest economy, it is very frustrating that we manage to complete so few mid-market deals each year.” The comment and the underlying data provide a striking affirmation of a major premise of this book: by any measure the largest segment of Brazil’s private sector is grossly underpenetrated by private equity investors.

External fundraising for midsize Brazilian GPs

Numerous explanations account for this disconnect between the sizable potential middle market deal flow and the low volume of investment activity directed to these firms. The problem in this market segment starts with fundraising. Recounting a saga repeated countless times not only in Brazil but by mid-market fund managers in most emerging market countries, the frustrated founding partner of a GP with a ten-year track record explained: “I spent two years trying to raise a fund of about US\$200 million. Although the process was very expensive for a small fund like mine, with the help of a placement agent I visited more than 80 LPs in the United States and Europe between 2011 and 2013, and still I came away empty handed. The LPs were unenthusiastic about investing in a small fund, and they were nervous about Brazil’s deteriorating economic situation.” With one or two notable exceptions, virtually every midsize Brazilian GP that attempted to raise capital externally during this period encountered the same result, presumably for similar reasons.²⁸ Although some of these GPs had been operating in Brazil since the early 2000s and could point to profitable exits (e.g., see Odontoprev, Senior Solution), international LPs found them wanting relative to their alternatives.

In a familiar emerging markets pattern, international LPs exhibited a strong preference to invest larger amounts of capital with a small number of Brazil’s largest brand-name GPs. In 2011, for example, 99 percent of the US\$7.1 billion total funds raised went to just five very large GPs, each with well over US\$1 billion in AUM.²⁹ In 2012 the pattern repeated itself; five GPs captured nearly 75 percent of total funds raised, although the total of US\$2.8 billion was

sharply lower, as Brazil's reputation as an emerging markets investment destination sharply deteriorated due to continuously poor macroeconomic performance, and fewer large funds were in the market.

Laden with billions of dollars of "dry powder" to invest, a handful of large firms compete with one another to execute deals at the top of Brazil's private sector pyramid, where a relatively small universe of 3,000 large companies resides (see Exhibit 7.11). These GPs have simply become too large to make investments in the middle market. "The individual investments in our portfolio companies range from about US\$80 to US\$200 million," acknowledged a partner in one of these large funds. Ironically, they are often targeting the same large companies with the easiest access to traditional sources of financing, unlike their medium-size counterparts that continue to be victimized by the financing gap.

This fundraising pattern speaks for itself. There is a gross mismatch between the primary destination for the bulk of private equity investment and the underserved 17,000 midsize companies that comprise the largest volume of potential deal flow. This is where competition is less intense, valuations are relatively attractive, and sector inefficiencies (e.g., fragmentation) create potential outsized growth opportunities for companies fortunate enough to receive a private equity investment. But judging from the anemic results from midsize Brazilian GPs seeking to raise capital externally, foreign institutional investors clearly have little appetite for committing relatively small amounts of capital. In addition to eschewing these fund managers because of their size, foreign LPs point to other significant differences when comparing these firm to the few large GPs, such as the relatively low volume of successfully exited deals with acceptable returns, the longer investment period for many midsize deals, and the relative inexperience of their professional deal teams.³⁰ With limited prospects in the international fundraising market, the future survival for most of these midsize GPs appears to depend primarily on their ability to attract capital from Brazilian LPs. Although some domestic institutional investors are gradually increasing their exposure to the asset class, the evolution of this funding option has its own hurdles.

The challenges of increasing local currency fundraising

Just as regulatory changes served as a catalyst for sharply increased private equity activity in the United States and other developed countries (see chapter 2), the Brazilian government attempted to give a strong boost to the asset class in 2009 by resetting the maximum amount pension funds could invest in private equity from 2 percent to 20 percent of their AUM. As the single largest repository of domestic savings with about US\$340 billion AUM in 2011, Brazil's approximately 400 pension funds represent an enormous untapped source of domestic capital for private equity investors. However, rather than embracing the regulatory change, as occurred in the United States and other developed countries, Brazilian pension funds have continued to be reluctant private equity investors, much to the frustration of GPs.

The most formidable obstacle to increasing local currency financing for private equity is the interest rate environment. Historically, Brazil has used an aggressive monetary policy to keep inflation in check, which has resulted in real interest rates that rank among the highest in the world.³¹ Investors of all stripes, therefore, have little incentive to stretch for higher returns by allocating a portion of their capital to riskier financial asset classes, as is the norm in most countries. "Brazilian pension fund culture has always been predominantly fixed income because of our country's history of high interest rates," explained the chief investment officer of a prominent local pension fund. This strong fixed income bias is predicated on the long-time practice in Brazil of pricing bonds to provide investors with a spread over the official inflation rate. For example, if a Brazilian ten-year government bond is issued with a 7 percent coupon and the inflation rate is 6 percent, investors automatically generate a return of 13 percent, which is adjusted periodically to reflect changes in the official inflation rate. Thus government authorities have created perverse incentives that allow pension funds and other large institutional investors to consistently generate real returns in the range of 5 percent to 7 percent by investing in highly liquid, risk-free government bonds. Conversely, institutional investors have little incentive to allocate capital to private equity—illiquid and relatively high risk—regardless of a GP's track record.

“It is very difficult for me to convince our Board to take the additional risk inherent in private equity when we can consistently get at least a 6 percent real return from our fixed income portfolio,” explained a Brazilian pension fund investment officer. “No matter how much I may like private equity and appreciate the rationale for constructing a diversified portfolio of financial assets, the fixed income rationale makes perfect sense for a fiduciary like ours.” Emblematic of the ease with which Brazilian pension funds generate unusually attractive returns, the pension fund for employees of the São Paulo Metro reported an enviable 19.5 percent consolidated financial return in 2012; 68 percent of its portfolio was allocated to fixed income securities and less than 6 percent to alternative assets, including private equity.³² The chief investment officer of another midsize pension fund with a similar track record and only modest allocations to private equity explained, “Even though I am personally attracted to the asset class, private equity is a lot of work for a small fund like mine. Not only is there more risk, especially compared to the fixed income alternatives, but we encounter a lot of GP governance issues. In addition, even when exits are good, they invariably take longer to materialize. Every single GP in our private equity portfolio has requested an extension of the investment period.”³³

And it gets worse. Although there is always an inherent tension between LPs and GPs over the fee structure, regardless of the country, the combination of high interest rates and *de facto* indexation puts Brazilian GPs at a distinct disadvantage. One Brazilian pension fund investment officer acknowledged in 2014, “We have significant pricing power. If a GP approaches us for capital, at least for now they must accept our conditions.” Little wonder then that LP terms in Brazil are extremely onerous compared to most other countries. For example, it is standard practice in all countries for LPs to be granted a preferred return on their committed capital (i.e. the “hurdle rate”) before any profits are distributed to the GP (discussed in chapter 1). However, once LPs receive their designated preferential return, it is customary for the GP to receive an equivalent return, called a “catch up,” and only then is the remaining capital gain distributed proportionately.³⁴ Due to the unprecedented pricing power of pension funds in Brazil, however, standard

practice is turned upside down, to the detriment of the GPs. As one investment officer explained his fee negotiation strategy with GPs, "We insist on a high hurdle rate, *plus* a spread to cover inflation, and we refuse to have any 'catch up.' It's a deal breaker for us if a GP resists our terms!" Thus, if the preferred return is 8 percent and the official inflation rate is 6 percent, the LP demands an effective hurdle rate of 14 percent, and the GP does not benefit from a "catch up." With this unprecedented formula for profit distributions, GPs begin to receive their performance-based compensation (e.g., carried interest) only *after* the LP has earned a full 14 percent on its original investment. For example, if an exited transaction generates a very respectable 25 percent IRR, the GP's share of carried interest will only equate to 11 percent. These unusually harsh terms are unheard of in developed countries, where LPs do not enjoy anything resembling the leverage exerted by their Brazilian counterparts, nor are these terms common practice elsewhere in emerging markets.

In another departure from standard international private equity norms, a precondition for many Brazilian pension funds that allocate a portion of their capital to private equity is participation on the GP's investment committee. In effect, these LPs insist on being active rather than passive investors, participating in decisions that customarily are the exclusive purview of the GP. Not only do some of these LPs have limited experience and qualifications to assess the quality of individual deals being considered for investment, but GPs frequently grouse that their participation often complicates and delays the decision-making process. "Their intrusions are totally dysfunctional," complained one GP, "but unless we accede to their terms, we'd be out of business." It is unsurprising, therefore, that virtually no Brazilian GP of any size approaches fundraising from domestic investors with enthusiasm. Instead, they begrudgingly accept this Faustian bargain in order to survive, hoping that sooner or later the environment will change and negotiations will be conducted on a more level playing field.³⁵

"If interest rates would start to come down," one Brazilian LP acknowledged, "we would have more incentive to diversify our investments and everything would change for the private equity industry." For a brief period, between 2009 and 2012, there was a

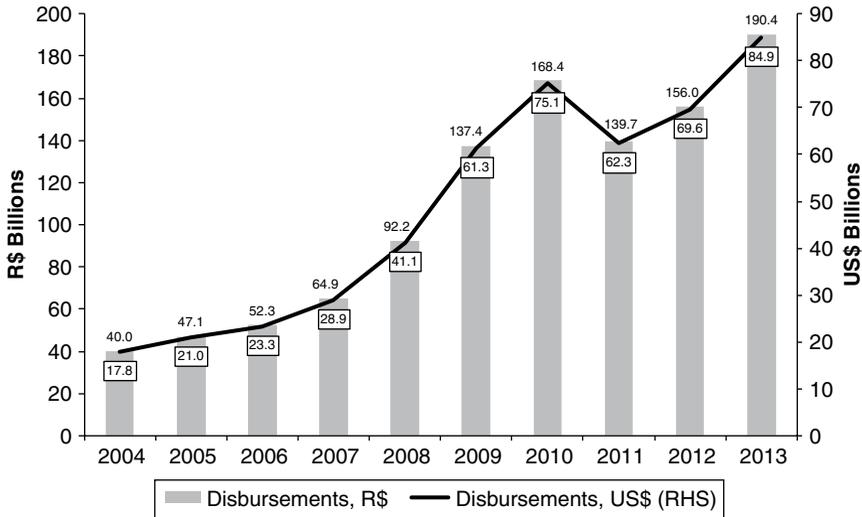
glimmer of hope that this prognosis would come to pass. “Starting in 2009, as interest rates started to decline, we began to diversify more aggressively, and we looked more at private equity and other alternative assets,” according to one local LP. But this favorable trend proved to be short lived once the looming threat of higher inflation returned. In the 12-month period beginning in January 2013, the Brazilian benchmark interbank rate rose steadily from 7.25 percent to 10 percent,³⁶ quashing any hopes of a more favorable domestic fundraising environment for private equity investors.

