

# Private Equity in Emerging Markets

The New Frontiers of International Finance

Edited by

**Darek Klonowski**



PRIVATE EQUITY IN EMERGING MARKETS

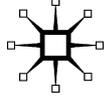
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THE NEW FRONTIERS OF  
INTERNATIONAL FINANCE

EDITED BY DAREK KLONOWSKI

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*To Krystyna M. and Roman K.*

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## PREFACE

### **Introduction to Private Equity in Emerging Markets**

Emerging markets are becoming a major force in global private equity. International investors are attracted to the general storyline of private equity in emerging markets due to these regions' rapid economic growth (driven by an expanding middle class, significant investment into domestic infrastructure, high rural-to-urban migration, and increased population wealth), more responsible public finance decisions, reduced debt, improved corporate governance regimes, and diminished reliance on foreign exports.

In addition, international investors perceive emerging markets as economic regions more resilient to financial turmoil and economic downturns. Emerging markets have proved adaptable to economic downturns, to evolving export conditions, and to looking outward for investment opportunities in the global marketplace. Many emerging market countries also show a strong manufacturing and service orientation and possess a superior raw material base. Other emerging markets, especially India, China, and Brazil, have also benefitted from investors' desire to direct capital to geographic markets, wherein capital can be employed at high increments or deal sizes in sectors related to infrastructure, banking, power generation and distribution, and natural resources (oil and gas).

Other markets, like Chile, Columbia, and Nigeria, which were previously perceived as too risky and too exotic, seem to receive more investments compared to the so called emerged markets like Poland or Hungary; global investors seem to embrace these new destinations and exhibit more tolerance for risk compared to the past. This may partially be explained by the desire to make up losses incurred in the recent financial crises—emerging markets seem to offer this opportunity. Emerging markets are expected to continue along a strong economic development path and a high growth trajectory in private equity; these countries are likely to continue to generate sound investment opportunities for global investors well into the future.

However, private equity investing in emerging markets has not been immune to evolutionary and transition challenges. Returns in emerging markets have been inconsistent and volatile, reflecting high variability of returns in public markets and fluctuations in foreign direct investment. Some emerging market countries are also perceived to present a geopolitical risk—a label any emerging country wishes

to avoid. In addition, it is difficult to process deals in emerging markets in a timely and effective manner. Challenges in deal execution reflect complex legal infrastructure, substandard accounting regulations, lack of preparation on the part of investee firms to receive capital, and corporate governance challenges (across the public and public sectors). In addition, exit opportunities are often unbalanced, either skewed toward public listings or sales to strategic investors. In some markets, exits are just rare.

In spite of these potential challenges, global investors appear ready to take a longer-term view of emerging markets, realizing that some countries will require time to improve their institutional development, legal infrastructure, exit opportunities, and so on. The true race among global private equity players in emerging markets is to establish a local footprint, develop local networks and contacts, develop a proprietary deal flow, gain operating experience, learn local customs and the local business climate, and develop a strong local pool of investment professionals. While the focus of private equity in emerging markets is currently on larger countries (like China, India, and Brazil), other smaller destinations like Poland, Turkey, Indonesia, South Africa, Nigeria, or may steal the spotlight from the larger markets. The first step in the process of penetrating these emerging markets is to get more intimate with these exciting markets. This short article offers such an opportunity.

#### Regional Analysis of Private Equity in Emerging Markets

The robust development of private equity in emerging markets is borne out in key statistics. First, private equity in emerging markets has secured an increasing slice of the global private equity market in terms of fundraising and investing activity (see the table given at the end of this article for a comparative analysis of five major emerging markets as classified by Emerging Markets Private Equity Association). Between 2007 and 2010, fundraising for emerging markets has grown from \$3.2 billion in 2002 to \$23.5 billion in 2010 (an estimate for 2011 equal to \$45.2 billion), with a peak fundraising of \$66.5 billion in 2008. Approximately 110 private new equity funds are raised every year for emerging markets, with an average fund size of about \$350 million. Fundraising in emerging markets accounted for 11.2 percent of global private equity fundraising in 2010. About 60.7 percent of fundraising for emerging markets was directed to emerging Asia while 23.8 percent was aimed at Latin America and the Caribbean. Investing has also followed a similar pattern with \$1.9 billion invested in 2002 and \$28.8 billion in 2010 (estimate for 2011 equal to \$28.2 billion), which translates into about 750 deals per annum (deal size equal to \$37.6 million). The peak investing period occurred in 2007 with \$53.5 billion of capital deployed. Investing in emerging markets in 2010 accounted for 13.2 percent of global private equity (up from 2.4 percent in 2002).

Second, based on 2010 data, private equity penetration (expressed as a ratio of private equity investment to GDP) in emerging markets is equal to 0.14 percent; this is relatively low compared to the developed private equity geographic regions (the United States—0.43 percent; Europe—0.31 percent; and the United Kingdom—0.34). China has been the largest recipient of private equity investment equal to \$9.2 billion in 2010 (0.16 percent of GDP).

**Table** Comparative analysis between five main regions in private equity in emerging markets<sup>1</sup>

<i>Region and country ranking</i> <sup>1</sup>	<i>Average annual statistics</i>				<i>Capital deployment ratio</i> <sup>2</sup>
	<i>Fundraising (\$ billion)</i>	<i>Investing (\$ billion)</i>	<i>Deal size (\$ million)</i>	<i>Number of deals</i>	
<i>CEE + CIS + Russia + Turkey: Russia, Turkey, Poland, Ukraine, Bulgaria, Croatia, Romania</i>	3.2	2.9	32.2	90	92.8%
<i>Latin America and the Caribbean: Brazil, Chile, Argentina, Colombia, Mexico</i>	3.1	3.2	47.4	67	104.3%
<i>Middle East and North Africa: Egypt, UAE, Pakistan, Saudi Arabia, Bahrain, Morocco, Tunisia</i>	2.1	1.2	27.0	44	58.8%
<i>Continental Africa: South Africa, Nigeria, Kenya, Ghana, Uganda</i>	1.3	1.4	29.2	48	109.3%
<i>Emerging Asia: China, India, South Korea, Indonesia, Singapore, Vietnam</i>	17.2	15.2	31.6	480	88.1%

*Source:* EMPEA.

*Notes:* <sup>1</sup>Countries are listed reflecting their relative ranking based on the 2008–2010 investment value; <sup>2</sup>The capital deployment percentage is defined as a ratio of cumulative investing to cumulative fundraising between 2001 and 2010.

Third, the financial performance of private equity firms in emerging markets has been vastly positive, with former postcommunist bloc countries (a ten-year return average equal to 16.1 percent) leading the way. While strong returns in the early years of emerging market development were driven mostly by price-earnings (P/E) multiple expansion and growth, private equity firms also benefit from the improved operational and financial performance of their investee firms (i.e., sales and margin growth) and further amplify returns with the use of leverage (which, in any case, is used in a more prudent manner compared to developed nations).

### **Book Objectives and Features**

The objective of this project is to develop a book focused on private equity in emerging markets that serves as a comprehensive analysis of private equity activities in emerging markets. The book's importance is threefold. First, many international investors and limited partners are intrigued by the prospects of private equity in emerging markets, but have an inadequate and insufficient level of expertise in this

area; this often unduly magnifies their perception of investment risks in certain geographic regions. Second, emerging markets are expected to continue along a development path of strong economic growth; they are likely to continue to generate sound investment opportunities for global investors in the foreseeable future. China is expected to overtake the United States as the world's economic superpower sometime between 2025 and 2030 (or sooner), while India is expected to become one of the world's largest private equity markets. Third, while there are many commonalities between various emerging markets, the book aims to highlight the differences between private equity industries in specific emerging markets by outlining investment opportunities, institutional infrastructure, exit opportunities, and returns.

The book has a number of unique features. Contributors are both academics and practitioners; this is a deliberate choice designed to reflect the diminishing boundaries between academia and practice in the field of private equity investing. Today, academics are invited by practitioners to optimally allocate capital across different asset classes and geographic destinations, to employ new financial tools and statistical techniques in financial modeling and decision making, and to investigate the underlying trends in private equity portfolios. Conversely, practitioners enjoy contributing to academic literature, presenting at academic conferences, lecturing at local universities and colleges, and contributing to policy decisions. Many practitioners have pursued their doctorates while many academics have obtained jobs in the industry. Second, the book illustrates private equity dynamics in various countries. Such dynamics are not well covered by current academic literature. While the book covers major players such as China, India, Brazil, and Russia, it also provides an in-depth analysis of less known and smaller private equity destinations like Vietnam, Nigeria, Mexico, and South Africa. While some of these countries are, from time to time, included in large data sets, "aggregated" academic papers often treat these countries as homogenous blocks and fail to provide in-depth analysis of their underlying local trends; it is in the understanding of these finer points, often omitted by aggregated studies, that private equity firms find either spectacular success or colossal failure. Third, the book analyzes topics that have received poor coverage in other academic texts. Unique topics include a consideration of the role of the investment committee in emerging markets, analysis of returns from some of the less well-perceived private equity destinations, and effective or ineffective entry strategies into emerging markets for general partners. Finally, while many chapters focus on the underlying risks of private equity investing in emerging markets, appropriate frameworks for analysis and investigation of these risks are provided.

### **Book Structure**

The book is organized into four major sections, each related to a specific theme of private equity in emerging markets. The sections are as follows: an overview of private equity; institutional and operational perspectives; regional development; and analysis of specific countries.

The first section provides a foundational overview of private equity in emerging markets. Four chapters are included in this section.

The second section covers institutional and operational perspectives on private equity in emerging markets. Four broad categories of chapters are included in this section and relate to institutional performance, the perspectives of the investment committee, financial contracting, and legal structuring.

The third part of the book focuses on regional perspectives. In this section, the authors focus on specific geographic regions and provide a comparative analysis of countries in the region. This perspective is important because it draws attention to the distinguishing features of certain regions and how different countries may respond to the underlying institutional, geopolitical, and economic challenges faced in these regions.

The fourth section focuses on specific countries. The dynamics of private equity development in these countries and the risks and rewards of investing in them are discussed. Eight countries are analyzed in detail: China, India, South Africa, Nigeria, Vietnam, Mexico, Brazil, and Russia.

*Darek Klonowski*

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PART I  
AN OVERVIEW OF PRIVATE EQUITY  
IN EMERGING MARKETS

# CHAPTER ONE

## PRIVATE EQUITY: THE DIFFERENCES BETWEEN DEVELOPED AND EMERGING MARKETS

*Richard T. Bliss*

### **Introduction**

From 2002 to 2008, private equity (PE) investments in emerging markets grew from \$2.0 billion to \$47.8 billion, a 24-fold increase, representing a compound annual growth rate (CAGR) of 70 percent. Over the same period, PE investment in the United States rose fivefold at a 31 percent CAGR. The 2008 number for emerging markets represents 13.8 percent of global PE investment versus just 2.5 percent in 2002.<sup>1</sup> This chapter explores some of the factors behind this explosive growth in PE investment in emerging markets. It also highlights important differences between developed and emerging markets and what they mean for both investors and entrepreneurs seeking funding.

Necessity demands that we accord a high-level discussion to this important topic. We rely on certain generalizations about both developed and emerging markets, understanding that no two countries or regions are exactly alike. Discussion of PE activity in developed markets is primarily based on the United States since this is where the venture capital (VC) industry began, and this is where the majority of PE fundraising and investment still takes place.<sup>2</sup> Later chapters contain a more detailed exposition of specific topics and countries/regions that may be of interest to the individual reader.

We begin by broadly describing what characterizes developed and emerging markets, emphasizing the important distinctions that may impact both entrepreneurial and PE activity. The next section looks at the VC process, from formation to exit, and highlights some of the important differences between developed and emerging markets. This chapter's last section looks at some of the specific types of investment opportunities emerging markets present and how they differ from developed markets.

### **Characteristics of Developed and Emerging Markets**

In this section, we discuss the definition of emerging and developed markets and then consider the differences between them that are most relevant to PE investment.

There is no definitive definition of “emerging” and “developed” markets. Wikipedia defines emerging markets as “nations with social or business activity in the process of rapid growth and industrialization.”<sup>3</sup> The International Monetary Fund (IMF) classifies 34 countries as “Advanced Economies” and 150 as “Emerging and Developing Economies.”<sup>4</sup> In 2010, these Advanced Economies accounted for 52.4 percent of the global gross domestic product (GDP) and 63.7 percent of the exports of goods and services. However, they only accounted for 15 percent of the world’s population.<sup>5</sup>

For our discussion, one of the most important differences between developed and emerging economies is their rates of growth—both economically and demographically. For the period 2003–2010, the IMF’s Advanced Economies averaged real GDP growth of 2.4 percent annually, compared to 6.8 percent growth in the Emerging and Developed Economies. More importantly, the latter are projected to grow through 2016 at more than twice the rate of growth in the Advanced Economies.<sup>6</sup> The United Nations, which estimates that the world population will hit 9.3 billion by 2050, notes that “essentially all of the growth will take place in less developed countries.”<sup>7</sup> And the emerging markets will be both growing and youthful—while only 13 percent of the US population is under the age of 15, in India the number is 33 percent, and the average for Sub-Saharan Africa is over 45 percent.<sup>8</sup> These demographic trends are key factors in the attractiveness of emerging markets for PE investment. Growing economies create new business opportunities, spur entrepreneurship, and require higher levels of investment. They also create a rapidly growing middle class with increased wealth that is tomorrow’s consumers.

A second area where developed and emerging markets differ considerably is in their legal system and regulatory environment. Aspects of the legal system important to investors and entrepreneurs include property rights (including intellectual property), contract enforcement, corporate governance, bankruptcy, securities law, and corruption tolerance. In a later chapter, Cumming and Johan discuss the impact of stronger legal protections on the contracts between VCs and their limited-partner investors, as well as the contracts between VCs and entrepreneurs. There is a large body of research suggesting that the quality of a country’s legal system is a factor in the level of PE activity.<sup>9</sup> The regulatory environment includes the ease of starting and running a business, labor market provisions that can make hiring and firing more expensive or wages noncompetitive, and capital market rules that either facilitate or stifle investment activity.

Measuring how conducive a country’s legal and regulatory environments are to PE investment is an inexact science. One attempt to do so is the Cato Institute’s Economic Freedom of the World (EFW) Index, which uses 42 data points to construct a summary index of “economic freedom” across five broad areas:<sup>10</sup>

1. Size of government: Expenditures, taxes, and enterprises
2. Legal structure and security of property rights
3. Access to sound money
4. Freedom to trade internationally
5. Regulation of credit, labor, and business.

Items 2 and 5 are most relevant to our discussion and are given in table 1.1.

**Table 1.1** Measures of economic freedom: Developed and emerging markets in 2000 and 2009

	<i>Legal structure and security of property rights</i>		<i>Regulation of credit, labor, and business</i>	
	<i>2000</i>	<i>2009</i>	<i>2000</i>	<i>2009</i>
United States	9	26	2	20
United Kingdom	3	27	6	12
Russia	88	63	108	99
China	78	44	102	78

*Source:* Economic Freedom of the World: 2011 Annual Report (<http://cato.org/pubs/efw/>).

It is clear from table 1.1 that in the last decade, Russia and China have risen significantly in the rankings, while the United Kingdom and the United States have fallen. In absolute terms, the developed markets are still more “free,” but the trends are clear and show that emerging markets are improving as places to do business and to invest.<sup>11</sup>

China and India accounted for 47 percent of all PE dollars invested in emerging markets in 2009, and were by far the two largest recipients of PE investment.<sup>12</sup> Both countries have taken significant steps in the last two decades to reach this position by making it easier for entrepreneurs to set up and run companies, and investors to get in and out of their investments. In India, these included reducing capital gains tax rates, allowing foreign institutional investors to hold 49 percent of the equity in any Indian company, and strengthening investor protection and disclosure regulations around initial public offerings (IPOs). In China, the establishment of special economic zones created competition for investment capital. Laws were passed to create private property rights, allow the formation of corporations, and establish a framework for bankruptcy.<sup>13</sup>

In addition to having better economic growth and improving environments for investment, emerging countries have also become significant players in several industries historically favored by VC investors. Russia and India are both major players in software development, and China has established a dominant position in several clean-tech and renewable energy market segments. China, India, and other Asian countries have become important centers for pharmaceutical research and development (R&D).<sup>14</sup> These trends not only can be traced to increased demand for these products in emerging markets, but are also spurred by the presence of well-educated workforces with the large number of engineers and scientists that these industries require. The fact that they work for wages lower than their counterparts in developed countries only makes these markets more attractive for high-tech entrepreneurial activity. It is well known that VC activity tends to occur in geographic clusters (Silicon Valley, Route 128, etc.), and there is no reason to believe this will not continue to be a trend globally.

Perhaps the most compelling difference between developed and emerging markets is the recent returns to PE investors. As outlined in table 1.2, funds invested in

**Table 1.2** Private equity and venture capital returns: The United States and emerging markets

	<i>PE/VC returns (%) in US dollars (periods ending June 30, 2011)</i>				
	<i>Year to date (%)</i>	<i>1-year (%)</i>	<i>3-year (%)</i>	<i>5-year (%)</i>	<i>10-year (%)</i>
US venture capital (VC)	12.3	26.3	4.3	7.4	1.2
US private equity (PE)	10.1	24.8	6.5	10.0	11.3
Emerging markets PE & VC	6.2	29.9	11.0	15.3	12.0

*Source:* Cambridge Associates, LLC.

emerging markets have outperformed both US VC and PE funds over one-, three-, five-, and ten-year horizons.

Lerner, et al. (2011) suggest several factors that might contribute to these results. First, fund size in the United States measured by dollars under management has increased more rapidly than the number of fund partners. Because of this, the fixed 2 percent management fee typical in PE funds provides more fee income to partners and potentially reduces the incentive value of carried interest, which is performance based. Second, because many current funds were established prior to the economic downturn that began in 2007, their terms are less favorable to the investors who were willing to make concessions in order to get their money into popular funds. Finally, an imbalance between supply and demand for PE funds has resulted in too much money chasing too few deals, increasing industry valuations, and reducing returns.<sup>15</sup> Whatever the reasons behind the relatively poor performance of US PE funds, the result has been a search for better opportunities abroad, first in Europe and more recently in emerging markets, with positive results. In light of the economic and demographic factors outlined earlier, there is no reason to believe this trend will not continue.

So far, we have focused on rapid economic growth and improving conditions for entrepreneurial activity and PE investment in emerging markets compared to their developed counterparts. Both of these factors make emerging markets more attractive for PE investors, and the recent returns data shown in table 1.2 appears to vindicate the move. We now turn to an important difference between developed and emerging markets that makes the latter riskier for PE investors: weak protection of intellectual property (IP) rights.

We saw earlier that emerging markets have improved in the area of property rights based on the components of the EFW Index. However, protection for IP rights is notoriously weak in some emerging markets, and this has implications for PE investment. The Property Rights Alliance publishes an International Property Rights Index, which includes a component specifically related to IP. China and India are in the third quintile and Russia in the fourth quintile based on the IP metric, far below most developed countries.<sup>16</sup> Data from the Business Software Alliance find software piracy rates of 79 percent, 65 percent, and 67 percent for China, India, and Russia, respectively.<sup>17</sup> A lack of respect for IP has potential

consequences for PE investors. Any R&D investment may be difficult to justify if the benefits of the efforts will be quickly copied by competitors with impunity. And if consumers are unwilling to pay the premium associated with official branded products, it may prove impossible to earn the margins typically associated with brand equity.

### **The Private Equity Process in Emerging Markets**

In this section we discuss the way in which fund formation, capital raising, and operation may vary in emerging markets. Specifically, we focus on the legal structure of PE funds, the source of their investment funds, and how they find, screen, value, and structure deals. Finally, we highlight the challenges posed by the exit strategies available in emerging markets.

#### Fund Structure

The limited partnership (LP) structure of PE funds has evolved over decades in developed markets and includes several favorable characteristics. The structure allows LP investors to diversify by investing across multiple funds and provides tax advantages, while the general partner (GP) can concentrate on the industry where his experience provides the most value. Low reporting and disclosure requirements allow the GP to focus on finding and monitoring good investments and keep administrative costs low. The finite life of the LP subjects the GP to ongoing discipline from the market and aligns well with the long-term investment goals of the fund's institutional investors. It also permits the pool of PE capital to expand or contract as investment opportunities arise or wane.

As efficient and proven as the LP structure is for PE investment, many emerging markets do not have comparable legal structures in place, or have only begun the transition. In India, The Limited Liability Partnership Act 2008 took effect in March of 2009. In China, the State Council published the long-awaited *Administrative Measures on the Establishment of Partnership Enterprises by Foreign Enterprises or Individuals*, on December 2, 2009, followed by the publication of the State Administration of Industry and Commerce ("SAIC"), the *Administrative Rules on Registration of Foreign Invested Partnership Enterprises* (the "SAIC Rules"), on February 2, 2010. Both went into effect on March 1, 2010. While all of these are steps in the right direction, there are still unanswered questions about accounting and reporting requirements, taxation, and how the new laws will interact with existing regulations in each country.<sup>18</sup> It will be some time before the real benefits of the LP structure are available to PE investors in India and China. In other emerging markets, PE funds will continue to be structured as corporations.

#### Fundraising

PE funds require investors able to commit large sums of capital for long periods of time. In developed markets, these investors include pension funds, endowments, and life insurance companies. For the year 2003, in the United States, these three

sources accounted for 88 percent of the VC capital raised. By contrast, in 2003, European VC funds only got 36 percent of their capital from these institutional investors.<sup>19</sup> Until now, most PE capital invested in emerging markets has come from these same sources via funds raised in developed countries. Other pools of PE funds for developing markets have come in the form of foreign aid and international development institutions, for example, the US Agency for International Development (USAID), the World Bank/International Finance Corporation (IFC), the European Bank for Reconstruction and Development (EBRD), and more recently, sovereign wealth funds.

Many emerging markets have high savings rates, and over time, retirement and pension savings will become sources of PE capital.<sup>20</sup> In Latin America, countries that include Brazil, Chile, Colombia, Mexico, and Peru, allow a percentage of their pension fund assets to be invested in private equity.

#### Screening

In developed markets, the typical VC fund receives hundreds of proposals a year—far more than the venture capitalist could possibly invest in. The challenge is to quickly screen this large number down to a manageable size that can be vetted more carefully. This is most easily done using criteria such as location, deal size and/or stage, and industry. The large number of proposals ensures that even after this process is completed, there will still be a sufficient number of deals for a more in-depth analysis. Reputable VCs also have a well-established referral network that includes accountants, bankers, lawyers, and angel investors who send deals their way.

In emerging markets, where the volume of desirable deals is much lower, there is little need for quick screening mechanisms. Due to the increased importance of social networks and cultural norms, the VCs' personal and professional networks may be the most important source of potential investments. Most PE funds in emerging markets will consider a wider range of industries and deal size than their counterparts in developed countries because using strict screens may result in little or no deal flow. VCs everywhere stress the importance of the "team" and the "idea," and the quality of their interaction with the entrepreneur, but the team's ability may be even more important in emerging markets where the ability to assess the market potential of new ventures may be more difficult.

#### Valuation

Emerging markets present additional challenges with respect to valuation. In developed economies, PE valuation is typically done using discounted cash flow and multiples analysis. When investing in emerging economies, several unique factors complicate these analyses. Analysts in developed markets start with the venture's historical financial statements. Even when unaudited, the financials can be readily checked for accuracy, and the most important value drivers are able to be validated. In emerging markets, many private companies are family ventures that may have lax recordkeeping and no valid financial statements. Compliance with regulatory and tax

requirements may also be sporadic. All of this makes developing usable projections a challenge.

Forecasted cash flows also need to accommodate the very real geopolitical risk of some countries, up to and including the possibility of expropriation of assets. Short of expropriation, there are many actions foreign governments can take that would adversely impact the value of PE investments.<sup>21</sup> In addition, reliable cash-flow forecasts require accurate macroeconomic and market research data, neither of which is readily available in many emerging markets. When economic data are provided, they may be inaccurate due to either poor collection/analysis techniques or willful manipulation. Jim Chanos, whose Kynikos Associates has \$6.5 billion of assets under management, recently said, “One of the things I’m pretty convinced of based on our analysis, is that inflation is under-reported in China by as much as 4 to 5 percent a year.”<sup>22</sup> If true, the impact of such a claim on cash-flow forecasts and other valuation variables is substantial and would certainly change the end result.

Estimating discount rates requires functioning, liquid capital markets, which do not exist in many developing countries. For multiples analysis, we need a sufficient number of comparable public firms or transactions (e.g., IPOs or mergers and acquisitions [M&A]), to calculate useful metrics to apply to PE investments. Cross-border data can be substituted, but that introduces a separate set of issues, which may not result in much improvement in accuracy. These include exchange rate risk, which is present in all foreign investment, but is likely to be exacerbated in developing countries where the currencies are more volatile. In short, much of the data financial analysts have at their fingertips to facilitate valuation in developed markets is inaccessible, inaccurate, or does not even exist in emerging markets.

### Financial Contracting

PE contracts in developed markets include numerous provisions intended to address the common problems that arise between investors and entrepreneurs. Adverse selection, information asymmetry, and disagreements about valuation can all be mitigated through good contracting. A complete discussion of these concepts is beyond the scope of this chapter, but things like preferred stock, enhanced voting rights, cumulating dividends, antidilution provisions, liquidation preference, pay-to-play, and other contract features all serve to protect the interest of PE investors (and sometimes entrepreneurs) and reduce risk for the parties under various circumstances. Other aspects of the deal, like milestones, staging, and change of control provisions, may be necessary just to get a deal done.

In developing markets, these common contract terms are found infrequently for a number of reasons. Outside investors are often limited to holding minority stakes in companies in emerging markets. This may not be problematic when the deal proceeds as expected, but can become a challenge if the company runs into trouble, as it precludes the use of certain antidilution and board representation contract provisions. These provisions may give the PE investor either a majority stake in the firm’s equity or on the board of directors (or both), allowing the outside investor to wrest control of the company from the entrepreneur/founder under certain extreme circumstances. The inability of a PE investor to gain majority control under

any condition may substantially increase their downside risk if the venture goes off track.

In other developing markets, convertible securities, different classes of equity, and enhanced voting rights are not allowed, meaning most deals are done through direct investment in common stock. Lerner and Schoar (2005) analyze 210 PE transactions between 1987 and 2003 from 30 developing countries and report the following:

- Investments in nations with effective legal enforcement are more likely to employ preferred stock and to have more contractual protections for the private equity group, such as supermajority voting rights and antidilution provisions.
- Contracts in low enforcement countries tend to rely more heavily on common stock (or even debt) and control the firm via majority ownership and board dominance.
- Relying on ownership as opposed to contractual protections seems to be only a partial remedy: these investments have lower valuations and returns.<sup>23</sup>

The number of deals and their valuations will improve when emerging markets can accommodate the more complex terms found in PE contracts in developed markets, and also provide credible enforcement mechanisms.

#### Exit

In developed markets, the optimal exit strategy for PE investors is often an IPO. In both the United States and Europe, the most profitable PE investments have been those that ended up going public. In emerging markets—where only the largest and most established companies can expect to garner institutional investors—the prospects for an IPO exit may be dim. Typically, the only exit strategy for PE investors in emerging markets is a strategic sale, but often there are few potential buyers, resulting in depressed valuations. Some emerging market companies have taken advantage of cross-listing opportunities, which may provide several benefits, including improved liquidity and reduced mispricing, increased visibility to potential customers, suppliers, and creditors, and the creation of shares more attractive as acquisition currency. However, the actual benefits accruing to cross-listed emerging market companies may not be worth the additional cost for all but the largest companies.<sup>24</sup>

The exit challenges presented by emerging markets will diminish over time for several reasons. As developing economies grow and their capital markets improve, so too will the viability of emerging market IPOs and the interest of external M&A acquirers. In addition, the growing number of multinational companies based in emerging markets will increase the number of potential domestic acquirers for PE-backed ventures, ultimately creating more competition and better valuations.

#### **Types of Investments in Emerging Markets**

The nature of PE investment opportunities in emerging markets is fundamentally different from that in developed markets. In this section, we focus on several of

these emerging market opportunities, including infrastructure investment, low-penetration consumer markets, and privatization. Recall that IFC-defined “advanced countries” account for 85 percent of the world’s population—a potential market of almost 6 billion customers. The bad news is that as of 2008, 1.4 billion were estimated to live on less than \$1.25/day and another 2.7 billion on less than \$2/day.<sup>25</sup> However, the percentage of the world’s population living on less than \$1/day was halved between 1981 and 2001,<sup>26</sup> and there is no question that overall, emerging markets are becoming wealthier. These facts create both opportunities and challenges for PE investors.

### Infrastructure

In India, Pakistan, and Indonesia, countries with a total population of over 1.6 billion, approximately 50 percent of the people have no access to electricity.<sup>27</sup> China and India average 11 motor vehicles per 1,000 people, compared to 780 in the United States and approximately 575 in Canada, France, and Japan.<sup>28</sup> These two examples highlight the pent-up demand for infrastructure in emerging markets. In 2008, Morgan Stanley forecasted total infrastructure spending in emerging markets at \$21.7 trillion for the period 2008–2018, with 67 percent of the total in Asia.<sup>29</sup> PE firms are already investing in emerging market infrastructure projects with 24 firms in the Asia-Pacific region raising \$10.9 billion from 2009 to August 2011.<sup>30</sup> Given the huge infrastructure needs of Asia, especially India and China, we expect this to be a continued area of interest for PE investors and funds, and 70 percent of the investors recently surveyed by Preqin in June 2011 said they expected to make additional infrastructure investments in the coming 12 months.<sup>31</sup> One of the challenges for investors is reconciling the lower risk/return profile of infrastructure projects with the incentive schemes of PE funds. Eighty-three percent of the investors in the Preqin survey had IRR targets between 10 and 20 percent for their infrastructure investments, which is below the typical targets for other PE funds. The lower risk/return profile of infrastructure investments may force PE fund managers to reduce the usual 2/20 compensation arrangement, as just 51 percent of investors in the Preqin survey felt that their interests and those of the fund managers were properly aligned.<sup>32</sup>

### Low-Penetration Consumer Markets

The market capitalization of consumer product stocks in emerging markets is approximately \$500 billion. Compare this to the United States, Europe, and Japan, where consumer product stocks have a \$4.7 trillion market capitalization.<sup>33</sup> As emerging markets get wealthier, this gap will be narrowed, but by how much will be determined by how well entrepreneurs and PE investors meet the increased demand for consumer goods. For example, in urban India, penetration rates among consumers for cosmetics, deodorants, and diapers are 22 percent, 9 percent, and 2 percent, respectively.<sup>34</sup> Capitalizing on this will mean being more nimble and recognizing opportunities that the large, multinational consumer product companies either miss or come to late in the game.

For example, in the 1990s, shampoo in India was considered a luxury item and levied with an excise tax of 120 percent. This made the price of a 200 ml bottle of shampoo greater than the average daily wage of an Indian industrial worker. The global consumer product giants could not figure out how to solve this problem, but an innovative Indian entrepreneur introduced a single-use “sachet” of shampoo that took the market by storm. By resetting consumer perceptions around price and value, the entrepreneur created an entirely new user market, and shampoo sales exploded. Once the government saw the wide rates of adoption, the excise tax was reduced, and sales grew further. By the end of the 1990s, two-thirds of shampoo sales in India was these sachet packs.<sup>35</sup> In this case, the innovation was figuring out how to take an unaffordable consumer product—which had reached saturation in developed markets—and turn it into something accessible to a broad swath of the population. With low penetration rates across a wide range of consumer products and services, these opportunities abound in emerging markets and represent a fertile ground for PE investment. Other opportunities to create value for consumers may exist due to the alternative retail channels, varied distribution networks, and infrastructure challenges found in emerging markets.

#### Privatization/Restructuring

In developed markets, most of the factors of production are either wholly under public ownership, or majority public owned. Even “public service” companies have moved away from nationalization. For example, *Deutsch Post*, the German post office, was privatized in 1995 and is currently 30 percent owned by KfW, a state-owned bank and 70 percent owned by public/private investors. *Air Canada* sold 43 percent of its shares to the public in 1988 and became completely privatized ten years later.

In emerging markets, a far higher proportion of productive assets are under state ownership, and this represents another investment opportunity for PE funds. Governments raised \$213.6 billion in 2010 through privatization sales of state-owned shares.<sup>36</sup> The record year included the largest stock sale in history—a \$72.8 billion secondary offering by the Brazilian energy multinational *Petrobras*.<sup>37</sup> Other large emerging market privatizations in 2010 included the *Agricultural Bank of China* (\$22.1 billion), *Petronas Chemicals* (\$4.1 billion), and *Coal India* (\$3.5 billion). The last two transactions were respectively the largest IPOs ever in Malaysia and India. In addition to state-owned enterprises (SOEs) and their potential for privatization, there are millions of small and medium enterprises (SMEs) in emerging markets that are in need of restructuring.

The opportunity for PE investors in emerging market SOEs and SMEs is based on a simple fact: most of the companies have never faced competition in the marketplace and are not professionally run. Through restructuring, PE investors can bring significant improvements in efficiency and product quality, while reducing costs at the same time. The restructured company will be more efficient, have a sustainable cost structure, and be competitive not only domestically, but potentially in export markets. Investors may need patience, as regulations and the state’s desire to avoid

large-scale layoffs may mandate that the restructuring proceed slowly; but in the end, the potential for value creation is substantial.

### Conclusion

This chapter provides an overview of the important PE differences between developed and emerging markets. We began by presenting the unique characteristics of emerging markets that make them attractive for PE investment. These include high economic growth rates, increasing wealth, and an improving legal and regulatory climate. These factors have contributed to the superior returns achieved by emerging market PE and VC funds, which have beaten their US counterparts for the past decade, using one-, three-, five-, and ten-year horizons. On the down side, poor protection of intellectual property rights in emerging markets can increase the risk of certain types of investment (e.g., software).

The process of PE investing differs in emerging markets on several important dimensions. The LP structure found in almost all PE funds in the developed markets are not as widely used in emerging markets. In some countries there is no legal provision for LP firms, and in others, the structure is permitted, but does not carry all of the tax and regulatory benefits found in developed markets. The wide range of securities and contract provisions available to address common issues that arise between PE investors and entrepreneurs are rarely available to funds operating in emerging markets. In some cases the terms are illegal, for example, dual-class shares of stock, and in other cases, although permitted, the provisions are not enforceable. This can increase the risk to PE investors under certain scenarios, or in extreme cases, preclude a deal getting done. Emerging market valuations are challenging due to the lack of consistent and reliable accounting, macroeconomic, and capital markets data. The addition of country-specific and exchange-rate risks makes accurate forecasting and valuation difficult. Finally, a lack of IPO opportunities or M&A acquirers in emerging markets means PE investors may have to consider longer holding periods and alternative exit strategies.

The opportunities for PE investment in emerging markets are qualitatively different from those in developed markets. The huge infrastructure needs in developing countries create many opportunities for PE funds, especially in the areas of energy, transportation, telecommunications, and water. The second PE investment opportunity present in emerging markets is a largely underserved, but increasingly prosperous, consumer segment. PE funds will be able to create value for their investors by finding and investing in the innovative entrepreneurs and companies that figure out how to meet the growing demands of emerging market consumers. Finally, SOEs and SMEs in emerging markets represent a unique opportunity for PE funds. By investing in and then restructuring these companies, PE investors can create firms that are much more efficient and competitive both domestically and as exporters.

The goal of this chapter is to highlight how developed and emerging markets are different in ways that are of interest to PE funds. This is not meant to be a comprehensive treatment of the topic, but rather a succinct discussion of the important differences. For PE investors planning to pursue opportunities in emerging markets,

the hope is that this chapter helps you do so, better equipped to handle the unique characteristics of those markets.

### Notes

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8. <http://www.globalhealthfacts.org/data/topic/map.aspx?ind=82>; retrieved on February 12, 2012.
9. See Groh (2009), pp. 3–4 for a concise review of the literature.
10. See Economic Freedom of the World: 2011 Annual Report, <http://www.cato.org/pubs/efw/>.
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CHAPTER 2  
PRIVATE EQUITY IN THE EMERGING MARKETS:  
NO LONGER AN ASTERISK

*Joseph Quinlan*

**Introduction**

A new era has begun for private equity investors. The world is truly their oyster, with more regions, countries, sectors, and companies open to private equity investment than ever before. The action has shifted primarily to the emerging markets, the most dynamic growth pole of the global economy today and in the future. As a sign of the seismic shift in global economic power, the developing nation's share of world GDP—for the first time in nearly two centuries—is on par with that of the developed nations. Long a critical financial driver in the developed nations, private equity investors are on the cusp of becoming new strategic players in the emerging markets. The latter, full of promise and peril, are no longer an asterisk when it comes to private equity.

**Why the Emerging Markets?**

The answer to the above question is rather simple—the world has changed. We are on the verge of a more dynamic and inclusive phase of globalization led by the emerging markets rather than the standard bearers of the global economy—the United States and Europe.

The globalization of the late twentieth century was largely driven and dictated by the West. In this world, globalization was only nominally “global” given that cross-border flows of trade, capital, and people pivoted on the United States and the developed nations, namely, developed Europe. Global mergers and acquisitions were largely the exclusive preserve of the rich nations. Trade and investment ties between the developing nations were shallow and underdeveloped. Companies from the developing nations were mainly traders and unsophisticated enterprises—dependent on delivering goods to foreign customers through exports. They were rarely involved in deal activity, more passive than aggressive in global M&A deals. Multinationals from the West, in contrast, were more sophisticated and global

in scope, and were at the core of international capital flows and global private equity deals.

Today, we have reached the end of globalization as determined and designed by the United States, but not the end of globalization itself. The latter is being reconfigured with different characteristics—Chinese, Indian, Brazilian, Egyptian, and many others.

In the years ahead, the axis of the global economy will increasingly tilt toward the developing nations, with China at the front and center. In this multipolar world that is unfolding, the developing nations will set the tempo of global growth, trade, and investment. Traditional global capital flows will be altered, with more investment emanating from the developing nations and flowing to developed and developing nations alike. Global M&A will increasingly bear the hallmark of the developing nations as new emerging corporate giants from Brazil, Mexico, India, and other nations increase their global footprint via M&A.

As part of this dynamic, it has been the developing nations that have led the way forward in the postcrisis world, emerging from the global economic recession far quicker and stronger than the developed nations. Average real GDP growth in the developing nations in 2010 and 2011 was 7.3 percent and 6.2 percent, respectively, well above comparable rates of growth of the developed nations—3.2 percent in 2010 and just 1.6 percent last year. Importantly, for private equity investors, the developing nations have also fortified their presence in a number of key sectors that have long been under the domain of the West. Energy, mining, steel, automobiles, telecommunications, power generation, alternative energies, and finance—these key sectors of the global economy are increasingly being contested and controlled by firms from the developing nations, a trend that has not gone unnoticed by private equity investors.

Chinese companies are now on the verge of becoming global leaders in electric cars, solar panels, and wind turbines. Brazil is now a legitimate agricultural and energy powerhouse. India's growing software industry, the expanding technology capabilities of South Korea and Taiwan, the emerging middle classes, and economic take off of Africa—all of these trends, and more, speak to a new world of opportunity for private equity. At the macrolevel, the economics and finances of the developing nations have rarely been better, with copious international reserves, the emergence of competitive indigenous firms, the continued formation of large middle classes, and the budding indigenous talents/skills of workers, all converging to underpin the attractiveness of the emerging markets. In addition, more and more of the world's critical economic inputs—natural resources, capital, and labor—are increasingly under the domain of the developing nations, a dynamic that mandates that private equity investors become more familiar with the new and untapped terrain of Africa, central and eastern Europe, and interior China, to name just a few locales.

While India, Brazil, and China have emerged as the Big Three developing markets for private equity investors, accounting for 70 percent of total private equity fundraising in the first half of last year, private equity is also becoming more prominent in North Africa and sub-Saharan Africa, the world's truly last frontier. Nigeria, Kenya, Uganda, Egypt, and South Africa are just a few of the hot spots that have emerged in Africa over the past few years.

The rewards to investors include a better diversified portfolio, with higher yielding investments relative to the leveraged and mature developed nations. In the developed nations, double digit growth rates for companies is rare, and is the exception rather than the rule; it is the opposite in the developing nations. In parts of Africa, the development of many sectors and industries is just in its infancy; in China and India, double digit growth rates across a swath of industry remain the norm given the soaring demand of their burgeoning populations. Meanwhile, exit markets and mechanics continue to improve in many emerging markets, allowing investors to reap their rewards. The size of deals continues to expand as well, along with more public-to-private deals.

The risks, however, are not minimal. Political instability remains a clear and present danger in many emerging markets. As politics shift, so do the bureaucracies in charge of crafting policies effecting taxes, licenses, infrastructure development, capital requirements, and other related items.

Corruption and underdeveloped capital markets are two other key hurdles that can (and often) derail or delay deals. The shortage of local talent and worthy local partners, the lack of transparency, limited public information, cultural nuances, and unclear land-use rights—there is no end to the risks to private equity investors, but this is to be expected. Dealing with family-owned firms or with firms with deep and entangled state and political ties represent significant challenges as well, and require that private equity firms become very embedded in local markets. There is no substitute for local expertise and experience. Competent local capacity is very important for the success of private equity investors. Global private equity investors must be local.

At the macrolevel, private equity is still very new to most emerging markets; in some frontier markets, in fact, private equity investment is in its infancy but nevertheless gaining traction among the elites and technocrats, paving the way for future growth. Flush with massive international reserves, the capital markets of many emerging markets, including India and China, are poised to expand and mature over the next few years, becoming more sophisticated, accommodating, and comfortable with private equity investors.

### **The Future Favors the Emboldened and the Enlightened**

Despite some cyclical pressures, the long-term fundamentals of the emerging markets remain quite promising for private equity investors.

Near-term, it may not be all smooth sailing if Europe's sovereign debt crisis triggers a global economic slowdown in 2012, an event that would slow the pace of deal making around the global, including most emerging markets. Financial uncertainty brings with it financial paralysis.

One key caveat—while a significant growth engine of the global economy, the developing nations are still joined at the hip of the developed markets, dependent on growth and demand from the United States, Europe, and to a lesser degree, Japan. That said, if the developed nations experience an economic relapse in 2012, or weaker-than-expected growth due to Europe's financial problems, the emerging markets will not be spared. Deal activity would slow on account of the flight from

risk, more stringent global credit conditions, and mounting caution on the part of executives around the world.

The above scenario, however, is cyclical rather than structural in nature. Whatever the global growth rate in 2012, the rise of the emerging markets continues, supported by large capital reserves, soaring middle-class consumers, and a massive build-out of twenty-first-century infrastructure. Increasingly, it will be the developing nations that lead, with the aging, maturing and debt-laden West following. The world is changing for the better, creating unprecedented opportunities for emboldened and enlightened private equity investors.

## CHAPTER 3

# ECONOMIC AND SOCIAL PROFILES OF EMERGING ECONOMIES

*Abdella Abdou and Saeed Moshiri*

### Introduction

Private equity flow, like other components of foreign direct investment (FDI), is influenced by several economic, social, political, and institutional factors. This chapter focuses on the economic fundamentals that are most likely to impact the flow of private equity to emerging economies. In particular, we will present data on long-term average values and trends of key macroeconomic variables. We will also summarize the latest macroeconomic performance, and the institutional features of developing and emerging economies. The data are mostly presented by regional or other grouping of countries.

There are numerous classifications of developing and emerging economies.<sup>1</sup> We employ three of the most commonly used classifications of developing countries. Following the International Finance Corporation (IFC), which is involved in enhancing the private sector in developing countries and facilitating flows of foreign investment including private equity to emerging economies, we will categorize developing economies into six regions. This classification originates from the World Bank, which for operational and analytical purposes, groups countries by region and income. The six regions are: East Asia and the Pacific, South Asia, Middle East and North Africa, Sub-Saharan Africa, Latin America and the Caribbean, and Europe and Central Asia, commonly known as transition economies. The classification is updated annually, and the most recent data show 145 countries in these regional groups.<sup>2</sup>

The second group is the BRIC countries, and the third group is the N-11 (the Next Eleven) countries. Both of these groups were designed by researchers working at Goldman Sachs (O'Neil et al., 2005). While the BRIC countries—Brazil, Russia, India, and China—are well known, the N-11 are less so. The N-11 countries include: Bangladesh, Egypt, Indonesia, Iran, Mexico, Nigeria, Pakistan, Philippines, South Korea, Turkey, and Vietnam. Goldman Sachs considers them to have promising outlooks for investment and future growth. For the short-term analysis we will use the classification of countries by the International Monetary Fund (IMF), which is

similar to that of the World Bank except for few adjustments that will be noted later in the chapter. Following is the discussion of the data.

### **Description and Analysis of Data**

Table 3.1 presents the long-run averages of key macroeconomic and socioeconomic variables and the structure of the economies for the six regions, as well as for the BRIC and N-11 groups of countries for the period between 2001 and 2010. The average values are compared to the performance of these economies to the previous decade. (Data for previous decades are not shown in table 3.1). The arrows beside the average numbers indicate these comparisons as trends. It is clear from the data that the sizes of these economies have grown over time in each and every region. Similarly, per capita income has consistently increased in all regions, with some fluctuation and a U-shaped movement in the Middle East and North Africa, Sub-Saharan Africa, and Latin America and the Caribbean regions. While all the countries experienced positive growth rates, the trend relative to the 1990s in East Asia, and in transition economies, shows a downward movement; the trend in Africa, Latin America, and BRIC countries indicated a U-shaped movement, while the South Asia, Middle East, and North Africa, and N-11 countries show no change in trend.

The growth literature is unanimous on the necessity of adequate savings and investment for continued growth. The data indicate that in all the regions except for Sub-Saharan Africa, the savings ratios as a proportion of gross domestic product (GDP) are high by historical standards. Investment rates also seem adequate and bode well for future growth. Foreign investment has also become a key source for a continued capital accumulation and economic growth. The flow of FDI to the regions varies between 0.6 and 2.52 as a percentage of GDP. The flow of FDI to East Asia dwarfs flow to other regions (UNCTAD, 2011), but the 0.6 as a proportion of GDP seems to be miniscule, perhaps indicating room for future additional flows.

Developing and emerging economies are increasing their integration with the global economy as indicated by both FDI flows and trade. Table 3.1 shows that exports and imports as proportions of GDP are on rising trends in all the regions, as well as in the BRIC and N-11 countries. For instance, in 1990, the ratios of trade to GDP in East Asia and Latin America were 47 percent and 23 percent, respectively. The averages for the 2000s are about 58 percent and 45 percent, respectively. While the recent financial crisis has adversely affected world trade, the policy environment in most countries remains favorable to openness.

The single digit inflation rates are remarkable given that these countries have experienced high economic growth during the period, and when compared to the experience of many of these countries in the previous decades. For instance, Brazil and Russia each had inflation rates of over 100 percent in the 1990s. The ability of the regions to manage debt is adequate as measured by the government debt and debt service ratios. The trend in debt service ratio for many of the regions is captured by an inverted U-shaped curve indicating their increased ability to service debt.

The structure of these emerging economies is dominated by the manufacturing and service sectors. While the agricultural sector of these economies is still

**Table 3.1** Macroeconomic conditions of developing and emerging countries by region (average 2000s)

	East Asia	South Asia	Middle East	Sub Saharan Africa	Latin America	Transition Economies	BRICs	N-11
<b>Production</b>								
GDP (constant 2000 \$ billion)	9740 ↑	885.5 ↑	1185 ↑	447.5 ↑	2515 ↑	35 ↑	988 ↑	228 ↑
GDP per capita, PPP (constant 2005 international \$)	6980 ↑	2240 ↑	8574	1816	9049	9017 ↑	6979 ↑	6771 ↑
GDP growth (annual %)	3.70 ↓	7.12	4.30	4.80	3.37	5.61 ↓	6.67	4.91
Share of agricultural value added/total value added	4.71	19.13	8.02	16.83	5.75	7.56	10.58	8.87
Industry value added/total value added	35.29	26.51	39.40	33.19	28.98	34.81	39.95	34.04
Service value added/total value added	60.01	54.36	52.58	49.98	65.27	57.63	49.47	57.10
Gross savings (% of GDP)	30.04	30.96 ↑	36.33	15.95	20.39	20.58	31.56	25.76 ↑
Gross fixed capital formation (% of GDP)	25.71	26.88 ↑	21.29	19.28	19.28	24.08	26.43	23.33
FDI (% of GDP)	0.60	1.02	1.68	2.39	1.97	2.52	1.91	1.25 ↑
<b>Population and labor</b>								
Population (million)	2133 ↑	1484 ↑	350 ↑	767 ↑	559 ↑	14	684 ↑	103 ↑
Unemployment, total (% of total labor force)	4.70	4.65 ↑	11.74	n/a	8.09	13.08 ↑	6.38 ↑	7.16 ↑
<b>Trade</b>								
Imports of goods and services (% of GDP)	27.70 ↑	22.23 ↑	35.74 ↑	34.03 ↑	22.04 ↑	56.56 ↑	20.72 ↑	33.66
Exports of goods and services (% of GDP)	30.29 ↑	18.41 ↑	45.12	32.12 ↑	23.20 ↑	46.47 ↑	24.24 ↑	33.00 ↑
<b>Inflation and financial market</b>								
Inflation, consumer prices (annual %)	3.81	6.43	3.91	6.60	4.86	7.27	6.66	8.57
Total debt service (% of GNI)	n/a	2.47	2.38	2.62 ↓	5.73	7.30	3.75	4.30
<b>Social indices</b>								
School enrollment, secondary (% gross)	71.91	49.86	72.43	31.43	87.48	90.73	78.58	68.52
Life expectancy at birth, total (years)	72.16	63.71	71.29	51.92	72.95	71.13	68.45	68.78

Source: WDI (2011) and authors' calculations.

Note: Transition economies include the following countries: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Macedonia, FYR, Moldova, Mongolia, Montenegro, Poland, Romania, Russian Federation, Serbia, Slovak Republic, Slovenia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. BRICs include Brazil, Russia, China, and India. N-11 includes Bangladesh, Egypt, Arab Rep., Indonesia, Iran, Islamic Rep., Mexico, Nigeria, Pakistan, Philippines, Korea, Dem. Rep., Korea Rep., Turkey, and Vietnam.

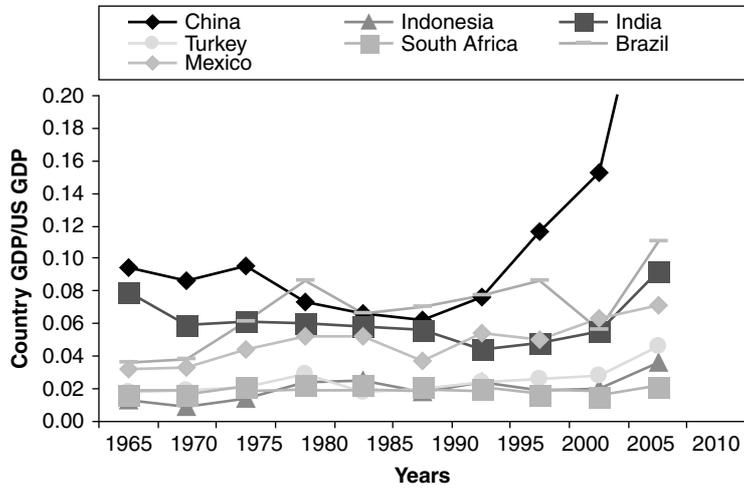
significant compared to advanced economies, the trend has been toward rapid decline of this sector. For instance, in 1990, the share of agriculture in GDP in East Asia and South Asia was 25 percent and 31 percent, respectively. The average values for the 2000s for these regions are 4.7 percent and 19.13 percent, respectively, indicating a dramatic decline in the importance of agriculture for these economies. A similar trend holds for all developing countries. But, we must also note that while the contribution of agriculture to income in developing countries is relatively small, its contribution to employment tends to be high.

The population in all regions except for the transition economies is increasing. Nevertheless, we must note that the growth rate of population in all regions though positive is on a declining trajectory due to declining birth rates. The positive growth of population however is expected to continue for a while mainly because of the hidden momentum of population growth. In other words, despite declines in birth rates, population will continue to grow in developing countries because, the presence of a large youthful population expands the pool of potential parents. This will most probably mean larger economy sizes in developing countries relative to advanced economies. The unemployment conditions are within single digits in all regions except for the transition economies and the Middle East region. The trend in unemployment is upward except in Latin America where it is declining. The rising unemployment rates in these countries may reflect the rapid structural changes and urbanization that are associated with declines in labor-intensive sectors. Although unemployment has been rising, GDP has been growing, implying higher labor productivity. A closer look at recent labor market conditions also reveals that while unemployment rates have been high among unskilled workers, there are shortages of skilled workers.

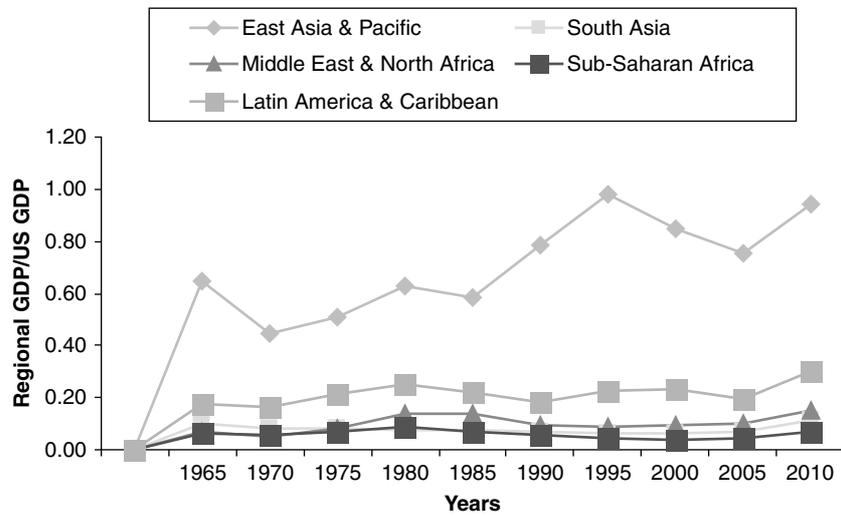
With regard to human capital in the form of education and health, and as measured by school enrollment and life expectancy, the developing regions have been doing even better. Indeed, this is an area in which there is a strong tendency to converge and catch-up with the advanced countries. School enrollment is relatively high in all the regions as well as in the BRIC and N-11 countries, but relatively low in Africa and South Asia. Life expectancy is high in all regions by historical standards, except in Sub-Saharan Africa where it is on the decline as a result of AIDS, tropical diseases, and due to the collapse of a number of states. But, there are improvements in life expectancy in Africa too relative to what the continent experienced in the 1990s. These advances in the human capital front will promote a conducive environment for entrepreneurial endeavors, as well as provide a skilled labor force for the growing modern sector.

### **Are Developing Countries Catching Up?**

One of the key concepts in growth theory is the idea of convergence. The literature in this area is specialized, varied, and controversial (Barro, 1991; Pritchett, 1997; Islam, 2003). We can employ a simple concept and figures to discuss the idea. We assume that the American economy is the frontier or the most advanced economy against which developing countries are compared. Figure 3.1 plots regional average GDP as a percentage of the US GDP. Figure 3.2 presents a similar ratio for selected



**Figure 3.1** Average regional GDPs relative to the US GDP between 1965 and 2010.  
*Source:* WDI and authors' calculation.  
*Note:* The relative GDP is the five-year average current GDP of a region divided by the current US GDP



**Figure 3.2** Average GDP for selected emerging countries relative to the US GDP.  
*Source:* WDI and authors' calculation.  
*Note:* The relative GDP is the five-year average current GDP of a country divided by the current US GDP.

developing countries. Figure 3.1 indicates that among the six regions, two, East Asia and Latin America and the Caribbean, are catching up, while other regions are neither converging nor diverging. In figure 3.2, the leading emerging economies China, Brazil, and India are catching up, while Mexico, Turkey, and Indonesia are moderately converging. While standard analytical procedures are required to arrive at firm conclusions, the data presented here indicate that parts of the developing world are on the convergence trajectory.

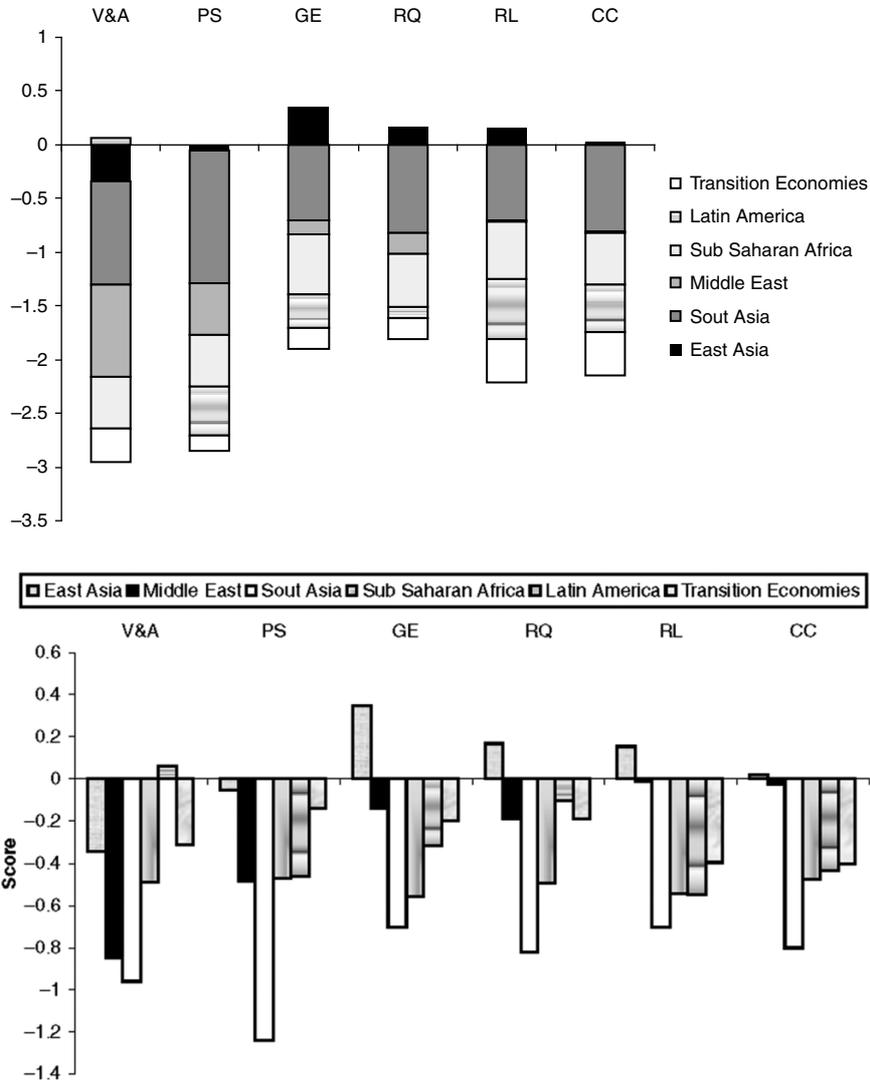
### **Institutional Quality in Emerging Economies**

Institutions are known to have a positive effect on the long-term economic performance of countries (Rodrik et al., 2004). Countries with higher institutional quality would have lower transaction costs and a better environment for capital, physical and human, accumulation. We use the measures developed by Kaufman et al. (2009) to compare the institutional qualities across the regions of developing countries. These measures known as Worldwide Governance Indicators include aggregate and individual composite indexes of governance based on 441 variables obtained from 33 different organizations including the World Bank, the World Economic Forum, and the Economist Intelligence Unit. They are categorized into six clusters or aspects of governance: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption.

Figure 3.3 shows the average institutional quality indices for different regions for the period 1996–2008. The institutional qualities are ranked from the lowest (–2.5) to highest (+2.5). As figure 3.3 shows, all regions, except East Asia, have negative indices representing weak institutions. Specifically, South Asian countries on average have the lowest institutional quality, followed by the Middle East and North Africa and Sub-Saharan African countries. East Asia ranks positive on five indices, but negative on voice and accountability. Latin America, on the other hand, ranks positive on voice and accountability, but negative on the remaining five indices. The Middle East ranks negative on all indices, but is relatively better on the rule of law and control of corruption. Clearly, developing economies have much to work on their institutional regime. The fact that in spite of weak institutional framework they have managed robust growth indicates the possibilities for even better economic performance as they improve the quality of their institutions.

### **The Crisis and Recent Economic Performances**

The current global economic crisis has brought to the fore both the strengths and weaknesses of developing and emerging economies. The slowdown of the economies of the United States and Europe has reduced demand for imports from developing countries and slowed their growth. Initially, the surge in domestic demand in the emerging economies was able to counter the decline in external demand, but this tendency has been weakened recently. Yet, growth in these regions remained robust relative to advanced countries. The average growth of GDP for the last two years for which data are available (2010 and 2011) indicates that the developing countries



V&A = Voic and Accountability, PS = Political Stability, GE=Government Effectiveness, RQ= Regulatory Quality, RL= Rule of Law, CC=Contro of Corroption, Average 1996– 2008

**Figure 3.3** Institutional quality by regions (averages between 1996 and 2008).

Source: Kaufman et al. (1999) and authors' calculations.

Note: Abbreviations are as follows: V&A—voice and accountability; PS—political stability; GE—government effectiveness; RQ—regulatory quality; RL—rule of law; CC—control of corruption. These figures include averages between 1996 and 2008.

grew by 6.7 percent compared to 2.4 percent in the advanced economies (IMF, 2012). While each and every region of developing countries grew at a higher rate than advanced economies, the regional growth rates indicate the differential impact of the crisis on the regions. During the two recent years, the average GDP growth for

the regions and key countries were as follows: Asia–8.7 percent, China–9.8 percent, India–8.7 percent, ASEAN-5<sup>3</sup>–5.9 percent; Central and Eastern Europe–6.8 percent; Latin America and the Caribbean–5.4 percent, Brazil–5.4 percent; Mexico–5.2 percent; Sub-Saharan Africa excluding South Africa–5.2, South Africa–3.0 percent; and MENA–3.7 percent.

The IMF's projection for the years 2112 and 2113 indicates moderate reductions in growth rates for Asia and Middle East and North Africa, but significant reductions in Latin America and the Caribbean, and Central and Eastern Europe. The only region for which the IMF forecasts continued improvement in output growth is Sub-Saharan Africa. This region is expected to grow further partly because of a wide range of investment opportunities in the area of agriculture, mining, and infrastructure development, and partly due to a rising middle class (IMF, 2011).<sup>4</sup>

To conclude, the long-term growth rates and the economic fundamentals of the developing and emerging economies as measured by the ten-year averages show a thriving economic environment. A protracted and even better performance may follow as these countries improve their institutional environment. While the global economic crisis has affected the developing economies adversely, these emerging economies have withstood its worst effects and have managed to avoid recessions. They therefore have become a cushion for the world economy during a major crisis, and will be key players on the road to global recovery.

### Notes

1. International organizations such as the United Nations, the World Bank, the International Monetary Fund, and the World Trade Organization have their own but overlapping classification of developing countries by region and income. Financial institutions such as Goldman Sachs, FTSE, MSCI, the Economist, Standard & Poor's, and Dow Jones have their own list of emerging market economies with much overlap.
2. For the most recent list of countries in these groups, see World Bank, 2011, p. 343.
3. ASEAN-5 stands for the five largest economies of the Association of Southeast Asian Nations, which has ten member nations. The five are Indonesia, Malaysia, Philippines, Thailand, and Vietnam.
4. The December 2011 issue of *Development and Finance* has a number of upbeat articles on Africa. A similar view is found in Miguel E. *Africa's Turn?* Boston: MIT Press, 2009.

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CHAPTER 4  
ASSESSING COUNTRY ATTRACTIVENESS  
IN THE VENTURE CAPITAL AND  
PRIVATE EQUITY LANDSCAPE  
IN EMERGING MARKETS

*Alexander Groh and Heinrich Liechtenstein*

**Introduction**

If you were an institutional investor deciding on the best options for allocating your international venture capital (VC) and private equity (PE) exposure in emerging markets, which destinations would you pursue?

In our research project “The Global Venture Capital and Private Equity Country Attractiveness Index” we tackle this question.<sup>1</sup> In this project, we have calculated an index in its third edition in 2012 that benchmarks 116 (thereof 83 emerging) countries across the world with respect to their attractiveness for international VC and PE investment. In addressing this, we first needed to understand the criteria institutional investors apply when they evaluate opportunities in various countries. Therefore, we interviewed selected investors, surveyed 1,079 institutional investors worldwide, and reviewed academic literature.<sup>2</sup>

Based on the findings we gained, we built our index to help investors judge the attractiveness of countries for PE or VC investors. Here, we comment on this index with respect to emerging market VC and PE. The emerging market attractiveness ranking is led by China, followed by Malaysia, South Africa, Chile, Saudi Arabia, Poland, and India. Despite this overall ranking, we also discuss the success factors of the countries that remarkably improved their investment conditions over the last five years, namely, Tunisia, Morocco, Saudi Arabia, and Egypt. We detect that all Northern African and almost all Middle Eastern countries covered by our index strongly increased their attractiveness for investors. Our index can help support investors’ allocation decisions on the enlarging map of potential target countries. However, several emerging markets are probably not yet sufficiently mature for VC/PE investments and too early an entry might not be a beneficial allocation strategy.

## The Global Private Equity Country Attractiveness Index

### What Drives Institutional Investors' International VC and PE Allocation Decisions?

Our index takes a top-down approach to evaluating country attractiveness for institutional investors making decisions about their international VC/ PE allocation by assessing how socioeconomic criteria affect the expectation of efficient deal making. Although the allocation process involves further decisions based on fund management teams by evaluating the general partners' competences, their track records, and other parameters (such as the fund's strategy, its size, the limited partner's desired exposure, timing of the fund closing, among others) in fund due diligence, our index does not account for these subjective, personal judgment decisions that are often made based on undisclosed data.

Our methodology follows a practical approach, evaluating the expected deal opportunities arising from the socioeconomic environment in a country. We summarize factors that shape national VC/PE markets into one single composite measure. To gain a deeper understanding of international VC/PE activity drivers, we utilized our survey and the vast academic literature on the determinants of vibrant VC/PE markets. We group the numerous criteria into six subheadings, each representing one of the six "key drivers" of country attractiveness for VC/PE investors. These drivers, applied to our sample set of countries, build our index: economic activity, depth of the capital market, taxation, investor protection and corporate governance, human and social environment, and entrepreneurial culture and deal opportunities.

#### Economic Activity

Clearly, the state of a country's economy impacts its VC/PE market. Good measures of prosperity, variety of corporations, overall entrepreneurial activity, and an economy's size and employment levels also estimate expected VC/PE deal flows. The decision to enter emerging economies often hinges upon the expectations for economic growth; rapid growth provides greater opportunity for VC/PE investments (Gompers and Lerner, 1998). Furthermore, VC/PE activity is cyclical and significantly related to GDP growth (Romain and van Pottelsberghe de la Potterie, 2004). Capital for risky investments, which amasses during periods of economic prosperity and development, fosters entrepreneurship (Wilken, 1979).

Although the economic activity key driver is independently important, it results from various criteria that are discussed in further detail in the following sections.

#### Depth of the Capital Market

Black and Gilson (1998) discuss the differences in the two types of capital markets that affect VC/PE decisions: bank-centered and stock-market-centered. Well-developed stock markets allow for IPO exits, which are essential for the development of VC/PE activity. Furthermore, this is also a strong indicator of M&A market size, which offers the possibility of deal sourcing and future divestment.

On the other hand, capital markets that are bank-centered prove less efficient in fostering the institutional infrastructure that supports VC/PE deal making. In addition to lacking a strong stock market, bank-centered capital markets cultivate a conservative approach to lending and investing. Social and financial incentives in these secondary institutions reward entrepreneurs less richly while penalizing failure more harshly, in turn compromising entrepreneurial activity. According to Greene (1998), inaccessibility to debt financing hinders economic development, and can prove especially difficult for start-up activity. The ability to find willing, risk-bearing backers is essential to success. Gompers and Lerner (2000) claim that this risk capital is cultivated through deep, liquid stock markets. Cetorelli and Gambera (2001) argue that bank concentration facilitates access to credit, in turn promoting growth in capital intensive sectors.

The quality of VC/PE deal-making infrastructure can be measured by the liquidity of the M&A, banking, and public capital markets. Countries in which these aspects are strong generally have professional institutions (investment banks, accountants, lawyers, M&A boutiques, consultants) that are key to successful VC and PE deals.

#### Taxation

We understand that income taxation drives corporate activity and new venture creation, which has been supported by various economic literature. Bruce (2000 and 2002) and Cullen and Gordon (2002) acknowledge the impact that tax regimes have on entry and exit barriers. Djankov et al. (2008a) confirm that taxes, both direct and indirect, affect entrepreneurial activity. According to Bruce and Gurley (2005), the gap between personal income and corporate tax rates incentivizes entrepreneurship.

However, such a link with VC/PE investments is difficult to establish. VC/PE activity is, in fact, not strongly correlated to tax brackets. Countries with relatively high corporate tax rates may still have very large VC/PE investments. On the other hand, many emerging countries with low corporate tax rates have little to no VC/PE investments on record. Generally speaking, while developed countries have higher tax rates, they also gain more VC/PE investments.

In our index, we focus on the incentives for new venture creation provided by the spread between the personal and the corporate income tax rates as suggested by Bruce and Gurley (2005), including an appreciation for tax regimes with low administrative burdens and requirements.

#### Investor Protection and Corporate Governance

Legal structures and the protection of property rights strongly influence the attractiveness of VC and PE markets. La Porta et al. (1997 and 1998) confirm that a country's legal environment determines the size and extent of its capital market and the ability of local companies to obtain outside financing. Roe (2006) reiterates the importance of strong shareholder protection through a comparison of the political determinants of corporate governance legislation for the major economies. Glaeser,

et al. (2001) and Djankov and his colleagues (2003 and 2008b) suggest that it is easier to enforce investors' rights in common-law countries.

Cumming, et al. (2006) determine that VC/PE-backed exits are correlated more to the quality of a country's legal system than to stock market characteristics. In 2010, Cumming and others extend this, claiming that differences in legal actions and accounting practices between countries strongly dictate VC/PE investments. Fairness and property rights protection strongly impact growth and emergence of new enterprises (Desai et al., 2006). Along these lines, La Porta et al. (2002) and Lerner and Schoar (2005) note that cost of capital is typically lower in countries with better investor protection.

As you can see through these cited studies, the quality of a country's legal system is the criterion on which its capital market and corporate environment depend. Without proper legal protection and enforcement, conducting business can become costly. Since VC/PE investments are forged on long-term relations with institutional investors, and investment source and host countries can be distant, investors must be confident that their claims are well protected before they allocate capital.

#### Human and Social Environment

Researchers have focused on how differences in culture can lead to various entrepreneurial activity levels (Black and Gilson, 1998, Lee and Peterson, 2000; Baughn and Neupert, 2003). Furthermore, countries with more developed educational institutions create an environment that supports and cultivates the market for risk capital (Megginson 2004).

Imagine a company unable to keep up with changing market conditions due to restrictions imposed on its employment policies; this company cannot compete at the same level as another company in a country with flexible labor market conditions and policies, all other things aside. As such, the companies, and the countries, would have different prospects for growth, and therefore varying attractiveness to VC/PE investments. However, Black and Gilson (1998) believe that these labor market restrictions impact VC/PE investment less strongly than the stock market.

Additionally, a society in which corruption, crime, black markets, or significant bureaucracy exist will have the highest barriers, and therefore the highest costs, to entry (Djankov et al., 2002). As some emerging countries have high-perceived corruption and crime levels, this factor is particularly important in assessing their attractiveness.

#### Entrepreneurial Culture and Deal Opportunities

Possibly the most important factor in the decision to allocate international VC and PE investments is the expectation of accessing viable investments. Innovative capacity and research output in a particular country are particularly important for VC investment. Researchers have shown that investment in R&D can estimate human capital endowment, and is highly correlated with VC investment (Gompers and Lerner, 1998; Schertler 2003).

Innovations and R&D are equally important for later-stage investments. Without such innovation through R&D, it would be difficult for businesses to build and maintain strong brand names and market positions that attract later-stage PE investors.

Despite the innovative output of a society, Djankov et al. (2002), and Baughn and Neupert (2003) claim that bureaucracy (i.e., excessive rules, procedural requirements, the need to obtain approval from various institutions, and cumbersome documentation requirements) can deeply hinder entrepreneurial activity. These time-consuming and costly burdens could discourage investment (Lee and Peterson, 2000).

#### Conclusions on the Determinants of Vibrant VC/PE Markets

Identifying the most appropriate parameters for our index is challenging. There is no general consensus about a ranking of the criteria; although some parameters have been discussed in more detail, we find no clear-cut interaction between them.

That being said however, we note that many of the criteria are highly correlated with each other. Black and Gilson (1998) refer to it as a “chicken and egg” problem: you cannot determine causality. One may argue that modern, open, and educated societies develop legislation to protect investors’ claims, favoring the output of innovation and the development of a capital market, which, in turn, stimulates economic growth and the need for VC/PE investment. However, one could argue the reverse: economic growth fosters innovation and the development of modern, open and educated societies. Others may believe that support for innovations, economic growth, capital markets, and therefore VC/PE activity, can only be developed through competitive legal environments. Another possible option is that modern, open, and educated societies are created by attracting investors through low tax schemes.

Although each of these arguments is reasonable and validated by the economic development of different countries over different historical periods, it is still crucial that these factors be improved in conjunction with one another to increase a country’s VC/PE attractiveness. Due to this, our index does not rely on the selection of only a few parameters; rather, a country must rank highly on each of the individual criteria for it to be ranked highly in our overall index.

#### Building the 2012 Index

Using the six key drivers discussed herein and confirming them among institutional investors, we developed the structure of our index. We further refer to these drivers as the six “latent” key drivers, because they cannot be measured directly, but rather are driven by a variety of other factors that are more easily measured through proxies. At times, we were constrained by the availability of these proxies for a large portion of our country sample. The six latent key drivers of VC/PE attractiveness include the earlier discussed components: economic activity, depth of the capital market, taxation, investor protection and corporate governance, human and social environment, as well as entrepreneurial culture and deal opportunities.