Despite the near-term disincentives created by the domestic interest rate environment, some signs suggest that the asset class will receive a more favorable reception from Brazilian institutional investors with the passage of time. As a senior investment officer at one of the largest pension funds predicted: “Because we are very optimistic about private equity in Brazil over the long term, I expect our allocations to increase as we build internal confidence, and more local GPs meet our standards. Moreover, because ours is one of the largest pension funds in the country, others are likely to follow our lead, and the amount of local funding for private equity will increase.” Even though data to support this more optimistic prognosis is scarce, the view is buttressed by anecdotal evidence. For example, there is a widespread consensus among LPs and GPs alike that the pool of skilled Brazilian professional institutional investors with responsibility for assessing private equity opportunities is gradually deepening, and some of the biggest pension funds have even created entire departments specializing in the asset class.³⁷

The catalytic role of government

The most notable exception to the reluctance of domestic financial institutions to commit capital to private equity has been the state-owned Brazilian Development Bank, commonly referred to as BNDES (National Bank for Economic and Social Development).³⁸ Founded in 1952, the bank has been actively promoting the asset class since the 1990s, when the domestic private equity industry was still in its infancy. To put the enormous size and influence of BNDES in perspective, the bank disbursed over R\$190 billion in 2013 (see Exhibit 7.13) to a broad range of Brazilian

Exhibit 7.13 BNDES Disbursements, 2004–2013



Note: Conversion from R\$ to US\$ as of May 7, 2014.

Source: BNDES Annual Report, 2013.

companies—both private and state owned—about three times the total amount disbursed globally by the World Bank the same year.

Through all the ups and downs of Brazil’s private equity history, BNDES has played a more prominent role than government-owned financial institutions in most other emerging market countries, providing both direct and indirect support to the industry. “We would not be where we are today,” explained one veteran Brazilian fund manager, “without the support we have received from special government programs designed to promote local private equity and venture capital. These programs have demonstrated convincingly that government support for private equity can serve as an effective catalyst.”

A significant part of the BNDES financing mandate has been to serve as an LP providing capital to carefully selected Brazilian GPs that invest in small and midsize firms. In much the same way as IFC and a few other private sector-oriented DFIs serve as a key source of private equity financing, the development bank also plays a highly influential role as a catalyst in attracting additional

domestic LPs to the fund managers it supports. For example, in 2011 the bank launched an initiative to invest R\$1.5 billion (about US\$670 million) in up to ten Brazilian GPs (eight mid-market private equity funds and two venture capital funds). The BNDES financial commitment to each fund manager was limited to a maximum of 25 percent of each fund, with the balance expected to be raised from other domestic LPs. The bank undertook a careful GP selection process, with priority given to fund managers with a commitment to invest in companies focused on the agribusiness and ethanol/biomass generation sectors. A third BNDES priority was support for local fund managers committed to strengthening the corporate governance practices of their portfolio companies, regardless of sector.³⁹

Three years later, in April 2014, BNDES launched a similar but even larger program, with a R\$3 billion (about US\$1.3 billion) allocation to finance up to 12 private equity and venture capital funds. As with the 2011 initiative, BNDES would serve as the anchor investor by providing up to 20 percent of the total capital raised by each fund manager. To qualify for the new initiative, GPs are required to meet a number of BNDES' selection criteria, including

- a verifiable track record, including exit performance;
- qualifications and previous private equity experience of the management team;
- adherence to acceptable fund manager governance procedures;
- competitive management and performance fees; and,
- binding commitments from other LP investors.

The bank estimated that its resources, when fully committed, “could leverage up to R\$10 billion in [private equity] investments in about 90 companies, seeking growth and improvements to their management and governance structures.”⁴⁰ Thus, as with past programs, BNDES sought to leverage its own financial resources for private equity investments to entice the participation of other domestic institutional investors. Significantly, BNDES anticipated that its financing initiative would encourage some Brazilian pension funds to reconsider their previous reluctance to commit capital to private equity.⁴¹

An uncertain future

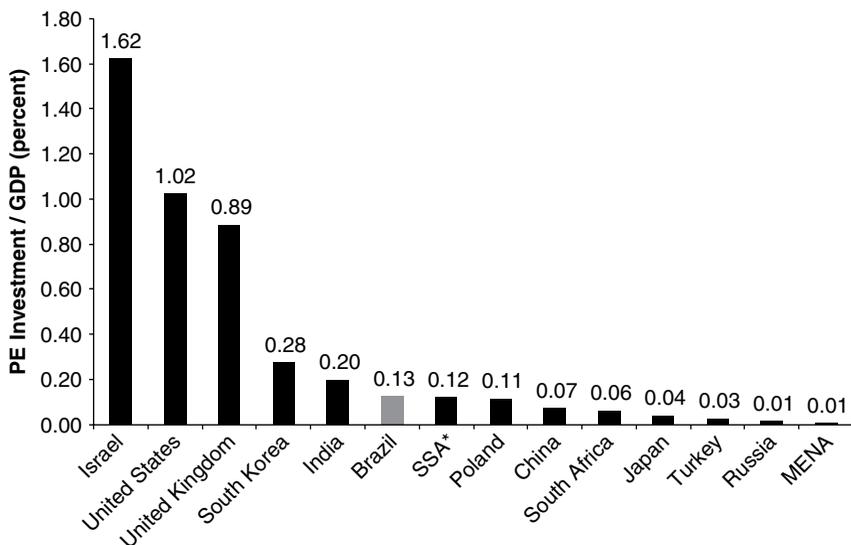
As noted earlier in this chapter, significant strides have been made during the past two decades to strengthen the Brazilian private equity ecosystem. Few emerging market countries have a larger, more diversified number of fund managers staffed by skilled professionals that have gradually accumulated experience at every stage of the private equity cycle. The BNDES, along with other government agencies, has developed a convincing track record of supporting the private equity industry, and notwithstanding the disincentives generated by a persistently high interest rate environment, increasing numbers of domestic institutional investors have gradually demonstrated a willingness to allocate a portion of their capital to private equity. Thus, many of the underpinnings for a thriving private equity industry are already in place, and have the potential to grow stronger with the passage of time.

However, in a discouraging but revealing commentary, one local investor concluded that notwithstanding more than 20 years of effort, “Brazilian private equity is still a cottage industry.” Although this may be an overly harsh assessment, the available evidence suggests that the asset class in the world’s seventh-largest economy has barely begun to achieve its potential. Two indicators in particular lend credibility to this conclusion. First, private equity investment in Brazil as a percentage of GDP remains miniscule, both in absolute terms and compared to other, more developed private equity markets (see Exhibit 7.14).

And the industry’s unmet potential is further demonstrated by a second metric: despite thousands of Brazilian companies that are prospective beneficiaries of both the financial resources and the value creation capabilities provided by private equity investors, the annual number of completed transactions for companies of all sizes is strikingly trivial, with only 55 deals executed in 2013 (see Exhibit 7.15).

It is undeniable that the private equity industry in Brazil is functioning well below its considerable potential. More than most emerging market countries, Brazil is marked by a sharply bifurcated structure. Residing at one end of the spectrum is a small core of fund managers with the demonstrated capability to raise multibillion-

Exhibit 7.14 Private Equity Penetration in Brazil vs. Other Countries, 2013



*Sub-Saharan Africa

Penetration rate signifies the amount of private equity investment in a given period as a percentage of GDP.

Sources: EMPEA, IMF, Center for Management Buy-Out Research, Pitchbook, Israel Venture Capital Research Center, Asia Private Equity Review.

Exhibit 7.15 Brazil Investments by Stage, 2013 (No. of Deals)

Stage	2009		2010		2011		2012		2013	
	No. of Deals	% of Total								
Buyout	6	18%	8	12%	10	15%	14	18%	14	25%
Growth	26	76%	50	76%	40	75%	45	56%	25	45%
PIPE	2	6%	2	3%	2	3%	3	4%	1	7%
Venture Capital	-	0%	6	9%	15	22%	18	23%	15	42%
Total Deals	34		66		67		80		55	

Source: Emerging Markets Private Equity Association. (Data as of 31 December 2013). February 2014.

dollar funds from sophisticated international institutional investors. Although competition at this high end of the market is likely to remain intense, placing upward pressure on valuations, there is little evidence to suggest that the best of these firms will not continue to attract the lion's share of external capital destined for Brazilian private equity. Time will tell whether there will continue to be adequate deal flow for these GPs targeting a limited number of large companies occupying the top of the Brazilian private sector pyramid. However, recognizing the possibility of a shrinking supply of attractive investment prospects, these large GPs have begun to adjust their strategies by gradually morphing into diversified asset managers, in much the same way as many Western megabuyout funds have evolved (see chapter 2). One obvious consequence of this shift is likely to be a rebalancing of their attention and resources to investment opportunities other than mainstream private equity.

Below these large funds lies a population of scores of small and midsize fund managers—those focusing on the investment opportunities among the thousands of midsize firms that have been highlighted throughout this book—and many are struggling to survive. Due to fundraising difficulties, most of these GPs significantly undershoot their potential to serve as financiers, value creators, and true partners for countless businesses that occupy the vast midsection of the Brazilian private sector. So long as interest rates remain inordinately high and de facto indexation is standard practice, local currency fundraising for most of these midsize GPs will remain difficult,⁴² and their prospects with international LPs appear no more promising. Although the evidence is anecdotal, as one Brazilian GP with more than a decade of experience observed, “not only is the middle-market private equity industry not growing, it may be shrinking because of our fundraising problems.”

Regardless of whether this dour assessment is exaggerated, it sheds light on the challenges that must be addressed in order to better serve the needs of the large midsection of Brazil's private sector. Despite the government's efforts to catalyze mid-market private equity, ironically, one of the most significant obstacles to an expansion of middle-market private equity in Brazil is the government's very own monetary policy. The imposition of high

real interest rates effectively channels the country's savings away from productive private sector investment. If and when these rates decline, the prospects for attracting considerably greater volumes of local currency financing for private equity are likely to significantly improve, especially for midsize GPs. This one change would likely accelerate the transition of private equity from a cottage industry, and allow it to begin realizing its potential as a significant source of financing and value creation for Brazil's large, diverse private sector.

8

Kenya: Challenges and Opportunities in a Frontier Market

In Africa there are hundreds of deals but you have to go and look for them. In the West investment bankers bring you deals, but in Africa they are way down the food chain. You have to work harder and it takes time to build relationships with the founders.

—Africa-focused fund manager

The demographics of Kenya are very compelling. With its youth and middle class, alongside the country's economic growth rate and fragmentation in sectors with good growth potential, I am optimistic that the [private equity] industry here will grow.

—Africa-focused institutional investor

“One of my biggest frustrations when speaking with outsiders is explaining that Africa is not a country,” explained a longtime private equity adviser residing in Nairobi. “There are 54 countries, each with its own distinct culture, ethnic mixture, and business environment that must be taken into account by prospective investors, whether private equity or otherwise. You cannot cross a border and think everything will be the same.”¹ As this chapter will demonstrate, Kenya is endowed with a set of characteristics—including its relatively large population and long history as the primary hub for East African business and finance—which in some respects sets it apart from the majority of the other 53 African nations from a private equity perspective. But set aside these distinctions, and it bears more similarities to than differences from most nations on

the continent, as well as other low-income countries throughout the developing world, that are striving to build a private equity industry.

In the shorthand of investors, then, Kenya's profile fits perfectly within the universe of so-called frontier markets, a broad category that encompasses the smallest and least developed countries, most of which were barely recognized by private equity investors until recently. Although the label itself is disturbingly imprecise—like so many others that attempt to categorize developing countries—according to IFC methodology, frontier markets generally refer to the world's poorest countries.² Not coincidentally, by any measure these countries also tend to have business sectors that are comparatively rudimentary and lacking in a critical mass of investment opportunities that are likely to attract a significant influx of private equity investors. Couched slightly differently, if generally true that the private equity ecosystem described in chapter 2 leaves virtually all emerging markets lagging developed economies, then frontier markets are even further behind—and Kenya is well within the mainstream of these countries.

With approximately 46 percent of its population living below the poverty line, Kenya is among the 40 poorest economies in the world.³ Like most other countries in this unfortunate category, Kenya is plagued by weak infrastructure, an inefficient financial system, and an unreliable regulatory and legal framework, all of which hinder overall business activity. In the World Bank's *Ease of Doing Business* rankings, for example, of the 189 surveyed countries in 2014, Kenya ranked 129th, seven places lower than the previous year. Confirming the challenging environment for investors, even by frontier market standards, Kenya ranked 134th in starting a business, 151st in enforcing contracts, and 166th in getting electricity. Access to finance is also a key constraint for many Kenyan businesses: 61 percent of SMEs' investments are financed internally as opposed to 24 percent by banks and 8 percent with equity; however, this is slightly better than the average for Sub-Saharan Africa, where approximately 79 percent of SME investments are financed from internal sources.⁴

Similar to other frontier markets, the private equity industry in Kenya is in its early stages compared to the more developed

Exhibit 8.1 Kenya Macroeconomic Indicators, 2008–2013

Billions of USD	2008	2009	2010	2011	2012	2013
GDP	30.5	30.6	32.2	34.3	40.7	45.1
Current Account Balance	-2.0	-1.7	-2.4	-3.8	-4.3	-3.7
Inflation (%)	15.1	10.6	4.3	14.0	9.4	5.7
GDP per Capita (USD)	785.8	768.4	787.9	816.8	942.5	1,016.5

Source: International Monetary Fund

emerging markets—it is newer, smaller, and far less established than China, Brazil, and the handful of other emerging market countries that has attracted the lion’s share of investor attention in the past 15 years. But it is worth recalling that the private equity profile of these larger countries was similar in the late 1990s when pioneering fund managers were just beginning to consider investing in emerging markets. At that time, there was virtually no private equity activity in China, and only a handful of funds were starting up in Brazil. Back then, the asset class was barely discussed in these markets, and when it was, “nascent” was the most oft-heard word to describe these local private equity industries.

In Kenya today, it is the rare private equity practitioner who does not resort to precisely the same term to describe the industry. But if this connotes small and new, it also suggests something with growth potential, which is reinforced by the country’s demographics. Kenya’s population has soared from about 10 million in 1963, when the country won its independence from Britain, to more than 40 million in 2013, including an estimated two-thirds who are age 25 or younger. GDP growth has been impressive in recent years, increasing from US\$30.6 billion in 2009 to US\$40.7 billion in 2012. As in other countries, strong economic performance has fueled the rapid expansion of the middle class, which in turn has driven the creation of new businesses catering to the expanding population of consumers with disposable income. As one institutional investor notes, “The demographics of Kenya are very compelling. With its youth and middle class alongside the country’s economic growth rate and fragmentation in sectors with good growth potential, I am optimistic that the [private equity] industry here will grow.”

It is this optimism about the attractive demographics that has lured increasing numbers of private equity investors to Kenya who view the market as a key access point to tap some of the growth dynamics characterizing a number of other countries in the region. “Those who have watched consumer growth explode in emerging markets like Brazil, India, and China recognize that Africa is now poised for the same dramatic expansion,” explained one investor. “Spending on consumer goods is projected to grow to US\$500 billion by 2020 [and] in the next 10 years over 200 million people on the continent are going to emerge from poverty into sort of a lower middle class, where for the first time they’ll have the disposable income to consume beyond the bare basics.”⁵

The managing director of one global private equity firm remarked enthusiastically, “We’re not even at chapter 1 of private equity in Africa.”⁶ This assessment accurately captures both the opportunity and the embryonic nature of the Kenyan private equity landscape. Broach the subject of private sector development in Kenya, and private equity is unlikely to even enter the conversation. Move on to private capital inflows, and the narrative is all about foreign direct investment, remittances, and occasionally microfinance. Private equity is largely unrecognized by most members of the business community, commercial bankers, government officials, and others with some level of professional responsibility for spurring higher levels of private sector productivity and growth. With a few notable exceptions, the same holds true for the thousands of Kenyan entrepreneurs and business owners who are the potential recipients of the capital and value-creating expertise that could be provided by private equity investors to grow their businesses. Nonetheless, there are unmistakable signs that this profile is slowly changing, albeit at an uneven pace.

Rapid Growth of Urban Middle Class: Necessary But Not Sufficient

Spend time with private equity investors in Kenya and a narrative begins to unfold that is identical to the one heard in virtually any other developing country, regardless of geography, level of economic development, or size. Optimism surrounding the potential for the asset class is based on the country’s demographics and an unstinting faith that deal flow will be

robust and sustainable for one reason above all others: the urban middle-class population is rapidly expanding. This new category of consumers is defined by its strong appetite for spending disposable income on a seemingly endless shopping list of products and services—fast food, pharmaceuticals, mobile phones, consumer durables, furniture, education, and health services. Urban dwellers also appeal to consumer-oriented companies because higher population density translates into significantly lower costs and higher margins for firms geared to mass market consumption. Moreover, these consumers are far more likely than their counterparts in the rural areas to have a bank account and access to the Internet—two factors that open wide the door to expanding consumer credit.

Kenya is no exception to this demand-driven middle-class dynamic and, unsurprisingly, many of the country's fund managers articulate an investment strategy that follows the same script: pick a consumer-oriented sector, identify a market leader, capitalize on opportunities for rapid expansion and consolidation, and execute. This oft-repeated scenario, based on a foundation of solid data, is compelling. For example, annual per capita income in Nairobi is almost twice as high as the level on a nationwide basis.⁷ At the regional level, a 2011 study by the African Development Bank predicted that East Africa is likely to demonstrate the strongest growth performance among Africa's sub-regions and that by 2060 it will have a per capita income ten times higher than 2010 levels.⁸

But Kenya also illustrates as vividly as any developing country that although a rising middle class may be an important driver of successful private equity investing, it is not sufficient. Savvy investors recognize that private equity is much more about the myriad micro factors within a company and sector than the broader macro trends. No matter how compelling the middle-class growth story, as described in previous chapters, a company lacking a qualified management team and workforce, sound corporate governance, and transparent financial reporting will likely fail to capitalize on this trend.

The genesis of private equity in frontier markets: The Kenya case

In 1996 the US\$20 million Acacia Fund was launched as the first private equity fund dedicated to Kenya, with the capital provided by the British development agency CDC Group (then known as the Commonwealth Development Corporation), other DFIs, and a few local institutional investors headquartered in Nairobi. Over the next

few years Acacia made a series of minority equity investments averaging about US\$1 million in small local companies across a broad range of sectors, from cement to dairy production to agribusiness. Not only was the fund itself a pioneering venture in the truest sense of the word but equally significant was that Acacia served as the indispensable training ground for many practitioners who were the true trailblazers as the first private equity investors operating in Kenya at the time, and who in later years would move on to create their own new private equity funds in the region. Thus, Acacia served as the catalyst for an emerging class of indigenous private equity professionals who formed the essential core of the industry as it began to slowly develop. In addition, with 18 investments in small- and medium-size enterprises, Acacia generated a positive demonstration effect for private equity among many local business owners as they watched their peers' businesses grow even though their ownership stake was being partially diluted by the entrance of new shareholders.

Despite the Acacia Fund impact on the Kenyan market, CDC was struggling to justify its continued support for single-country funds that were generating relatively low returns. Moreover, CDC was seeking to move away from direct investments to a model of supporting fund managers as a limited partner. In 2001 this strategic reassessment culminated in the spin off of all its SME investments into a new and separate entity, which would eventually be named Aureos Capital. Another development finance institution, Norway's Norfund, also invested in the new firm, attracted by its support for SMEs. The newly created Aureos took over CDC's existing investments in 139 companies, including the entire Acacia Fund portfolio.⁹ In 2003, Aureos launched a US\$40 million successor fund to Acacia to invest in East Africa, and over the subsequent decade the firm continued to invest in SMEs in the region, as well as in other emerging market regions.¹⁰ Reflecting on this beginning stage of private equity in the region, one of the earliest investors in Kenya emphasized, "Not only were the DFIs absolutely critical in the early years from a funding standpoint, they also heavily influenced our investment priorities." This meant, not surprisingly, the investment criteria and portfolios of Kenya's first funds closely mirrored the characteristics of growth capital private equity investing elsewhere in the developing world, even though the size of the GPs and the companies was smaller: minority equity investments in firms identified as having

high-growth potential led by an entrepreneurial founder who tightly controlled and managed the business but who was open to outside investors, and a clear value creation agenda that would lead to a profitable exit within a reasonable time period. During the first few years of the new millennium, Aureos had the SME growth market in Kenya largely to itself. Although a few other funds sporadically entered the region, most targeted larger, more established businesses.