Assuming that the VC/PE attractiveness of a country is determined by the six key drivers, we must find data that allow us to estimate these. For example, ideally,

we would be able to express the quality of a country's deal-making environment by its number of investment banks, M&A boutiques, law firms, accountants, and consultants. However, these data do not exist on a global scale, and the only alternative is to gather more general information (i.e., the level of debt provided by the banking sector, or estimates about the perceived sophistication of the financial system among others) that shapes the latent key driver, the depth of the capital market. While they may not be perfect proxies, we believe that the more developed these criteria are, the deeper the country's capital market. This, in turn, leads to more deal-supporting institutions to facilitate VC and PE activity. This principle is maintained throughout the index construction; through numerous proxy parameters, we are able to evaluate each latent key driver. As described in detail in Groh et al. (2010b and 2012), we use 51 data series and different weighting and aggregation techniques to condense the information into a single composite score.

### **The 2012 Emerging Market VC/PE Attractiveness Ranking**

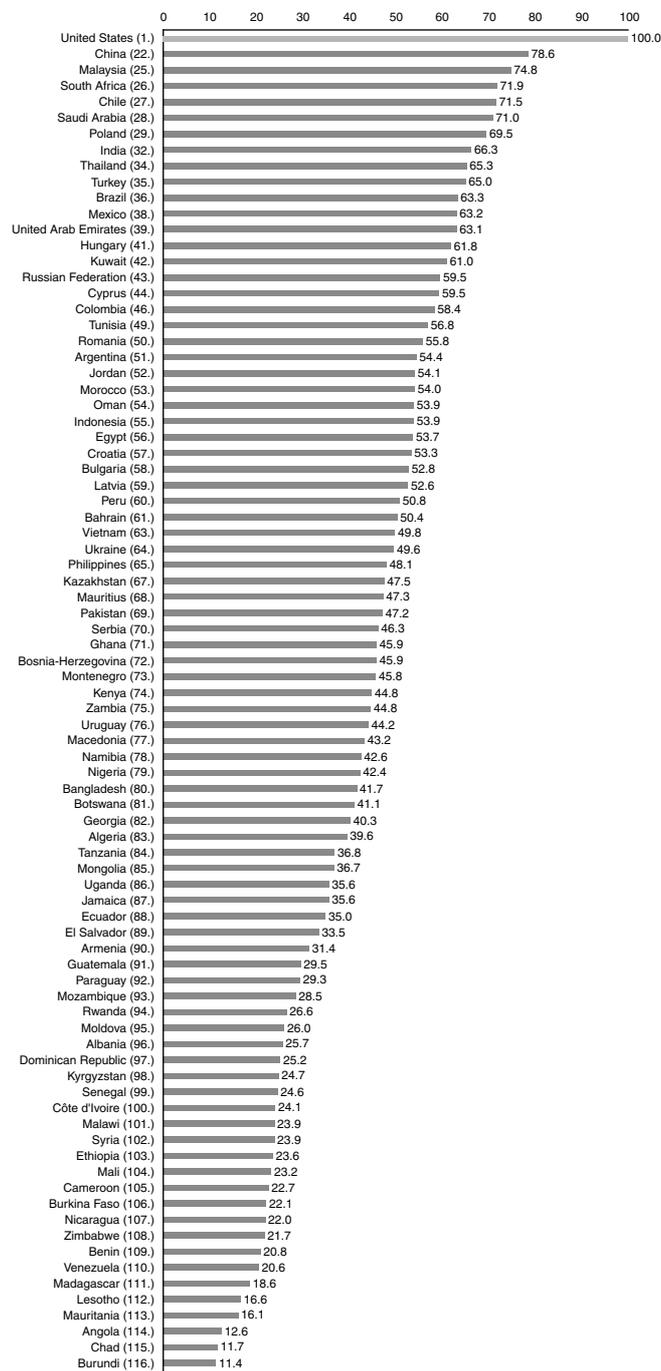
In calculating our global 2012 index, the United States is the most attractive country for VC/PE investments. Therefore, we use the United States as the benchmark and rescale its score to 100 to serve as a reference point for all other countries. Since we focus on emerging markets in this book, we exclusively provide the results for 83 countries tracked by our index and considered emerging by the IMF. These 83 countries include those that have been reclassified "industrialized" in 2011. The ranking of the emerging markets (and their distance to the United States) is presented in figure 4.1.

Of course, our index leaves some room for debate; some may feel that particular countries are ranked too high, while others are too low. We note that the index ranking is the result of commonly available, transparent, aggregated socioeconomic data, which is relevant for investors in VC and PE assets. The results can be traced to the level of the individual data series, and hence, can be reconciled.

The data used to construct this index is based on the available information in the year end of 2011. As such, the index shows the current attractiveness ranking and includes the economic outlook for 2012. This index should be enriched by investor knowledge, experience, and expectations prior to making decisions on investment allocations.

Figure 4.1 reveals that the highest ranked emerging country is China (globally ranked 22nd), followed by Malaysia, South Africa, Chile, Saudi Arabia, Poland, and India. We comment on Brazil, the Russian Federation, India, China, and South Africa (the BRICS) in a subsequent section, and note first that maybe the biggest surprises are the ranks of Chile, Saudi Arabia, and Poland. These countries continuously improved their VC/PE investment conditions and now rank at the top level of the emerging markets. This becomes more transparent if we track the five-year development of their index ranks in figure 4.2.

Figure 4.2 indicates the improvement/decline of the VC/PE attractiveness of emerging markets over five years. It supports the appreciation of Chile, Saudi Arabia, and Poland and also reveals the astonishing development of Tunisia, Morocco, and Egypt. In fact, all Northern African and most of the Middle Eastern



**Figure 4.1** Ranking of 83 emerging countries (including the 2011 reclassified) and the United States with respect to their attractiveness for VC and PE investors.



**Figure 4.2** A five-year comparison of 83 emerging countries (including the 2011 reclassified) with respect to their attractiveness for VC and PE investors.

countries covered by our index show remarkably improved investment conditions. In particular, Tunisia substantially increased her score due to her local capital market development and investor protection. Morocco benefited from economic growth expectations, and improvements of her human and social environment. Chile's rank is supported by expected growth and by increased capital market activity. Saudi Arabia also has emerged stronger through economic activity and an improving human and social environment, while Poland has developed a strong capital market and enhanced its corporate governance and investor protection.

There are several other emerging markets with notably improved investor attractiveness in recent years. However, their overall ranks are still low, thus probably not yet qualifying them for immediate investment. Therefore, these countries should be closely monitored because their economies might soon become sufficiently mature for receiving VC and PE allocations.

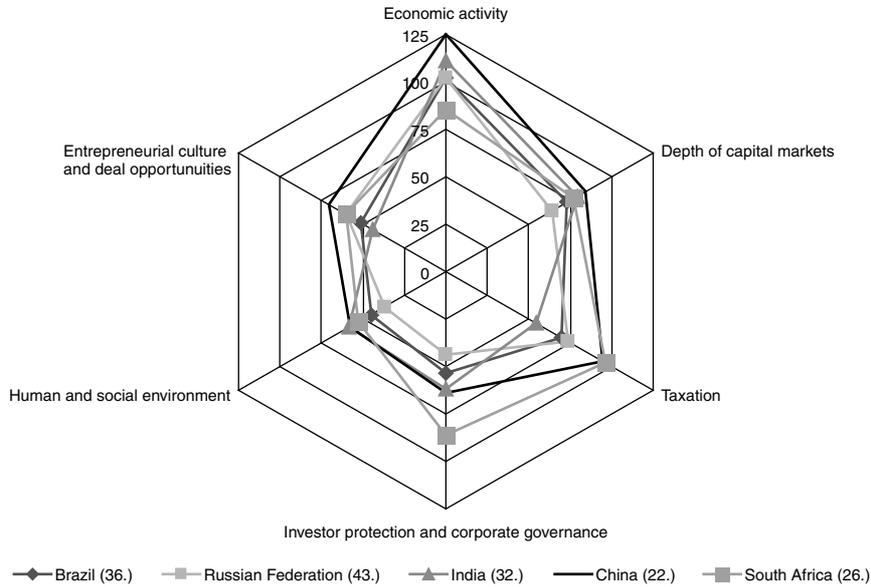
On the lower end of the figure, we find the countries with deteriorating rankings over the last five years. These losses might not necessarily be due to an overall decreasing quality of investment conditions. Some of the countries just became outperformed by their peers in the competition for investor attraction. This competition is fierce, and small changes of the attraction determinants may cause volatile rankings, in particular for the lower-ranked countries.

#### The Very Special BRICS

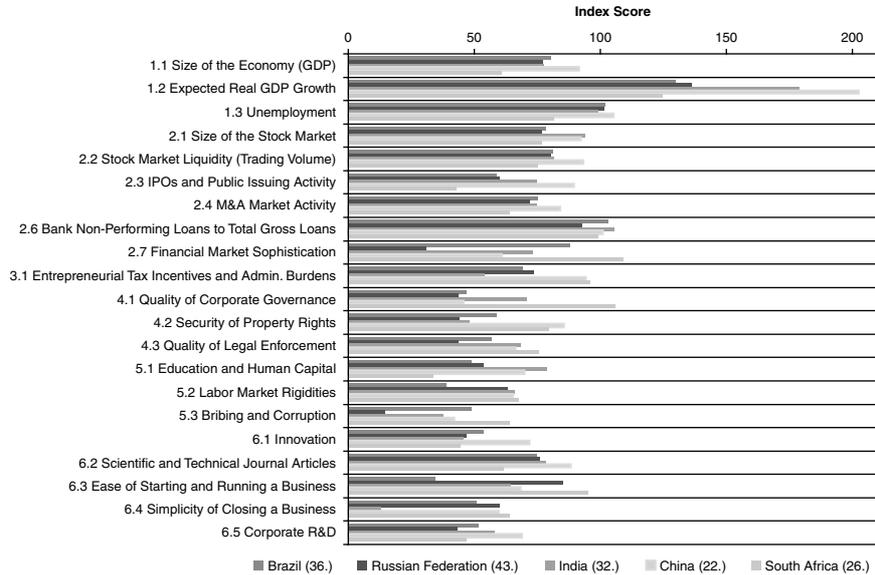
Due to their size and their expected catch-up potential, the BRICS experience high investor attention since recent years. In 2011, China has been among the top countries of worldwide VC/PE activity, trailed closely by India. Furthermore, as also revealed in figure 4.2, Brazil substantially improved her VC and PE investment conditions. South Africa, probably caused by her close ties with the United Kingdom and her implementation of a similar legal and capital market oriented culture, has been ranked quite high in our index since its inception. Only Russia lags behind the other BRICS somehow in her VC/PE market attractiveness. The drivers outlined in figures 4.3 and 4.4 may help to explain this.

Investors are capitalizing on the strong economic growth in the BRICS. However, it is not only the economic situation that explains rising VC and PE activity. In parallel to their economic progress, the BRICS, though Russia to a lesser extent, have developed strong capital markets. China meanwhile ranks second worldwide with respect to stock market size and liquidity, or public issuing activity, and India follows closely. Further, the number and volume of M&A transactions are on high levels. This secures professional investment environments, general liquidity, and deal opportunities.

Nevertheless, figure 4.3 also shows that the key driving factors of VC/PE attractiveness are skewed in these countries. They are generally characterized by strong economic activity (although less so for South Africa with a smaller economy and a high unemployment rate) and capital markets, but the key drivers related to investor protection (not so much for South Africa), human and social environment and entrepreneurial culture, are rather poorly developed. To gain further insight, we disaggregate the key drivers to the subsequent level of their underlying data series and present them in figure 4.4.



**Figure 4.3** The current state of the six key drivers for VC/PE attractiveness of the BRICS.



**Figure 4.4** The current state of more granulated drivers for VC/PE attractiveness of the BRICS.

Figure 4.4 supports the argumentation on economic growth and the BRICS's capital markets. However, it exposes some concerns about these countries, and more generally, about most other emerging markets. Corporate governance factors (except in South Africa) and investor protection are big obstacles to tackle. The countries also suffer due to the high levels of perceived bribery and corruption, while innovations and corporate R&D are relatively weak. These arguments are particular valid for Russia, and thus, explain her lag when compared to the other BRICS.

Growth and development in emerging economies are not widespread, but rather concentrated in particular hubs or regions. Furthermore, we have seen that wealth creation is typically allocated among small elite groups, and its benefits are not experienced across the entire population. This presents not only socioeconomic and political challenges in those countries, but also affects their VC/PE attractiveness. If the countries cannot transfer the wealth effects of growth to a broader part of their population, it is unlikely to improve the other key driving forces for VC/PE attractiveness, and if the pace of economic growth slows down, the countries will deteriorate their VC/PE attractiveness ranking.

### Conclusions

For investors to thoroughly analyze investment opportunities, it is essential that they assess the following six criteria in addition to utilizing their personal knowledge and experience: economic activity, depth of the capital market, taxation, investor protection and corporate governance, human and social environment, as well as entrepreneurial culture and deal opportunities.

Breaking down these key driving forces in 51 data series, we developed an index that measures the attractiveness of 116 countries (thereof 83 emerging markets) for investors in the VC and PE asset classes. Our index allows a ranking of emerging VC and PE markets' attractiveness that is led by China, followed by Malaysia, South Africa, Chile, Saudi Arabia, Poland, and India. Compared to such a ranking five years ago, Tunisia, Morocco, and Saudi Arabia have improved most in investor attraction.

Emerging markets provide numerous investment opportunities and need strong financing for their expected economic growth, but this may be misleading. In many of these countries, it is challenging to get access to transactions due to the relative immature nature of their institutional deal supporting environment. As such, deals can be much more cumbersome and costly. Furthermore, weak investor protection may be coupled with bureaucracy, perceived bribery, or corruption, and can result in lower returns on the investment. Investors should thoroughly examine both the advantages and disadvantages of emerging market opportunities, as the advantages may prove to come at a cost. The landscape of investable emerging markets is enlarging. However, there are also many countries that are probably not yet sufficiently mature to support the VC and PE investment rationale. Early entry in these countries may allow investors to establish early relationships and to gain local experience. Nevertheless, too early entry seems not to be advisable.

### Notes

1. For further details regarding the methodology behind the construction of our index, please visit our website (<http://blog.iese.edu/vcpeindex/>). You can also contact us directly. Please refer to our website <http://blog.iese.edu/vcpeindex/> and Groh et al. (2012).
2. Please refer to detailed descriptions in Groh and Liechtenstein (2009), Groh et al. (2010a), and Groh and Liechtenstein (2011a, b, and c).

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PART II  
INSTITUTIONAL AND OPERATIONAL  
PERSPECTIVES ON PRIVATE EQUITY  
IN EMERGING MARKETS

CHAPTER 5  
EMERGING MARKET PRIVATE EQUITY,  
ITS RECENT GROWTH AND DIFFERENCES  
WITH PRIVATE EQUITY IN  
DEVELOPED MARKETS

*David Wilton*

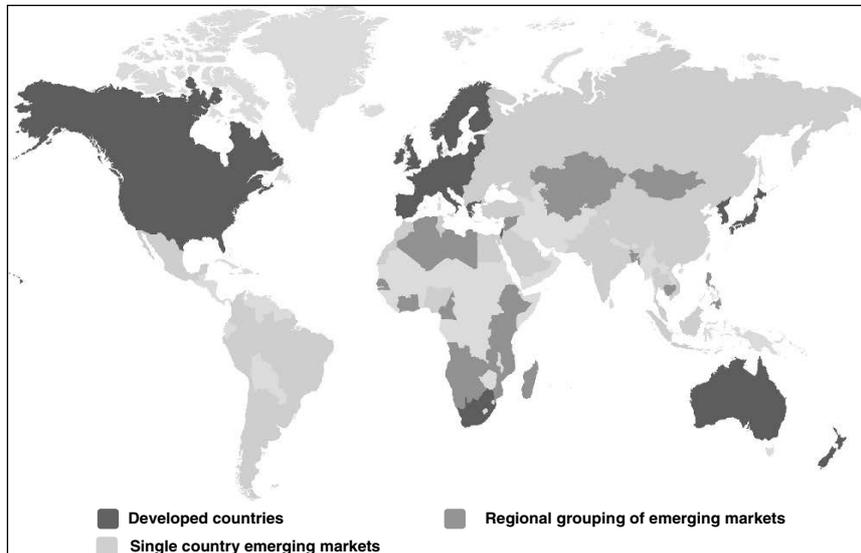
**Introduction**

The opportunity in private equity in emerging markets has developed significantly in the last decade, in both scale and quality. However, in important respects it remains different from the predominant leveraged buyout (LBO) opportunity in the United States and Europe.

This chapter explores two broad themes: (i) What has driven the growth of the private equity opportunity in emerging markets since 2000, and what is required to grow the opportunity further; and (ii) the differences between private equity in emerging markets and developed markets, the implications for investors, and how investors can think about and manage these differences.

**The Growth of the Private Equity Opportunity in Emerging Markets**

In 2000 when IFC created a dedicated department to manage investments in funds, it had already been investing in private equity funds in emerging markets for a decade with generally disappointing results—returns on the 1990s vintage private equity funds that the IFC backed are currently running around 4–5 percent, much below the returns on IFC's direct equity investments in the same period. When we investigated why the returns had been so lacklustre, one conclusion was that we had been supporting funds in countries in which, while the general demand for equity financing was high, too few of the control positions suited to private equity were available. At that time we concluded that the only emerging markets with enough deal flow for country-dedicated funds were the BRICs plus South Africa. We now think the investable opportunity is much broader, a genuinely global opportunity, as the map in figure 5.1 illustrates.



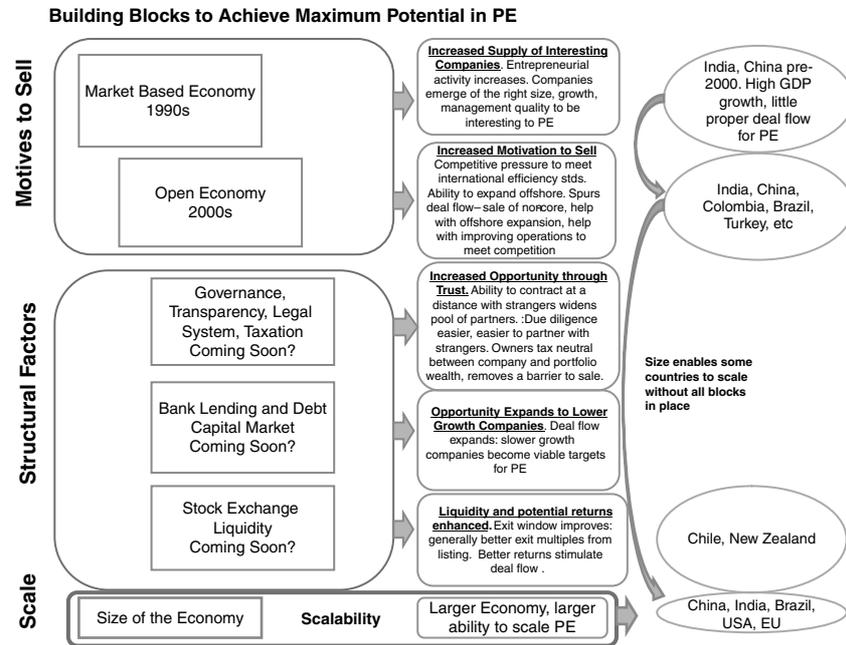
**Figure 5.1** An increased set of private equity investment opportunities in emerging markets.

To understand why the private equity opportunity in emerging markets has grown so much in the last decade, we need to step back a little and look generically at the building blocks that enable the industry to function successfully.

Private equity has been an established industry in the United States and Europe for long enough that investors have not needed to think about the foundations that are required for the industry to exist. The deal flow is there, and there are general partners (GPs) eager to raise funds to pursue it—it is just a matter of selecting the GP you want to back. However, when a business is transplanted from its home geography, it becomes necessary to enquire how many of the building blocks that enabled the business to flourish back home are in place to enable it to flourish in its new home and, to the extent that some are wholly or partially missing, whether the business can be modified to succeed without them?

In my simple mental model of private equity, there are a series of building blocks that affect both the supply of suitable deal flow and the options available to fund managers to create return on equity. These building blocks are summarized in figure 5.2 and are discussed in the rest of this section. The potential scale of the private equity industry in a country is a combination of the number of building blocks that are in place and the size of the economy. A small number of building blocks in place in a large economy can lead to a larger private equity industry than a country with many building blocks in place but a small economy.

The growth in the private equity opportunity seen in emerging markets since 2000 has largely been driven by an increase in the availability of control positions.



**Figure 5.2** A framework for analysis of the development of private equity in emerging markets.

The motivation of company owners to sell influence and/or control to third parties has increased.

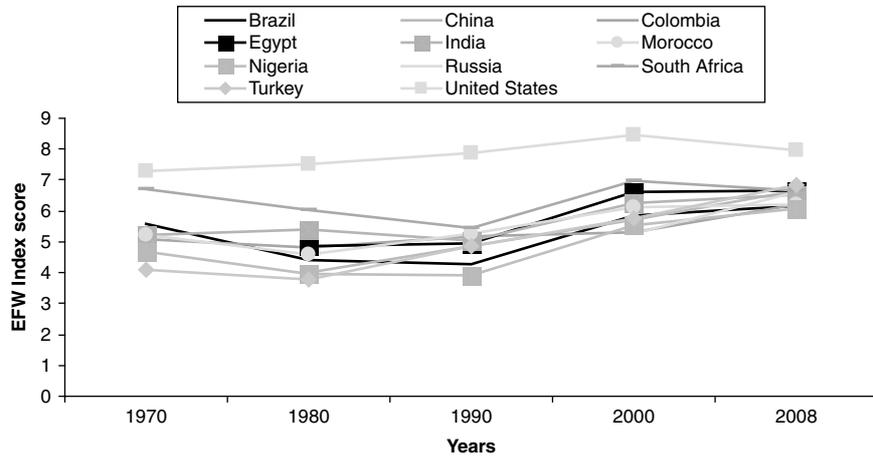
Why look at control positions? Private equity requires that value be created in a limited period of time before capital must be returned to investors. For a private equity fund, it is much more certain that value can be created and an exit achieved in a limited time period if the fund has either outright control of a company or a minority position with significant control-like rights through a shareholders agreement. For private equity to take root, there must be a large enough group of owners of companies who are willing to give up total or partial control of their companies. It is not enough that owners of companies would like additional equity financing—they need to be prepared to give up some degree of control to obtain it.

There are only a limited number of situations that motivate owners of companies to part with control, the most prominent of which are listed in table 5.1.

The first building block question to ask in moving private equity to a new country is this: (i) How many of these motives to surrender control are functioning and (ii) given the scale of the economy, does this provide enough deal flow for a private equity fund to have adequate selectivity in its deal selection? In a very large economy such as China, a single motivation to sell control, such as strong growth that is too big for internal financing, can support a viable private equity industry. In a smaller

**Table 5.1** The interplay between seller’s motivation to dispose, the investee firm’s specific situation, and the private equity firm’s desired ownership position

<i>Motivations for sellers</i>	<i>Investee firm’s situation</i>	<i>Position</i>
Positive motivation to sell	• Strong growth situation	Minority
	• Prelisting clean-up	Minority
Neutral motivation to sell	• Geographic expansion	Minority
	• Generational change	Majority
	• Conglomerate focus on core business selling non-core	Majority
	• Privatization	Majority
Negative motivation to sell	• Distressed business	Majority
	• Distressed owners	Majority

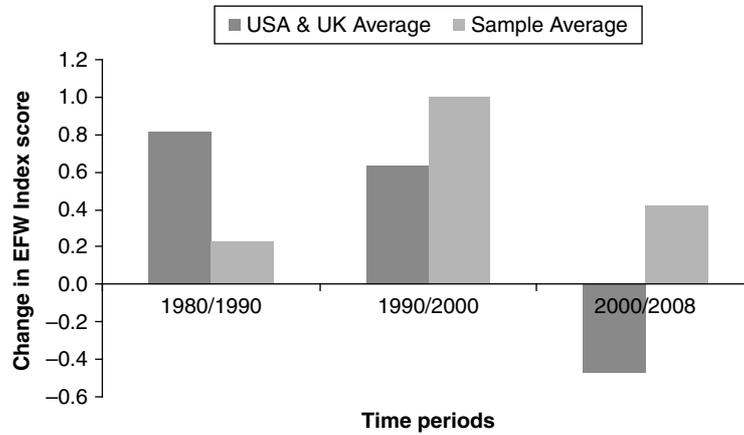


**Figure 5.3a** The Fraser Institute’s Economic Freedom of the World (EFW) Index levels in selected countries between 1970 and 2008.

economy, multiple motivations to sell control will be required to generate enough deal flow to allow a fund to be properly selective.

Note that GDP growth is not listed as one of the drivers of deal flow suited to private equity. GDP growth will certainly increase the general demand for equity finance, but a high general demand for equity finance is not necessarily the same thing as a strong supply of the control positions required by private equity.

What occurred post-2000 in multiple countries to increase the motivation of owners of companies to sell control? In my opinion, there were two broad phases: in the 1990s many countries shifted to more market-based economic systems followed, after 2000, by a shift to more open economies. That these two trends occurred is shown in figures 5.3a, 5.3b, and 5.4.



**Figure 5.3b** EFW Index changes in specific time periods.

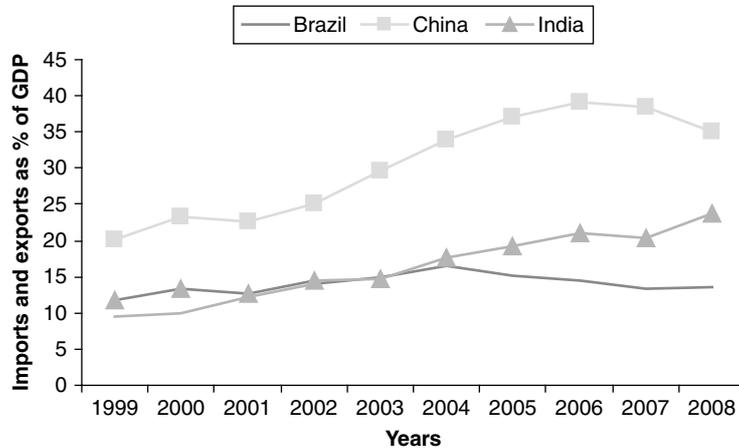
Source: Fraser Institute, Economic Freedom of the World (EFW) Index; [www.freetheworld.com](http://www.freetheworld.com).

Figures 5.3a and 5.3b use the Fraser Institute's Economic Freedom of the World Index to illustrate the significant improvement in conditions for business that occurred in emerging markets after 1990, particularly between 1990 and 2000. This period saw an increase in entrepreneurial activity, acceleration in GDP growth, and the emergence of companies of a scale and quality that were interesting to private equity buyers. Yet the 1990s was not, generally, a good period for investors in emerging market private equity. This is partly because while the companies were growing and emerging, their owners were not motivated to either sell out or to share control with external investors. Additional equity financing might have been nice, but no need was seen for external advice or partnership.

The opening up of economies that occurred post-2000 is illustrated by figure 5.4 that shows exports as a percentage of GDP as a proxy for the greater openness to trade and capital flows over this period.

The greater openness to trade and capital flows after 2000—globalization—created both opportunities and pressures that made owners of companies increasingly open to both selling businesses and bringing in active third-party investors. The internal business dynamic in a closed economy is quite different from that in an open one. In closed economies, business owners tend to not focus on a core business and use spare cash flow to diversify, creating conglomerates. They are also less aware of foreign standards of efficiency and seek offshore expansion less actively. In this less competitive environment, they see less need for external advice.

Opening the economy changes the internal dynamic. Facing greater external pressure, firms look more to build a competitive core business and sell off noncore businesses to fund the growth and improvement of the core business. Entrepreneurs are more interested in partnering with groups that can help make the core business more competitive, expand production lines, or expand offshore. Faced with a more



**Figure 5.4** Exports and imports as a percentage of GDP for Brazil, China, and India between 1999 and 2008.

*Note:* Between 1990 and 2008, countries achieved strong growth in exports and imports (Brazil—45 percent, China—73 percent, India—104 percent).

competitive environment, business owners become more willing to combine with or sell to competitors, creating platform buildup and industry consolidation opportunities. If several countries in a region make a similar shift toward more market-based open economies, opportunities arise to create larger, more efficient, multicountry businesses.

The shift to market-based economies in the 1990s encouraged larger, better managed companies to develop and create growth, while the opening of economies after 2000 made activist third-party capital attractive to help grow companies, improve efficiency, and acquire surplus assets. The resulting increase in availability of outright control or minority positions with control-like rights created the conditions for private equity to thrive.

As the availability of deal flow has increased across multiple countries, so has the quality of the investment opportunity. The obvious point is that greater deal flow allows greater selectivity. The less obvious point is that the increase in deal flow made it viable for fund managers to become local.

In my experience, private equity is a very local business, so the ability to be local is important. Each market has its own networks for sourcing transactions, its own quirks in due diligence, and its own approach to operating businesses. Someone local, both physically and culturally, will have better access to potential vendors through belonging to local networks; be better placed to understand the reputations of vendors; understand the particulars to be aware of in due diligence in the local market such as the number of sets of accounts and family or relationship ties in companies up and down the supply chain that may not transfer to a new owner; be better placed to identify talented local senior and middle management, and convince them to leave comfortable and prestigious positions in more established firms

for the higher risk/reward of a private equity backed firm; and better positioned to understand cultural factors that will assist a close working partnership to develop during the holding period, creating a bond that can be used to enforce the shareholders agreement independent of legal channels.

It was noted at the start of this section that in 2000, IFC concluded that the only countries with enough deal flow to support country-dedicated funds were the BRICs and South Africa. Where deal flow was insufficient at the country level to provide the selectivity needed to support a country-dedicated fund, fund managers and investors turned to subregional or regional funds as a way of getting a large enough deal base. While broadening geographic coverage remedied the deal-flow issue, it made the fund manager more distant from each individual market. The growth in deal flow across multiple countries since 2000 has now made dedicated country funds viable in a wide range a countries (see figure 5.1), and this in turn has improved the quality of the private equity opportunity in emerging markets by enabling fund managers to become much closer to the markets in which they are investing.

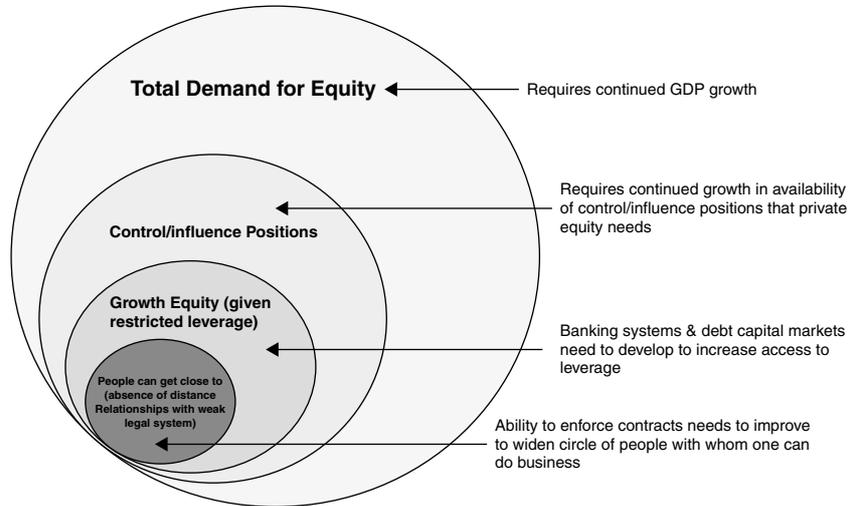
In any given country, the supply of deal flow suited to private equity can be viewed a little like a set of Russian nesting dolls—see figure 5.5. The outer doll in the set, the total demand for equity, will be driven by the size and growth of the economy. Within this total demand, only those companies whose owners are willing to part with some degree of control or influence to obtain equity finance will be attractive targets for private equity. There are a limited number of motivations for owners of companies to part with control (refer to table 5.1 for a description). Since 2000 the motivation to part with control has been stimulated by the pressures and opportunities created by more open economies.

Within the group of companies whose owners are willing to part with some degree of control, one factor that determines whether companies are potentially attractive acquisitions for private equity funds is the availability of leverage. The lesser the leverage available, the more the attractive target companies become limited to high-growth companies.

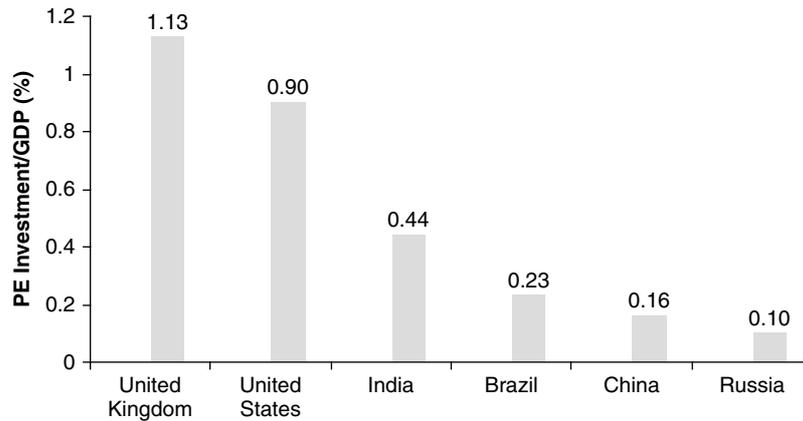
Within the group of high-growth companies, with owners willing to part with some control, a fund manager is limited to dealing with those companies with whom he or she can develop a relationship of trust. If the legal system allows efficient contract enforcement, this can be a relatively large group. If contract enforcement is poor, the fund manager will be constrained to deal only with those companies with which he or she can develop a personal relationship.

What might be the next steps for further expanding deal flow in emerging markets? Using capital committed as a percentage of GDP as a measure of market development, the emerging markets, including the BRICs, are currently much less developed in terms of private equity than the United States and Europe (see figure 5.6 for private equity penetration).

Clearly, it is to be hoped that the trend of the last 20 years to more market-based and more open economies will be sustained or at least not be reversed, as it is this trend that has underpinned the growth of private equity in emerging markets. If current economic stresses in the global economy were to lead to policies



**Figure 5.5** The Russian “nested dolls” concept as a framework for deal-flow analysis.



**Figure 5.6** Private equity investment as a percent of GDP.

Source: EMPEA.

of protectionism and balkanization, it would tend to limit the further growth of private equity, and, at the extreme, cause it to shrink.

Beyond a continuation of the existing trends, two developments at the local level will help the growth of private equity opportunity—improved access to debt finance and improved ability to enforce contracts. These are two of the structural factors in figure 5.2 earlier.

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

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

### **How Similar or Different Is the Private Equity Opportunity in Emerging Markets and Developed Markets?**

As the opportunity in emerging market private equity has expanded since 2000, the risks and the differences with private equity in developed markets have declined somewhat. However, differences are still present, and it is worthwhile for the investors to understand what the differences are, and how they might shape an approach to investment in emerging market private equity. The differences affect both the scale of the opportunity and the risk. Of those differences affecting risk, my experience is that some can be mitigated considerably.

Overall, I think that (i) the risks in emerging market private equity have, in the last decade, typically been overstated by investors; (ii) the emphasis on growth and efficiency improvement as the source of return on equity in most emerging markets results in a private equity model that is less exposed to cyclical- or macroshocks than the developed market private equity model that is more dependent on leverage and also possibly on multiple expansion; and (iii) for investors not restricted by a large

minimum commitment size, there is a broad diversification opportunity of which few investors are taking advantage.

A glance at table 5.2 shows that the performance of private equity in emerging markets relative to developed markets has improved dramatically over the last decade. While the average return on private equity in emerging markets lags behind that of the United States and Western Europe over 15 years, in the last 10 years it has surpassed that of the United States, and in the last 5 years it has surpassed that of both the United States and Western Europe. It is particularly noticeable that return on private equity in emerging markets has surpassed that of developed market PE in the postcrisis period.

The progressively better returns from private equity in emerging markets, both absolutely and relative to developed markets, suggest two things. First, that some aspects of private equity in emerging markets have improved and reduced the quality gap with private equity in developed markets, and, second, over the crisis some of the differences have worked in favor of private equity in emerging markets.

What are the differences between private equity in emerging and developed markets, how have the differences evolved, and how should investors think about and manage these differences?

I have summarized some of the major differences between private equity in emerging and developed markets in table 5.3.

The key structural difference between emerging market and developed market private equity is the reliance on growth for returns in private equity in emerging markets. It was noted earlier that the lower leverage typical in private equity in emerging markets reduces the scale of the opportunity. The lower leverage also has the advantage of making private equity in emerging markets relatively more resistant to macro- and cyclical shocks of the type recently experienced.

There are four basic drivers of returns in private equity: leverage, valuation multiple expansion, revenue growth, and higher margins caused by improved efficiency. Each of these drivers of return requires a certain skill set and environment to be successfully executed, and each has its own risks. The returns on most private equity

**Table 5.2** Performance of private equity firms in emerging markets

Years	Comparative net "end-to-end" returns as of June 30, 2011		
	US Equity Index (%)	Western Europe Private Equity Index (%)	Emerging Markets Venture Capital and Private Equity Index (%)
3	6.6	1.1	11.2
5	10.0	11.3	15.5
10	11.4	19.3	12.1
15	12.5	18.8	9.7

Source: Cambridge Associates.

**Table 5.3** The characterization of the main differences between private equity in developed and emerging markets

<i>Emerging Markets PE Difference to US/EU PE</i>	<i>Scale Impact</i>	<i>Risk Impact</i>	<i>Risk Mitigation</i>
Return driven by growth rather than leverage	Lower leverage reduces the number of companies suitable for acquisition	Less subject to macro and cyclical risk than LBO. Higher execution / operational risk	Select GP able to manage operational risk.
Mostly minority positions	Lower investment per transaction	Implementation of value/exit plan requires co-operation of majority. Shareholders agreement may be difficult to enforce. Exit may be difficult.	Select GP with the skills required to become viewed by the majority as a partner. IFC's experience is that ability to firm a strong relationship achieves co-operation and mitigates enforcement risks. IFC experience is that minority exits compare favorably to control exits.
Weak contract enforcement	Limits the range of people a GP can work with	Enforcement of shareholders agreement can be difficult.	Select GP with the skills required to become viewed by the majority as a partner. IFC's experience is that ability to firm a strong relationship achieves co-operation and mitigates enforcement risks.
Smaller companies	Smaller transaction sizes.	Potentially longer time to scale to size required to exit. Smaller companies may be more vulnerable to macro shocks.	In IFC's experience, transaction sizes have to become quite small before there is a noticeable increased in negative outcomes.
Exits: Limited IPO, less liquid stock exchanges, less M&A activity	Limits capital willing to enter the market to that with less time sensitivity and more tolerance for illiquidity	Less developed capital markets reduce exit opportunities. Can be either trapped or need to give up some return to secure an exit.	IFC's experience is that while returns on IPO are higher, trade sales provide good returns. GP needs to be aware of volatility in the exit window and be prepared to opportunistically exit even if it appears premature. LPs need to be aware of the greater difficulty of exiting listed stocks and ensure alignment of interest with the GP on distributions in kind.
Availability of experienced GPs	Not possible to crystallize the PE opportunity without a competent GP	Huge return quartile gaps in PE. Lack of experience greatly increases risk.	IFC returns from 1st time funds have been surprisingly good – in excess of 20% net. There appears to be an early mover advantage. Still, not for the faint of heart.

*Note:* Abbreviations include: GP—general partner; IFC—International Finance Corporation; IPO—initial public offering; LBO—leveraged buyout; LP—limited partner; M&A—mergers and acquisitions; PE—private equity.

transactions come from a blend of these four basic drivers. However, the blend differs across markets, fund managers, and periods of time.

A private equity strategy based heavily on leverage uses little equity and extracts a lot of cash during the holding period: it is very reliant on a stable macroenvironment and continued access to debt, neither of which held in the period immediately following the crisis. Reduced access to debt and declining earnings and margins due to a weak macrosituation will have an especially large negative impact on returns on equity in a heavily leveraged company.

A strategy based primarily on generating return on equity through revenue growth and improvement in margins will come under pressure from a macroeconomic slowdown or increased competitive pressure in the particular industry. However, a high-growth company with low leverage will be less vulnerable to macro- and cyclical shocks than a highly leveraged company with low or no growth. The relative resilience of a strategy emphasizing growth, a common strategy in emerging market private equity due to low availability of leverage, is something we have seen in the postcrisis period.

The focus on revenue growth as a primary driver of returns also results in a business model with considerable impact on job creation and support for small- and medium-sized businesses. In 2009, an examination of companies supported by the funds in which IFC had invested showed median and average job growth postinvestment of 12 percent and 22 percent, respectively. Sixty-four percent of companies had been small and medium enterprises (SMEs) at the time of the initial investment.

However, while a growth-focused strategy with low leverage is more resilient to macroshocks, a private equity strategy anchored in growth and efficiency gains is also more exposed to execution risk. A growth strategy is very dependent on the skill of the GP and the company management to avoid operating and strategic execution problems at the company level. Execution of a growth strategy would be expected to be more difficult in emerging markets due to a number of factors including fewer experienced GPs, the prevalence of minority positions, and fewer experienced senior and middle managers.

We manage this greater execution risk through seeking GP teams with the right skills and experience to actively assist the management of investee companies.

As noted earlier, the different private equity strategies each require particular skills and market environments to be executed successfully. Part of our investment process is to understand what the drivers of return are in each market, and to then ensure the skills and experience of the teams we back match with the way the returns need to be made. In a market where returns mostly come from organic growth, we look for GPs whose teams have the skill and experience to actively assist and guide the management of investee companies. Those with experience at a senior level in corporate operations, consulting, and as entrepreneurs are typically most able to actively help management. If a significant part of the growth is expected to be inorganic, as for example it often is in Brazil, then mergers and acquisitions (M&A) experience in the team is relevant. If leverage is important, as it is in South Africa, financial structuring skills will be relevant to executing the strategy, and investment banking experience in the team is necessary.

As most of the countries in which we invest require a growth-focused strategy, we mainly seek teams with a core of members who bring operating experience from past positions.

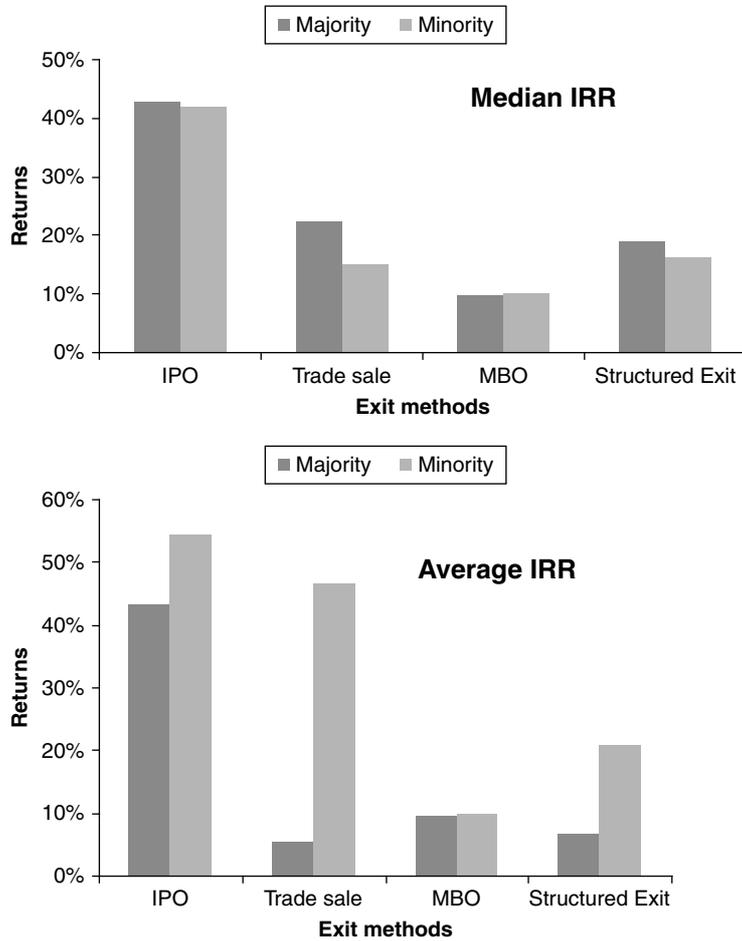
Teams with strong operating experience bring a further benefit when dealing with minority positions in countries with weak contract enforceability. Through being seen to add value to the company they are able to form a bond, a partnership, with the majority owner, which, in our experience, reduces the risks of weak contract enforcement significantly. A strong feeling of partnership both reduces the probability that the majority will try to squeeze out the minority or limit the minority's share in the up-side and gives the minority greater persuasive ability to enforce the shareholders' agreement.

This understanding of the importance of partnership between the GP and the investee company in mitigating the risks of minority positions in countries where contract enforcement is weak was formed only gradually. Our initial conclusion, after reviewing the poor experience of our 1990s funds with minority positions, was that minorities did not work. We continued to back funds making minority investments as a necessary evil—in most countries minority positions were all that was available. These later funds' investments in minorities were successful and, when compared to the earlier funds, the difference lay in the ability of the GP to be seen as a partner through adding value.

In the earlier funds, the minority had too often been deprived of its due share of the up-side. When an investment was very successful, the majority was unwilling to share the profits. They asked: "Who has created this wealth, us with dirt under our nails or this passive investor, nice as they are as a general sounding board?" Having convinced themselves that the minority had contributed little except capital, the majority would then proceed to arrange things so that the minority received an enhanced debt-like return, rather than the full equity return due. In the later funds, where the GP had contributed to the growth of the company and was seen as a partner, the GP's right to full participation in the gains was not questioned.

Figure 5.7 compares returns from exits of minority and control positions in companies backed by funds in which the IFC has invested, and the results from minority positions are good, indicating that the risks can be managed.

The importance of selecting a GP whose team has the right skill and experience for a particular market is highlighted by an exercise we did several years ago to see what impact different factors were having on our returns and development results. As a development institution, the IFC backs many first-time fund managers—around 50 percent since 2000—and also seeks ways to back private equity in the frontier where few other investors will go. We expected that one or both of these factors would have some negative impact on results. Table 5.4 compares the top and bottom 10 percent of funds in our portfolio at that time (March 2009). As expected the difference in both returns and development impact between the top 10 percent and the bottom 10 percent is considerable. What is surprising is that the additional risks that the IFC takes as a development organization in backing first-time funds and seeking out frontier investments did not appear to contribute to the difference in results. The best 10 percent of the funds were in fact more invested in the frontier (proxied by exposure to International Development Association, or IDA, the



**Figure 5.7** A comparative analysis of median and average returns for different situations of private equity firms' ownership position (majority versus minority) returns.

poorest countries) than the worst 10 percent, and, by coincidence, the percentage of first-time funds was the same in both the best and worst 10 percent. The major difference, the factor driving the wide variance in results, was the quality of the fund manager.

The 150 funds in the sample comprised a mix of vintage years from the 1990s to the mid-2000s, a period over which the IFC's learning curve in respect to fund investing was steep. As a measure of GP quality, we applied a small subset of our current diligence criteria related to manager skill set and a degree of "localness" to each fund, and scored each fund between 0 and 1 based on the extent to which the

**Table 5.4** A comparison of private equity performance for the top and bottom 10 percent of IFC funds

	<i>IRR as of March 2009<sup>1</sup> (%)</i>	<i>Development Impact Score<sup>2</sup></i>	<i>1st time funds percentage (%)</i>	<i>IDA %<sup>3</sup></i>	<i>Average Deal Quality score<sup>4</sup></i>
Top 10%	44.6	2.10	53	27	0.97
Bottom 10%	-38.3	0.14	53	13	0.17

*Note:* <sup>1</sup>Sample size is equal to 150 funds in IFC's portfolio in March 2009, excluding those in the J-curve. This relates to sample average %; <sup>2</sup>the scores in this category range between highly successful = 4 and highly unsuccessful = -1; <sup>3</sup>this relates to countries with less than \$1,000 GDP per capita; <sup>4</sup>the scores in this category range between maximum = 1 and minimum = 0.

diligence criteria were met. The top 10 percent met the simplified diligence criteria while the bottom 10 percent generally failed comprehensively.

The risk associated with first-time funds and the frontier is interesting and deserves further examination. Our experience leads us to believe that there is an early-mover advantage in emerging market private equity investing. Currently, our returns show first-time funds returning 21 percent<sup>1</sup> compared to 14 percent for non-first-time funds. If first-time funds are selected carefully enough, so that they have local presence and the skill set required to generate returns in the particular country, then, in less competitive markets, the fund team have considerable time in which to conduct diligence on each target company. There is time to properly understand companies and to develop relationships and action plans before investing. The neophyte fund team is not forced by competitive pressure into errors of haste. This early-mover advantage will decay over time as markets become more competitive, and eventually the risk of backing first-time funds will rise to the levels seen in developed markets and expected by investors; however, for now, the early-mover advantage persists in many countries.

The potential to achieve commercially attractive returns extends over a much wider geography than most investors' comfort zones. The IFC's performance compared to the top quartile of the Cambridge Emerging Markets Private Equity Index and the Morgan Stanley Capital International Index (MSCI) is shown in table 5.5. The long-term performance of the IFC's private equity portfolio is consistently in the top quartile and in excess of returns that would have been achieved on the same cash flows invested into and taken out of public equity in emerging markets.

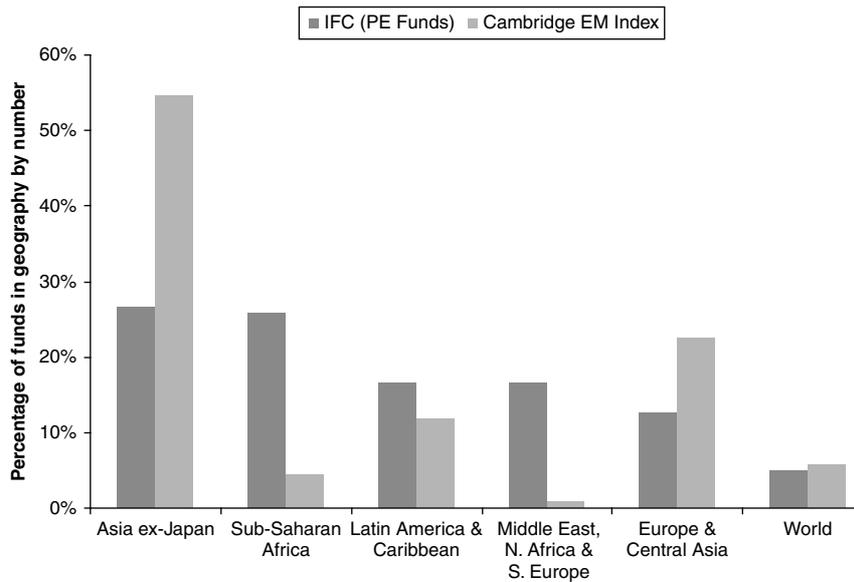
Analyzing this performance, a key point is that the IFC's geographical exposure is wildly different from that of the index. As figure 5.8 shows, the index is 55 percent in Asia while IFC's exposure is only 27 percent; the index is only 4 percent in Africa while IFC currently has 26 percent of its private equity portfolio in Africa. Certainly over the period since 2000, geographical diversity and IFC's push to the frontier has benefited returns: currently our 11.5-year return on African private equity is 20.2 percent. For those investors who are not limited by a large minimum commitment size, the broader opportunity is very interesting.

**Table 5.5** A comparison of returns for various averages

<i>Index</i>	<i>IRR from January 2000 to June 30, 2011 (%)</i>
IFC: Private Equity Funds*	22.2
IFC: All Funds**	18.5
Cambridge EM PE Top Quartile***	19.8
Cambridge EU PE Top Quartile***	21.7
Cambridge US PE Top Quartile***	17.4
MSCI (IFC PE Fund Cash flows)****	12.8

*Note:* \* includes: agribusiness, clean technology, mid-capitalization, mining, pharmaceuticals, SME, VC and health care funds; \*\* includes: agribusiness, clean technology, mid-capitalization, mining, pharmaceuticals, SME, VC, health care, debt, forestry, infrastructure, listed, real estate, secondary funds; \*\*\*all PE fund types excluding forestry, infrastructure, real estate, and secondary funds; \*\*\*\*identical cash flow stream converted into cumulative MSCI shares; valued as the new terminal value (on June 30, 2011) for the series of cash flows.

*Source:* Cambridge Associates for Cambridge data (June 2011); independent consultant analysis on IFC provided data set, data as of December 2010.

**Figure 5.8** IFC's exposure by geography compared to the Cambridge Index.

### Conclusion

The opportunity to invest in private equity in emerging markets has grown considerably since 2000, in scale, geographical scope, and quality. The growth to date has been driven by the combination of a shift to more market-based economies and greater openness to trade and capital flows, which have led to an increase in the

availability of equity positions with control or control-like rights attached. Further increases in the scale of the opportunity require a combination of continued economic growth and improvement in contract enforcement and the availability of debt finance.

Return on emerging market private equity has improved considerably over the last decade, and over the last three years exceeds that on both US and EU private equity. IFC's experience demonstrates that the risk of private equity in emerging markets relative to developed markets is not as large as is commonly thought. The increase in deal flow, which has allowed the spread of country funds to multiple markets, has diminished risk by increasing localization—placing teams in the countries in which they invest. The use of much lower levels of leverage in emerging market private equity relative to developed markets has provided a buffer against recent macro- and cyclical shocks. Risks related to contract enforcement, minority positions, and managing operational risk can be mitigated effectively through careful selection of GPs with the right skill sets for local conditions, and, quite strikingly, there appears to be an early-mover advantage that has improved the odds that first-time funds will meet with success.

The immovable issue facing investors appears to be one of scale and diversification rather than risk. While the opportunity for good returns is widely spread, it is, as yet, in many places not deep. This constrains the geographic footprint available to investors with large minimum commitment sizes, and careful investors will want to avoid flooding the markets. However, for those investors whose minimum commitment size is moderate enough to permit it, it is possible to build a well-diversified portfolio with excellent potential return.

#### Note

1. This excludes one extreme outlier, which, if included, takes the return on first-time funds to 27 percent.

CHAPTER 6  
THE INVESTMENT COMMITTEE IN PRIVATE  
EQUITY: A POWERFUL TOOL FOR EMERGING  
MARKET FUND MANAGERS

*Nicholas B. Callinan*

The essence of managing private equity lies in exercising judgment. Key decisions must be made under the pressure of time, with incomplete information, and in the face of many uncertainties. The private equity (PE) professionals themselves are constantly exercising judgement—about whether to pursue a particular deal, about the people and the markets, and about whether a reasonable deal may be negotiable within a reasonable period of time. However, the key decisions in the chain leading to an investment being made—or dropped—are usually made by the fund management firm through a process that is more or less formal. If fund management is a matter of finding, making, and managing investments in private companies, it is the “making” part that holds the key to the success of the portfolio. That’s where the investment committee (IC) adds its value.

We all know what an IC does: it makes the final decision to invest a fund’s capital. However, such a narrow view risks selling short the value an IC can bring to private equity investing. In my experience of working for many years with funds, including in emerging markets, the IC can be of crucial importance to a management firm, and it can make a far more extensive and valuable contribution than just signing off investments—in fact, it is at the heart of how a firm operates. This is especially so for new or young firms. Before I consider the particular value of ICs, especially in emerging markets, let us first look at the different types of ICs, and how the makeup and function can vary from firm to firm.

**Different Types of Investment Committees**

Formal Investment Committees

If we start by looking at the composition of ICs, we will see that the origins of the firm, its size, and its age all have a bearing on who sits on the committee and on what it does. Management teams that have been set up by institutions (such as

banks, sovereign funds, endowment funds, and pension funds) usually have the most structured ICs—I categorize these as “formal.” Institutions have established systems and approval processes into which the private equity operations must fit. Formal ICs will usually have a majority of members appointed by the institution and few or even no voting members from the deal-making team.

Another group of funds are those where the capital investors dominate the management professionals. Examples are funds set up by large, single investors (such as family offices) or those sponsored by government or transnational organizations (such as the US Agency for International Development [USAID] funds in Europe). In these, too, the ICs tend to be formal. The capital providers usually demand a formal IC structure, though perhaps not one so formal as the institutional funds. In addition to appointing their own representatives, the capital providers may appoint external members, people selected because of their relevant experience or stature. Usually, there will be one or more of the senior members of the deal-making team as well. These ICs tend to operate more or less like an institution’s IC, receiving proposals and making decisions, but they are usually less constrained by institutional policies and procedures.

Large, well-established PE firms, managing large funds or groups of funds, may set up separate ICs for each fund or group of funds, and constitute them with senior partners of appropriate experience. Such ICs normally respond to investment proposals submitted by deal teams at an advanced stage in the investment process. They may interact with the deal teams to a limited extent but normally do not have the time to get down to working-session levels of involvement. I include these ICs in the formal category.

#### *Interactive Committees*

Numerically, the most common form of PE funds manager, and the most interesting from our point of view, is the typical small or medium-sized firm, set up by experienced professionals who have raised the capital for their various funds and who lead the investment process. In these firms, the IC usually involves all the senior partners and, because they typically engage with the deal makers, help them in shaping the investments, more like in a working session. I describe them as “interactive” ICs. The scope of operations of these ICs will vary enormously and reflect the personalities of the senior partners.

#### *Participative ICs*

I will add one further descriptor of ICs to the “formal” and “interactive,” and that is “participative.” This refers to an interactive IC that includes in its meetings most, if not all, of its investment professionals. We will discuss later the benefits and costs of this approach.

When you look at how different structures of an IC can affect a firm, you can see how the differences define a firm’s operating character. The formal ICs act “top down,” and are designed to ensure compliance with internal policies, maintain investment discipline, keep control of deal professionals, and be efficient decision makers. Investment proposals are presented quite formally to the IC, which then hands down its decision to proceed or not. To some extent, formal ICs are also

designed to control the risk of legal problems or adverse publicity that could arise from the PE activity. Formal ICs can be most appropriate in large organizations or in situations where the deal teams must be kept in check. They usually have limited interaction with the deal makers who can come to see them as the main obstacle to completing an investment. Formal ICs often set quite strict parameters that proposals must address and have formal sign-off procedures for all investments.

In less structured markets, such as emerging markets, formal ICs may not deal so well with the complexities and trade-offs that have to be made in deploying capital. The interactive IC works well here. Because it is made up of the senior deal makers in the firm, it is more likely to work with deal teams on how to improve a marginal deal rather than just to kill it. Taking more of a “bottom up” approach, the interactive IC looks at deal proposals initially in draft form, and then works on them, ironing out wrinkles and making improvements to see if they can be made into investments.

These differences between formal and interactive ICs will shape a fund’s portfolio—for better or worse—and determine its success over the long term.

### **Different Functions of an Investment Committee—What It Does, or Can Do**

Practices vary widely on how much of the overall investment management process is covered by the IC. Some firms limit the scope of the IC to formal decision making. Others treat the whole investment process, from deal-flow management through to portfolio monitoring, as a continuum and use the IC as the main forum for managing the resources of the firm. The way an IC works can change quite significantly over time as the management firm evolves, adding new funds, new people, and new investors. I have seen all the following functions performed by ICs although, perhaps not all in the same firm.

#### Investment Decisions

Obviously, this is the IC’s fundamental activity—making decisions to invest or divest and approving the terms and conditions. Often this formal role includes two other components: certifying compliance with fund documentation and allocating broken-deal costs. First, in terms of compliance certification, a fund’s documentation—limited partnership (LP) agreement, side letters, management agreement, etcetera—will include matters negotiated with the manager as restrictions on the fund. Typical examples are: prohibitions on certain industries; geographic limitations; portfolio concentration limits; coinvestment rules; dealing with related party transactions and conflicts of interest; compliance with standards (e.g., environmental reports, labor, and “transparency”). Typically, the IC must ensure that these requirements are all met before it signs off an investment. Second, a sensitive issue between investors and managers is the way broken-deal costs are handled. Appropriately, a fund manager must cover the costs of finding and investigating potential deals and of preparing a solid case for an investment. If the deal is dropped—and most are—this is the manager’s risk. However, the LPs usually agree that, from some advanced

point in the process, the fund will accept the final closing risk. If the deal breaks after this, the costs incurred from that point may be reimbursed. Quite often, this point is defined as when the IC resolves to proceed with a transaction subject to confirmatory due diligence and documentation.

#### Managing Deal Flow

All firms track their deal flow and manage the progress of potential investments. Typically, early on, a brief paper is produced for the IC, called a “deal qualifying memo,” “two pager” or similar. If the deal is not killed at this stage, its progress is monitored more closely. In a firm with an interactive IC, the dialog with the deal team about the active deals will be as much in the nature of a working session as decision making. As a deal progresses further, the IC receives updates and eventually a full draft investment memorandum. It may give conditional approval to a deal, setting improvements to terms or further analysis that must be completed for it to continue. Once a formal decision has been made to invest in a business, a final version of the investment document is kept as a record and becomes the reference against which the subsequent performance of the deal is reported.

Professionals who work on deals usually do so in teams. These individuals have different skills, experiences, and strengths. Some are “hot” investors—they can see the opportunities, relate well to the management of the potential investee, are generally optimists, and would do many deals, perhaps too many. Others are “cold” investors—very analytical, skeptical, suspicious of management, and would do virtually no deals. A firm needs both sorts of professionals and a way of integrating their approaches if it is to carefully invest its capital. The IC is perhaps the most effective place to do this so that the best judgments are made. The IC can also help manage personality differences in teams, depersonalizing decisions so that the professionals, particularly the more junior ones, can see that the decisions are based on a proper assessment and process and are not reflections on individuals.

#### Quality Control

A fund manager needs, and its LPs may insist on, some formal level of quality control, particularly for firms managing several funds. An IC does this, ensuring that there is thorough analysis and due diligence for all deals, the terms and conditions include appropriate protections, exit assumptions are realistic, and so on. Quite often, firms require a deal team to have the IC approve the issuance of any terms sheets for a deal. As part of this quality control, some ICs insist on meeting the management of potential investees both to get a feel for them and to get to know them before starting the close association with them that will follow if the investment proceeds.

#### Deal Monitoring

In smaller firms, the IC may oversee the formal monitoring of the portfolio, receiving and probing the periodic reports on investee companies and monitoring progress

toward an exit. On the last of these, the IC can be most useful in focusing the deal professionals on grooming investments for exit. Since the timing, terms, and conditions of the exit determine the fund's return on the investment, the IC makes this decision.

One final IC decision that is worthy of comment is the one on whether or not to invest further capital in a troubled company. In these most unwelcome of situations, the IC is faced with the question of throwing good money after bad. In its deliberation, should it treat the requested investment as incremental or new, or as the cost of avoiding the loss of the original investment? Inevitably, it feels it is being asked to pay again for what it had already bought. It has to decide if the company is out of business or just out of cash. These are the toughest decisions for the IC, and they can create significant tensions between the IC and the deal professionals. Their complexity increases exponentially if the investment has been syndicated with other investors—but this is a topic unto itself.

#### Management and Control of the Firm

Most firms need a way of managing where they apply their internal resources. Apart from the fund capital, a manager effectively allocates two key resources: the time of its professionals and the spending of its management fees. The IC can be used as a mechanism for focusing its people on the most prospective deals and controlling cost budgets, particularly those for retaining lawyers, accountants, and other external advisors.

Firms quickly realize that, since they reject far more deals than they make, they have to become experts at saying no. Some would say: "You can't kill a deal too fast." As soon as a deal is killed, all the time and money spent on it to that point is lost; so it is vital to keep control of where the firm's resources are spent. A good IC will pay particular attention to making timely decisions to drop deals without stifling creativity in improving marginal deals.

#### Training

PE investing has always been described as an apprenticeship business. An experienced PE professional is one who has been through at least one cycle from raising funds through to liquidating investments. This was considered to take up to ten years, the life of a fund. Nowadays, five or six years seem adequate to qualify someone as "experienced." Perhaps this is reasonable given the industry is more mature now—it can be studied in business courses, and there are experienced external support professionals in areas such as law, accounting, and investment banking, who handle many of the complexities that the PE professional used to handle, and who can reduce the scope for errors in process and documentation.

In spite of formal training, most learning still takes place on the job. I have found that one of the most powerful contributors to the development of new professionals is having them participate in the whole process of deal-flow management right through to the final decision. They can see how deals are analyzed, negotiated, priced, documented, and closed. They also learn the standards of the firm.

Participation in the process does not necessarily mean having a vote in the decisions. Participative interactive ICs may require all those present to engage in the consideration of the merits of an investment proposal and to express a judgment, but in the end will usually count only the votes of the most senior participants as the designated members of the IC.

Participative interactive ICs also help build teams. This can be extremely valuable in the early years of a management firm, particularly for those in emerging markets. It is also a way to “burn in” new hires, who may be senior executives from outside the PE industry, without damaging their egos too much.

Clearly, there is a cost in tying up the full investment team in participating in IC meetings. In the early years of a fund management firm, as the team is being built and processes developed, this cost can be well justified by the benefits described. Over time, however, you would expect to see the IC become less of a teacher and more of a standard interactive committee.

### **The Decision-Making Mechanism**

When investors ask a manager how it makes its investment decisions, the answer typically describes the theory rather than the actual practice. There are three broad theoretical models:

- *Unanimity*. This is easy to understand. It is often used in small firms where the IC consists of all the partners; it gives each of them a veto. Formal committees also can favour unanimity when the IC includes members who have special interests to protect.
- *Majority rule*. Again, this is clear and easy to operate. “Majority” can be simple or more complicated; for example, it may be required that specific members be part of any majority decision, giving those members a veto. LPs often like this approach when they are concerned that the “headline” professionals in the firm may not spend enough time on the particular fund. They can require that these key, experienced professionals exercise appropriate quality control and sign off all investments.
- *Consensus*. This approach is often cited but not often explained. The working definition I use is that an investment proceeds only if no voting member of the IC is strongly opposed to it. This allows for abstentions, for example, when a member says: “I have heard the investment case, I have made my points explaining my judgment against proceeding but I can understand the counter arguments. I am not so much against the investment that I would vote against it.”

In practice, whatever their theoretical model, most ICs have a couple of key senior individuals who, formally or informally, dominate the decisions and effectively exercise a veto. But, regardless of how its IC makes its final decisions, most firms have a strong internal culture of collective responsibility. It can be poisonously destructive of a firm’s culture if individuals, with hindsight, say

about a troubled investment: “I never liked that deal at the time we were doing it.” Unsurprisingly, I have never heard this comment made about an investment that turns out well.

### **Some Pitfalls to Watch Out for in the Way Investment Committees Operate**

Deal makers, particularly those who work with formal ICs, may develop the approach that they will do any investment they can get through the IC. This can lead them to focus on managing the investment process rather than on the investment itself. Particularly damaging are such distortions as: selective reporting of due diligence; adjusting the investment case financial and exit projections to just clear the fund’s internal rate of return (IRR) hurdles; downplaying weaknesses and risks in the deal; and overestimating the capabilities of the management. The dangers here are obvious.

It is very important that all potential investments are thoroughly probed so that the risks and returns are as well understood as possible when the final judgments are being made. This means ICs must operate in a climate of openness where rigorous questioning is expected, the facts are all laid out, strengths and weaknesses are all discussed fully and frankly, and selective analysis is not tolerated. There are no perfect PE investments; all of them are made on the balance of judgment. The IC process should support the best judgment being made. As every experienced fund manager knows: “Getting money out is easy—getting it back is hard.”

Another matter to watch for is “trading support,” where a professional goes easy on colleagues’ deals with the explicit or implicit understanding that they will support his. Deal professionals must understand that everyone’s carried interest depends on the portfolio performance, and therefore a bad deal that could have been avoided hurts everyone.

Deal professionals, particularly younger ones, can feel threatened by the IC process, especially if they come from a transaction background, like investment banking. They often start from the position that any deal that can be done should be done. They are naturally anxious to do deals and they can see a rejection from the IC both as a restriction on their advancement and a blow to their egos. They must learn that it’s not personal. PE investing is a participative not a spectator sport. Once a decision to invest is made, money changes hands and reality begins. Those hockey stick revenue increases, improving margins, and management strengths that were the basis of the investment case will be put to the test.

Although there are many benefits from an interactive IC that engages with the deal team and helps with advice on improvements to a deal, the IC must ultimately make a decision to proceed or not with the deal. If the IC becomes too involved in the deal, it can lose objectivity. This can be true particularly in difficult deals where there are strong attractions but also important problems. Some of the most difficult decisions in this category are those for follow-on funding to a troubled investment. The IC must maintain sufficient detachment to be able to make its best judgment based on the facts and the analysis.

### **Special Considerations in Emerging Markets and How Investment Committees Can Deal with Them**

One of the features of an emerging market is that there are few PE investors with experience in it. At best, there may be international professionals with experience across emerging markets in general. With few funds operating in a new market, there are not going to be many professionals who speak the language, know the business environment, and have spent five or more years making PE investments there. By the same token, experienced deal makers who come into an emerging market, however many investments they may have made elsewhere, are unlikely to have the language skills or an understanding of the market or the culture in the country. Left to themselves, they could end up doing the “dumb deals left for foreigners.”

Fund managers setting up in emerging markets will recruit experienced international PE professionals from abroad to work with talented but inexperienced individuals from the country. They then need to integrate the strengths of both groups of individuals, work to overcome their shortcomings, and do this while making good investments for their fund. I believe the best way to do this is through a well-managed IC. International professionals will often know the key success factors for companies in various industries. They have an experience of the structures of specific industries and firms elsewhere and can apply this knowledge in assessing local investments. The local professionals, for their part, will understand the important dynamics in their business community. Cost structures, distribution, and competition are all likely to be unique to their market. Other local factors like taxes, constraints on foreign ownership, or restrictions on repatriation of capital can determine investment structures and significantly affect potential exits. The IC is where many of these issues can be addressed and understood, and the solutions added to the firm's know-how.

Part of the apprenticeship for PE professionals is coming to understand different industries, different deal structures, and learning how to exercise judgments. The IC meeting can be an invaluable classroom for all professionals, from senior executives to analysts. Not only do they benefit in their own deals from the questioning and the ideas from senior colleagues and peers, but also they learn from the other deals being considered, which are real-life and real-time case studies. Participation also brings a sense of shared responsibility for the fund's portfolio.

If the IC's remit extends to monitoring the portfolio, issues that arise in one investment can be instructive for managing others. In this respect, one of the most valuable learning experiences for a young team managing a fund in an emerging market arises from an investment that runs into trouble. Although these situations are painful, they show inexperienced professionals the importance of a thorough analysis of the risks in a deal, the strengths and weaknesses of the terms negotiated, and the actions that can be taken to correct the situation or mitigate the losses.

In an emerging market the interface between the local and the international perspectives can be most important. Within the firm, it can give rise to frustration and potential friction between the international and local professionals. In the market, it can cause frustration with the owners of local companies with whom the fund negotiates, as they frequently have a poor understanding of how PE works. They can

be suspicious. They can have problems with investment terms, particularly around issues of pricing, management control, exits, governance, money out, and sometimes, transparency. Not being sure of themselves and often lacking experienced local advisors, they can make themselves uninvestable.

On the other side, the local PE professionals can tend to focus too much on the terms and conditions of a deal because they are trying to justify paying too high a price. Such terms can often include complicated ratchet and earn-out arrangements. These terms seldom provide the protections that the PE professional thinks they can, and they can scare off the company owners and managers. However, under pressure to make investments, a local deal team will want to do the best deal they can negotiate with the owners of the local companies and lose sight of whether or not they should do the deal at all. This may explain why the pricing and terms of many resulting deals often have an emerging market premium rather than a discount. There are no magic solutions to these issues, but a good IC can greatly assist in managing them.

Local professionals may feel that the foreign members of their team don't really understand the local culture and are unreasonable in expecting to impose their foreign standards. The internationals, for their part, argue that "gravity is the same everywhere." Regardless of where you are, you cannot make money if the pricing is wrong, the margins and cash flow are weak, the exit is unlikely, and the shareholder protections are not adequate. Another trap for team members is "backing themselves," where enthusiastic deal doers see a business opportunity that looks good, they have seen it work in other markets, and they know how it can win—they could do it! But they have to learn that they are investors and not operators. If the managers in the business are not good enough, they won't deliver and the investment will fail. The professionals also have to learn that good businesses are not necessarily good investments. They must be able to identify how the fund will make its money in the deal. Sometimes they do this by forecasting an aggressive initial public offering (IPO), forgetting that an IPO is not an exit. Other times, they will justify exit valuations by using "comparables" that are multibillion dollar companies listed on international stock exchanges. Once again, all these matters can be managed through an interactive and participatory IC.

Some funds in emerging markets are regional, operating across several countries. They have additional challenges. Not only do they need to manage the differences between their experienced international and local deal professionals, but also they have to deal with the differences between the various countries covered by their fund. Running a centrally located team that travels to the various markets is one way of reducing the coordination problem. The alternative is to set up deal teams in the major countries covered. This is more costly, but usually more effective in finding and managing investments. With dispersed country teams, the IC becomes even more important as a way of integrating the fund management. It can also open up opportunities both to help companies expand across the region and to look to replicate investments that were successful in one country into other countries. A further, significant benefit is that a well-constructed IC will effectively allocate the fund's capital across the region. It does this not by deciding the amount of capital for each country but by subjecting all investments to the same IC investment

process so the capital goes where the good investments are. Compare this to a single country emerging market fund that will do the best deals it can find in the country, regardless of their objective merit.

### **Conclusions**

This discussion of ICs is not intended to be prescriptive. There is no one, universal way to set up and operate an IC. I have concentrated more on interactive ICs because they are most common in independent (i.e., noncaptive) small and medium-sized management firms. I have also paid attention to participative ICs because they are a powerful training and development tool for firms in their early years. From my experience in emerging markets, where most firms are in their early years, such ICs are an effective way of melding highly talented but inexperienced (in a PE sense) local professionals with seasoned international professionals.