Between 2003 and 2008, when the private equity industry was experiencing meteoric growth in the larger, more mature emerging market countries (see Exhibit 4.2), the earliest movers had limited competition for deals in Kenya. Paradoxically, it was only in the aftermath of the 2008–2009 global financial crisis—a time when investors of all types were in distress and beating a rapid retreat to low-risk, safe havens—that a number of new private equity funds began to open their doors for business in Nairobi. Driven by the combination of favorable macroeconomic and demographic indicators, as well as encouraging support from the DFI community that was giving an increasingly high priority to financing small and midsize companies, these first-time GPs believed that East Africa was ripe for attractive deal flow.

Kenya was a logical base for private equity investors entering the region. For more than half a century, it had served as the principal hub for multinational corporations and financial institutions operating in East and Central Africa. Virtually every international organization and DFI that attached a high priority to Sub-Saharan Africa had its East African headquarters in Nairobi. Additionally, Nairobi was considered a hospitable place to live compared to other cities in the region. One local fund manager acknowledged, “We are attracted by the lifestyle. Even Nigerians would rather live here.” As a result of these factors, Nairobi has become the center of the private equity industry operating in East Africa, serving as the base for several dozen GPs and a large number of service providers specializing in private equity, such as lawyers and accountants. The Kenyan capital also became the headquarters for the region’s first industry body, the East Africa Venture Capital Association.

The success of the private equity model in South Africa further fueled the drive into East Africa. Home to the earliest private equity commitments on the continent, South Africa has bred a number of local firms, such as Ethos Private Equity and Brait. In addition,

many of the pan-African GPs, whether based in London, New York, Washington, or within Africa, have a critical mass of their portfolio in South Africa. As Western LPs' appetites were whetted, several adopted a pan-African strategy—even though many understood that the dynamics of private equity investing outside of relatively well-developed South Africa would be vastly different than within. Asked why his firm was making the push into East Africa, one fund manager responded, "It's simple. Our investors want us to diversify into these markets." An East Africa-based private equity adviser echoed this sentiment, "GPs realize that they have to look beyond South Africa—primarily because their LPs are telling them that they won't be providing support unless their funds diversify into other African countries."

The evolution of a bifurcated private equity landscape

At first glance, the layered structure of the Kenyan private equity industry is not dissimilar from the larger emerging market countries, even though the overall universe of fund managers is far smaller. At the upper end of the market reside a few large international GPs that compete on a sub-regional and continent-wide basis for a relatively small but growing pipeline of cross-border investment opportunities that require sizeable financing commitments, such as capital intensive infrastructure projects in sectors like telecommunications or extractive industries (e.g., oil and gas). This category includes the likes of global private equity firm Warburg Pincus, which spearheaded a US\$600 million investment in a Central and East Africa-focused energy exploration and production company in 2013, and Actis, a global emerging markets fund that acquired an interest in a Nairobi-based construction management company focused on local real estate developments. A number of other global players have also increased their commitment to the region, such as The Carlyle Group, which closed a US\$698 million pan-African fund in 2014.

In addition to these large global players, about half a dozen relatively large pan-African GPs in the AUM range of US\$500 million to nearly US\$2 billion, such as Emerging Capital Partners (ECP), AfricInvest, and Helios Investment Partners.¹¹ Most of these pan-African GPs have professional teams working from Nairobi-based

offices, and their investment strategies primarily target sizable transactions with companies that operate regionally rather than within the borders of a single country. But these large funds tend to compete with one another for limited deal flow at the high end of the market. “Except for infrastructure, there are very few US\$100 million deals in Sub-Saharan Africa north of South Africa,” explained an adviser to a number of these large fund managers, “and it’s even challenging to find good deals requiring a private equity investment over US\$50 million.” A similar assessment was offered by the partner of a large pan-African fund: “Given the size and maturity of the Kenyan private sector, I would be surprised if we close at most one deal a year here for the foreseeable future.”

Below this thin layer of global and pan-African funds competing for a limited number of relatively large transactions, a fledgling private equity industry with an entirely different profile has emerged in Kenya. Even by emerging markets standards, these firms’ capital under management is modest, ranging from US\$20 million to US\$140 million. With individual investment sizes of about US\$1 million to US\$10 million, these few dozen GPs focus on providing growth capital to Kenya’s small and midsize founder-led companies, typically in exchange for a minority equity stake. Similar to their counterparts elsewhere in emerging markets, they place a high premium on targeting companies that are willing and able to take advantage of the value creation expertise they offer. Most significantly, almost without exception, these are first-time fund managers. By 2013 most had been in business for only two or three years. As a result, their portfolio of completed deals was understandably thin, and they had registered few exits.

As the number of GPs in the region has increased, so too has the competition for attractive deals. In a 2014 survey of over 40 fund managers seeking East African investments, 96 percent expect competition for new deals in the region to intensify, a 41 percent increase from the year prior. Juxtaposed to this evidence of an increasingly competitive environment, the same survey reported that a total of only 12 deals was executed in Kenya in 2013, 6 more than the previous year.¹² Although it is difficult to draw conclusions from only one survey, the data suggest that either this universe of small and midsize GPs must generate considerably more deal flow or many are destined to disappear.

Surprisingly, according to the survey, despite the paltry number of deals executed in Kenya, these funds managers are overwhelmingly bullish about their deal flow prospects. One fund manager explains, "It's been about 50 years since independence, which has resulted in the start up of many local businesses; now many of these founders are thinking actively about succession, and they want liquidity. Some are emotionally attached to their business but may not have family members to take over, while others recognize they may not have the in-house capacity to scale up the business." A more seasoned investor with over 20 years of experience in the region offered a more cautious assessment: "In Africa there are hundreds of deals but you have to go and look for them. In the West investment bankers bring you deals, but in Africa they are way down the food chain. You have to work harder and it takes time to build relationships with the founders."¹³

Exhibit 8.2 Sampling of Funds Investing in Kenya, 2008–2013

Fund Manager	Fund Name	Geographic Detail	Sectors
8 Miles LLP	8 Miles	Sub-Saharan Africa	Generalist
Actis	Actis Emerging Markets 3	Global Emerging Markets	Generalist
Adenia Partners	I&P Capital III	East Africa, West Africa	Generalist
AfricInvest-TunInvest Group	AfricInvest Financial Sector Fund, AfricInvest Fund II (AFII)	Sub-Saharan Africa	Financial Services, Generalist
Altira Group	African Development Corporation Fund	Sub-Saharan Africa	Generalist
Catalyst Principal Partners	Catalyst Fund I	East Africa	Generalist
Citadel Capital SAE	Africa Joint Investment Fund	Sub-Saharan Africa	Generalist
Databank Private Equity Ltd.	AAF SME Fund	Sub-Saharan Africa	Agribusiness

continued

Exhibit 8.2 Continued

Fund Manager	Fund Name	Geographic Detail	Sectors
Decorum Capital Partners (Pty) Ltd.	New Africa Mining Fund II	Sub-Saharan Africa	Energy & Natural Resources
Development Partners International	African Development Partners I	Sub-Saharan Africa	Generalist
East Africa Capital Partners (EACP)	Africa Telecommunications, Media and Technology Fund I, LLC	East Africa	Media & Telecom
Emerging Capital Partners (ECP)	ECP Africa Fund III	Sub-Saharan Africa	Generalist
Fanisi Capital	Fanisi Venture Capital Fund	East Africa	Generalist
GroFin Capital	GroFin Africa Fund	Sub-Saharan Africa	Generalist
Helios Investment Partners	Helios Investors II	Sub-Saharan Africa	Generalist
I&P Management (Indian Ocean) Ltd.	I&P Capital III	East Africa, West Africa	Generalist
InReturn Capital	InReturn East Africa Fund I	East Africa	Generalist
Pearl Capital Partners (PCP)	African Agricultural Capital Fund (AACF)	East Africa	Generalist
Progression Capital	Progression Eastern African Microfinance Equity Fund (PEAMEF)	East Africa	Banking & Financial Services
TBL Mirror Fund	TBL Mirror Fund	Kenya	Generalist
The Abraaj Group	Africa Health Fund	Sub-Saharan Africa	Health Care & Life Sciences

The Quintessential Private Equity Pioneer

“Pioneer” generally refers to an individual who opts at considerable personal sacrifice to embark on something entirely new that, if successful,

opens opportunities for those who follow. By definition, pioneering initiatives entail unusually high risks and uncertain outcomes. Although the term may be overused when referring to emerging market private equity investors, nowhere is it more accurately applied than when describing that rare breed of adventuresome individuals who choose to launch a fund in a frontier market. The composite fund manager CEO profile in Kenya depicts an individual born in the region but who had the good fortune to study abroad, most likely in a US or British university, possibly but not necessarily followed by an MBA or other graduate degree. He then worked for few years with a brand-name firm, probably a large international bank, management consulting firm, or multinational corporation.

Although reasonably successful and financially secure, by his mid-to-late thirties the allure of returning “home” becomes an obsession. At this stage, our pioneer feels compelled to apply the skills and experience acquired early in his career to launch a homegrown private equity fund. He is motivated by a vision that Kenya is poised for economic takeoff, and that small and midsize private businesses will lead the way, capitalizing on growth opportunities in a broad range of sectors, be it basic infrastructure, consumer goods, pharmaceuticals, private health-care services, construction materials, or countless other underfinanced industries. He has done his homework and understands fully that his idea entails very high financial risk, personal sacrifice for himself and his family, high odds of failure, and perhaps most importantly, that many years will pass before his compensation comes close to the earnings generated in his previous job, if ever. But even with his eyes wide open, he is driven: “My life’s journey was to get back to East Africa,” explained one exemplar of this special breed who founded a new Nairobi-based fund. “To do good and do well” is more than an idle cliché for this pioneer.