As an independent firm matures, manages larger funds, and expands, its IC will evolve with it. A participative structure may become unwieldy and so could grow into a more formal, but still an interactive, model. The formal IC structure is certainly the most appropriate for captive funds and large fund managers. These organizations will have other ways of achieving deal interaction and of arranging training for their investment teams.

Effective private equity investors will give thoughtful consideration to how their investment committees are set up and how they operate. Show the IC, and you reveal the firm.

CHAPTER 7  
VENTURE CAPITAL CONTRACTS: IMPLICATIONS  
FOR EMERGING MARKETS

*Douglas Cumming and Sofia Johan*

**Introduction**

The Organization for Economic Cooperation and Development (OECD, 1996) has argued that the financing of entrepreneurship and innovative ideas will facilitate economic growth and the competitive advantage of nations in the twenty-first century. We know that small high-tech companies contribute disproportionately to innovation and economic growth. We also know that the primary source of capital for these small high-tech start-up companies is venture capital (VC), and VC facilitates the success of companies that eventually are listed on stock exchanges. For example, while VC averaged less than 3 percent of corporate research and development (R&D) in the period 1983–1992, it was nevertheless responsible for more than 8 percent of the United States' industrial innovations in that decade (Gompers and Lerner, 2004).

In this chapter we seek to understand, in view of what we know, why emerging VC markets lag so significantly relative to developed VC markets. We focus on VC contracts, and review international evidence on differences between VC contracts. VC relationships are governed by two main types of contracts. First, there are contracts between institutional investors and the fund managers to establish the terms of limited partnership. This contract is employed for the life of the fund. Limited partnership contracts are critical for institutional investors since it is their only means of governance over the activities of the fund manager and the partners. That is, limited partners cannot get involved in the day-to-day activities of the fund, otherwise they risk losing their limited partner status. It is therefore crucial that the limited partnership contract determines the boundaries within which the parties operate for the life of the fund at the outset. In this chapter we explain how legal systems impact fund manager fee arrangements, among other things, to better align the interests of institutional investors and VC fund managers.

Second, there are contracts between the VC fund itself and investee companies. These contracts are extremely detailed and set out the type of security and a long list of veto and control rights that the VC investor has over the investee. These

contracts are extremely effective in allocating the cash flow and control rights for the investor(s) and the investee. Contracts govern the relationship in terms of providing incentives as well as decision rights for the future of the venture. Contracts are extremely influential in shaping the actions of the parties and thereby the investment outcomes.

In this chapter, we review evidence on VC limited partnership agreements (in the first section) as well as VC contracts with investee companies (in the second section). We discuss international evidence and note salient differences in governance that therefore exist across countries. We show that empirical evidence is highly consistent with the view that VC contracts are more likely to be superior in developed markets than in emerging markets in terms of aligning the interests of institutional investors and VC fund managers, and in terms of superior contracts between VC fund managers and their investee companies. These results provide a core understanding of the mechanisms that give rise to international differences in the size of VC markets. Governance is a defining attribute of VC as a form of financial intermediation. Better legal systems have sound implications on the assertiveness of important mechanisms for solving agency and control problems inherent in the financing of young, innovative companies. Thereby, a sound legal framework can be regarded as an important prerequisite (but certainly not a sufficient condition) for the development of sustained VC development in a country. As such, it is important to improve legal conditions as a prerequisite to the development of VC markets in emerging economies. Implications are discussed in the concluding remarks section.

### **Venture Capital Limited Partnership Fees: Emerging vs. Developed Markets**

Venture capitalists source their investment capital for their VC funds from institutional investors such as pension funds, life insurance companies, banks, and endowments. High-net-worth individuals and corporations are also potential sources of capital. VC funds are then most commonly organized by venture capitalists as limited partnerships with funds to be committed to the fund for 10–13 years, referred to also as life spans. VC funds are typically in excess of \$50 million in committed capital, and venture capitalists typically receive management fees of 1–3 percent of committed capital and 20 percent carried interest, or share of the profits. VC funds are not invested in companies for the purpose of gaining interest on debt or dividends on equity; rather, VC funds are invested in early-stage privately held companies with a view to exiting investments in 3–7 years for the purpose of effecting a capital gain in an initial public offering (IPO) or an acquisition exit.

VC and private equity (PE) funds are financial intermediaries between institutional investors (such as banks, endowments, pension funds, life insurance companies, high-net-worth private individuals) and private companies seeking funding. Institutional investors do not have the time and skills to carry out due diligence in selecting worthy entrepreneurial companies for financing, and to carry out the monitoring and value-added advice to bring investments in small- and medium-sized enterprises to fruition (the investment process in an investee company can

take anywhere between 2–7 years before an exit event such as an IPO, acquisition, or write-off). Institutional investors therefore commit capital to VC and PE funds so that venture capitalists who are specialized fund managers can manage the investment process in entrepreneurial companies.

The most common form of organization of VC and PE funds in the United States has been a limited partnership structure that typically lasts for ten years, with an option to continue for an additional three years to ensure that the investments have been brought to fruition, and the fund can be wound up (Sahlman, 1990; Gompers and Lerner, 2004). Other countries around the world that allow limited partnership structures have likewise made use of such structures.<sup>1</sup> Countries that do not allow limited partnership structures have made use of corporate forms that closely resemble limited partnerships in the covenants governing the partnership.<sup>2</sup>

Limited partnerships and similar forms of organization involve an assignment of rights and responsibilities in the form of a very long-term contract over a period of ten or more years. The purpose of this contract is to mitigate the potential for agency problems associated with the venture capitalists' investing institutional investor capital in private entrepreneurial companies. The massive potential for agency problems in the reinvestment of capital (elaborated later), and the long-term commitment by institutional investors in the limited partnership, makes extremely important the assignment of rights and obligations in the contract in the form of restrictive covenants.<sup>3</sup>

Cumming and Johan (2006, 2009) study a sample of VC funds that include eight funds each from the Netherlands and the United States, six funds each from the United Kingdom and Malaysia, four funds from the Netherlands Antilles, three funds each from Germany and Belgium, two funds each from the Cayman Islands and South Africa, and one fund each Philippines, Canada, Finland, New Zealand, Luxembourg, Brazil, Switzerland, and Italy. The fund managers include seven each from Malaysia, and the Netherlands, six from the United States, three each from the United Kingdom and Germany, two each from Belgium and South Africa, and one each from the Philippines, Canada, Finland, New Zealand, Brazil, Italy, Vietnam, the Czech Republic, Sweden, Norway, France, South Korea, and Uzbekistan.

Cumming and Johan (2009) (see also Johan and Najar, 2010) examine compensation arrangements in VC. VC funds in the United States typically have fixed management fees of around 1–3 percent of the committed capital of the fund (analogous to the case of mutual funds that often have management expense ratios of 1–2 percent), and a carried interest or performance fees of typically 20 percent of the profits made (Cumming and Johan, 2009; Johan and Najar, 2010) (unlike the case of mutual funds). The fixed management fee enables fund operation overheads to be met prior to fund liquidity events. VC funds are typically organized as limited partnerships for a period of 10–13 years and invested in early-stage private companies that are considerably illiquid as liquidity events (such as an IPO or an acquisition) typically take 2–7 years. Fixed management fees therefore should sufficiently meet foreseeable overheads arising from the investment and divestment process to be carried out by the managers before any profits are earned. Performance fees on the other hand align the incentives of the fund manager and the fund manager's institutional investors.

Cumming and Johan (2009) also analyze fund clawback provisions against the fund manager for poor performance of the fund. Clawback provisions enable institutional investors to claw back any profits paid out to fund managers in the event of subsequent investments resulting in losses exceeding the profits made. Clawbacks lower the risk faced by institutional investors in the event of poor performance; from the fund manager's perspective, a clawback is the exact opposite of an incentive performance fee. They compare and contrast the role of legality in "positive" performance incentive fees versus "negative" clawbacks (i.e., "carrots" versus "sticks" in compensation). Furthermore, they assess the probability of the fund structure enabling share distributions to institutional investors, or whether the fund mandates cash-only distributions. Share distributions to a fund's investors shift the decision of when to liquidate an equity position in an entrepreneurial investee company from the fund manager to the funds' investors. The cash versus share distribution decision is important as it affects the timing of payment via the realization of capital gains among a fund's investors, and therefore affects institutional investor compensation, which is interesting and useful to analyze in conjunction with fund manager compensation.

The data in Cumming and Johan (2009) indicate that legal conditions by far have the most statistically and economically significant effect on compensation: fixed fees are lower and performance fees are higher in countries with stronger legal conditions. For example, they show that a move from the Philippines to the United States (one of the most extreme improvements in legal conditions in our data) gives rise to a reduction in fixed fees by approximately 1.5 percent, and an increase in performance fees by approximately 10 percent. A more modest improvement in legal conditions from the Philippines to South Africa, for example, gives rise to a reduction in fixed fees by approximately 0.9 percent and an increase in performance fees by 5.9 percent. These results are robust to controls for a variety of factors including market conditions, institutional investor and fund manager characteristics, including education and experience, as well as fund factors such as stage and industry focus, among other control variables available in the new detailed international data set. In fact, the legal environment is found to be the most robust statistically significant and economically significant factor in explaining the differences in fixed and performance fees among the funds in the international data set introduced in Cumming and Johan (2009). These relations are depicted in figure 7.1.

The data in Cumming and Johan (2009) further indicate that the legal environment is the most statistically and economically significant determinant of clawbacks among private investment funds. A reduction in the quality of legal conditions increases the probability of clawbacks: for example, clawbacks are approximately 26.8 percent more likely in the Philippines than in South Africa, and approximately 44.9 percent more likely in the Philippines than in the United States.

Importantly, they notice the asymmetry in fund manager compensation in relation to legal conditions: on the one hand fund managers have higher fixed fees and lower performance fees in countries with weak legal conditions; on the other hand, fund managers in countries with weak legal conditions are more likely to face the downside risk of a clawback on their fees. This asymmetry is intuitive as risk-averse fund managers trade off a higher fixed fee for a lower performance fee when legal



Finally, note that empirical evidence is likewise highly consistent with the view that VC funds have more restrictive covenant clauses in developed markets than in emerging markets. Cumming and Johan (2006) find evidence that the quality of law affects the use of covenants across countries. First, regarding the quality of the rule of law and related factors pertinent to the legality of a country, they observe a statistically significant positive relation between the quality of a country's laws and the number of covenants pertaining to fund operations (such as the sale of fund interests, restrictions on fundraising, and matters pertaining to public disclosure). An increase in the legality index from 20 to 21 (a typical improvement among developed nations) increases the probability of an extra covenant pertaining to fund operation by approximately 1 percent, whereas an increase from 10 to 11 (a typical improvement among emerging markets) increases the probability of an extra covenant pertaining to fund operation by approximately 2 percent.

In sum, covenants and fee structures are much more efficient in countries with better legal systems: lower fixed fees, higher incentive fees, and more restrictive covenants. Hence, developing markets suffer in terms of the VC sector by virtue of legal systems that do not facilitate the most efficient contractual structures.

### **Venture Capital Contracts with Investee Firms: Emerging vs. Developed Markets**

In this section we first describe types of clauses in VC contracts in the first subsection. Thereafter in the second subsection we review evidence on VC contracts with investee companies.

#### Types of Clauses in Venture Capital Contracts

VC contracts independently allocate cash flow and control rights (Gompers, 1998; Kaplan and Stromberg, 2003; Isaksson et al., 2004; Parhankangas et al., 2005) through security design and various specific veto and control rights. Common equity securities represent equity ownership in a corporation, providing voting rights, entitling the holder to a share of the company's success through dividends and/or capital appreciation. In the event of liquidation, common stockholders have rights to a company's assets only after debt holders and preferred stockholders have been satisfied. Preferred equity is capital stock that takes precedence over common equity in the event of bankruptcy, and provides that prespecified dividends are paid before any dividends are paid to common equity. Preferred dividends are fixed and do not fluctuate. Preferred equity holders cannot force the company into bankruptcy in the event of nonpayment of dividends, but must pay all preferred dividends in arrears prior to paying dividends to common equity holders. Convertible preferred equity is preferred equity that can be converted into a specified amount of common equity at the holder's option. Debt is an amount owed to a person or organization for funds borrowed. Companies that fail to pay interest on debt can be forced into bankruptcy by debt holders. Convertible debt is debt that can be converted into a specified amount of common stock at the holder's option.

Veto rights are passive rights that can be exercised to prevent certain actions from being taken by the management or the board of directors. Veto rights typically cover issues relating to asset sales, asset purchases, changes in control, and issuances of equity. Veto rights over asset sales enable the holder to prevent the board from raising the issue or resolution of asset sales at the shareholder level. A VC for example could veto the proposal of the purchase of a new physical asset to be tabled to the board of directors or shareholders if it for example feels that an upgrade is more appropriate. This ensures that VC will in effect influence the outcome of the capital expenditure decision to its satisfaction without being seen as an impeding managerial/ director/shareholder prerogative. Veto rights over asset purchases enable the holder to prevent the board from raising the issue or resolution of asset purchases at the shareholder level. Veto rights over changes in control enable the holder to prevent the board from raising the issue or resolution of changes in control of the company at the shareholder level. Veto rights over issuances of equity enable the holder to prevent the board from raising the issue or resolution of issuing new equity at the shareholder level. Veto rights over other decisions enable the holder to prevent the board from raising any particular issue or resolution at the shareholder level. For example, these issues include, but are not limited to, hiring key personnel, external consultants, and legal and accounting advisors; releasing information to the public; or other decisions.

Control rights, by contrast, are proactive rights that enable the holder to bring about a change in the direction of the company because they give the VC the right to take a particular action as a residual right of control. Perhaps the most effective control right is the right to replace the CEO. Venture capitalists typically have the right to replace the founding entrepreneur as CEO even where they do not have a majority of the board or a majority of the voting rights. This right is either explicit or implicit by virtue of a combination of other rights (such as through a majority of board seats or holding other rights enumerated later). There are of course other rights that venture capitalists incorporate into their contracts with entrepreneurs to regulate their relationship over the life of the investment. Drag-along rights enable the venture capitalist to force the entrepreneur to sell shares in the same way as the venture capitalist chooses. The holder of redemption shares has the right to make the entrepreneurial company redeem the shares as per the terms of the agreement. Typically, the terms specify the redemption price per share and the date at which the holder may seek redemption. Antidilution rights enable venture capitalists to retain the majority holding of a company and give venture capitalists more bargaining power over sequential financing rounds, albeit leading to a larger dilution of entrepreneurial control. The holder is entitled to proportional equity allocations that maintain a constant equity ownership percentage in the company. The holder of protection rights against new issues has the right to vote on this issue at the stakeholder level. The votes per share may be disproportionately allocated toward certain stakeholders such as the venture capitalist. Analogous to veto rights for changes in control, a co-sale right and a right of first refusal provide venture capitalists protection in the event the entrepreneur tries to sell the company in part or whole to a new owner, and hence can be used as threat points in negotiation by the venture capitalist. With a right of first refusal at sale, before the company can be sold, the

holder of the right of first refusal at sale must be offered the same terms for sale of his or her own shares. The company cannot be sold to another party unless the holder turns down the terms that are offered. With a co-sale agreement, any stakeholder who wishes to sell his share of the company must also offer to the holder of a co-sale agreement the option to sell his or her shares at the same terms. Also, an initial public offering (IPO) registration right can be used as a threat point in negotiation where the entrepreneurial company is not yet in a position to be a publicly listed company. The holder can compel the company to register shares held by the investor on a stock exchange. Often the holder of IPO registration rights also has piggyback registration rights, which enables the holder to compel the company that is already in the process of filing a registration statement to extend the registration statement to cover the holder's class of shares. Finally, information rights typically call for the company to supply timely financial statements and other items not generally available to other stakeholders.

#### **Empirical Evidence on Venture Capital Contracts and Governance with Investee Firms: Developed versus Emerging Markets**

Empirical evidence is consistent with the view that VC funds are more likely to include more contractual covenants in developed than developing markets. This evidence is reviewed herein.

Gompers (1998) and Kaplan and Stromberg (2003) examine specific details in US VC contracts based on hand-collected samples of 50 and 213 investments, respectively. More specifically, the Kaplan and Stromberg study comprises 213 investments in 119 US portfolio companies by 14 limited partnerships. Based on US-only data sets, both Gompers (1998) and Kaplan and Stromberg (2003) show that venture capitalists separately allocate cash flow rights, voting rights, board rights, liquidation rights, and other control rights. They find that convertible preferred equity is used, and that cash flow rights, voting rights, control rights, and future financings are often contingent on observable measures of financial and non-financial performance. As well, venture capitalists often include clauses to mitigate the potential holdup between the entrepreneur and the investor. Kaplan and Stromberg show that venture capitalists retain control of the management of the firm if the firm performs poorly. If firm performance improves, then entrepreneurs regain control and also additional cash flow rights. Venture capitalists relinquish control and liquidation rights as firm performance improves, but for the most part retain their cash flow rights.

Other work has focused more specially on law quality in influencing VC contracts with a broader sample of 39 countries in the developing and developed world. Specifically, Cumming et al. (2010) provide evidence that cross-country differences in legality, including legal origin and accounting standards, have a significant impact on the governance structure of investments in the VC industry (see also Cumming and Walz, 2010): better laws facilitate faster deal screening and deal origination, a higher probability of syndication and a lower probability of potentially harmful coinvestment, and facilitate investor board representation of the investor and the use of securities that do not require periodic cash flows prior to exit.

Cumming et al. (2010) focus on international differences in governance structures and investment patterns in VC in three related and equally important categories: (1) time from fundraising to deal origination (which reflects screening and due diligence), (2) syndication and coinvestment, and (3) board seats and security choice. To fully understand the structure and governance of venture capitalists vis-à-vis their entrepreneurial investees, it is useful to examine each of these complementary and interrelated aspects in unison. Further, a joint analysis of each of these governance mechanisms that addresses the various stages throughout the investment cycle of the venture capitalist facilitates a fairly comprehensive picture of the source of international differences in VC markets.

The first main pillar of our analysis focuses on the screening process, which is of vital importance to venture capitalists. For instance, venture capitalists in the United States receive more than 1000 requests for financing each year, but complete at most only a couple of deals in a typical year. In terms of cross-country differences in VC finance, where the legal and institutional framework impedes the due diligence and investment process (e.g., through slow bureaucracies, risk of contract repudiation, etc.), this slows down the rate of investment and the ability of a fund to properly manage deal flow and the financing of meritorious entrepreneurial firms.

The screening and due diligence process is in turn closely connected to syndication and coinvestment, or the interaction among different investors within any investment. This is the second main pillar of Cumming et al.'s (2010) analysis. Prior research has established the notion that syndication enhances venture capitalist screening, monitoring, and value-added advice from investors to entrepreneurs. By contrast, coinvestment (i.e., the investment of different funds of the same VC firm into the same entrepreneurial firm) does not facilitate these governance mechanisms and may reflect an agency problem vis-à-vis the institutional investors if one VC fund is using capital to bail out the bad investments of another VC fund within the same VC organizational structure.

Cumming et al.'s (2010) third and final pillar invokes an analysis of the interaction between venture capitalists and their investees. They study cash flow and control rights that focus on the substantive aspect of governance as opposed to the form of governance. In regard to the control rights, they investigate the question of whether the venture capitalist has a seat on the board of directors of the entrepreneurial firm. In regard to cash flow rights, we extend prior work by examining whether the financial contract between the venture capitalist and the entrepreneur involves just upside potential for the investor, or whether there are both period cash flows provided to the investor, prior to exit, as well as upside potential. That is, they have specific details on the contract that get beyond the form of the contract and go more closely at the substantive structure of the contract.

In each of the three main areas of our analysis, Cumming et al. (2010) analyze the impact of different legal systems and thereby consider the legality index. We also consider the robustness of the legality results to legal origin variables (English, French, German and Scandinavian) as prior work is consistent with the view that English legal origin facilitates capital raising through stronger legal protections afforded to investors. We further consider accounting standards, as they directly

relate to information asymmetries faced by investors, which are particularly pronounced for early stage investments in high-tech companies. The effect of laws is considered while controlling for economic conditions (GNP per capita, MSCI index performance, etc.).

A key component of Cumming et al.'s (2010) analysis rests with the introduction of a very large international dataset of 3,828 venture capitalist investments from 39 countries (from North and South America, Europe and Asia) and 33 years (1971–2003). We show that the legal framework has a strong impact on each of these closely related areas of governance, and significantly build on and extend the literature on international differences of venture capital. The new data introduced herein reveal a number of key results with respect to international differences in time to investment and deal origination, syndication, co-investment, board seats, and the functional form of the financing instrument chosen. Our first central result indicates that better laws facilitate faster deal screening and origination. Second, we show that better laws lead to a higher probability of syndication and a lower probability of potentially harmful co-investment. Third, we show that better laws also facilitate board representation of the investor. We also find evidence that law matters in terms of influencing the probability of using securities which afford periodic cashflows prior to exit, albeit this latter finding is not as statistically robust. Overall, however, we do note that law plays an important role in the extensive VC data introduced herein for a wide variety of robustness checks, such as inclusion or exclusion of the US from the dataset. Legal conditions are an important condition for enabling venture capitalist governance structures that facilitate the financing of high-tech entrepreneurial ventures, and the success of a country's VC market.

The empirical evidence presented in Cumming et al. (2010) sheds new light on the structure of the VC market and the governance structure of the VC-financed entrepreneurial firms in a number of aspects. The extensive international dataset from 39 countries introduced herein indicates that the legal system has a strong impact on the various aspects of the venture capitalists' investment pattern and the venture governance. We note that because some of these legal measures are highly correlated, it is difficult to empirically assess which aspect of the law is relatively more important. In our data, nevertheless, we are able to show that better laws in terms of higher Legality indices (which encompasses the efficiency of judicial system, rule of law, corruption, risk of expropriation, risk of contract repudiation, and shareholder rights), as well as English common law judicial systems, stronger accounting standards (curtailing earnings aggressiveness), and stronger creditor rights and anti-director rights all facilitate the deal origination process, increase the probability of syndication and mitigate the probability of (potentially damaging) co-investment. Board representation of venture capitalists is also significantly more pronounced in countries with stronger legal systems. These results are robust to consideration of economic conditions (GNP per capita, MSCI market conditions, etc.), and other fund and investee characteristics. Further, they found some evidence of less frequent use of securities that provide periodic cash flows in common law countries, although in general the evidence relating specific legal indices to the allocation of cash flow rights was not as robust.

### Conclusion

Financial contracting is critical to governance in VC. Financial contracts are material to the allocation of risks, incentives, and rewards for investors and investees alike. They have a significant relationship with actual investment outcomes and success. We reviewed two main types of contracts in this chapter: contracts between VC funds and their institutional investors, and between VC funds and their investee firms. Limited partnership agreements define the covenants and compensation terms for VC investors. We reviewed evidence in this chapter that limited partnership contracts related to market conditions and fund manager characteristics, and how these contracts differ across countries.

Regarding contracts between VC funds and their investee firms, we examined in this chapter the cash flow and control rights that are typically assigned in VC with investee firms, and when do fund managers demand more contractual rights. We showed that different contractual rights assigned to different parties influence the effort provided by the investor(s).

By considering VC contracting in an international setting, one gains an understanding of why VC markets differ with respect to fund governance, investee firm governance, and investee firm performance.

The empirical evidence presented in this chapter sheds new light on the structure of the VC market and the governance structure of the VC-financed entrepreneurial firms in a number of aspects. The extensive international data set from 39 countries introduced herein indicates that the legal system has a strong impact on the various aspects of the venture capitalists' investment pattern and the venture governance. We note that because some of these legal measures are highly correlated, it is difficult to empirically assess which aspect of the law is relatively more important. In our data, nevertheless, we are able to show that better laws in terms of higher legality indices (which encompass the efficiency of judicial system, rule of law, corruption, risk of expropriation, risk of contract repudiation, and shareholder rights), as well as English common law judicial systems, stronger accounting standards (curtailing earnings aggressiveness), and stronger creditor rights and antidirector rights all facilitate the deal origination process, increase the probability of syndication, and mitigate the probability of (potentially damaging) coinvestment. Board representation of venture capitalists is also significantly more pronounced in countries with stronger legal systems. These results are robust to consideration of economic conditions (GNP per capita, MSCI market conditions, etc.), and other fund and investee characteristics. Further, we found some evidence of less frequent use of securities that provide periodic cash flows in common law countries, although in general the evidence relating specific legal indices to the allocation of cash flow rights was not as robust. We also showed that country-specific differences exist apart from legal and economic development, and offered explanations for the observed differences based on the vast array of data introduced herein.

These results provide a core understanding of the mechanisms that give rise to international differences in the size of VC markets. Governance is a defining attribute of VC as a form of financial intermediation. Better legal systems have sound implications on the assertiveness of important mechanisms for solving agency and control

problems inherent in the financing of young, innovative firms. Thereby, a sound legal framework can be regarded as an important prerequisite (but certainly not a sufficient condition) for the development of sustained VC development in a country.

By considering international data sets, and not data from just one country such as the United States, we are able to gain a significant amount of insight into how VC funds operate in relation to their legal and institutional environment. It is the authors' hope that this chapter will not only provide an understanding of how VC funds operate through financial contracts, but also that it will inspire further empirical work in the field so that we may better understand the nature and evolution of VC markets in the years to come.

### Notes

1. For example, for funds in Europe, see [www.evca.com](http://www.evca.com).
2. Australia, for example, has only allowed limited partnerships since 2003; prior to that time funds were set up as trusts, but functionally these trusts involved rights and responsibilities that mimicked the limited partnership structure; see Cumming et al. (2005).
3. Agency costs may be mitigated but generally can never be eliminated. See generally, Farmer and Winter (1986); see also, for example, Jensen (2001, 2004), Kaiser and Stouraitis (2001), Pawlina and Renneboog (2005), Citron et al. (2003), and Peasnell et al. (2005) for specific contexts.
4. They are also referred to as tax pass through entities. As a recent example, it has been recently reported that a private investment fund that made a US\$1.2 billion profit from an investment in South Korea did not pay any taxes on the profit in that country as the transaction was conducted through an offshore fund set up in Labuan, Malaysia. Another fund reportedly made a US\$1 billion tax-free profit in that same country. See "South Korean Tax Probe into Foreign Private Equity Funds." *Financial Times*, April 16/17, 2005, p. 2.

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## CHAPTER 8

### LEGAL AND COMMERCIAL CHALLENGES IN PRIVATE EQUITY IN THE MIDDLE EAST

*Rajeev Dewan*

#### **Overview**

Middle Eastern countries have some of the fastest growing economies of the world, and have shown some of the most outstanding GDP growth rates over the past 10 years. In light of these growth rates, and despite the political instability in the region, revenues generated by oil and gas trade, and the resulting accumulation of wealth and a growing middle class, present a number of opportunities for private equity (PE) investors. This growth has been further reinforced by the adoption of certain market reforms and privatization efforts by these governments in respect of certain sectors such as education, energy, health care, and transportation.

Over the last ten years, the PE industry in the Middle East has evolved from a virtually nonexistent, to a booming prospect, to an industry facing a shakeout (Booz & Company; INSEAD, 2010). As a result of such growth, the impacts of both the global financial crisis and the evolving political uncertainty in the region, PE firms in the Middle East are left asking how they will raise funds, where they will invest, and when and how will they exit their investments (INSEAD, 2011).

This chapter provides an overview of the PE industry in the Middle East, from its inception to the current state of the market, and will examine some of the key characteristics of the PE industry in the Middle East. Further, this chapter will identify some key legal challenges that face the PE industry in the Middle East.

#### **The Emergence of Private Equity in the Middle East**

The PE industry in the Middle East is relatively nascent; prior to 2004, none of the regions' funds exceeded \$150 million in assets under management, as a majority of the funds were less than \$100 million (Fakhro et al., 2011). Before 2001, PE activity in the Middle East was primarily only in Egypt, thanks to its favorable regulatory environment, strong macroeconomic fundamentals, and its privatization activities

at the time. By 2004, the region's PE market had more than tripled to 26 funds whose average size soared to \$190 million.

This growth was largely attributable to the wealth generated by rising oil prices, which provided the region with cheap funds for local general partners (GPs) to access. In particular, the money raised by PE firms in the Middle East jumped from less than \$1 billion in 2004 to \$10 billion in 2008 (Booz & Company, 2010).

Prior to the explosive growth of the PE industry in the region, the Middle East was traditionally viewed as a source of limited partner (LP) money for international PE firms seeking to raise capital for its investments in Western Europe and North America. As a result of a gradual recognition by the region's governments for the need to invest in their own markets and adopt more liberalized "investment-friendly" policies to facilitate economic growth and attract foreign capital, these trends have since changed. Accordingly, some of the region's most cash-rich governments started major domestic investment drives, in primarily strategic areas, such as energy, health care, infrastructure, and real estate (Booz & Company, 2010). As a result of the rapid accumulation of wealth in the region, sovereign wealth funds (SWFs) and high-net-worth (HNW) local families were making more regional investments (see table 8.1 for a list of the major sovereign wealth funds in the region).

The focus on domestic investment opportunities was further exacerbated as a result of the increased scrutiny of Middle Eastern money and investments following September 11, and resulted in the significant redeployment of Middle Eastern capital from the United States back home.

During this period of growth, the market was highly fragmented: over 72 GPs managed approximately 100 funds between 2005 and 2008, with a very small number of firms controlling the bulk of the value (Knowledge@Wharton, 2011). For example, Abraaj Capital managed approximately 20 percent of the Middle East market's fund values through just three funds.

**Table 8.1** Sovereign wealth funds in the Middle East

<i>Sovereign fund name</i>	<i>Country</i>	<i>Assets under management (\$ billion)</i>
Abu Dhabi Investment Council	UAE—Abu Dhabi	627.0
SAMA Foreign Holdings	Saudi Arabia	431.0
Kuwait Investment Authority	Kuwait	202.8
Qatar Investment Authority	Qatar	65.0
Brunei Investment Authority	Brunei	30.0
Investment Corporation of Dubai	UAE—Abu Dhabi	19.6
Mubadala Development Company	UAE—Abu Dhabi	14.7
International Petroleum Investment Company	UAE—Abu Dhabi	14.0
State General Reserve Fund	Oman	8.2
Public Investment Fund	Saudi Arabia	5.3
RAK Investment Authority	UAE—Ras Al Khaimah	1.2

Source: Sovereign Wealth Fund Institute ([www.swfinstitute.org](http://www.swfinstitute.org))

### Profiling Local Private Equity Firms in the Middle East

PE firms in the region could—and can still—be broadly classified into three major categories (Booz & Company, 2010): regional firms, international firms, and financial intermediaries and affiliates. First, there are the regional PE firms. These are regional pure-play firms based in the region whose investments were made primarily in the Middle East. These firms enjoyed a strong local business network and knowledge of the local market. Examples of such firms included Abraaj Capital, Citadel Capital, Gulf Capital, and Investcorp. Second, the market has seen a number of international PE firms. These firms represent pure-play international firms based outside of the Middle East with a regional presence. These firms were established players with established track records in the global market, which recently set up a presence Middle East. For the most part, these firms view the Middle East as a market primarily for raising funds, more than as a destination for investment, given their limited knowledge of local business and market practice. Examples of these firms include the Carlyle Group, Kohlberg, Kravis, Roberts, and Colony Capital. Last, there are intermediaries and affiliates. These are PE firms affiliated with investment banks and government organizations. The strength of these organizations is based on the credibility of their affiliated entities and their ability to leverage their organizational network. Examples of these firms include Standard Chartered Private Equity and HSBC Private Equity Fund.

### Key Characteristics of the Private Equity Industry in the Middle East

#### *Role and Influence of Limited Partners*

Unlike the PE model in North America and Western Europe, where LPs are passive investors who defer to the GPs to manage, source, execute, and exit investments, such dynamics are reversed in the Middle East, where the LPs exercise substantial power and influence over the GP. The extent of participation from HNW individuals and family groups in PE is one of the defining features in the Middle East, as roughly a third of all LPs in the region comprise HNW individuals and families who have associations with prominent businesses in the region (Booz & Company, 2010). In light of this, many PE investments in the Middle East are often sourced by influential LPs who are local HNW families, and in some cases, the LPs may act as the buyers or coinvestors in deals. The latter point often raises conflicts of interest issues that the GPs must delicately navigate as part of the deal-making process, particularly in circumstances where non-arm's-length relationships exist between the LPs and potential investment opportunities that the GPs are exploring.

#### *Strong Local Networks and Dominance of Family-Owned Business*

A key driver of doing business in the Middle East, which is not unlike other emerging markets, is the importance of relationships and local connections. Family-owned businesses account for approximately 40 percent of nonoil GDP in the Middle East. Given the dominance of family-owned businesses in the region, this point is exacerbated and effectively mandates PE investors develop and leverage connections with such families. Barclays recently estimated that family-owned businesses run

75 percent of the private sector economy in the Middle East and hire 70 percent of the labor (Barclays Wealth and EIU, 2009). These factors help to explain why international PE firms have limited their involvement in making investments in the region (Fakhro et al., 2011).

## **Key Legal and Commercial Challenges**

### Legal Framework

By their very nature, PE investments are inherently complex, as they raise issues relating to sourcing, implementing, managing, and exiting these investments. These issues are compounded in the Middle East, where the legal framework is often underdeveloped. Specifically, aside from the liberal tax regimes, PE investors in the Middle East do not enjoy many other structural advantages, as there are significant gaps between the regions' legal frameworks, particularly with respect to company law and bankruptcy legislation as compared to those of North American and Western European markets. Accordingly, these deficiencies impact how PE investments are executed.

Some of the principal legal challenges and some suggestions on dealing with these issues are summarized below, and relate to ownership restrictions and minority shareholder rights, bankruptcy and insolvency legislation, limitation of local company law, and legal structuring issues.

#### *Ownership Restrictions and Minority Shareholder Rights*

Most, if not all, Middle Eastern countries impose requirements under local company law, which restricts the level of foreign ownership. For example, under the existing company law in the UAE,<sup>1</sup> most companies incorporated under local law must have at least one or more UAE nationals as shareholders, whose shareholdings in the capital of the company must not be less than 51 percent. As a result of these restrictions in the UAE and comparable restrictions in other Middle Eastern jurisdictions, investments by foreign entities in the Middle East are typically structured as minority investments. This raises a number of issues in terms of structuring an investment to address the legal risks associated with minority ownership and highlights the importance of PE firms' understanding, namely, what legal provisions exist under local law in the Middle East that provide for the protection of minority shareholders, and what additional protections can be incorporated into the legal documentation governing the relationship between the PE investors and their local partner shareholders.

In order to deal with the restrictions imposed on foreign ownership in the Middle East, a market practice for foreign investors to enter into additional contractual arrangements (e.g., trust arrangements, nominee agreements, powers of attorney, license agreements, and so on) has evolved over the years, with the objective of giving the foreign investor sole control over the local company at both the management and shareholder level.

A key risk associated with these arrangements is that they would likely contravene the concealment laws in place in most Middle Eastern jurisdictions that prohibit

such arrangements. That being said, some uncertainty remains as to whether the competent authorities would actually choose to enforce these laws, given that these arrangements are common practice in most Middle Eastern jurisdictions and have been key factors to attracting foreign investment to those jurisdictions.

#### *Bankruptcy and Insolvency Legislation*

One of the main limitations in structuring PE investment in the Middle East has been the general lack of acquisition finance and the availability of leverage. Highly leveraged deals are incompatible with Sharia law, and the kinds of security packages typically used in North America and Western Europe to secure debt funding are not generally available in the Middle East. For example, in most Middle Eastern countries, the ownership of real estate is limited to the locals, and this presents a challenge to lenders looking to secure and enforce security over such assets.

Moreover, the sanctions under local law are quite extreme in circumstances where debt obligations are not met. In most jurisdictions, dishonored debt results in immediate imprisonment. During the global financial crisis, many local companies' directors and officers were held personally accountable for dishonored cheques and unpaid debt, resulting in their imprisonment and the freezing of many company accounts.

#### *Limitations and Pitfalls of Local Company Law*

Typically, Western PE deals involve different classes of shares as a mechanism to provide their holders with different rights. For example, the class of shares typically held by a PE investor would carry significant voting and control rights. Share classes are often used as a means to provide management with incentives through various share compensation arrangements. The use of such share class structures is generally unavailable in the Middle East (with the exception of public joint stock companies in Bahrain), as the issuance of shares with different economic rights conflicts with the principles of both local and Sharia laws.

In terms of enforcement of contracts and legal proceedings, the judiciary in the Middle East is governed by Sharia law and presents challenges to those unfamiliar with its rules and restrictions. Further, the enforcement of contract law is lacking, and civil proceedings present challenges to those used to a common law process. Saudi Arabia, for example, ranks 140 out of 183 countries for enforcing contracts (International Finance Corporation, 2010a,b).

#### *Holding Company Structures and Choice of Law*

In light of these legal challenges, a number of PE investments in the Middle East have been structured, when possible, through the use of offshore companies (i.e., British Virgin Islands, Cayman Islands, and so on), and thus they have not invested directly into the operating businesses established under the local law. These steps are taken so that PE investors can avail themselves of the benefit of a legal regime that (i) provides them with rights as shareholders that are more analogous to the rights they would have under the laws of certain Western European and North American

jurisdictions, where they are accustomed to doing business; and (ii) provides these investors with more certainty in terms of how the law will be interpreted and applied by the courts or other competent authorities. In addition, PE investors will attempt to ensure that the principal legal documents are governed by a foreign law (English law is often chosen), and that disputes are referred to foreign courts or international arbitration.

### Family Businesses

The relationship-based, family-driven nature of the business landscape in the Middle East has historically not yielded the transparency that global institutional investors and GPs expect. Most family-owned businesses are unstructured, lacking formal holding company structure, and having control exercised entity by entity (Barclays Wealth and EIU, 2009). Accordingly, although the family businesses are central to Middle Eastern economies, they pose a number of challenges for PE investors in terms instilling a culture of corporate governance, implementing internal controls, and adopting international business practices.

The Damas Jewellers (“Damas”) case highlights the challenges that family-owned companies face in terms of adopting international business practices and complying with corporate governance standards. Damas is a Dubai-based retail jewelry company run by a prominent UAE family that went public on Nasdaq Dubai in 2008 through an international offering led by Citigroup and HSBC, raising \$270 million. In 2010, subsequent to its being made a public company, it was revealed that the family management withdrew large sums of money from the company without proper authorization, and the company had conducted a number of questionable non-arm’s-length transactions with the founding family. This matter was pursued by the Dubai Financial Services Authority (DFSA), the regulatory authority governing listed companies on Nasdaq Dubai and financial services firms licensed in the Dubai International Financial Centre (DIFC). The DFSA acted swiftly and removed the implicated individuals from the company’s board and prevented these individuals from becoming officers and directors of public companies in the DIFC. This step was unprecedented in the region, as generally, with the exception of the Capital Markets Authority in Saudi Arabia, regulators in the Middle East have not actively pursued this type of regulatory transgression. This case is an example of the developing maturity in the Middle East with respect to its regulatory environment.

Despite the challenges that such businesses pose, there are also corresponding opportunities for the PE industry. Specifically, family-owned companies are looking to divest some of their investments, scale up the investments that they retain, and improve the overall performance of their investments (Fakhro et al., 2011). As these businesses are transferred from one generation to the next, the younger generations may become more receptive to outside talent with the operational experience and management skills that PE firms offer. On the other hand, family business owners and HNW individuals in the Middle East derive a large share of their wealth through inheritance, and thus subsequent generations may not have any interest in ceding control of the businesses that they have inherited. Accordingly,

these families may look to either partially or completely sell their interests to PE firms (Fakhro et al., 2011).

### **Capital Market Regulatory Reform**

The capital markets in the Middle East are largely undeveloped and lack the maturity and depth of their more developed counterparts. With the exception of Nasdaq Dubai, the regulations have been drafted to safeguard the interest of retail investors to the peril of institutional investors. Two notable examples highlight this division: (1) the book-building process is regulated by the capital market authorities whereby the regulators have to be satisfied on the offering price of shares to be sold under an IPO; and (2) the sell-down of shares by an existing shareholder through an initial public offering (IPO) is generally not permitted and not market practice. These factors, coupled with the lack of market liquidity, likely deter PE firms from using an IPO as an exit strategy. Moreover, these factors have also contributed to the lack of institutional participation in these stock markets, as retail investors typically account for 90 percent or more of the trading on the region's stock exchanges (Fakhro et al., 2011).

In order to further foster PE in the Middle East, there needs to be some regulatory reform to adopt international standards and best practices tailored to the local environment and business culture. One of the principal shortcomings of the Middle Eastern markets is the lack of harmonization between different regulatory systems, and this must be addressed in order to provide some uniformity in the standards to which market participants are subject.

### **The Global Financial Crisis and the New Realities**

The global financial crisis impacted the Middle East as oil prices collapsed, real estate prices went into a free fall, leverage became scarce, and risk appetite was curtailed. Thus, some of the key themes emerging in Middle Eastern PE industry relate to SWFs, capital overhand, consolidation of GPs, and LP rights. First, SWFs shifted their focus toward geopolitical investments, most notably into their financial sectors. For instance, at the end of 2008, the Qatari government requested its SWF QIA to invest \$3.5 billion to acquire 20 percent of all local banks listed on the Qatar Stock Exchange (QSE, Booz & Company, 2010). Second, there is significant capital overhang in the region (i.e., PE firms in the region are still sitting on about \$11 billion of unspent capital—a result of the furious fundraising they did before the economic crisis). This may accelerate the need for new strategies from PE firms operating in the region. As a result, PE firms in the region are under tremendous pressure to deploy the amount raised or else LPs will demand the capital back. GPs in the region may also find it difficult to raise further funds if this “dry powder” continues. Third, in an increasingly challenging fundraising environment, GPs will need to prove to PE investors that they can create sustainable track records of value creation and exits. Accordingly, “first team, first fund” PE firms, which raised funds during the height of the markets, will lack the track records of investments

and exits in the current environment, may be unable to make it to the next fundraising cycle, and may encounter further challenges (INSEAD, 2011). Fourth, following the losses incurred through global financial crisis, LPs are demanding increased transparency and more robust reporting on each portfolio company. They want to understand the control that fund managers have over their portfolio companies through contractual affirmative and negative rights. In addition, some LPs are formalizing their approach to due diligence, adding capabilities that will allow them to pick the right PE funds and a “flight to quality” (Fakhro et al., 2011).

### Summary

Despite the challenges that the Middle East is facing in general, it remains one of the fastest growing regions in the world, and presents a number of investment opportunities for PE firms. Whether the industry implements the lessons learned as a result of the global financial crisis, and whether its governments have the political will to make the necessary regulatory and legal changes to remove the impediments to its future prosperity, remains to be seen.

### Acknowledgment

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### Note

1. The UAE government has published a draft of a new Commercial Companies Law, which in part amends the existing foreign ownership restrictions. It is anticipated that this legislation will be effective in late 2012.

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## CHAPTER 9

### FINDING PROFIT INTO AND OUT OF CHINA

*Lucy McNulty*

In 1840, an Englishman noted: “If we could only persuade every person in China to lengthen his shirttail by an inch, we could keep the mills of Lancashire working round the clock.”

Fast-forward to present day, and China’s influence on the global stage is no less significant. A potential market of 1.3 billion customers is, after all, seductive. And post-2008, in the face of underperforming global financial markets, the breadth of opportunity promised by the world’s second-largest economy has grown ever-more alluring to foreign investors. China’s nascent private equity (PE) sector is no exception. Certainly, its PE penetration rate—the total annual flow of PE finance as a percentage of total gross domestic product (GDP)—would seem to suggest there is plenty of room for expansion. With a penetration rate of only 0.1 percent GDP, the industry currently generates 20 times less than that seen in the United Kingdom, where PE funding flows total 2 percent GDP, and eight times less than that in the United States.

China’s PE sector has, however, developed into a very different beast when compared to its US and European counterparts. For all of its celebrated growth, this remains an emerging market.

US and European deals are primarily focused on large takeovers of underperforming businesses or big public companies’ subsidiaries, and regularly exceed \$1 billion. While PE capital in China almost entirely flows into minority investments of profitable fast-growing private companies, deal size is rarely more than \$100 million.

This is PE with Chinese characteristics—more growth capital investment than PE as we know it.

And the cultural idiosyncrasies do not end there. For this is a society in which the concept of *guanxi*, the basic reciprocal dynamic in personalized networks of influence, dominates, blurring the lines between the personal and the professional. In short, if you haven’t shared a meal with a prospective target, you will never share a business deal. You need first to win the boss’s trust and friendship, and then you can discuss how to work together. Here, a deal is more than just a deal.

It is a unique market, and one that is increasingly being shaped by the emergence of a privileged group of domestic firms with inordinate access to capital, the rapid rise of renminbi (RMB) funds, and the growing importance of mergers and acquisitions (M&A) as the exit strategy of choice.

Enter blindly, and you will get burnt. So let's begin with an assessment of the landscape.

### **The Changing Role of Foreign Private Equity in China**

China's PE space is fast becoming an insider's market. A more aggressive generation of senior communist party officials' offspring, known colloquially as *taizidang* or princelings, wield outsized influence in the burgeoning home-grown industry. Their ascendancy is making it more difficult for less-well-connected operators, including foreign firms—a trend exacerbated by government officials' drive to make clear that China does not need foreigners' money as much as it did in the past.<sup>1</sup>

In this environment, domestic houses, such as CDH, SAIF, New Horizon, and Hony Capital, have an unfair advantage. These firms were present at the creation of the sector. Today they form one part of a tripartite alliance, which also includes China's National Social Security Fund (NSSF) and the China Securities Regulatory Commission (CSRC). The firms get funding through NSSF and profits through the CSRC, which approves all domestic initial public offerings (IPOs).

The October 2009 establishment of the ChiNext board on China's Shenzhen Stock Exchange, for private companies to go public, increased their dominance further.

The Chinext Price-Earnings multiples have been well above levels in the United States and Hong Kong from the start. The high valuations make it a very profitable place for firms to exit from their investments. But the CSRC acts as a strict gatekeeper, controlling both the number and quality of Chinese companies allowed to make an IPO on Chinext. It has a clear preference for companies that have received finance from China's PE elite, since these companies have already received the perceived seal of approval from recognized investors (and often the *guanxi* of the PE firms extends into the CSRC). This means that the companies invested in by these firms have a better chance of being chosen by the CSRC to go public on Chinext. And, when the investment cycle is bullish, Chinext's high valuations all but guarantees that these firms achieve better annual investment returns than others. The NSSF's pay-as-you-go pension scheme, which saw 10 percent of the national pension system's capital invested into alternative investments, such as domestic PE, additionally cemented local houses' collateral and power.

For the hundreds of other foreign firms active in China, including the global giants TPG, KKR, Carlyle, Blackstone, and Goldman Sachs, making money in the region can seem increasingly challenging.

Not only is competition with local capital intense, but also it is growing increasingly more intense with foreign capital too, as many limited partners (LPs) now look to China as one of the last remaining global markets offering healthy returns.

There is therefore a lot of capital chasing fewer deals. In this environment, investors can only differentiate themselves by closing faster, paying a higher price, or a

combination of both, and as such prices are being driven up. The small number of good private companies who have not already gone public, or had notable exit events, can demand higher valuations. In addition, other good deals, in restricted sectors such as tourism or military defense, for example, may be reserved for domestic or strategic investors, thereby taking more of the supply of attractive companies off the market for foreign firms.

Throw into the mix the risk firms face of buying into a company that may have engaged in corrupt practices, or of inadvertently acting as a money-laundering vehicle for corrupt investors in the market, and China's PE sector begins to resemble something of a minefield for foreign investors.

Nonetheless, PE ought to play an important role in modernizing the Chinese economy, channeling funds to promising but capital-starved companies. Those benefits will only be felt if the industry is run in a professional and competitive manner, however. And that is where foreign firms come in.

There is after all a clear benefit to attracting a sophisticated foreign investor base with useful knowledge and skills in international PE. By opening up the domestic market to limited foreign participation, the Chinese government is hoping that local players, and by extension China's indigenous PE sector, will benefit from a transfer of such expertise.

Of course, the gradual internationalization of RMB has a key role to play in all this. Offshore firms' unwillingness to miss out on the opportunities presented by an appreciating local currency keeps their interest in an increasingly difficult fundraising environment, in which allegations of accounting fraud proliferate. Their ability to easily channel local players' foreign capital into overseas investment opportunities also helps promote their relevance to a domestic market, which has become progressively more focused on foreign exchange (FX) investment as RMB opens up.

Schemes such as the Qualified Foreign Limited Partner (QFLP) program, enabling licensed non-Chinese PE firms to convert foreign currency into RMB for onshore investment in China, play on the growing offshore interest in the Chinese currency. The initiative marks a modest step toward further foreign involvement in the sector, but with the first QFLP quotas awarded in early 2011 and the related fundraising just gathering steam, it is too early to draw conclusions on its impact. Certainly, the availability of quotas should make it easier for foreign firms to do deals in China—eradicating funds' dependence on investee companies to convert foreign exchange into RMB will significantly simplify procedures. The program is, however, still comparatively untested and fund sponsors will have to navigate new relationships and expectations not only of regulators but also of onshore investors, as quotas exist side by side with domestic funds. This will undoubtedly prove challenging—there are fewer local investors, and such investors are also typically unfamiliar with the asset class and international fund operation. The city-level governments sponsoring these schemes also have their own agendas, centering on tax revenues, job creation, and general local prestige. QFLP participants are worried too that fund sponsors will be unable to manage the conflicts of interest created by managing multiple funds. Sponsors will need to address how much each fund gets and where good investments are allocated, for example.

But, China's tendency to reward first movers in such initiatives is well known. Nonparticipants risk being left out in the cold as regulations develop. Already, global giants such as Carlyle, Blackstone, and CLSA Venture Capital have won the approval to participate, and a rush of new entrants is expected this year.

Many are hopeful that it is the first step to relax China's investment rules, and are eyeing up opportunities in fast-moving consumer goods, real estate, clean technology, and water treatment plants. Carlyle has also recently taken an 80 percent stake in Asia's largest provider of cinema digital servers in a bid to cash in on the explosive growth of the Chinese film-going market. KKR has pledged to expand its Hong Kong office in a bet on a Chinese economic slowdown and increasing interest among distressed debt investors in China.

Realistically, however, any deregulation will be a deliberate, and invariably slow, process. In the meantime, those entering China will need patience to understand the Chinese regulations, industry dynamics, and investors. But patience alone is not enough.

### **Structuring Funds**

It is all too easy for foreigners to trip up in the way they approach the sector. Compliance with Institutional Limited Partner Association (ILPA) principles is uncommon. Many domestic investors consider the standards to be overly complex and not relevant to a market at such an early stage of development. LPs are also currently not organized or sophisticated enough to bargain effectively with fund managers.

Certainly, some internationally standard terms do not translate well. The "key man clause," usually an important protection for LPs, would currently be an untenable inclusion in China-based deals, for instance. With new funds regularly appearing on the market, the employer-employee relationships is not yet established enough, nor market participants' short-term gains lucrative enough, to stop interfund poaching. Of course, as funds begin to establish themselves, turnover will lessen. But a string of high-profile cases in 2011—in which key executives departed for reasons related to retirement, spin outs, and, in some cases, death—should encourage general partners (GPs) to consider how they might adequately show LPs that their firm's strength transcends the credibility of a single individual.

Too often, fund terms are simply being left up in the air, exasperating already mismatched expectations between investor and sponsor in terms of what they think they are getting out of a fund, particularly in relation to how long investor capital will be tied up within it.

Long-term capital commitment is a novel concept to many individual Chinese investors. Without concrete deal terms to ascertain what such a commitment involves, offshore participants are often left uncertain of investor loyalty to a deal and increasingly concerned as to the efficacy of domestic procedures should a default occur. And rightly so, for here fundraising procedures at the individual level are at best sloppy and at worst illegal, with banks not only frequently utilizing high net worth (HNW) investment products to raise funds against many more investors

than legally allowed, but also doing little to vet such investors' abilities to meet requirements in terms of capital or experience.

Background checks are both difficult and also potentially very damaging to future business if contacts or powerful investors were to discover such investigations were in progress. In answer, some funds have begun to demand investor capital upfront, which they are then free to invest as necessary over the course of the deal—a solution that has the added benefit of ridding domestic investors of the various clearance obligations that any capital call in China requires.

This is not a viable solution at the institutional level, however, where fundraising remains a significant challenge. Sophisticated and government-level investors typically favor domestic PE funds over their more restricted foreign counterparts. Chinese fund managers are, after all, more likely to know how the system works and, perhaps more importantly, how to work the system.

Here too, the concept of *guanxi* reigns supreme. It is not uncommon for domestic LPs to opt out of a fund if an out-of-favor or rival LP is also involved, for example. Deal terms between two local LPs can also often be so dramatically different that it is simply not viable to have them in the same fund.

In this environment, the need for an anchor LP, as key decision maker for smaller domestic LPs, is much more pronounced. Deals are unlikely to progress without one in place. But sourcing that first anchor, capable of corraling other LPs into a fund, is no easy feat. It requires a substantial investment in relationship cultivation between GP and anchor, and often begins with coinvestment on an offshore fund.

Fundraising strategies must adapt accordingly—this is not an environment in which funds will be raised quickly. Expectations regarding the size and scope of a fund need to be realigned and ambitious initial targets scaled down, to more realistic proportions. The emphasis should be on long-term plans not short-term gains.

Even so, offshore firms' disappointment at the industry's slow progress to date has led many to focus efforts on circumnavigating the issues presented by greater involvement in the sector. As such, structural innovation should form an increasingly important part of China fund formation over the next couple of years.

### RMB Funds

The most creative engineering is expected in the RMB fund space. For these funds present some of the most challenging structural obstacles, and therefore should also provoke the most interesting workarounds.

The rapid rise in RMB funds created its own set of problems relating to transparency and conflicts of interest between RMB and US dollar vehicles advised by the same investment manager. China's 2007 Partnership Enterprise Law saw the domestic fund industry move from a sector dominated by offshore US dollar funds, to one which enabled local LPs. As China's growing local investor base began raising and investing in RMB funds, existing offshore LPs became concerned about the possibility of becoming marginalized. China is slowly moving toward convergence between offshore and RMB funds, but LPs and GPs will continue to debate the issue until RMB funds are able to freely receive capital commitments regardless of where the investor is based and are not restricted as to their investment activities by

virtue of having foreign LPs. Until convergence has been established, RMB funds are likely to remain relatively small so as to minimize conflicts of interest between GP and offshore LPs. To counteract this, some foreign firms have opted to raise multiple, smaller RMB funds across the country in a bid to test the water in this space with various parties.

But there are tax issues too. An offshore USD-fund GP managing an RMB fund creates tax concerns whether or not the manager is going to create a permanent establishment for the USD fund as there tends to be the same, usually China-based, people making investment decisions for onshore funds.

Fund structure and the source of income to managers are therefore relatively transparent to local tax authorities. This increases the risk for the USD fund managed by the same fund group, which also presents issues in relation to RMB funds, particularly in light of the lack of clarity of foreign fund tax treatment.

Local tax authorities have mixed views on how QFLP participants should be treated, for example. Some argue they should be viewed as passive investors and thereby subject to 10 percent tax, while others believe they should be treated as active investors and taxed 25 percent because they have engaged onshore managers to manage money. Uncertainty has resulted in a significant degree of push back from participants, reluctant to potentially leave themselves open to a 25 percent tax leakage through involvement in the RMB funds platform. Many are working to encourage local government authorities to establish agreements regarding tax treatment in advance, and GPs are shopping around in China in order to find friendly locations to domicile funds under preferable tax treatments. A final resolution of this issue awaits guidance from the national tax authorities.

The October 2011 issuance of the Ministry of Commerce's (MOFCOM) "Circular on Cross-Border RMB Direct Investment" and the People's Bank of China's (PBOC) "Administrative Measures for Conducting Foreign Direct Investments in Renminbi" should prompt further innovation in this space. With proper governmental approvals, these rules offer a potential route for legally obtained offshore RMB to be used in direct capital investment from Hong Kong into China, and thereby makes it possible for foreign players to invest offshore RMB capital into their preexisting pure RMB funds without tainting the domestic branch with the consideration that it is a foreign-invested fund.

Purely domestic RMB funds have long been considered to be the more reliable and practical method of investment, but to date most foreign firm involvement in this space earned only carry and management fees. These regulations are set to change that, although, as ever, progress will be slow. The volume of offshore RMB allowed to be invested cross-border, without prior MOFCOM approval, is currently limited to a significantly small RMB300 million<sup>2</sup>. Exceeding this limit will incur a lengthy MOFCOM approval process, which at best will considerably delay business and at worst result in rejection of a deal. There has also as yet been no official recognition of the rules from China's State Administration of Foreign Exchange or the Administration for Industry & Commerce, which could present a problem as all deals rely on the approval of these authorities to be completed. Such obstacles are likely to deter global giants such as KKR, Warburg, or Goldman Sachs PIA.

But for the more forward-thinking funds, this is the latest in RMB fund technology, and these rules open up the possibility of parallel RMB fund structures. Of course, there remain uncertainties. It is unclear how the domestic tranche of such funds will be set up, for example. There is also ambiguity as to whether such deals will really be seen as purely domestic funds or if foreign involvement will hinder them.

PE lawyers suggest that those setting up foreign-invested RMB funds include an opt-out agreement in the deal terms, enabling fund managers to exclude the foreign element of a fund, should it become clear that its existence is hampering the successful closure of a deal. An opt-out in this instance would be a useful means to quickly revert a fund to a purely domestic RMB entity. But as it is not currently mandated by Chinese law, there remain practical problems to consider, such as who would manage the fund.

Regional PE firms nonetheless expect such structuring to become commonplace within RMB funds. “Our GP will manage parallel RMB and QFLP funds,” said one Hong Kong-based market participant. “If the QFLP fund can’t invest, the RMB fund will still do so. Regulations in principle regard the parallel RMB fund as local for most purposes even though our GP is foreign-owned, as long as the GP interest is less than 3 percent.”

#### Offshore/Onshore Alliances

An increase in joint ventures between foreign and domestic firms could also be likely. This is something domestic firms are already pushing for. Hungry for a piece of the action at the top level, they ask for 50/50 fund management splits as they see it as an opportunity to garner access to overseas funds and insight into foreign management expertise. It, however, remains an unwelcome concept to foreign firms, but this may change as firms grow increasingly frustrated with an environment uncondusive to overseas involvement.

Aligning with local players would expand the *guanxi* network to enable offshore players to reach more local investors and profit from the insider advantages that local funds enjoy. Many local funds have already caught on to this, with the more progressive among them asking for a percentage of the GP in return for involvement in the fund, when foreign funds approach them.

Creative structuring will be needed, however, as the minutiae of setting up such joint alliances is finalized. It is important to stop and think about how the relationship will work. Who for example will have the power of veto? What is acceptable in terms of bribery or corruption? Will the foreign fund’s know-how be siphoned off by the local partner?

There will be enormous cultural differences at play, as well as a completely different view of risk in both markets. In short, it will be two alien worlds colliding for the initial period. Domestic funds may have different levels of experience, but they are still very “domestic animals,” and therefore very much influenced by local government. How an alliance can function successfully in that environment is a big question that needs to be addressed early. Those funds with well-established brand names will not want to risk their name by turning into structures that open them to

investment that they would not normally be involved in. But for those firms willing to invest the time, to address, and work around the various obstacles that such alliances will present, the opportunities could be huge.

#### VIE Structures

The variable interest entity (VIE) structure, used for years to circumvent rules banning foreign investment in certain sectors such as Internet and telecommunication, has recently come under intense scrutiny.

Essentially a series of contract agreements that allow foreign investors control over companies operating in China that they do not actually own, signals of Chinese government's intent to more closely regulate VIEs have sparked fears that the structure could be outlawed entirely.

MOFCOM national security review process, notice no. 53 released on August 26, 2011, stipulated that foreign investors are not allowed to evade a national security review in M&A through any means, including indirect ownership and "contractual controls" or offshore dealings. Some lawyers interpret this to mean that MOFCOM has the jurisdiction to regulate VIEs and the government may assert the right to instruct a Chinese entity that is indirectly held by foreign investors via a VIE to either terminate the control or risk having their operating license revoked.

Despite the rule and internal discussions among various governmental agencies including MOFCOM, the CSRC, and the Ministry of Industry and Information Technology on the subject, Chinese regulators have not agreed on how to regulate VIE. It is reasonable to expect that the area might be regulated better in order to find more effective ways to have deals disclosed and understood. But regulatory inaction to date has given comfort to many that the structure is deemed acceptable. Certainly, outlawing the structure would damage the market irrevocably, and put hundreds of Chinese companies that are listed abroad into a tailspin. For this reason, any restriction of VIEs is likely to be only prospective or will at least exempt VIEs that are already listed abroad.

Foreign firms should take comfort from the fact PE lawyers continue to recommend their clients to consider the structure. "Don't use this without getting advice from a Chinese law firm, but subject to that there is no reason why foreign partners should not use a VIE structure for PE investment," said one.

#### **Antimonopoly Law: Raising New Competition Issues for Chinese Assets**

China was one of the last major economies to introduce a modern competition law. After over a decade of protracted debate, China's Anti-Monopoly Law (the AML) was enacted by the National People's Congress on August 30, 2007, and came into force on August 01, 2008.

It was the country's first comprehensive competition law and marked a significant step toward China's full participation in the global economy.

Kirkland & Ellis's US-based antitrust partner Christine Wilson said that many in the international antitrust community initially questioned whether the AML

would be used to achieve protectionist goals, a sentiment fueled by China's decision to challenge the Coca Cola/Huiyuan Juice deal just five months after the AML took effect. She noted that concerns about the use of the AML to promote industrial policy goals had dampened in recent years as MOFCOM's merger enforcement has appeared, for the most part, to track international norms.

She warned, however, that the merger review process still requires considerable time. As with any new regime, the authorities are proceeding cautiously so as not to miss any competition concerns. "They therefore require a great deal of information even before accepting a filing," Wilson said.

Firms could consequently find themselves working with MOFCOM for weeks before the regulator will even accept a filing. This invariably challenges deal timelines, with review periods sometimes longer than those in the United States or Europe. Wilson noted that "companies should recognize that when doing a deal that touches China, they should factor in an extensive period for MOFCOM's merger review process."

The AML has extraterritorial implications that may relate to agreements and transactions concluded or implemented outside China that have an effect in China. It includes merger control, prohibition of anticompetitive agreements defined as "monopoly agreements," and prohibition of abusive conduct by companies holding a dominant market position.

"China is seeking to prove that its competition enforcement regime should be taken seriously in the international arena," explained Wilson. In the recent Seagate/Samsung transaction, for example, MOFCOM required remedies even though the EU and US authorities had reviewed the deal and they did not feel the need for remedies. "China is demonstrating its independence," said Wilson.

She advises foreign firms, when considering deals that touch China, to analyze MOFCOM's likely reaction at an early stage—particularly as the agency demonstrates greater independence.

The deals that get through are the ones that have been walked through the regulators in advance.

### **Exiting Investments**

In today's volatile global markets, sourcing a profitable exit route has grown significantly more challenging. Previously preferred exit options have now been rendered unfavorable. Fewer PE firms, for example, are now willing to enter into secondary or tertiary buyouts, because there is less cash available. Accounting scandals abroad, such as Hong Kong's SFC investigation into fraud in Chinese companies, have deterred many ChinaCos from listing on foreign exchanges. China's attractiveness has changed. This is no longer a market people throw money at without question. Investors are now more sophisticated in market analysis, and are thereby giving more thought to how a business is positioned domestically, competitive threats, cash flows, and so on. In the current climate, there is better value in private wealth than public wealth. Of course, if economic conditions improve, the value attained in public equity markets could also improve. But for now M&A is fast filling the gap left by poorly performing equity capital markets. Associated with this, of course, is the

delist-relist trend. The spate of management buyout offers for US-listed ChinaCos, dissatisfied with undervaluation in US markets, began with the acquisition and delisting from the New York Stock Exchange of the Chinese pharmaceutical company Tongjitang Chinese Medical in April, and continued with similar moves by Harbin Electric and Chemspec International, among others. The trend has a limited life span, but many market participants and most notably TPG's Jim Coulter thinks this will be a big theme of 2012.

### Conclusion

China's nascent PE sector is unique, and as it continues to grow, so too do the parameters, and the rules of the game continue to shift. Those who enter this undoubtedly challenging landscape with a thorough understanding of its idiosyncrasies, and, perhaps, more importantly, with the knowledge of how to work around these will make great headway. Here, the old adage "to fail to prepare is to prepare to fail" rings true.

### Notes

1. Local bosses, wary of coming under princeling influence, as a first step to squeezing them out, have become more welcoming of foreign investors as they think it will be harder for the government to muscle in on government-backed firms.
2. And to date has been limited to foreign direct investment rather than PE-style fund investment.

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CHAPTER 10  
FIVE RULES FOR WINNING IN CHINESE  
AND ARAB PRIVATE EQUITY

*Jeffrey Towson*

The world's first two emerging market superpowers have officially “emerged”—and in a fairly spectacular fashion.

Both China and the Middle East, the undisputed financial titans of the emerging market asset class, have now had their official arrival moments. It occurred in the depths of the 2008–2009 financial crisis. As the Western world languished and worries of global contagion were rampant, China and the Middle East had already recovered. It surprised almost everyone that the first two major economies to get off the mat were both in the emerging markets.

And the world also got to witness a first in global finance: the spectacle of leading Western companies and governments going hat in hand to Riyadh and Beijing asking for cash.

By 2010, it was clear that both of these economies had attained economic superpower status in all the ways that really matter. First, they are both financially large. China has become the world's second largest economy (gleefully displacing its long-time rival Japan), and the Gulf Cooperation Council (GCC) now has a cumulative gross domestic product (GDP) of over \$1 trillion (with a population of only about 38 million). Second, they are both cash rich. They are increasingly the world's creditors, while the developed economies are increasingly the debtors. And, as the West has learned, having lots of assets is not the same thing as having cash. And finally, they both command strategically important global positions. China dominates the natural resources and manufacturing sectors globally. It also dominates Asia politically, economically, and increasingly, militarily. Meanwhile the GCC, particularly Saudi Arabia, has a commanding position in the world's energy markets. When Federal Reserve chairman Ben Bernanke speaks, the world's markets stop to listen. The same thing now happens when Saudi oil minister Ali Al-Naimi speaks.

Both China and the Middle East have become pivotal players in global markets and are able to punch well above their economic weight class. That is as good a definition for economic superpower status as any.

For Western investors, engaging with these officially “emerged” markets is now a requirement. Private equity (PE) and venture capitalists are increasingly focused on these regions for both raising capital and making investments. In an interesting parallel, regions that multinationals such as Coca-Cola have long viewed as “must have” consumer markets have now become “must have capital markets” for PE and venture capital (VC) limited partners (LPs).

However, selling Coca-Cola or iPads in China is one thing. While there may not be rule of law, clear regulations, or completely free markets, a can of Coca-Cola can be sold in Wuhan and Chongqing in much the same fashion as it can be sold in Chicago and Toledo. The business is approximately the same.

However, investing in capital markets with limited rule of law, shifting regulations, active government involvement, and generally rapidly changing economics is a fundamentally different challenge. Investing successfully as a general partner (GP) or a LP in such an environment is simply different from what it is in the West.

For PE and VC investors, going from New York to San Francisco is mostly a geographic transition. The primary differences are some state regulations and their own personal networks. Going from New York to Paris is a geographic, cultural, and mild politico-economic transition. The changes are larger, but in both cases the transition is fairly comfortable.

Going from New York to Shanghai, however, is a geographic, politicoeconomic, regulatory, cultural, and language transition. It means moving from American international free market (mostly) capitalism to Chinese state capitalism. It means going from rule-of-law liberal democracy to centralized autocracy and from well-developed regulations and governance processes to rapidly changing, vague, and inconsistently applied regulatory environments. There are also large cultural and language differences—which are not small issues in face-to-face private, illiquid transactions.

This type of transition makes Western LPs and GPs very nervous. Ironically, Western investors have historically been much more comfortable putting money in Rome and Athens (both members of the new PIGS [Portugal, Italy, Greece, Spain] asset class) than in Doha and Tianjin (both highly dynamic and rapidly rising emerging market cities).

But a lot of this caution is in fact warranted—and prudent. The risks are real. Western investors frequently fail in these two emerging markets. It is commonly said in China that a “foreigner and his capital are easily parted.” But the frequent failures of Western GPs and LPs in these markets stand in stark contrast to the great wealth the local investors are accumulating in these very markets. How then can this phenomenon be explained?

The truth is that Western investors routinely fail in the Middle East and China primarily because they routinely pursue failing strategies. They take strategies they work with in the West and apply them to these fundamentally different investment terrains. It is not a market problem—all markets have risks. It is not a politico-economic problem—all systems have risks. It is overwhelmingly a strategy problem.

The key to winning in Chinese and Arab PE is to consistently follow an investment strategy suited to the terrain. And fortunately, there are proven strategies with long histories of success to copy.

The winning China/Middle East strategy with the longest track record can best be described as “direct” and “value-added” PE. It is a strategy that focuses on eliminating intermediaries and on adding overwhelming value (both perceived and economic) at the time of investment. Most foreign firms such as KKR in China and the Carlyle Group in Dubai—as well as local private equity firms such as Amwal Al Khaleej in Saudi Arabia and Hony Capital in China—have gravitated to this type of direct, value-added strategy over time. The complete strategy is called “value point,” and it is explained in detail in *What Would Ben Graham Do Now? A New Value Playbook for a Global Age* (Jeffrey Towson). Five of its key rules are summarized here:

**Rule No. 1: Don’t Underestimate How Different the Environment Is**

China is state capitalism and the Middle East is “godfather capitalism.” Both are fundamentally different politico-economic systems—with little in common with Western investment environments.

Both China and the GCC are fundamentally different from the Western, liberal, rule-of-law democracies. And while frequently described as “developing economies,” neither region is developing into a system similar to that in the West. Regulations will continue to change frequently in China. And an independent media is not coming to Saudi Arabia anytime soon. Additionally, while both economies are large, the average GDP per capita will remain quite low (approximately \$11,000 for Saudi Arabia and approximately \$2,200 for China). These are rapidly changing, highly uncertain markets with large populations of low-income people. They are fundamentally different.

A simplistic way to think of the differences is Western free-market capitalism vs. Chinese state capitalism vs. Middle Eastern “godfather capitalism.” In Chinese state capitalism, the state is the dominant player in the economy—acting through bureaucracies, regulations, and large state-controlled companies. In Middle Eastern “godfather capitalism,” a small number of families have effective control of most aspects of the economy. They typically own or control most of the major companies. The result of both systems is the same—highly politicized markets with a large degree of centralized politico-economic management (sometimes mismanagement). Generally speaking, godfather capitalism is simpler than state capitalism and a more easily navigable system for foreigners.

Two case examples are worth summarizing across these five rules. The first is a foreign PE firm that entered the Middle East, had initial problems, but eventually succeeded. The second is a foreign real estate firm that entered China, had initial success, but then encountered multiple serious challenges.

**Case 1: The Carlyle Group Enters the Middle East**

In 2006, the Carlyle Group entered the Middle East to begin making direct investments. While they had been raising money from the region for decades, this was their first major initiative for extensive direct investing.

And in true Carlyle form, they entered with a fairly impressive bang. They opened a luxurious office, hired Western-trained Arabic-speaking staff from around the world, and hosted a large conference with UK prime minister Tony Blair flown in to speak. The region's major investors and companies from across the region were all invited to attend and listen to Prime Minister Blair—as well as the Carlyle founders. It was an impressive event, and virtually every major family in the region was aware that the Carlyle Group was entering Middle Eastern PE.

However, in the middle of the conference, a well-known Saudi investor rose to ask a question of the founders. Approximately summarized, his question was, “What is it you are going to do here that we cannot?”

It turned out to be a fortuitous and important question. The Middle East is definitely still a developing economy—but it also has a long history of successful private transactions through well-established networks. How was the Carlyle Group going to compete in—or add value to—the existing system? And if all Carlyle was bringing was capital and a famous name, these were things the region already had in abundance.

#### Case 2: Morgan Stanley Properties Enters Shanghai

Also, in 2006, approximately eight hours flying time to the East, Morgan Stanley Properties made a similar spectacular entrance into Shanghai. They opened a large office, hosted a conference on a boat on the Huang Pu River, and made similarly ambitious proclamations. And while they had been active in the region for several years, this was, similar to Carlyle, a large new initiative for direct investing.

Morgan Stanley's plans, according to the press release, were to invest in real estate portfolios across all China property types, including publicly traded or privately held real estate companies, and direct real estate assets and developments.

In both of these cases, marquee, highly capable, and highly capitalized, Western firms launched large direct initiatives into emerging markets. And ultimately, the core question for both would be the same. What are you going to do here that others cannot? What is the right strategy for winning as a foreign GP on these fundamentally different and highly competitive investment terrains?

#### **Rule No. 2: Who You Are Matters**

In these highly politicized, mostly insider markets, who you are—and who is foreign and who is local—is a big deal.

Both the Middle East and China are highly political markets—with extensive state involvement through bureaucracies, regulations, state-owned enterprises, and quasi-state-owned vehicles. Government is the rule—not the exception. What the West calls “crony capitalism,” most of the world calls “business.”

For foreign hedge funds and other public equity investors, this primarily plays out in terms of increased uncertainty in the long-term intrinsic value of companies. Five years in China can be a very long term in terms of changing regulations. They typically deal with this by going more short term.

But for GPs and LPs in private equity and venture capital, the political nature of the markets has a much more powerful impact. It plays out extensively at the company level and at the deal level. And it plays out in the longer holding periods of illiquid assets. That's where the strategy problem lies.

At the deal level, the first problem is access. In both China and the Middle East, good deals are usually closely held in private, well-established networks (the bad companies are usually open for bidding). This lack of deal access for foreigners is particularly true in the Middle East where the deal volume is small, and families have been doing deals together for 30+ years. Who you are and who you know matters. This is referred to as "guanxi" in China and "wasta" in the GCC.

The next problem after getting access to good deals is actually winning the bid. Competition can be ruthless, and even if you win, the competition can drive up the price. To do well, you need to both access the good deals and limit the number of competing bids. Reputation in both political and commercial terms is most often the dominant factor in this. And being local versus being a foreigner is a big deal.