Once the decision has been made, even though he knows there will be a steep learning curve and painful mistakes will be made along the way, he is confident and clear headed about the fundamental strategy for his new venture: “I knew I wanted to focus on mid-market growth capital—first because that’s where the most attractive opportunities would be, and second because I wanted to focus on deals that would be too small for the big international players who were beginning to sniff around Kenya and East Africa” He also was confident that his firm could generate “alpha returns,” assuming they could identify and fill the gaps in management know-how among a few carefully selected, fast-growing companies. In other words, the strategy would entail more than bridging the financing

gap for promising businesses; there would also have to be a value creation component. And so, our Kenyan pioneer became one of the first to launch a private equity fund in his country.

The challenging transition from “nascent” to mature

If the Kenyan private equity industry is gradually to mature and play a more significant role as a source of financing and value creation expertise for small and midsize entrepreneurial businesses, these relatively new, untested funds will have to demonstrate an ability to ramp up their performance in order to attract additional funding. This profile of first-time fund managers lays bare one of the key challenges in frontier markets: How does one convince institutional investors to commit capital to GPs with thin experience and no demonstrable results? The young founder of one Nairobi-based GP acknowledged, “We still need to show a track record of success, which means exits with satisfactory returns for our original LPs. I’d like to be out fundraising for Fund II now, but it’s too early. First we need to focus on managing and ultimately exiting our investments.” To some extent, the key ingredient is something that cannot be accelerated: time—time for these fund managers to build their skill sets and prove that they have the capability to be successful private equity investors in Kenya. “Because the industry is so new,” explained the founder of one Kenyan fund manager, “everything takes longer.” Nonetheless, a number of additional dynamics and challenges are at play that will have to be overcome in the quest to build a viable private equity ecosystem in Kenya.

Capitalizing on regional investment opportunities

Although Nairobi is the base for a number of local businesses, most GPs in the region set their sights on companies that have a capability to market their products and services beyond Kenya’s borders into other East African countries. “We are very much a regional fund” is the common refrain of virtually all Nairobi-based GPs. The managing partner of one of these funds explained, “Kenya simply is not large enough to sustain a fund with our strategy.” Given

the relatively small size of the Kenyan market, adopting a regional strategy makes sound investment sense, allowing fund managers to focus on companies with the capacity to operate in multiple countries. A regional strategy also creates opportunities to achieve rapid growth by acquiring companies in other nearby countries. “The consolidation opportunities in the region are so amazing” was the enthusiastic assessment of one fund manager. “If an entrepreneur is not starting a company with a regional outlook, he is dead. You simply do not build a company for just one market in East Africa.”

But cross-border strategies create their own challenges. As local companies expand their geographic footprint, they require more sophisticated know-how. “A lot of owners now recognize that once their company goes across a border, they don’t have the skills to operate regionally. Running a business is no longer straightforward, explained one fund manager. But this warning also provides another example of how an experienced private equity firm may contribute nonfinancial value add to a portfolio company. When Aureos invested in a Kenya-based microfinance lending institution in 2006, for example, a key pillar of the investment strategy was facilitating a merger between its new portfolio company and another microfinance investee in Uganda. The combined company has since been acquired by an even larger regional microfinance provider with loans in at least ten African markets.

Regional investment strategies also offer Kenyan fund managers the opportunity to capitalize on a spate of new government initiatives to actively promote regional economic and financial integration among the five countries that comprise the East Africa Community (EAC).¹⁴ The EAC’s common market protocol (signed in July 2010) aims to establish a regional marketplace with liberalizing regulations to encourage the free movement of goods, services, capital, and labor, believing that doing so will encourage greater investment, lower the costs of doing business, and allow successful companies to grow as a result of the scale that can be achieved by serving larger markets. While tangible changes have been slow to materialize, the goal of creating a single integrated free trade area for the region’s 130 million citizens by the end of 2015 remains unchanged, and there has been some progress in reducing tariff barriers, improving cross-border transportation infrastructure, and taking the initial steps toward the harmonization of monetary, exchange rate, and tax policies.

Regional investment strategies, no matter how appealing, entail additional layers of complexity, risk, and staffing requirements that can be especially taxing for small, first-time GPs. In East Africa, for example, the lingua franca in Kenya and Uganda is English; in neighboring Tanzania, Swahili is more commonly used in some firms. Moreover, historical tensions exist between some countries in the region, adding additional dimensions of risk. Stakeholders are well aware that the original EAC was founded in 1967, but fell apart after ten years of effort due, in part, to political and ideological differences between Kenya, Tanzania, and Uganda that obstructed agreement on key regional integration measures. In addition, despite the best intentions, regional economic groups sometimes add costly regulatory barriers for firms operating across borders. These challenges serve to reinforce the admonition to investors stated at the beginning of this chapter: “Africa is not a country...” Although potential advantages to the pursuit of a cross-border strategy are clear, so are the additional risks.

Striving to Build a Regional Champion: The Growth of Athi River Steel Plant¹⁵

Athi River Steel Plant (Athi Steel), located approximately 30 kilometers outside of Nairobi on the Athi River, transforms local scrap metals into quality steel products, including billets, rolled bars, structural steel, and nuts and bolts. In 1998, at a time when Kenya was importing more than 50 percent of its steel products, Athi Steel became one of the Acacia Fund's first private equity investments. The proceeds from the Acacia investment allowed Athi Steel to increase production capacity by, in part, the installation of a 2.5 ton induction furnace and a 12-inch hot rolling steel mill.

In 2006, after Acacia had exited Athi Steel, the company again partnered with a private equity fund when Aureos Capital¹⁶ acquired a minority stake in the business. The investment proceeds were used primarily to finance the Athi Steel's acquisition of Great Kenfast Works (GKW), a manufacturer of cold rolled steel products located nearby. GKW's cold rolled products were complementary to Athi Steel's hot rolled products, and the acquisition allowed the company diversify its product offerings and achieve efficiency-enhancing economies of scale. However, post-investment Athi Steel encountered a number of new challenges, including a weakening local currency that drove up equipment costs, rising domestic interest rates

that increased borrowing costs and delayed payments from customers, and unanticipated regulatory hurdles.

Despite these obstacles, working closely with its private equity partner, the company implemented a number of value-creating initiatives that improved performance. Capitalizing on the merger with GKW, the company was able to increase product flexibility and capacity utilization, which resulted in installed melting capacity increasing from 4,000 tons in the 1990s to 120,000 tons by 2012. Over the same time period, the number of Athi Steel employees increased from 20 to nearly 800, environmental and health/safety standards were put in place, and annual revenues grew more than 90-fold. In addition the company began exporting its products throughout the region, and is considering the construction of a new production facility in Tanzania.

Deepening the pool of skilled private equity professionals

One of the salient features of private equity, apparent from the opening pages of this volume is the skill-intensive nature of the investor's job description. At virtually every stage of the private equity investment cycle described in chapter 1—from deal origination, due diligence, and valuation, to negotiations with entrepreneurs, value creation, and exit—the consummate private equity professional must apply a broad range of skills that are honed over countless years of working on deal after deal. Cliché or not, in the world of private equity, there is no substitute for hands-on experience that can only be accumulated over time. By and large, however, the practitioners who staff the first-time funds that dominate the Kenyan private equity landscape are relatively new to their profession. Some will eventually become world-class practitioners, but only after climbing a steep and protracted learning curve. There are no shortcuts.

This view was reinforced by one of the more experienced private equity professionals in Kenya: “The best of these first-time fund managers are originally from the region; they know the local business terrain very well and are trusted by local entrepreneurs. But they just don't have much deal-making experience. They're learning on the job.” This profile is often acknowledged by the highly motivated entrepreneurial founders of these funds as they reflect on why, despite considerable talent and tireless efforts over a number

of years, they have struggled to demonstrate success. It is a painful process of self-discovery, as one explained: "I felt prepared to run a private equity fund based on my previous experience. I had started a successful company in my late twenties and sold it several years later. I knew all about international investors from my fundraising experience all over the world, and as a former entrepreneur myself, I was confident that I understood Kenyan business owners and what it would take to work with them to build value." Absent from this self-portrait, as he soon discovered, was transaction experience. Although he eventually raised sufficient capital to launch his first relatively small fund, expectations of early success soon evaporated. The paucity of transaction experience, coupled with an understandable impatience to get started and demonstrate success, led to an endless string of problems. Reflecting on his early trials, he candidly explained the price paid: "We made our first three investments very quickly. We didn't really do the research and due diligence before making these investments, and with the benefit of hindsight the outcome was what you would expect. If true that you learn by making mistakes, in the beginning we paid our dues!"

If the founders of these first-time GPs are learning on the job, their professional teams often are even less endowed with the basic private equity skill set. The founder of one Nairobi-based GP explained his recruitment strategy: "I look for individuals who are insatiably ambitious, hardworking, and willing to climb a steep learning curve." Glaringly missing from this profile, however, is a sobering reality that characterizes virtually all of these new fund managers: the scarcity of individuals with years of private equity or related transaction experience. But the recruitment problems are not only a function of prior relevant experience. The additional challenge often is convincing a prospective new employee to work in an industry where the ultimate financial rewards are to come years into the future, not to mention uncertain. One fund manager noted, "In addition to finding people with the right skill set to work in this space, we have to convince potential new recruits that the high opportunity cost is worth it. After all, we could all be making a lot more money doing other things than working at a small private equity fund, where the lucrative financial payout is years in the future, if at all." These human resource challenges are a striking feature of the private equity industry in Kenya, as in other frontier

markets. With the exception of the handful of larger GPs that have migrated to Kenya after years of experience in larger emerging markets, this ranks among the most formidable near-term challenges for building the industry.

Moving beyond the DFIs: The fundraising challenge

Although Kenya's first-time fund managers seek to attract capital from commercial LPs, they usually have limited success and rely heavily on the DFIs for the bulk of their funding, which is the norm in most frontier markets. As noted in chapter 4, DFIs have played a pivotal role in spurring the growth and development of the emerging markets private equity industry from the very beginning. But in countries such as Kenya, they remain not only important but also indispensable, often constituting 80 percent to 90 percent of a local fund's capital. IFC, for example, allocates about 40 percent of its capital earmarked for private equity in Sub-Saharan Africa (outside of South Africa) to first-time funds, and its Nairobi-based team expends considerable time and effort working with its designated GPs to mobilize additional capital, both from other DFIs and commercial LPs.¹⁷ In addition to IFC, several of the European bilateral development agencies have been among the most active LP investors in Kenya, including DEG (Germany), FMO (Holland), PROPARGO (France), and Norfund (Norway).¹⁸ Thus, DFIs are playing an essential catalytic role as the providers of the seed capital for first-generation funds that otherwise would have little chance of getting started. With few exceptions, the GPs headquartered in Kenya are simply too new, too small, and too inexperienced to attract significant capital from commercial sources.

However, the consensus among both the DFI community and the fund managers themselves is that this dependence on donor financing must diminish if the private equity industry in Kenya is to mature and grow. The founder of one Nairobi-based GP that received about 90 percent of its capital from the DFIs observed, "Everyone is going to the same DFI sources, and this is not a sustainable model. It stands to reason that they will be less forthcoming if we all approach them again for follow-on commitments." The imperative, therefore, is for these GPs to build a track record of

successful exits and ween themselves away from DFI dependence by attracting commercial LPs to their follow-on funds.

One alternative funding source with the potential to offer a solution to these Kenyan teams is domestic institutional investors, including pension funds, insurance companies, asset managers, and high net-worth individuals. Judging from experience in China and a number of Latin American countries, the presence of local investors enhances the comfort level of international LPs that may be considering investments in Kenyan GPs, in addition to serving as a financing source. Local LPs, according to this logic, are understandably more knowledgeable about the landscape and idiosyncrasies of their market.

Although assets under management for many of Kenya's local institutional investors have been growing at a rapid pace in recent years, private equity has yet to become a significant presence in their investment portfolios. Kenyan pension funds managed more than US\$7.3 billion in assets by mid-2013,¹⁹ and had been granted regulatory authority to allocate up to 10 percent of their assets to "other investments" inclusive of private equity. Nevertheless, nearly all have shied away from the asset class due to a number of factors. For example, investment officers in these large financial institutions, as in most emerging market countries, lack the basic skills to assess private equity as an alternative investment. They also have concerns about the so-called J-curve effect²⁰—many pension fund trustees are accustomed to holding their positions for intervals of only about three years, and therefore are reluctant to take a longer-term perspective even when there is a reasonable prospect of generating higher returns. Local LP incentives to invest in private equity are further undermined in Kenya as in many other developing countries by the availability of relatively risk-free fixed income securities offering attractive real interest rates.²¹ This aversion to committing even a small portion of capital to private equity is further compounded by the asset class' short history in Kenya. Without a track record demonstrating attractive returns relative to fixed income alternatives, convincing local LPs to become private equity investors is a tough sell for fund managers even when the diversification benefits are highlighted.

However, the biggest hurdle remains regulatory constraints and burdensome red tape. Kenya's chief regulatory authority, the Retirement Benefits Authority (RBA), requires a pension fund's Board of Trustees to submit a letter of intent before finalizing an investment in any private equity fund, which must then be approved by the RBA—a procedure not required for any other investment. One frustrated local asset manager exclaimed, "I can wake up tomorrow and buy a building, but I can't invest in a private equity fund." Even though most pension fund managers expect their requests to be approved, they are deterred by the process itself. Echoing investor sentiment the world over, the same manager added, "If someone is required to write to a regulator to get approval, they don't do it. You only talk to your regulator if something is wrong."

In 2014 the RBA announced that it was considering a separate investment category for private equity and venture capital, with the goal of streamlining the regulatory approval process for local investors in order to encourage them to allocate capital to private equity. The Kenyan regulators were following the example of their South African counterparts who revised private equity investment guidelines for local pension funds in 2011, which resulted in a noticeable unlocking of local currency financing. In addition, the industry in Kenya has begun to make progress toward enhancing the awareness and understanding of local investors and their regulators of private equity as a legitimate asset class worth considering. One local investor noted, "The DFIs are telling all of the first-time fund managers that they strongly support their efforts to raise local capital. As a result, many of these GPs have started talking to us and given us a much better understanding of what they do." One indicator that these efforts were beginning to bear fruit was when a local private equity fund, the Ascent Rift Valley Fund, reportedly raised over US\$4 million in 2014 from Kenyan pension funds. As elsewhere in emerging markets, few developments would go further to boosting the Kenyan private equity industry than efforts to induce even a fraction of the country's pool of domestic savings to be directed to local GPs.

Kenya's Growth Enterprise Market Segment (GEMS): A Potential Exit Route?

In January 2013, Kenya's Nairobi Securities Exchange (NSE) launched the Growth Enterprise Market Segment (GEMS), an initiative designed to support efforts by the country's small and midsize firms to raise capital.²² One driver of the government's new program is a belief that it will mitigate the reluctance of family-owned businesses to go public because of the onerous NSE listing requirements, including the stipulation that founders cede a significant amount of control of their companies. Before approving GEMS, Kenyan regulators examined various models of emerging market small business exchanges with similar objectives, such as Egypt's NILEX, Brazil's Nova Mercado, and neighboring Tanzania's Enterprise Growth Market.

To list on Nairobi's Main Investment Market Segment (MIMS), a company is required to have a minimum of 1,000 shareholders and five years of audited financials with profitability demonstrated in at least three of those years. In contrast, the less onerous requirements for listing on GEMS include

- a minimum of KES10 million (approximately US\$115,000) fully paid-up capital,
- the issuance of at least 100,000 shares; at least 15 percent available for trading,
- at least 25 independent shareholders within three months of listing,
- demonstrated operation for one year; no profitability required,
- five directors, with at least one-third nonexecutive, and
- directors with no bankruptcy, fraud, criminal offense, or financial misconduct for the proceeding two years.

Although many listing requirements are easier to satisfy than those of the main exchange, GEMS does not compromise on issues of transparency and disclosure. Like all other listed firms, GEMS companies are required to adhere to International Financial Reporting Standard (IFRS) and submit audited accounts annually.

The first company to list on the exchange was Home Afrika, a housing and commercial property developer that has expanded its operations to Tanzania, Uganda, South Sudan, Ethiopia, and Rwanda.²³ Many of Kenya's smaller private equity funds are tracking Home Afrika's experience on GEMS, hopeful that the new exchange will offer a potential exit route for their own portfolio companies.²⁴

Raising the private equity profile among entrepreneurs

If investors in Kenya agree on one characteristic of the country, it is the abundance of talented, hardworking entrepreneurs. Like their counterparts in developing countries everywhere, these are the resourceful individuals who are accustomed to dealing with adversity, have an insatiable passion to commercialize an idea, and are endowed with an indomitable work ethic. But until recently most were unaware of private equity. As one 2010 survey of African businesses concluded, “Entrepreneurs rarely seek out private equity as a way of growing their business as they are often unaware of it...”²⁵

Judging from the accounts of many Kenya-based private equity firms, however, this reality is gradually changing. Echoing a familiar theme expressed in many developing countries during the early years of building their private equity industries, one local investor explained, “When we first started in Kenya, every meeting with an entrepreneur began with PE 101; we had to explain the fundamentals from scratch. Fortunately this is no longer the case.” The pattern recurs virtually everywhere: once the asset class begins to gradually gain credibility and the local press heralds this or that entrepreneur attracting a private equity investor, the demonstration effect invariably works in the fund manager’s favor. But this process takes time and hinges upon the GP’s ability to build trust with the founders of these firms. “In this [Kenya] market, it can take years to build relationships. In the early days, the entrepreneurs/founders tend to be very suspicious, and we have to make repeated visits to explain what we do and demonstrate that our interests are aligned.” One Kenyan entrepreneur who partnered with a fund manager who took a minority stake in his business expressed a theme voiced by founders of small and midsize firms in all emerging markets: “These private equity guys add value—that I can tell you. It’s not just about capital. They provide long-term direction, technical support, and they come with diverse backgrounds and many experiences.” Further elaborating, he noted, “They became an ally to me by challenging our decision-making processes and Board composition. They also worked closely with us to ensure we were meeting international best practice standards. We would definitely partner with a private equity firm again.”

Building a sustainable private equity industry: The challenges ahead

The Kenya case illustrates the formidable challenges encountered by all frontier markets in building a private equity industry, despite the undeniable need in these countries for the scarce capital and expertise provided by private equity professionals to firms that meet their investment criteria. Not surprisingly, the factors that will determine the future maturation of the industry as a whole are closely correlated with how quickly and well individual GPs gain experience and demonstrate success with exits. Some signs point in a favorable direction, but the challenges remain formidable. One imperative is that the DFIs continue to play their indispensable role—as LPs providing capital, as a source of education and training for both GPs and LPs, and as a credible advocate with the government. Also, as in other countries, Kenya's private equity industry will grow and become a more significant contributor to the country's private sector development only if it receives much stronger attention and support from the government. As one fund manager bemoaned, "I would like the government to be a factor, but it is not. The government needs to recognize that this is an important industry for building the country, and it must appreciate the importance of allocating resources into building up local fund managers."

The relatively short history of private equity in emerging markets suggests that in markets like Kenya, where the industry is relatively nascent, the path that lies ahead will be difficult and long. Much will hinge upon how quickly the local GPs build capacity within their teams and demonstrate a credible track record that attracts new LPs. As has happened elsewhere, some of these firms are likely to succeed, while others fall by the wayside. Notwithstanding the challenges and uncertainties, however, there is palpable optimism among many of the pioneers that have entered into this market who believe in the potential of Kenya, of its entrepreneurs, and of the role private equity can play to spur private sector development.

9

Looking through a Hazy Crystal Ball

Ours is more or less a cottage industry, and the jury is still out on how rapidly it will transition to something more durable and mature. But there are clear signs of progress. For example, a few years ago we were fortunate to see 100 reasonably credible deals a year; now the number is 160 to 180.

—Founding Partner of a GP focusing on
mid-market investments

Yogi Berra, the New York Yankee baseball player renowned for his famous quips, is alleged to have pronounced with his characteristic wisdom, “It’s very difficult to make predictions, especially about the future.” If forecasting future trends is generally a fool’s errand, as Berra suggested, emerging markets private equity poses especially precarious challenges due to its relatively brief history and limited data. Compounding the dangers are the obvious difficulties of generalizing about what may or may not come to pass in more than 150 countries, each with its own history, culture, demographics, and capabilities. Nevertheless, one prediction can be made with reasonable confidence: just as the asset class is unrecognizable today from its embryonic beginnings about 20 years ago, it is likely to bear little resemblance a decade from now to its present profile.