The third problem is that regulations can vary between foreigners and locals. And this is an evolving situation. You frequently see the pattern of fairly flexible open regulations initially—which attracts foreign expertise into the market—and then a shift to more limiting regulations in order to help domestic competitors once the foreign expertise is localized.

In Case 1, the Carlyle Group's initial ambitions into the Middle East quickly ran headfirst into this problem. They began to compete for private deals based on their reputation and capital. But they quickly discovered that most of the good deals were handled privately. You could certainly compete in open auctions such as for a mobile license in Saudi Arabia (the second KSA mobile license worth approximately \$2 billion attracted over \$20 billion in bids), but attractive land and construction contracts are by and large unobtainable for foreigners. In competing for private deals, Carlyle Group found it had few advantages against well-entrenched local networks with deep political relationships.

Additionally, at the same time, locally owned Middle East PE firms, such as Amwal Al Khaleej, were being founded. Unlike Carlyle, these firms were owned by leading Middle Eastern business people—and they could combine the owners' political access and insider networks with the PE group's capital and expert management.

At the same time, Morgan Stanley Properties was having the exact opposite experience in China. They began closing attractive real estate deals rapidly. They found that their reputation and ability to access foreign capital was an advantage as Shanghai continued to upgrade its central business districts. They had less success in residential areas where local developers were quite strong, but they were in a flurry of activity elsewhere: development and redevelopment deals, high-profile properties on Huai Hai Lu, and so on.

Unlike the Middle East, there were no deeply entrenched deal networks or competitors in Shanghai at that time. It was much more of an open playing field, and Morgan Stanley's strengths were very effective—for a while.

**Rule No. 3: Live By Politics, Die by Politics**

Highly political private equity strategies are popular, profitable, and perilous.

Government and politics are dominant in state capitalist and godfather economies, and this plays out extensively in private transactions. The no. 1 investment strategy in private equity (and real estate) in the Middle East and China today is still political connections.

But “political connections” do not mean some sort of crony capitalism. Most of the time, it means working with state-owned entities that just happen to dominate the economy. If you want to work in telecommunications in China, it means dealing with state-owned China Mobile and China Unicom. If you want to work in oil and gas in the Middle East (the dominant industry), it means working with state-owned Saudi Aramco and Sabic.

But to be fair, in many cases, such relationships are somewhat unsavory in nature. Pre-initial public offering (pre-IPO) PE strategies in China are heavily influenced by political connections and increasingly attracting the politically connected. Land deals in Saudi Arabia are almost entirely political. PE in Mubarak’s Egypt was overwhelmingly about connections to the ruling class.

The key point is that government is dominant in many industries. And this means a structural disadvantage for foreign investors.

For Carlyle Group’s Middle East ambitions, rule no. 2 and rule no. 3 proved to be significant challenges from the beginning. There was no flurry of deals in the years after their launch. For Morgan Stanley in Shanghai, these same rules were not significant problems in the first years—but less than four years later, they would find themselves struggling in the same way.

A final point. It is worth noting that the political strategies you see so often in these regions cut both ways. They can make companies rich, but they can also make them poor. State capitalist systems often have two main political factions (with the military very often being the third leg of the stool). The political factions typically are fairly well balanced, but they do cycle back and forth over time. And when a group cycles out of power, it can frequently lose business (and assets) quickly. You can watch politically connected PE and real estate firms rise and fall in tandem with political changes.

**Rule No. 4: Build a Powerful and Durable Value-Added Advantage**

Your most powerful strategy is to move from LP to GP—and from a source of capital to a source of value.

Foreigners in these economies have structural disadvantages. If you don’t see it, just assume it is there (or will emerge later). So the starting point for any winning strategy is to have powerful (and durable) advantages at the deal level.

The most powerful of these advantages is to add overwhelming value (both economic and perceived) to the deal. Don’t just bring capital to a company, bring technology too. Bring access to foreign customers. Bring a luxury brand. Bring a valuable reputation. When Warren Buffett purchased 10 percent of the Shenzhen-

based electric car manufacturer BYD in 2008, the management stated they only agreed to the deal because of who Warren Buffett was.

The winning strategy in Chinese and Arab private equity is *to go direct* with a *powerful value add*. Value point is based on building such advantages in the short and long term.

There are five basic advantages you can build as an LP or GP in these regions. The first advantage relates to reputation (i.e., reputable capital). As discussed, who you are matters in markets with limited rule of law, active political involvement, and shifting regulations. In such uncertain situations, trust and reputation become more powerful. People frequently do business with relatives and friends from childhood for this reason. A trusted reputation will actually have far more power in China or the Middle East than in the West.

The second advantage relates to political access. As discussed, this is the primary strategy for many private equity firms in these markets. This tends to be powerful for locals in the long term and helpful for foreigners—but usually only in the short term.

Third, management can be a source of added value. The presence of effective management is something that is taken for granted in the West. In much of the world it is actually a unique and rare asset. In Western China and in Saudi Arabia, a foreign investor who can bring strong management to a business will have distinct advantages. And it is a surprisingly durable advantage.

Fourth, local and foreign capabilities can add value. As both regions are developing economies, you could more accurately describe them as “developing capabilities” economies. Hutongs are being upgraded to apartment buildings. Bicycles to cars. Polluted rivers to clean ones. Deals that deploy both capital and capabilities can be powerful.

Such deals can often be positioned against the development curve of the industry. For example, Saudi Arabia is currently showing rapid development in its financial services sector. Basic retail banks are adding investment banks. Mortgages and consumer loans are slowly being introduced to the market. An investment partner such as GE Money that can bring both capital and deep capabilities in consumer lending would have unique access to deals in this space.

Brands, technology, business models, services, foreign customers, etc. are all capabilities that can be strong advantages when competing for deals. Generally speaking, a capability plus capital beats capital alone almost every time.

Such capabilities can be further broken into two categories: foreign and local. Local capabilities are those that you bring to a deal and then they become localized. An example would be the investment banking expertise Morgan Stanley brought to its 1995 joint venture with China Investment Capital Corp (CICC), one of the first investment banks in China. At that time, investment banking was new to China, and such expertise was a powerful capability. It was how Morgan Stanley got access to the deal. But after the bankers were trained, the capability quickly became localized, and such expertise is now common in China.

Foreign capabilities, in contrast, are capabilities that continue to stay out of the region. For example, a new university launched in Dubai that offers degrees from a top-tier Western university would be a good capability deal for foreign investors. In

this case, the capability is valuable (Western degrees for graduates), and it also stays foreign. If the Western university exits the deal after five years, the degrees leave with them. Brands, foreign customers, and technologies are foreign capabilities that are effective ways to add value and secure your claim to the asset.

And the more advantages you deploy the better. Bringing capital, reputation, political access, management, and foreign capabilities to a single transaction works well almost everywhere. Overall, your most powerful strategy is to move from LP to GP (i.e., go direct) and from being a source of capital to *a source of value*.

In Carlyle's case, the group's initial entry into the Middle East was slow because it came to the deals with primarily reputation and capital (advantage no. 1). Unfortunately, the Middle East already has plenty of both.

However, over time they began to shift their strategy to management and capabilities—which is what the Middle East lacks. As a region with lots of capital and few companies, it is heavily dependent on capabilities brought in from the United States and Europe. Virtually every Middle Eastern business today is a combination of a local partner and a foreign brand, technology, customers, business models, etc.

This capability and management approach (providing value, not just capital) is what eventually opened the door for Carlyle in the Middle East. They have advantages in deals where the facility is in the Middle East but the customers are in Europe. Or where the company is in Saudi Arabia but requires American technology.

Today, the PE market in the Middle East has been effectively bifurcated between local firms that compete on political access and foreign firms that compete on management and capabilities. Both add value but in different ways. PE deals are rarely about money in the petrodollar capital of the world.

For Morgan Stanley Properties in Shanghai, this same dynamic played out in reverse. Local Chinese firms became increasingly strong in reputation, political access, and capital. And unfortunately, it is hard to have superior management or capabilities in real estate. Residential apartments are not that complicated. Foreign real estate firms quickly left residential deals and gravitated to more technical or luxury projects—such as large mixed-use developments and Grade A skyscrapers. But local Chinese firms are rapidly building up their expertise in these areas as well. Even the new Shanghai Tower, soon China's tallest skyscraper at 600+ meters, is now being built by Chinese companies.

So while Morgan Stanley had two to three very successful years, where they had significant advantages at the deal level, these advantages have largely disappeared now. Rapidly rising local firms have almost matched them in management and capabilities—and continue to have advantages politically. This leaves Morgan Stanley Properties in the situation you never want to be in: a foreign investor in hypercompetitive China with no strong advantage. You can still succeed, but it's a very hard way to make a living.

For PE and VC in China, you see this pattern frequently. A foreign company enters and relies on reputation, capital, and capabilities (usually technology, etc.). They have two to three successful years, and then the local competition surges. If it is in technology, they can maintain their advantage (i.e., Softbank out of Japan, Steamboat Ventures from Disney). If it is something like real estate, you see them quickly struggle as local companies match their expertise and have superior political access.

**Rule #5: Know Where You Can Win and Where You Can't—Before You Start**

Winning in Chinese and Arab private equity is about deploying a value-add strategy in places where you can actually win

You need a strategy that gives you a strong and durable advantage at the deal level. This lets you overcome structural disadvantages and gets you access to closely held deals. You need to be a *value-added partner of choice*.

However, you also need to recognize that in many cases such an advantage is not possible (such as in Chinese residential real estate). It's best to know where you can win in the long term and where you can't, before you start.

There are many sectors where foreign PE and VC firms are not allowed. And then there are places where they are allowed but can't really win. Such areas include GCC real estate, Chinese social media, Shanghai residential real estate, Chinese insurance, GCC oil & gas, and many others.

In contrast, foreign firms that chose well have done exceptionally well. These include: the Family Office out of Bahrain investing in China, Asia Alternatives helping Western pension funds invest in Asia, Harvest Capital in Hong Kong raising money from the West and the Middle East for Chinese real estate, SinoLatin Capital in Shanghai investing in Latin America resources for Chinese state-owned enterprises (SOEs), MKW Capital in Macau, and Carlyle Group in China—which got their early and built-up scale in time.

Ultimately this is a strategy problem. With a winning strategy, China and the Middle East are no more difficult than the United States and the United Kingdom. All of the earlier mentioned groups have variations of value point. All of them have built up clearly articulated and durable advantages at the deal level—and they have focused on the places where you can win.

**A Last Thought from the World's First Cross-Border Investors**

For Westerners, global investing (developed plus developing economies) is a relatively new frontier. It has existed for decades but was not really necessary. The Western markets were big enough such that for most of the past 20 years you could ignore the emerging markets if you wanted to.

Ironically, the group that has the longest track record of such cross-border investing is the one group that could not ignore other markets. As far back as the 1970s, the Saudis were generating tremendous oil wealth but had only small local markets to invest in. They were forced to learn to go global early on. What the West now calls global investing, the Saudis have been doing (and struggling with) for over 40 years. Leading Saudi investors such as Prince Alwaleed have been crossing borders for decades—and have gotten quite good at it. Currently, Prince Alwaleed's company has investments in over 130 countries.

If there is one final lesson to learn from the world's first cross-border investors, it is humility. Assume you always know less than the investors in the region you are trying to enter. Assume they have better networks. Assume they have multiple advantages—some you can see and some you can't. Basically, assume you are perpetually disadvantaged. Adopting this sort of humility will force you to do two things:

First, you will realize you need a concrete, powerful, and durable advantage to overcome your weaknesses. Being smart and hardworking is not enough.

Second, you will be forced to reposition yourself as a value-added partner. You need to think beyond capital—which is rarely enough. You will need to bring tremendous value to both your projects and to your partners, so that they are always eager to have you involved. Fortunately, there are many ways of accomplishing this. By reputation. By relationships. By capabilities. But you will know you have succeeded because you will suddenly find all the doors opening for you. You will start getting invited to the best deals in these regions. And your investment world will expand exponentially. Good hunting.

PART III

CROSS-COUNTRY STUDIES OF PRIVATE  
EQUITY IN EMERGING MARKETS

CHAPTER 11  
PRIVATE EQUITY IN CENTRAL AND EASTERN  
EUROPE—OPPORTUNITIES IN AN EMERGED  
MARKET: THE PRACTITIONER’S PERSPECTIVE

*Petra Salesny*

**The Macroeconomic Environment**

Size of the Region

When we speak about Central and Eastern Europe (CEE) as a private equity market, we speak about the countries of the former Eastern bloc. From a private equity investor’s point of view, the region comprises two major markets with distinct characteristics and risk profiles. On the one hand, there are the Central and Eastern European countries, which are today members of the European Union (EU): Poland, the Czech Republic, Slovakia, Slovenia, Hungary, and the three Baltic states, which are EU members since 2004, and Bulgaria and Romania, which joined the EU in 2007. On the other hand, there is Russia and the other former Soviet Republics or members of the former Commonwealth of Independent States, often referred to as “CIS countries.” CEE and CIS are separate and distinct private equity markets for a number of reasons: there is a different type of private equity opportunity available in each of the markets, there is a different universe of fund managers operating in each of the markets, and the risk/return profile of private equity investing in the two markets is different. In short, while the private equity opportunity in Russia/CIS continues to be an emerging market opportunity, CEE is an “emerged market” today. A closer look reveals that the private equity opportunity in CEE indeed combines emerging market characteristics and developed market characteristics in a very unique way, which I will further examine in the following sections.

While Russia is a significant private equity market, only Ukraine, Moldova, Belarus, and to an extent Kazakhstan, from among the other CIS countries, have started to develop private equity industries that attract international institutional investors. When institutional private equity investors speak about CIS as a geographic target market, they typically do not include any of the other former Soviet Republics, as the private equity industries in these countries are still very immature or even nonexistent.



**Figure 11.1** Key economic and demographic characteristics of CEE and CIS.

Source: CIA World Fact Book 2012.

Increasingly, Turkey has been moving into the focus of international institutional private equity investors, who are attracted by the country's strong growth, its young population, and a rapidly developing private equity industry. Today, CEE is often used to designate a geographic market including Turkey. It also includes the countries of former Yugoslavia, which, with the exception of Slovenia, are not EU member states today.

Including Turkey, the CEE and CIS region has a total GDP (PPP) of \$5,814 billion and a population of 379 million. It is in any respect a sizable market and presents a sizable private equity opportunity. It should not be overlooked that Russia is the largest and fastest growing consumer market across Europe (see figure 11.1 for a perceptual overview of key demographic and economic indicators of CEE and CIS).

While the CEE private equity market has become a EUR-denominated market in the sense that almost all the private equity funds operating in the CEE region are today EUR-denominated, Russia/CIS continues to be a USD environment, with practically all private equity funds operating in the market being USD denominated. Only Slovenia and Slovakia are members of the Eurozone today and have adopted the EUR as their national currency.

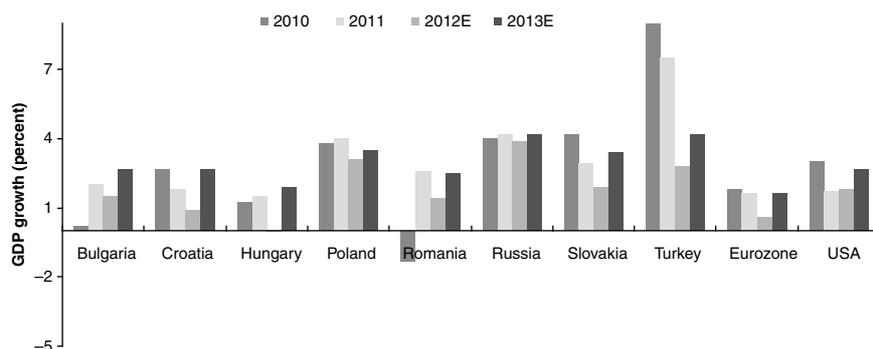
#### Macroeconomic Parameters

It is important to bear in mind that CEE is not a homogeneous block, but made up of many countries with very different macroeconomic fundamentals and prospects.

The global financial crisis has further highlighted these differences. While countries with weak fundamentals like the Baltic States and Ukraine suffered severely, countries that previously did not overheat, have relatively healthy local banking sectors, and the flexibility to aggressively loosen monetary conditions are doing well, some of them strikingly so. Poland was the only country in all of Europe boasting a GDP growth in 2009; it grew 3.8 percent in 2010, 4.0 percent in 2011, and is expected to grow 3.1 percent and 3.5 percent in 2012 and 2013, respectively (Bank Austria/Unicredit). Overall, all major CEE economies are developing significantly better than their reputation would suggest. With the exception of Romania, all major CEE countries enjoyed positive GDP growth in 2010; all major CEE countries, including Romania, showed growth in 2011 and, with the exception of Hungary, have solid GDP growth forecasts for 2012 and 2013, exceeding the Eurozone average (see figure 11.2). The GDP growth forecasts for Poland, Slovakia, Russia, and Turkey for 2013 are each more than double the level forecasted for the Eurozone. Average GDP growth in the major CEE countries is also expected to outstrip US growth.

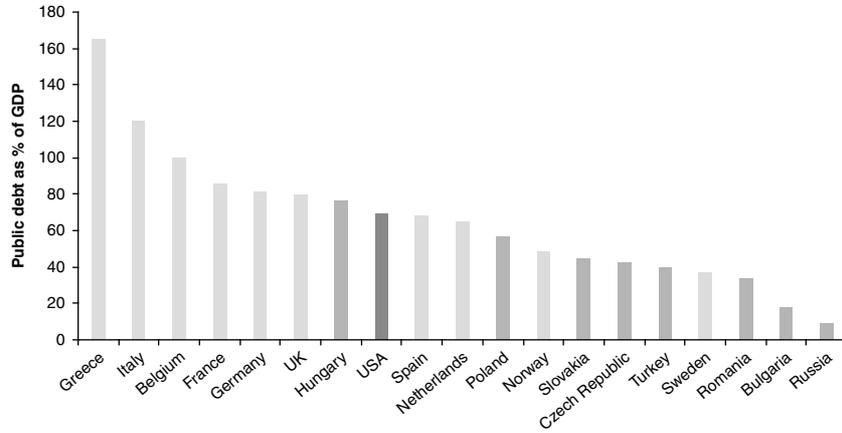
Contrary to widespread perception and a number of press reports in connection with the 2008 financial crisis and its potential impact on CEE, public debt measured as percentage of GDP in the most important CEE economies is lower than in the key economies of Western Europe, including those of the United Kingdom, Germany, France, and Italy (review figure 11.3). Many major CEE countries as well as Russia are fulfilling the Maastricht criteria, or are much closer to fulfilling them, than many countries in Western Europe or the United States (see figure 11.4).

The euro-convergence criteria, also known as the Maastricht criteria, are the criteria for EU member states to enter the third stage of the European Economic and Monetary Union and adopt the euro as their currency. With respect to government finance, there are two criteria: the ratio of the annual government deficit to GDP must not exceed 3 percent and the ratio of gross government debt to GDP must not exceed 60 percent. Figure 11.4 shows where the key CEE economies, the Eurozone,



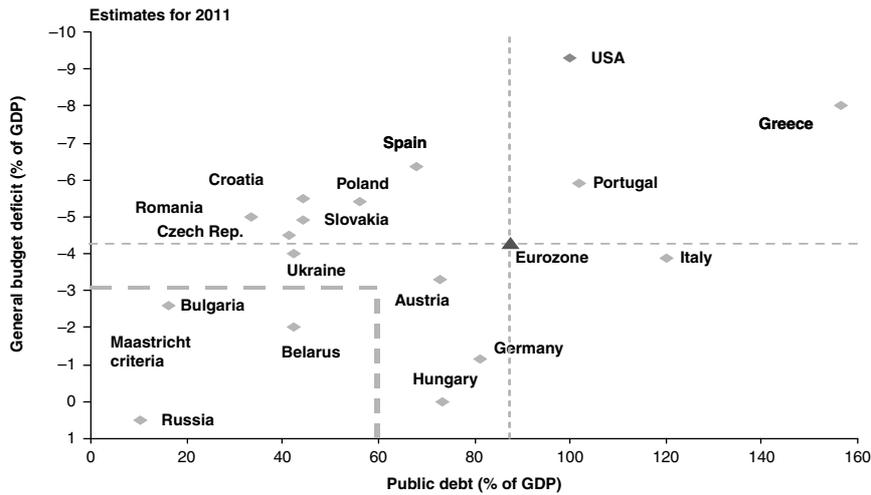
**Figure 11.2** GDP growth (in percent) across selected countries in CEE, the Eurozone, and the United States.

Source: UniCredit; Bank Austria—CEE Quarterly 1–12; UniCredit Factsheet 1H2012; Bureau of Economic Analysis; International Monetary Fund; World Bank.



**Figure 11.3** Public debt as a percentage of GDP in selected countries.

Source: CIA World Factbook 2012.



**Figure 11.4** The graphical depiction of the Maastricht criteria.

Source: Raiffeisen Research.

selected Western European economies, and the United States stand with respect to those two criteria in 2011.

There are a number of macroeconomic factors that set CEE apart, both from other emerging markets as well as the developed markets. Most notably, growth in the CEE economies is not as high as in other emerging markets, such as China or India; however, the legal, political, and economic risk in the CEE region is also

significantly lower: all CEE countries now have democratic governments and capitalist market economies, and almost all of them are EU member states and have adapted their legal and regulatory frameworks to EU standards. Convergence towards Western standards is ongoing, and the CEE economies continue to catch up. Ownership and intellectual property are protected, strong corporate and bankruptcy laws have been introduced in all jurisdictions, and law enforcement and the judicial process are continuously improving. All these elements clearly distinguish the CEE countries from the markets of emerging Asia, Africa, or Latin America, as well as Russia, and the other former CIS countries, which continue to carry political, economic, and legal emerging market risks.

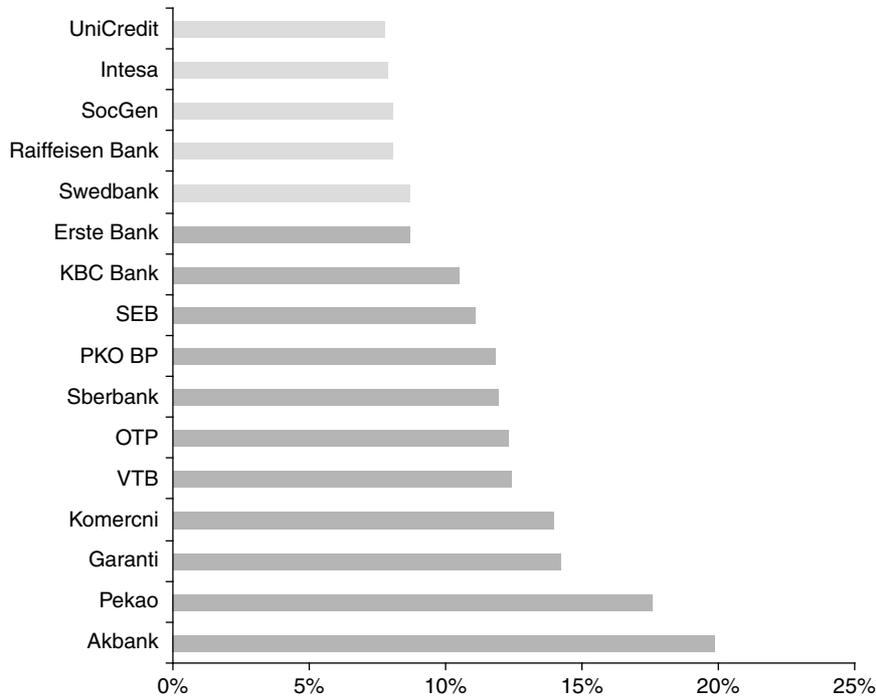
Constrained by decades of communism, the fall of the Berlin Wall and the Iron Curtain in 1989 unleashed a boom of new company formation and entrepreneurial development. The freedom and competitiveness of the economies have increased dramatically ever since. Generally, the CEE countries have lower tax rates and simpler tax systems than their Western European neighbors, labor markets are less regulated, and business start-up regulation is simpler and encourages entrepreneurial endeavor. As the CEE economies were newly built, the governments had the opportunity to avoid going down paths that had not proven successful or effective enough for their Western neighbors and learn the lessons from some of their mistakes and failures.

Government influence has been substantially reduced, and many of the CEE countries today have fewer state-owned enterprises than Western European states. While, for example, there were approximately 8,400 state-owned enterprises in Poland when the economic reforms were initiated, contributing more than 70 percent of the GDP, all enterprises with industrial significance were privatized by 2003, and 3,000 of them were liquidated or reassigned to more viable businesses. In former Czechoslovakia, approximately 95 percent of the GDP was generated by state enterprises; however, by 1999, approximately 75 percent was attributable to privately owned companies.

In contrast to other emerging markets, the private equity industry is not restricted by regulation in the CEE countries, and no capital transfer restrictions apply in CEE or Russia.

The CEE banking sector, considered the Achilles' heel of the region is still delivering good results on average. In fact, many major CEE banks are better capitalized than many Western European banks (see figure 11.5).

As many Western EU nations struggle to meet the Maastricht criteria, with the economies of Spain and Greece suffering dramatically, the distinction between Western Europe and Eastern Europe is becoming blurred. Is Poland really less "developed" than Spain? Or Greece? Western Europe versus Eastern Europe used to designate democratic, capitalist market economies versus communist Eastern bloc economies, and after the fall of the Berlin Wall continued to designate developed versus developing economies in Europe. Today the attributes "Western" and "Eastern" are of little more than geographic significance. Many institutional private equity investors continue to address Eastern Europe within their emerging market allocations alongside emerging Asia, Africa, and Latin America. While Russia/CIS belongs in this allocation basket, the CEE EU



**Figure 11.5** Bank capitalization (Tier 1) as at the end of December, 2010.

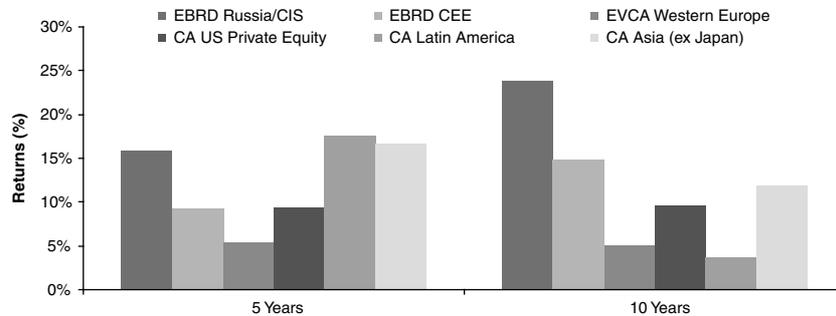
*Source:* Various.

member countries do not for a number of reasons, which I will further examine in the following sections on the characteristics of the private equity opportunity in the region.

### The Private Equity Market

#### Performance Comparison of the Global Private Equity Markets

Based on data from the European Bank for Reconstruction and Development (EBRD), Cambridge Associates, and the European Venture Capital Association (EVCA), private equity in CEE and Russia/CIS has outperformed all other markets globally over the ten-year-horizon, including Western Europe, the United States, Asia, and all other emerging markets (review figure 11.6). This makes the private equity markets of CEE and Russia/CIS the only emerging markets to have paid the much sought-after risk premium to investors so far. Over the five-year-horizon, private equity fund performance in Latin America and Asia has been higher than in CEE and slightly higher than in Russia/CIS. These returns are largely unrealized today; it will be interesting to see how performance will compare when these vintages have generated cash returns.



**Figure 11.6** Market performance in terms of end-to-end returns, net of fees and expenses, as of December 31, 2010.

Source: Cambridge Associates, EBRD Fund Performance Report 2011, EVCA (EVCA data in EUR; other data in \$).

Toward the end of 2010, the EBRD shows a total performance for its combined private equity fund portfolio in CEE and CIS of 1.71x cost and an IRR of 17.01 percent. The cost multiple on the realized portion of EBRD's portfolio stands at 2.14x and the IRR at 20.12 percent; the cost multiple on EBRD's partly realized portfolio stands at 3.06x and the IRR at 26.33 percent.

The EBRD's performance data is a suitable proxy for the private equity market performance in the region as the institution is by far the largest private equity investor in the CEE and CIS countries and has invested in the region since the early 1990s. The EBRD is an AAA-rated international development bank owned by more than 60 states; it has seeded and shaped the private equity industry in the region and, especially in the 1990s, invested very broadly in private equity in the region with a view to developing the private equity industry and the local economies. As of December 31, 2010, the EBRD has made capital commitments of \$3.6 billion to private equity funds in CEE and CIS with a total capital of \$18.2 billion. This portfolio includes 88 private equity fund managers and 133 private equity funds, representing 1,163 underlying investments in companies, of which close to 70 percent have been exited. The EBRD is also a large lender in the region and invests directly in privately held companies. Russia and Poland, the largest markets in the region, also represent the largest exposures in the EBRD's private equity fund portfolio by investment cost, namely 29 percent and 23 percent, respectively, followed by Romania (9 percent), the Czech Republic and Slovakia (9 percent), Hungary (6 percent), Bulgaria (6 percent), and the Baltics (5 percent), with 7 percent invested in Western CIS, the Caucasus, and Central Asia.

Notably, the private equity vintages following the Russian crisis of 1998 have been the most profitable in the history of the region, due to capital scarcity, currency devaluation, the postcrisis economic recovery, and the ability of a growing group of local fund managers to exploit these conditions. The post-2008 vintages present a very similar opportunity, and time will tell whether history will repeat itself, and whether these vintages are also to generate exceptionally high returns.

### The Development of the Private Equity Market in CEE from the Early 1990s to Today

The early 1990s saw mostly privatizations and the restructuring of state-owned enterprises, as well as start-ups built on “imported” Western business concepts. Privatization processes were slow and often opaque. Privatized companies often suffered from inefficient business models and weak management and required radical restructuring. This often meant a reduction of the workforce, which was met with political resistance. Seed investing carried risk due to the scarcity of experienced managers with the necessary skillset, the problem of limited access to credit, and overall market volatility. Inflation was high, and a large portion of the capital flowing into the region was short term and speculative. In addition, the lack of credit experience and appropriate credit rating processes led to arbitrary lending by the banks and a distortion of the financial markets. Many banks ended up with massive portfolios of nonperforming loans, and often the governments’ only alternative was privatizing banks by selling the entities to foreign strategic buyers. The environment was not suited for the development of private equity.

In contrast, the late 1990s were marked by GDP growth and declining inflation and provided a healthy breeding ground for private equity. The privatization of banks led to a reasonable credit environment. More than 100 private equity funds were established. A lot of early-stage expansion capital was flowing into the region financing the liberalization of the telecom industry and new technologies. The drawback was that these businesses were highly capital intensive, and many of the new concepts, technologies, and business models were untested. On the positive side, local management talent was increasingly becoming available.

The shock of the 1998 Russian crisis slowed the GDP growth and initiated significant restructuring. The following years were marked by the global technology boom, which did not leave Eastern Europe unaffected. Valuations and stock market prices were elevated to unsustainable levels. The burst of the bubble led to a slowdown in private equity investing until valuations had returned to realistic levels. A wave of industry consolidation set in, for example, in cable TV and alternative telecom operators.

Since the mid-2000s the focus of private equity investing has moved to later-stage expansion capital transactions for mid-sized businesses and buy-and-build strategies. Unlike in other emerging markets, including Russia and CIS, where the deal flow continues to be dominated by growth capital investing, the private equity opportunity in CEE today has developed beyond the typical emerging market stage and is dominated by small- and middle-market buyout transactions. Investment targets are profitable, growing businesses, which are managed by their founders or local managers who have acquired the necessary skills and experience. Leverage and mezzanine capital are available, which further spurs buyout activity. At the same time, the pool of local management talent is continuously growing and is reducing the dependency on expatriate managers, as local management develops the neces-

sary skills and experience, and the region attracts Western-trained managers from Eastern Europe to return to their home countries after working abroad.

Today, the spectrum of investment opportunities and value-creation strategies in the region is wide. Private equity opportunities include:

- Small- and mid-market buyouts, typically conservatively leveraged
- Buy-and-build investments where companies have outgrown their founding entrepreneurs, with the objective of consolidating fragmented industries and creating national and ultimately regional market leaders
- Spin-offs by larger international and local corporations resulting from the rationalization of operations and industrial portfolios (i.e., disposal of noncore assets)
- Growth and expansion financing
- Public to private transactions of companies with little free float, with the objective of consolidating shareholder base and enhancing company focus
- Privatizations/divestments of noncore activities by state-owned firms
- Early-stage investing

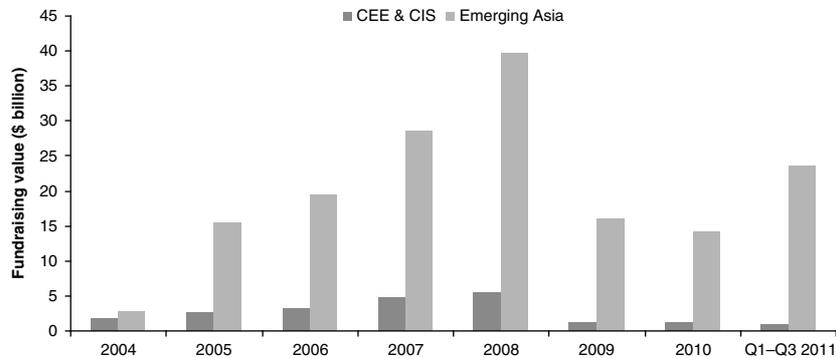
CEE is not generally considered to be an important venture market, and there are only few and relatively small venture funds operating in the region.

#### Capital Supply and Demand, Entry Valuations, and Leverage

Central and Eastern Europe is a region of growth and development with significant demand for private as well as public capital, driven both by the production of goods and services for export as well as the growing local middle class and its demand for goods and services. Yet by most measures the region remains severely underserved with equity capital. In Russia, capital is even scarcer than in CEE, and with the global financial crisis the scarcity of capital in the region has further deepened. According to the EVCA, private equity investments as a percentage of 2010 GDP was 0.314 percent in Europe, but only 0.119 percent in CEE and as low as 0.085 percent in Ukraine, and 0.019 percent in Slovakia.

In the fundraising peak year 2008, just over \$5 billion were raised by private equity funds in CEE and CIS combined. This compares to \$40 billion raised for China and India in the same year, followed by an impressive \$16 billion in 2009, \$14 billion in 2010, and \$24 billion in the first ten months of 2011. In CEE and CIS combined, the annual fundraising volume has remained below the \$1.5 billion mark since 2009 (see figure 11.7).

In stark contrast to the private equity markets of Western Europe, the United States, and emerging Asia, all of which have a marked capital overhang, demand for equity capital in Eastern Europe continues to outpace supply. The CEE private equity market therefore generally benefits from lower deal competition. The relative inefficiency of the private equity market has a favorable effect on entry valuations and transaction terms and conditions. Entry valuations for private equity transactions in CEE and CIS have generally been lower than in the developed markets of



**Figure 11.7** Fundraising volume (in \$ billion) in CEE and CIS in comparison with fundraising in emerging Asia between 2004 and 2011 (through third quarter).

Source: EMPEA Fundraising & Investment Review 2011; Alpha Associates.

Western Europe, the United States, the emerging markets of Asia, and more recently Latin America and, in particular, Brazil, which have all attracted large volumes of private equity capital in the recent years.

While the local buyout funds operating at the large end of the middle market face a certain amount of competition from pan-European funds, the lower end of the middle market and the small end are dominated by local players and continue to be practically void of international competition. This is reflected in the lower entry valuations for private equity transactions in companies with an enterprise value of less than EUR 70 million compared to larger transactions, which were on average  $6.7\times$  EBITDA in the portfolio of ALPHA CEE II L.P., Alpha Associates' second CEE private equity fund, launched in 2006.

While leverage and mezzanine capital have been available, the leverage levels deployed by private equity fund managers in transactions in CEE have always remained significantly below the aggressive leverage levels seen in Western markets before the crisis, which has kept the risk of the transactions relatively lower. In ALPHA CEE II L.P., the aggregate debt levels in the portfolio companies were only at a conservative  $3.5\times$  EBITDA on average in 2007, and have decreased to  $1.2\times$  EBITDA in 2010. In Russia, private equity transactions are virtually fully unlevered.

#### Universe of Fund Managers

With more than 100 private equity fund managers active in the CEE and CIS region, the region offers a relatively large universe of fund managers to select from. It is a far smaller number of managers than the number of managers operating in China or India; however, importantly, many CEE fund managers are today raising their third, fourth, fifth, or even later generation fund and can show realized track records. Alpha Associates considers approximately 40 fund managers in the region

as “institutional quality fund managers.” They have strong track records and skilled and experienced local teams, which have learnt valuable lessons, have successfully managed private equity portfolios through different market cycles, and can attract an international institutional investor base.

Since the early 1990s, when the private equity industry started to develop in the region and many private equity funds were set up, the private equity market has gone through a wave of consolidation: the managers raising funds today are those that have done well while underperformers have disappeared from the market. Therefore, today’s fund manager universe carries a “survivorship bias.” Investors can choose proven teams for investment. There is no need to back first-time fund managers or managers with unrealized track records and pay for their learning curves, as is often the case in emerging markets.