It is worth recalling that in the mid-1990s private equity was barely visible in emerging markets. It did not even exist, for example, in China, Kenya, and most other developing countries. During the ensuing years the asset class passed through a number of cycles,

gradually gaining credibility and momentum, although more so in some countries than others. As would be expected with any new industry, emerging market private equity practitioners have had to climb a steep learning curve. Some have disappeared, but many others have adjusted admirably to early failures and missteps. The survivors, along with countless newcomers, have become more knowledgeable and aware, and the industry has far exceeded the expectations of anyone involved during the pioneering days. For example, the asset class has experienced steadily higher volumes of fundraising and investment, expansion into virtually every corner of the developing world, and a burgeoning core of LPs and GPs specializing in private equity in emerging markets. To put this encouraging growth and diversification in context, emerging markets represented just 4 percent of total global private equity invested in 2004. A decade later the figure had reached 10 percent.¹

This overall growth and expansion into new territories in some respects has far surpassed even the most optimistic forecasts made in the early days of the new millennium. Who could possibly have imagined, for example, that in 2013 Sub-Saharan Africa would rank at the very top of the LP list of emerging market preferences for private equity investing? Or that IFC, the largest DFI with a mandate to promote private sector development, would make the transition from outright skepticism about private equity in the early 2000s to a track record in 2014 that boasted US\$4 billion invested as an LP in 200 emerging market GPs, and that the combined financial return from these funds since 2000 would reach almost 19 percent?² Or that even the largest international GPs operating in emerging markets, not to mention the local fund managers, would be staffed overwhelmingly by top-tier private equity professionals from emerging markets rather than Westerners, as was the case in the 1990s?

Numerous factors have contributed to this progress, as highlighted throughout this book. Most notably, as the industry has gradually grown and gained traction, a powerful demonstration effect has taken hold. As a result, private equity is now far more widely recognized and understood among business owners as a way of accessing not only long-term capital but also value-creating expertise. Countless fund managers in a diverse range of developing countries recount variations of the same story: “When we first

started as private equity investors, we had to begin each conversation with a company founder by giving a tutorial we called ‘Private Equity 101.’ Now, as a result of all that’s happened in the past few years, this introduction is no longer necessary.” Virtually every investor and entrepreneur interviewed for this book commented on the importance of this demonstration effect as an important factor driving the expansion of the asset class, and they anticipate it will continue to play a pivotal role well into the future. Thus, there are clear signs that the asset class has emerged from obscurity, capturing resources and attention nearly unimaginable at the beginning of its trajectory.

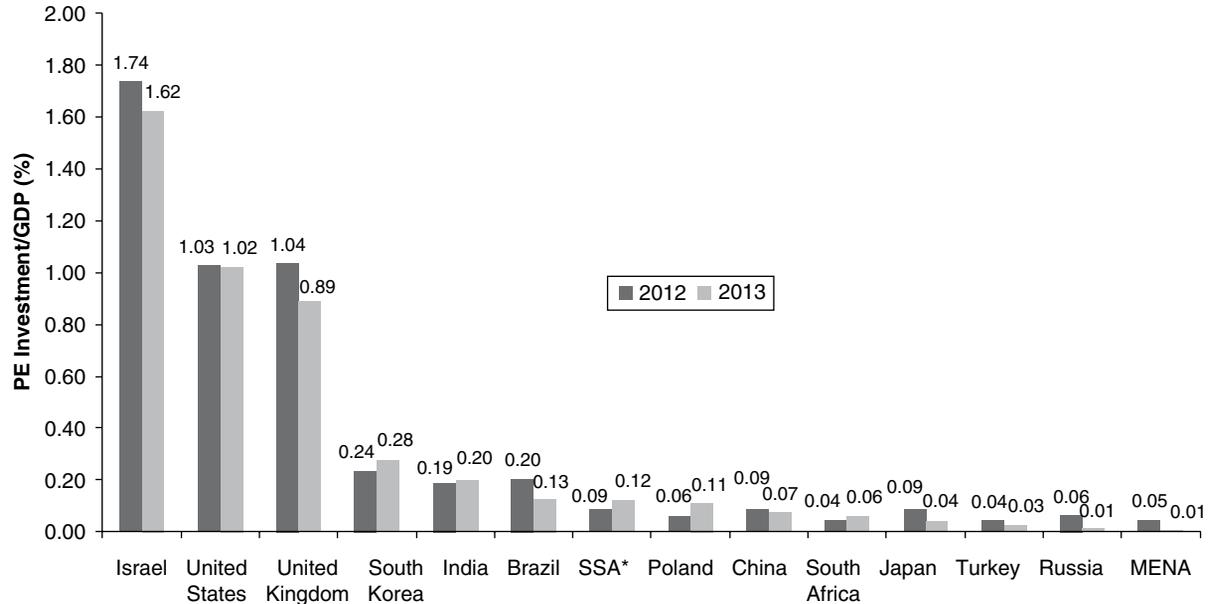
On the other side of the ledger, however, by any measure the asset class remains a relatively nascent industry in most emerging markets. Even though private equity activity has expanded rapidly, it remains strikingly insignificant relative to its potential to bridge the financing and value creation gaps that impede the performance of so many companies in these countries. Even in China, India, and Brazil, the three developing nations attracting the most private equity fundraising in 2013 (US\$9.6 billion, US\$1.1 billion and US\$1 billion, respectively), the volumes are insignificant—private equity investment as a percent of GDP was less than 0.2 percent in all three countries. In contrast, applying the same metric to the United States, the comparable figure was about five times greater (see Exhibit 9.1).

Future prospects: More questions than answers

Whether these figures are indicators of a “glass half-full or half-empty” remains an open question. The future course of private equity in emerging markets generally, as well as in individual countries, remains clouded with uncertainty. At this relatively early stage of the industry’s maturation, there are more questions than answers, and future performance will hinge on many of the issues raised in previous chapters. For example, consider the following:

- As discussed in chapter 2, the pace of change in individual developing countries to a large extent will depend on their level of success in building a more supportive ecosystem. Although

Exhibit 9.1 Global Private Equity Penetration



*Sub-Saharan Africa

Penetration rate signifies the amount of private equity investment in a given period as a percentage of GDP.

Sources: EMPEA, IMF, Center for Management Buy-Out Research, Pitchbook, Israel Venture Capital Research Center, Asia Private Equity Review.

some countries have made modest progress, most veteran emerging market private equity investors observe that they encounter many of the same obstacles to success as when they first began. “After 15 years in the trenches it’s not getting any easier,” asserted one investor with undisguised frustration about his experience in a range of developing countries. “All the factors that made these environments tough when I first started investing still exist.” Regardless of whether they are operating in China, Brazil, Kenya, or scores of other developing countries, practitioners recount too many stories of why, after all these years, the business of private equity is still so much tougher in these markets compared to developed countries. For example, deals take longer to close in part because of deficient information that complicates the due diligence process, value enhancement in portfolio companies is constrained by acute shortages of human capital, and exits are difficult to execute because of weak or nonexistent local IPO markets. Anyone who has spent time in developing countries recognizes that these are deep structural issues and that change comes about very slowly, over a period of years, if not decades. Nevertheless, even the most patient private equity investors understandably are concerned about how quickly individual countries will make progress in addressing these obstacles.

- Another common thread, described in chapter 5 and illustrated specifically in the chapters on Kenya, China, and Brazil, is the increasingly bifurcated structure of the industry, which raises questions about whether the trend will continue, and if so, with what consequences for the stakeholders. As competition for a limited supply of deals at the peak of the private sector pyramid intensifies among the relatively small number of very large GPs who heavily dominate international fundraising, will valuations become inflated, making it more difficult to generate attractive returns? And the corollary, of course, involves questions about the future behavior of those international LPs who want exposure to emerging markets, but have a preference for erring on the side of caution by backing the industry’s brand names. Emblematic of this conservative approach, one LP acknowledged, “You’ll never get fired for making the decision to invest in KKR.” Is this play-it-safe mantra sustainable, or will a broader

universe of institutional investors dip into the asset class and target a more diversified range of fund managers that have successful emerging markets track records but are somewhat smaller and less well known?

- On the other side of the bifurcation divide, what does the future hold for mid-market private equity? As GPs in this segment of the market continue to improve their track records over time, will they have more fundraising success with international investors? As one LP observed, “Many of the local teams I meet are good but inexperienced. They have not been through an entire fund cycle from start to finish, which we consider critically important.” But this reality has created a frustrating Catch-22 for most GPs that is difficult to overcome. Due to the relatively short history of private equity in emerging markets, it stands to reason that many GPs are unlikely to have deep experience or a persuasive track record. But absent a string of successful exits, it has been extremely difficult for these firms to attract LP investors.³ Although this fundraising conundrum is likely to resolve itself naturally for some midsize GPs as time passes and they demonstrate strong results, what actions might be initiated to attract attention more quickly by international LPs?
- How quickly will the pace of local currency financing for private equity accelerate, if at all? The outcome of this vexing question is country specific, and depends in part on exogenous factors beyond the direct control of investors, as illustrated, for example, by high domestic interest rates in Brazil. But even if interest rates decline, local currency financing also hinges upon the willingness and ability of the key local institutions to become more proactive. What has to happen in individual countries to encourage local institutional investors—the guardians of deep pools of domestic savings—to allocate larger portions of their capital to private equity? And how can governments be persuaded to take action, such as implementing regulatory changes, that encourage rather than impede greater local investment in private equity? The responses to these critically important issues will heavily influence the overarching question that is at the centerpiece of this book: How rapidly and effectively will the private equity industry in emerging markets expand and

strengthen its capabilities to play a larger role as a provider of two scarce resources that are required by growth-oriented companies to enhance their performance and become more competitive: medium and long-term capital and value-creating expertise?

Considerable uncertainty surrounds this question and others that will influence progress in individual emerging market countries as well as the asset class as a whole. But if private equity investors are able to expand their footprint and generate acceptable financial returns, facilitated by more hospitable ecosystems and other success factors highlighted in previous chapters, the benefits will extend far beyond the investors themselves. As argued from the opening pages, the overall private sector within these countries will also gain—additional jobs created, more tax revenues generated, environmental and safety standards raised, and a number of other improvements that will spur higher levels of economic growth and lower incidences of poverty.

A modest “to-do” list for the future

Cliché or not, there are no quick fixes to encouraging more private equity in emerging markets, but there are specific actions that at least on the margins would improve the future prospects for the asset class. Although the “to-do” list is extensive, following are a few examples of specific initiatives that would contribute to deepening and broadening private equity activity in the countries at the centerpiece of this volume.

More local currency financing

“It is ridiculous that the private equity industry in emerging markets is so dependent on foreign capital,” one long-time investor decried. The remedy, of course, is concrete actions that encourage and incentivize local institutions to invest in the asset class. If only a tiny fraction of the deep pool of domestic savings that has accumulated in developing countries were channeled from locally based institutional investors to private equity fund managers, as has occurred for decades in the United States and Western Europe, the impact would be transformative.

More governments must follow the example of such countries as China, Brazil, Chile, and a few others that have adjusted their regulatory frameworks to allow local pension funds and other large savings institutions to allocate increased portions of their assets to private equity. A related challenge is addressing the knowledge gap that causes most investment officers and senior executives of these local institutional investors to be largely uninformed about private equity and reluctant to diversify into an asset class they do not understand. Just as GP investment teams have had to ascend a steep learning curve, so too with local investors who could allocate more of their capital to an asset class that offers the prospect of diversification and potentially higher returns for their overall portfolios. Although institutional investors in some countries have begun to recognize that a small allocation to private equity should be part of a sensible investment strategy, very few have professionals with the background or specialized training needed to perform basic due diligence on the fund managers. Moreover, even those who are endowed with the requisite knowledge are often distrustful of the GPs to be the guardians of even a small portion of their capital. This observation was confirmed time and again in country after country during the course of the research for this volume. In order to accelerate private equity investment, especially in the middle market, this local institutional investor culture must change.

As illustrated in the Brazil and Kenya chapters, the obstacles to encouraging an expansion of local currency financing of private equity are often compounded by very high interest rates. Education, training, and regulatory reform will count for little so long as LPs gravitate toward low-risk, highly liquid fixed income securities that generate attractive returns. Lower interest rates would do as much as any other initiative in these countries to stimulate higher levels of local currency investing in private equity.

More reliable information

From the opening pages of this book, it has been necessary to caution readers about the paucity of reliable data on private equity in emerging markets. If, as argued in previous chapters, the future of the asset class hinges in part on a heightened awareness and understanding among key decision makers, especially local government officials and

institutional investors, it starts with more and better information. This severe deficit is aggravated by the striking inconsistencies among the organizations that collect, analyze, and disseminate data and other information about the asset class. For example, the various private equity and venture capital industry associations and other research groups⁴ do not even agree on a common methodology for defining what is and is not “private equity.” This in turn generates enormous inconsistencies on reporting basic information such as annual fundraising and investment statistics. Some include venture capital as an integral component of private equity, while others do not; some consider real estate and/or infrastructure as part of the private equity asset class, while others do not; “impact investing” in developing countries has recently come into favor and is anointed with the private equity label even though many believe it is too new and ill-defined to be considered a distinct asset class; and some organizations count various forms of debt financing, although most of these credit instruments have no value-creating characteristics that are considered a distinguishing characteristic of private equity. These reporting disparities invariably foment confusion among stakeholders who are critically important to the future growth of the asset class, such as local government regulators who are responsible for establishing rules and regulations for private equity investors, and foreign and local LPs who have specific guidelines that govern their allocations based on well-defined definitions of different asset classes.

If a major goal of the organizations involved in emerging markets private equity research and analysis is to raise awareness and understanding of the asset class, they must make a more concerted effort to mitigate the confusion sown by disseminating inconsistent data. The obvious first step would be a push for agreement on an acceptable methodology for reporting basic information. All those with a stake in expanding the footprint of the asset class would clearly benefit from more effective coordination and cooperation among these organizations that are the most important sources of information.

Credible benchmarking of performance

The information deficit is further aggravated by the unreliability of benchmarking data, a decision-making tool commonly used

by professional investors to make comparative judgments about financial returns, both among different asset classes (e.g., public equities versus private equity) or the same asset class in different markets (e.g., private equity returns in the United States compared to emerging markets). With the exception of a small number of publicly listed mega-buyout firms such as Apollo, The Carlyle Group, KKR, and Blackstone that are legally obligated to regularly disclose detailed information about their performance, the majority of fund managers—commonly structured as private partnerships—are not subjected to disclosure requirements. Unsurprisingly, therefore, they tend to maintain a thick veil of secrecy regarding their financial performance.

Although various research organizations publish benchmarking data about private equity performance,⁵ the information is incomplete and therefore of limited use. Although financial return data are solicited by benchmarking organizations on a strictly confidential basis, many GPs lack confidence in the process and opt not to provide information. In addition, the data collection process is marred by a self-selection bias that further skews the results and undermines the credibility of benchmarking—GPs with a good track record are more likely to provide data than those that have underperformed.⁶ Well aware of these serious shortcomings, savvy institutional investors who are responsible for determining how much and to whom to allocate capital have little faith in benchmarking data as a useful decision-making tool. They cannot, for example, make reasonable judgments about how the asset class performed over time in emerging markets compared to developed countries, or how returns from private equity in X, Y, or Z emerging market country compare to public equities in the same country.

Making a convincing case for private equity in emerging markets, as this book sets out to do, requires credible evidence based on historical experience demonstrating to investors that they will be well rewarded relative to their alternative investment opportunities. Readers are likely to have noticed by now, however, that these pages contain virtually no benchmarking data that would significantly buttress the case. Indeed, nothing has been more frustrating to the author than the absence of credible benchmarking data that would make the underlying premise of this book far more persuasive.

There is no easy solution to this problem for an industry with limited disclosure requirements. So long as most GPs remain private partnerships, benchmarking for the asset class will lack credibility. It may be too glib to suggest, but perhaps there is an entrepreneur toiling away in a remote garage somewhere who has the skill set, confidence-inducing integrity, and the will to launch an enterprise devoted to strengthening the flow of credible benchmarking information to industry stakeholders. If so, perhaps an angel investor will recognize the opportunity and provide seed capital for the new company.

Advocacy with local governments

Expanding the breadth and depth of private equity activity in emerging markets is predominately the responsibility of the GPs, LPs, company owners, industry associations, and other private sector stakeholders profiled in previous chapters. However, as emphasized throughout this book, governments also have a crucial role to play in determining the pace and direction of investment in their respective countries. As first noted in chapter 2, governments have long intervened in market-driven economies to facilitate the achievement of public policy priorities, and when done effectively these initiatives complement rather than compete with private capital and expertise. When government officials take actions to stimulate additional private equity investment, as has occurred countless times in developed countries, the benefits for the economy as a whole can be substantial. Moreover, as vividly illustrated by the catalytic Yozma program in Israel (see chapter 2), the best of these initiatives do not distort markets or necessitate large government expenditures.

With a few notable exceptions, such as China and Brazil, developing country governments have been slow to implement initiatives designed to encourage additional private equity investment. A large part of the explanation for this inaction stems from a lack of awareness and understanding among key government decision-makers of private equity's potential to strengthen the private sector's role as a force for economic growth and poverty reduction. The problem is especially acute in frontier markets, where the asset class is newer, less established, and therefore more likely to escape

the attention of overburdened policymakers. In these countries, as demonstrated in the Kenya chapter, a more receptive government could clearly make a significant difference. But, as a senior IFC official confided, “Most government officials in these countries don’t have a clue about how to execute policies that would encourage more private equity investment.” Mitigating this problem begins with measures to increase understanding, followed by guidance to assist relevant public servants in designing and executing policies and programs that will encourage additional private equity activity.

Spearheading such initiatives could be the work of private, non-profit institutions and/or quasi-public institutions that are endowed with the expertise and reputation for objectivity that lends credibility to their efforts. IFC and other private sector-oriented DFIs, for example, are already active private equity advocates, especially in frontier markets where they have long focused on knowledge transfer initiatives as well as serving as a source of financing. Their efforts could be buttressed by increased participation among the various global, regional, and country-specific private equity industry associations. The members of these stakeholder organizations have the expertise and incentive to provide time and resources to more effective advocacy initiatives in the countries in which they operate.

To be clear, “advocacy” is not about tax breaks, loosening disclosure requirements imposed on fund managers and their portfolio companies, or expensive subsidies. Rather, constructive advocacy concentrates on carefully targeted initiatives designed to better inform public officials, regulators, and local institutional investors about the asset class and its benefits. It might take the form of skills training for the investment officers of public pension funds to strengthen their ability to perform GP due diligence, or providing regulators with information on the benefits derived from more effective protection of minority shareholder rights based on the experiences of other countries, or simply holding “Private Equity 101” workshops for relevant government officials. Individually, these initiatives may appear modest, but over time they hold the promise of making a significant impact on the outlook and actions of key government decision makers.

Making progress one deal at a time

This bare bones “to-do” list hardly scratches the surface of the challenges that must be addressed in order for private equity in emerging markets to play a larger, more constructive role, particularly as a force for private sector development and poverty reduction in countries where it is practiced. It is of course true that there is no proverbial silver bullet, no single prescription that will suddenly catapult the asset class to greater import in developing countries. Instead change will come gradually—one deal at a time, one local policy initiative at a time, one additional LP investor at a time. And as this happens, the benefits for individual companies and countries, as well as for the private equity investors will be palpable. Whether it is company’s efforts to implement specific actions to improve health and safety standards for its employees, provide better skill-based training that enhances productivity, adopt world-class corporate governance standards that result in attracting additional financing, or a host of other performance-enhancing measures as described in previous chapters, the empirical evidence is overwhelming: private equity investors have both the incentives and the skills to markedly improve not only the competitiveness and profitability of individual companies but also the overall private sector contribution to a country’s growth and development.

Compared to the fledgling industry that began to percolate and grow 20 years ago, there is justification for cautious optimism about what lies ahead for the asset class. Of course, the basis for Yogi Berra’s skepticism was sound; making predictions about the future is a precarious business. Nevertheless, based on unmistakable, albeit slow and uneven, progress, there is good reason to believe the day will come when private equity in emerging markets is no longer underappreciated and underutilized.

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