The universe of fund managers operating in CEE is separate from the fund managers operating in Russia and CIS. CEE funds do not include Russia in their geographic focus, nor do Russia-focused funds target CEE countries. The larger, established, and most successful CEE fund managers typically target multiple countries out of multiple offices in the region. Some managers focus on subregions, such as the Baltic region, the Central European countries, or Southeastern Europe. With the exception of Russian funds, country-focused funds are typically small. Russian private equity funds typically focus on investment in Russia, with small allocations to neighboring countries, typically Ukraine, Kazakhstan, Belarus, and Moldova.

Fund managers operating successfully in CEE and Russia/CIS are the local managers. No Western European fund manager has a significant track record in private equity investing in the region. As opposed to Asia, large Western private equity firms have not been successful in establishing franchises in the region, as the incumbent fund managers were already well established and could demonstrate strong success by the time some of the pan-European firms were looking to establish local teams and raise funds focused on the region.

The largest CEE-focused fund raised to date has total capital commitments of EUR 1.5 billion, and the largest Russia-focused fund to date has raised \$1.1 billion. Most fund sizes range from \$100 million to \$500 million.

#### Exit Routes

Trade sales both to regional as well as global strategic buyers continue to represent the most important exit route for private equity investments in both the CEE and CIS regions. The experience of privatizations and the strong inflow of foreign direct investment, coupled with the absence of a long history of family ownership, which is often a major impediment to the sale of private businesses in Germany, France, and Italy, create a favorable environment for asset transfers in the region.

At the same time, IPOs offer a viable exit route for larger companies as the local stock markets have attained critical mass and sophistication. With a total market capitalization of EUR 103.4 billion at the end of 2011, having grown from EUR 33.7 billion in 2000, the Warsaw Stock Exchange (WSE) is the largest stock exchange in the CEE region, followed by Vienna, Prague, and Budapest. With 61 out of 121

IPOs in Europe in Q3 2011, WSE was the no. 1 market in Europe in terms of the number of IPOs, and the no. 2 market in terms of the value of the IPOs.

Pension fund reform in Poland was modeled after Chile, which successfully fueled its domestic capital market. Polish pension funds can invest only 5 percent of their net asset value outside Poland, which creates pressure to find investment opportunities in the domestic market. The Polish pension funds are growing rapidly as positive net inflows continue as a result of demographics and the growing middle class. The assets held in the Polish pension funds amounted to PLN 221 billion (EUR 56 billion) in 2010, up from PLN 86 billion in 2005 and PLN 179 billion in 2009.

In Russia, the formation of the RTS-MICEX group, Russia's largest stock market, was successfully completed by a merger of the two exchanges RTS and MICEX in December 2011. The market capitalization of the 255 companies listed on MICEX, the larger of the two, amounted to \$770 billion in December 2011. This figure will almost double through the merger with RTS. As in CEE, trade sales have been the dominant exit route for private equity investments in Russia. However, the larger companies in the portfolios of the Russian funds have increasingly sought liquidity via the IPO route over the past years, often through a dual listing in Moscow and on the NYSE.

#### Investor Sentiment

Although CEE and CIS private equity has attracted a large group of sophisticated investors from the United States, Western Europe, the Middle East, and Asia over the past years, international investor sentiment towards CEE, despite its strong historical returns, has generally been and continues to be rather lukewarm compared to other private equity markets. This is even more so with respect to Russia, where investor sentiment is very negative, despite exceptionally strong returns. In fact, the sentiment of institutional private equity investors towards Russia has consistently been the most negative of all emerging markets for many years. Russia ranks almost without exception firmly last in any investor sentiment survey conducted by the Emerging Market Private Equity Association (EMPEA). The most recent surveys saw China come out on top in 2010, closely followed by India, while Brazil led the ranks in 2011 ahead of China. Many investors shy away from Russia without taking a critical look at the fundamentals of the private equity opportunity in the country. News about the confiscation of assets or the expulsion of Western business people has been prominent. Interestingly, many investors are deterred by the political and legal risk in Russia, while seemingly undeterred by the manifold risks attached to private equity investing in other emerging markets. It appears that only Russia is passionately blamed for a lack of democracy and the rule of law, while other emerging markets escape such scrutiny.

To date, European investors have represented the largest group of institutional investors in the CEE and CIS private equity market, followed by US investors. The full spectrum of investor types is represented in the region: according to the EBRD, corporations represented 8 percent of all investors between 1992 and 2009, pension funds 12 percent, funds-of-funds 16 percent, banks and insurance companies

18 percent, development finance institutions and government agencies 31 percent, and other investors 8 percent. Only very few local institutional investors in CEE and CIS can or do invest in the asset class. For the pension funds in most countries, restrictive regulation, not willingness, is the major hurdle.

#### How to Build Investment Exposure to CEE and CIS Effectively

Institutional investors with broadly diversified investment portfolios often question whether it is the private equity or the public market route they should choose in order to build investment exposure to the CEE region. The public markets of Eastern Europe are still relatively underdeveloped. Market capitalization and trading volumes are low, and sector mix is very limited. In CEE, the local public markets are dominated by banks, the incumbent telecom operators, and heavy industries. For example, these industries accounted for 66 percent of the market capitalization and more than 70 percent of the trading volume of the Polish stock exchange in 2010, and for 75 percent of the market capitalization and 93 percent of the trading volume of the Czech stock exchange in 2011. Private equity, on the other hand, offers access to the full spectrum of growth sectors in the region, including consumer products and services, business services, communication, IT and software, and health care. These opportunities cannot be accessed effectively or at all through the public markets.

Institutional investors further often question whether they should invest in local funds in the CEE region in order to access the CEE private equity opportunity or if CEE exposure should be built through investing in pan-European private equity funds or pan-European funds-of-funds. But the fact is that the private equity market of CEE is set apart from Western Europe by a discrete set of investment opportunities that require distinct know-how and skills. As a result, there is a separate set of fund managers operating in the region with superior access to and experience in capitalizing on opportunities in the region. Pan-European buyout funds typically pursue large leveraged buyout transactions and do compete for such transactions in the region with the local fund managers. However, transactions of a size large enough to appear on the radar screen of such funds are rare in CEE, and when they do appear local fund managers typically have an advantage to access and execute them given their local expertise and resources. Pan-European funds-of-funds typically have only very small or only “opportunistic” allocations to the region. Therefore only a specific allocation to the region will allow investors to capitalize on the private equity opportunity in CEE.

#### Conclusions

The CEE private equity opportunity combines emerging market characteristics and developed market characteristics in a very particular way, resulting in a unique risk/return profile. I expect private equity in CEE to continue to deliver attractive returns to investors. Local expertise, know-how, and experience in investing in private equity in the region have been and remain key to effective fund manager and investment selection in CEE.

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CHAPTER 12  
PRIVATE EQUITY, RISK, AND  
REWARD IN AFRICA

*Carolyn Campbell*

Africa is experiencing a renaissance after years of false starts and bad press. Private equity, risk capital that only flows in when the landscape appears sufficiently safe and fecund, has risen to \$1.5 billion since 2000 from a very low base. Across the continent, home to six of the world's ten fastest-growing economies, many countries have seen positive growth rates and economic improvement, surprisingly outside of the oil-producing countries. The economic revival has accompanied a seismic political shift, with the majority of the African countries holding multi-party elections for the first time since the independence movements of the 1960s. Meanwhile, education and enhancements in human capital have swept the continent, with a rapid expansion in schooling since the 1970s. The vast majority of Africans now attend school, adult literacy rates have soared, and modern economic management techniques are permeating business. Freedoms such as civic and media openness are unprecedented and have moved Africa squarely onto the global economic map.

This perfect economic storm is driving greater opportunities for investment. Several features make this moment for private equity expansion in Africa unique. First, being last may just mean being lucky. Africa is a virgin continent (by Asian and Eastern European standards), with 60 percent of the world's remaining arable land. Yet, starting from a fresh economic plane as opposed to undergoing deep transformation from some entrenched system, these countries are far less burdened by legacies of old technology or pollution. Moreover, Africa benefits from a significant leapfrog effect. Typical of newly democratic regimes, these countries are embracing rather than suppressing new technological advances, such as information technology, data switches, and 4G, which enhance market efficiency and further bolster economic growth. Africa is also a frontrunner on environmental, social, and governance matters having deep experience historically working with multilateral financial institutions. Finally, the continent is experiencing a generational shift, as a relatively young and increasingly educated workforce emerges.

### **Back to the Future: African Investment Space in Context**

The continent has made sweeping changes in a relatively short period of time. At its origins, Africa was essentially tribal in context, without great political shapes along the lines we see today. The continent was colonized by the English (Egypt, Sudan, Kenya, Ghana, Nigeria, South Africa, etc.), the French (French West and Equatorial Africa—Ivory Coast, Senegal, Algeria, Benin, Mali, Burkina Faso, Madagascar, etc.), the Portuguese (Angola, Mozambique), the Germans (Cameroon, Togo, and Tanzania), Belgians (DRC), and the Italians (Libya, Somalia, and Eritrea although no one ever really colonized the Horn). A deep undertow of distrust developed as a result of the brutal tactics used by the colonizers to subjugate these populations. Then came waves of independence starting in the 1950s and reaching the Portuguese colonies last. Some countries had immediate success, while others had periods of civil conflict (Nigeria, Kenya) and even war (Angola, Liberia, and Sierra Leone).

Early on during the period of independence, several countries experimented with socialism. Mostly as a result of guilt over former colonial transgressions—Leopold’s Ghost, the Herero, and the Namaqua genocide; the Zulu and the Boer War; and the like—the continent received a disproportionate amount of global aid, more than \$300 billion since 1970. State-owned control combined with massive amounts of donor aid created a colossal window for corruption and economic waste as those in power squandered government-controlled financial means. Aid on such a grand scale for the most part did not achieve its objectives as abandoned railroads and airports proliferated, and entire economies ended up in ruins.

Since 2000, the continent has enjoyed a period of relative political stability, as seen in successful democratic elections in Nigeria, Kenya, Ghana, Angola, South Africa, Botswana, Mali, and most recently Tunisia and Ivory Coast; indeed Ivory Coast lived through a civil war and the Battle of Abidjan in mid-2010 only to return immediately to a high-growth trajectory. Accordingly, the continent has seen a rise in private sector investment, in particular, private equity, portfolio, and lending. Africa has become competitive compared with the other fastest-growing regions of the world to the degree that removing Africa would significantly distort global analyses. Leaving aside financing from large Chinese state banks, where private equity investment has been increasing steadily, growth in banking has been uneven but is now starting to gain traction among both domestic groups and global banks.

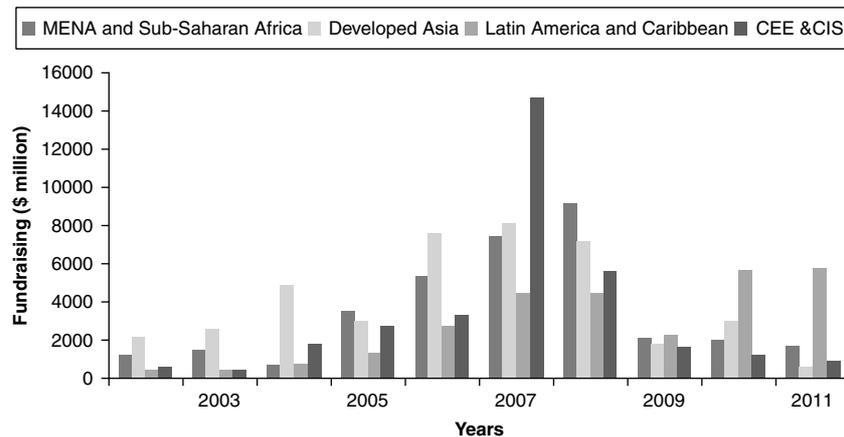
### **Private Equity Drivers**

Private equity and hedge funds began turning to Africa—the world’s last untapped economic frontier—in 2000. Private equity funds—Emerging Capital Partners, for instance, a pioneer and one of the largest private equity fund managers on the continent—directed hundreds of millions of dollars (over \$1.8 billion) into the private sector as macroeconomic and political fundamentals stabilized across the board. The result has been returns competitive with the other fastest-growing regions of the world, aiming for money multiples of three times and rates of returns on the order of 25–30 percent. During the global financial crisis of 2008–10, hedge funds were forced to retrench; however, even this source of private sector funding is making a

return. This period of economic revival is marked by distinctly African investment trends: old African investment was ports, power, and railroads; new African private equity is consumer growth industries, telecom and media, health care, technology, agribusiness, energy and facilitation industries (logistics, building supplies), and real estate, reflecting a growing middle class, plus unique rural opportunities (shea butter, jatropha, local refining to deal with lack of road network). While Asia still attracts the lion's share of investment, Africa has continued to move up as a geographic area of interest, pulling ahead of Central and Eastern Europe, Russia, and the Middle East (see figure 12.1).

Fundamentals have improved across the map in Africa. Inflation, public debt as a proportion of GDP, and public deficits are stable and under control in most countries. Trade between Africa and the rest of the world has increased by 200 percent since 2000. Meanwhile, since 2000, FDI has risen fivefold to \$55 billion, consistently exceeding total aid by a large margin. Regional trade is also picking up, increasing from 6 percent to 13 percent of total trade. Bolstering these trends, the continent has seen widespread privatization and regulatory reforms. As in Asia, relatively small increases in capital are capable of producing large productivity gains, and productivity in many sectors is improving. Reinforcing the burgeoning private sector, on the World Bank's annual ranking of commercial practices, 30 out of 46 African governments made things easier for business in the past year.

The middle class—the consumer class—is growing, and with it consumer spending. An estimated 60 million Africans have an income of \$3,000 per year, set to rise to 100 million, increasing the proportion of working-age people to dependents. Productivity is higher in cities where transport costs are lower, and 40 percent of Africans are now living in cities up from 30 percent pre-2000. Along with income



**Figure 12.1** Historical private equity fundraising across high-growth emerging markets (\$ million).

Source: EMPEA (September 30, 2011).

levels, consumer spending in sub-Saharan Africa has risen by 4 percent annually, reaching nearly \$600 billion in 2010 and projected to reach \$1 trillion by 2020. The biggest consumers (ex-SA) are to be found in Nigeria, Ethiopia, Kenya, Uganda, Ghana, Tanzania, Ivory Coast, and Senegal. Accordingly, the services sector (plus agribusiness) in Nigeria now equals the oil output. While mineral resources seem poised to remain an important sector, the most significant contributors to growth are changing, with less reliance on exports and more on domestic demand (consumer spending and imports).

### **Land of Opportunity: Distinctly African Investment Trends**

These broad trends aside, the African private equity opportunity is unique in time and space, allowing many African countries to play leapfrog in key sectors. While each sector entails challenges, they are identifiable and common to their emerging market counterparts elsewhere:

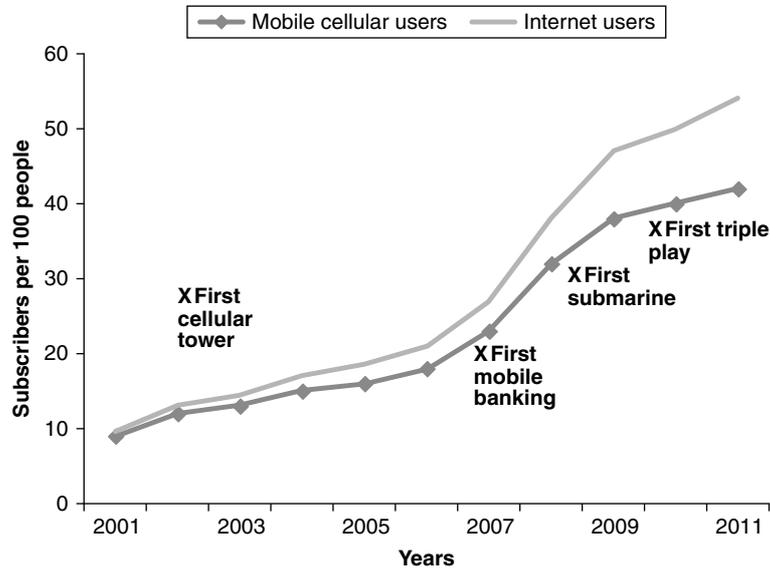
- *Technological leapfrog.* As a result of the high capital costs, Africa did not spend billions of dollars on fixed-line infrastructure like North America and Europe did. In 2000, the continent had roughly 2 percent telecom penetration, so catch-up via fixed line was not a realistic option. Internet penetration was negligible. How did telecom penetration reach 60 percent only a decade later? Technological leapfrog: GSM and CDMA penetrated the region at breathtaking speed, indeed among the highest growth rates in the world. The same is true for Internet, where penetration flared up from virtually zero to 11.5 percent during the period. In many countries, this growth occurred against a backdrop of political hiccups that did not impede it in the least. What counted was the history and functioning of the regulators, which proved to be independent by any emerging market standard. Technological leapfrog in turn bolsters consumer spending by improving access to consumers via mobile technologies, itself a growth industry across Africa.
- *Technological risk.* Capital needs of next-generation technologies, such as broadband cable or cellular tower expansion, need to be met, in particular, by large amounts of debt financing for capital expenditure and so the banking sector growth needs to keep pace.
- *Energy leapfrog.* The continent faces an excess demand for energy to power ongoing growth. Kenya, Ghana, Nigeria, Tanzania, Uganda, Cameroon, Morocco, and South Africa are taking measures to transform the sector by decoupling generation from distribution, privatizing, increasing the number of concessions granted, and rationalizing tariffs. While traditional sources of energy such as hydro remain strongly favored, private investment is focused on other sources (for instance, in gas-abundant Nigeria, gas-fired solutions), and renewables are a major focus in terms of legislation and funding. South Africa, Zambia, Botswana, and Namibia in the south and Kenya, Senegal, Morocco, and Mozambique stand out as frontrunners in paving the way for renewables such as wind, solar, and biofuels.

- *Energy risk.* With strict pressures on public budgets and low (albeit rising) levels of income, contractors need to assess the counterparts on power-purchase agreements and also whether tariff promises are realistic.
- *Agricultural leapfrog.* Africa has vast amounts of arable, uncultivated land: 60 percent of the world's total. Numerous buyers from less fertile parts of the world are knocking at the doors of African governments for land purchases and agricultural concessions. The world's next breadbasket could easily sell out, but fortunately this is occurring in an era of strong ecological pressures, yielding innovative proposals for intercrop farming of edible crops and bio-fuels. Formerly barren land is coming under concession for jatropha, soy, sunflowers, and, yes, ethanol. Gaining political acceptability in the past five years, the biofuels' moniker "food for fuel" has achieved rebranding as "fuel for food," reflecting acceptance of the last frontier's role in a combined agroenergy solution.
- *Agricultural risk.* On both the food and biofuels sides, refining and distribution require a road, rail, or port network near to crops. The road network is lacking in nearly all of Africa outside of South Africa, so agricultural investments need to consider the burden of additional infrastructure development. In addition, with numerous countries and tariffs, commodities risk remains prevalent even on a local level.

These three trends exemplify the types of opportunities and risks investors must legitimately confront. Even within a given sector, one can distinguish lower risk deals, such as growth companies and listed stocks, from higher risk deals, such as start-ups and unlisted companies. Finally, most private equity deals are small-to-mid-cap in Africa, and African stock exchanges are larger cap; therefore a mismatch exists, and private equity firms must remain creative in structuring exits. In any event, the risk-reward profile of a private equity investment depends on where the deal falls within the sector.

### ICT Sector: A Meteoric Rise

Starting in 1999, telecom penetration began to grow from a low base of 2 percent to more than 60 percent as governments opened up the sector and issued mobile network licenses to mobile network operators (GSM and CDMA) across the continent (see figure 12.2). Fixed-line infrastructure was not an option to keep pace with demand as a result of the high costs of installation. Accordingly, in looking for solutions, African governments engaged in a classic show of leapfrog and began issuing mobile network licenses. License bids began to grow into hundreds of millions of dollars and reached above 1 billion dollars in some countries. Several local operators, such as MTN of South Africa, Celtel, and Orascom established operations that grew into multibillion dollar companies, and international operators, such as France Telecom, Vodafone, Etisalat, and Airtel, established significant positions in the market. With the consolidation of markets, the presence of smaller operators declined in comparison. As of the end of 2011, some estimated 660 million subscribers were on



**Figure 12.2** Telecom trend line between 2001 and 2011 in sub-Saharan Africa.

Source: World Databank.

the mobile network, surpassing the Latin American telecom market in 2011 by over 5 million subscribers, and set to widen the gap even more in coming years.

While initially the larger operators were looking for private equity capital, their needs declined over time with their increased access to public markets and global debt providers, leaving opportunities for private equity to invest in the smaller operators or specific country operations. Meanwhile, new opportunities began to arise in data and backbone infrastructure, including wireless and fixed “last mile” solutions, submarine cables and terrestrial fiber, and various ICT services such as mobile banking and carrier services as well as cable television (Internet convergence). The growth in demand for ICT services has in turn been fueled by a steady increase in disposable income, based on favorable demographic trends such as increasing urbanization, a relatively young population, and a growing middle class, with 128 million households predicted to have disposable income by 2020, and 50 percent of all Africans predicted to be living in cities by 2030.

While telecom overcame its coverage constraint through the build-out of mobile network licenses, Internet provision has been constrained through the lack of connectivity with the rest of the world. Africa solved its connectivity issue with the rest of world with the landing of several submarine fiber optic cables: three in the east (TEAMS, Seacom, Easy) with an additional one, LION 2, under development, and three in the west (Main One, Glo, Sat 3) with an additional one, WACCS, due to go live in the second quarter of 2012. Once landed, the challenge becomes building the terrestrial capacity in order to deploy Internet cable, by laying fiber on the ground or

using satellite connectivity. Around the continent, companies have been doing that increasingly since 2010, following the cable landings.

The kinds of companies playing to this market do not have easy access to public markets or global debt providers and are good opportunities for private equity. Given the evolution to date, it is easy to imagine the African market trending the same path as most developed markets previously did: once the infrastructure is in place, people subscribe to high-speed Internet and mobile telephony in the home and want instant access out-of-doors, so when at home, they want big bandwidth and streaming television, and when outside they want 3G/4G mobile telephony. The TV market has thus strengthened against earlier expectations that it would dwindle. Indeed, Nigeria's movie industry, which reached \$800 million in revenues (surpassing Bollywood and second to only Hollywood on a per capita basis), has 300,000 employees and is one of the largest employers in Africa.

### **An Enlightened Africa Risk Assessment**

*Africa risk* is a well-accepted concept, but what does it really mean? Africa like any other emerging market has a certain amount of systemic risk, yet the African space is often set in a risk category of its own. Looking at emerging markets over the past 20 years, and in light of the positive sustained change that has occurred in most countries, the separate "Africa" distinction is passé, and the continent should be discussed in the same paradigms as other emerging markets. In private equity, risk is basically defined as the chance or probability that an investment will lose value and reward is the probability that it will return a multiple of the original investment over a period. Add to this the fledgling nature of certain features of emerging markets (recent opening up of the economy, political shifts, growth from a low economic base) and you have emerging market private equity risk. Which of these features is most salient in Africa? Let's correct some basic misperceptions.

First let us take regional risk. Africa is a continent with 54 countries and vast amounts of land, and risks across countries and sectors are far from homogenous. Regional integration while improving remains relatively weak in terms of monetary and commercial unions seen in other regions such as Latin America, Europe, and Asia. Given the lack of regional integration, domino-type crises such as the Asian financial crisis of 1997 (sparked by the Thai baht crisis) or the Argentinean debt crisis of 2001 that spread across Latin America are less likely in Africa. African regional risk is low when judged by the standards of other emerging markets. Meanwhile, in terms of political risk, the political stability of Africa's frontrunners is on a par with the BRIC grouping, and greater than that of the fastest-growing East Asian countries.

Then take rule of law and corruption—are risks related to these features more probable in Africa? In terms of rule of law, the continent that has risen out of its colonialist past benefits from a long history of well-developed legal systems based on English and French law. Regulatory risk in many parts of Africa is on a par with other emerging markets as many countries have now gained over a decade of experience

with the regulation of private sector ownership in the telecom, banking, and energy sectors. A positive trend has been set with an expansion of the development of national codes that adopt good governance principles based on the Organization for Economic Cooperation and Development (OECD), Commonwealth Association for Corporate Governance, and the South African King Report guidelines. Countries that already have national codes in corporate governance include Ghana, Kenya, Malawi, Mauritius, Nigeria, South Africa, Tanzania, Uganda, and Zambia. Moreover, these national codes reveal a bias for an “inclusive” approach that is consistent with the African value system of commitment to coexistence, consensus, and consultation.

Finally, corruption perceptions are skewed. Having received more donor aid than any other region, Africa is highly experienced with advanced transparency and ESG (environmental, social and governance) systems. Many indices place Africa, or African countries, ahead of other emerging markets. Global reports on corruption have placed Africa ahead of Russia. Moreover, the indices themselves tend to be flawed. First, the most oft-cited one is Transparency International (TI), which measures perception as opposed to actual corruption. Second, while many indices regularly place African countries (in particular rogue African states such as Somalia) low on the list, they are in good company alongside Venezuela, Russia, Bolivia, Thailand, and other prominent emerging markets. Meanwhile, on the most recent TI index for 2011, more than 15 African countries ranked ahead of India, more than 35 countries ranked higher than Russia, and 12 countries, including South Africa, Ghana, Rwanda, Botswana, and Namibia, ranked ahead of Brazil and China. Not surprisingly, investors actually investing in Africa now place technical concerns above macroeconomic ones and on a par with political risk, at least in key markets; for them illiquid markets and weak legal and governmental institutions are larger concerns than political concerns. Political risk and corruption remain highest only for those that have *never* invested in Africa.

So, the risks particular to Africa are not broad political or macroeconomic ones. The risks are more nuanced and vary from country to country, just as they would in any emerging market economy. Indeed, these economies are growing at rates much higher than the developed world; they hold vast reserves of natural resources and young, motivated, urban populations. On the contrary, some of the real risks that investors should focus on are the following:

- *Availability of local capital.* On one hand, lack of capital renders the space less competitive (positive for investors), on the other it leaves investments stranded (negative). On the investment banking side, global shops are moving in, like Barclays Capital, BNP Paribas, Calyon Bank, Citigroup, Deutsche Bank AG, JPMorgan, Nomura, Credit Suisse, and UBS, and local investment houses are emerging (Afrinvest, Chapel Hill, Vetiva, Dyer & Blair, Ecobank), driving local currency market transactions.
- *Financial reporting/IT.* Fledgling systems make it hard to ensure consistent reports to global shareholders.
- *Foreign exchange.* Deal with through diversification and export-orientated businesses as hedging is costly.

- *Shortage of managerial talent.* Schooling gains need to be consolidated and more training provided, although the African diaspora is filling the gap and returning.

### Conclusion

This will be Africa's century one way or the other—the world needs its resources and markets, and modern Africa is largely positioned to flourish. Africa possesses vast, untapped land and other human and natural resources while benefitting from the technological, scientific, and economic gains made in previous decades in other parts of the world, setting the continent on an enviable course of leapfrog and catch up. As current trends continue, Africa will attract an increasing share of the world's investment resources and set in motion a positive, reinforcing cycle of investment, solid returns, more growth, and more investment. Moving in faster and in greater abundance than public sources, private equity bolstered by other forms of private capital will be pivotal, as both driver and beneficiary.

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## CHAPTER 13

# PRIVATE EQUITY IN LATIN AMERICA

*Cate Ambrose*

### **Introduction**

In many of Latin America's major economies, the historical legacy of leftist governments has given way to a new model of political leadership, bridging a commitment to social development with sound macroeconomic policies and market-driven growth. Over the last decade, political leaders in Brazil, Mexico, Chile, Colombia, and Peru have pursued free-trade agreements and courted foreign investment. Today, investors going into Latin America for the first time are positively impressed by the relative ease of doing business there as compared to other emerging markets, and by the level of institutional and legal certainty.<sup>1</sup>

A favorable policy environment coincides with positive macroeconomic trends in Latin America. As developed countries struggle with debt crises, Latin governments and financial systems are flush with cash from booming exports of natural resources. An expanding middle class has fueled demand for consumer goods and services, and businesses are making new capital expenditures to incorporate technologies, hire workers, and expand operations. Hedge funds and other public equity investors have driven up the region's stock indices over the last five years, with the exchanges in Brazil, Mexico, Peru, Colombia, and Chile posting triple-digit gains.<sup>2</sup>

Most recently, emerging market private equity (PE) investors have turned their attention to the region. A record \$10.3 billion was raised for Latin American private equity in 2011, exceeding the previous record of \$8.1 billion committed in 2010. The first generation of PE funds was raised and invested in Latin America in the mid- to late 1990s before a perfect storm of macroeconomic and market crises, including the Argentine default, the Brazilian devaluation, and the bursting of the Internet bubble in the United States, forced many PE managers to unwind portfolios and quit the region. Since a new cycle of fundraising initiated in 2006, capital committed to funds investing in Latin America has increased every year with the exception of 2009.

An annual survey of over 100 institutional investors conducted by the Latin American Private Equity & Venture Capital Association (LAVCA) provides insight

into an ongoing shift in perceptions about the region: in 2011, only 38 percent of survey respondents cited political risk as a negative factor, down from 50 percent in 2010. Widespread coverage of the region's strong macroeconomic performance, particularly in contrast to the ongoing crises in Europe and the United States, appears to have influenced investors as well: only 14 percent of 2011 LAVCA LP survey respondents cited economic risk as a negative factor in Latin America, and 54 percent described the macroeconomic environment as "positive" or "very positive."

At the same time that Latin America is experiencing record foreign investment flows, revenues generated from booming exports and domestic consumption have filled the coffers of public and private pension funds. These local institutional investors are seeking to diversify portfolios across asset classes and geographies, creating an additional pool of investment capital for PE, infrastructure, energy, real estate, and other projects.

There is no lack of opportunity to put those resources to work. Until recently, Latin American businesses have been starved for capital, with bank credit tight and access to public markets limited to only the largest firms. Today mid-sized companies across a wide range of sectors are poised to serve expanding global and domestic demand for goods and services. Real estate investors are seeking to address an undersupply in housing, commercial, office, and tourism space, and infrastructure funds have been raised to finance a wide range of projects, from energy to transport, water, and sanitation.

New PE/VC investments realized in 2011 totaled \$6.5 billion, according to proprietary data collected by LAVCA from over 170 firms active in Latin America. Of that total, about two-thirds, or \$4.2 billion, was invested in Brazil, where 90 out of a total of 173 Latin American deals were completed. Colombia and Mexico were represented with 9 percent and 13 percent of total deals, respectively, and 10 percent and 7 percent of total dollars invested.

Deals closed in 2011 reflected investment themes that have dominated in recent years, with a majority of dollars committed to transactions in energy, logistics and distribution, and sectors targeting consumer demand, especially for services. Investments in companies poised to capitalize on expanding consumer credit were popular targets, as well as in health care, and there were several large deals in regional fast food franchises. One noteworthy trend over the last three years has been an increase in technology investing, ranging from investments in large data centers and software developers to Internet start-ups and online gaming businesses—46 technology deals were reported to LAVCA in 2011. Other sectors represented include manufacturing and agribusiness.

Perhaps the most important development revealed by 2011 LAVCA data is the remarkable number of exits realized. A historic record of \$10.6 billion was raised through 37 divestments with financials disclosed, with another 16 exits reported without financial information. Latin American business and family groups and multinational firms seeking a foothold in the region were ready buyers of PE-backed assets. Exits in 2011 also included a total of seven initial public offerings on regional and global exchanges.

### Political Support for Private Equity

A fundamental distinction between developed world private equity and the investments that are steadily increasing in Latin America is the relative lack of leverage in Latin American deals. PE investors take a hands-on approach to managing portfolio companies by modernizing management practices, fixing corporate governance, and incorporating new technologies.

Today Latin American business owners seek out PE investors with regional or global scale that can help them access new markets, while others look for investors with industry-focused strategies, who bring sector-specific expertise and networks.

In this context, the region's policy makers view private capital flows from global firms as a form of foreign direct investment and a vehicle for making their economies more competitive. And local PE funds are often raised with commitments from high-net-worth sources and then invested in firms with high growth potential, efficiently reallocating capital within the economy.

As a result, political leaders have recognized PE and venture capital (VC) as a means to create, finance, and professionalize businesses, and have launched campaigns to cultivate domestic fund industries through regulatory and tax initiatives and publicly funded programs.

They have also expended personal political capital. In December 2011, while in the United States Mitt Romney's opponents in the presidential campaign maligned him as a job destroyer for his role at Bain Capital, Brazilian president, Dilma Rousseff, hosted a ceremony to award the FINEP national prize for innovation and personally handed awards to PE and VC managers, with a video of the event available on the presidential website.

That same month Brazilian finance minister, Guido Mantega, presented a package of tax reforms designed to encourage long-term investment in the country, which featured the elimination of a tax on foreign exchange transactions (IOF) for overseas PE commitments.

### Getting Regulation Right

Brazil has been developing a specific regulatory framework for PE and VC (PE/VC) since 1994 when the CVM, Brazil's securities regulator, ushered in rules to create a fund vehicle for investing in smaller companies and start-ups, the FIEE. That vehicle, along with the popular FIP structure, which was created in 2003, is exempt from income and capital gains tax.

In addition to tax-efficient fund laws, over the last decade, Brazil has approved laws to simplify bankruptcy filings, protect minority shareholders, and to strengthen corporate governance standards and accounting principles for publicly traded firms.

These efforts and others have secured Brazil a top position in an annual ranking published by LAVCA, the *Scorecard on the PE/VC Environment in Latin America*. The publication, which was first published in 2006, was created in collaboration with the Inter-American Development Bank and the Andean Development Bank to measure the regulatory and investment environment specific to PE/VC, and ranks

12 countries on indicators including laws governing fund formation, tax treatment, minority shareholder rights, corporate governance, and restrictions on local institutional investors.

Over a five-year period the LAVCA Scorecard has tracked improvements in major markets including Colombia, Mexico, and Brazil. Chile has ranked first consistently, due to the country's strong scores on three indicators that most of the region scores poorly on: the strength of its judicial system, protection of intellectual property rights, and perceived corruption. Brazil has maintained a strong second position, with Mexico, Colombia, and Uruguay rounding out the top five rankings.

In contrast, it is worth noting that Brazil ranks at the bottom of the World Bank's Doing Business measures, as a reflection of the overall complexity of business and tax regulation in the country. The process of structuring and winning approval for new funds in Chile, Peru, and Colombia can be slow, and across the region, local and international funds are often incorporated offshore.

Nonetheless, the Scorecard has provided an effective platform for the region's fund managers to encourage ongoing improvements to legal frameworks specific to PE/VC as these industries mature. Typically, the problem of designing regulation that will work in practice has been resolved through what is in effect a trial and error process, with fund managers educating local regulators on the asset class.

Nowhere has this been more evident than in regulation allowing local pension funds to invest in PE, which has proven to be one of the most effective means to spur fund formation in developed and developing economies. In Brazil, Mexico, Colombia, Peru, and Chile, pension funds and insurance companies are investors in PE funds, but their exposure to the asset class, and limited partner-general partner (LP-GP) relations overall, are sometimes compromised by efforts to protect investors from downside risk.

### **The Role of Local Institutional Capital**

Today, assets under management at private and public pension funds in Brazil, Mexico, Chile, Peru, and Colombia total \$785 billion, and by one estimate medium-term potential investments in PE could total \$20–\$25 billion. Increasingly, local pension funds are playing a critical role in the development of the PE industry in Latin America.

In Brazil, the largest of the country's voluntary private pension funds, Previ, Petros and Funcef, have been investors in local PE and infrastructure funds since the late 1990s. Their commitments to the first generation of fund managers meant that Brazilian GPs were able to raise, invest, and exit multiple funds, and today the country has a significantly deeper pool of experienced managers than other regional markets.

However, the LP-GP relationship in Brazil has been compromised by the fact that pension funds sit on investment committees. This practice originated when the first commitments were made, and a concession was made on behalf of GPs in order to increase transparency and build investor trust in the asset class. The idea was that over time, pension funds would evolve into their role as LPs, but instead the practice

has become entrenched. Most recently, it has become a deterrent for international institutional investors looking to allocate capital to funds managed by Brazilian managers with local pension fund commitments.

Protecting institutional investors was a priority for Mexican regulators in 2009 when they approved rules allowing the country's private pension funds, or Afores, to invest in PE, infrastructure, and real estate funds for the first time. Given the size of the economy, the Mexican PE market is relatively underdeveloped, and there was a strong political commitment to spur private investment and allow Afores to diversify out of fixed income.

But Afores are still restricted to investing only in publicly listed securities, so regulators created a special vehicle that is traded on the Mexican exchange, Development Capital Certificates (CKDs).

There is some legitimate concern over the complexity of the CKD vehicle, as fund managers are obligated to use separate structures for local and international investors and to satisfy complex reporting and disclosure requirements. However, Mexican regulators have continued to streamline the CKD structure since it went into effect, and there is hope that in the future they will no longer need to be publicly listed.

Whatever the challenges, approximately 20 CKD vehicles have been issued to date, and the opportunity to tap the large and growing reserves of Afores has clearly had a detonator effect on fund formation in the Mexican market. Since the regulation was passed in 2009, the initial trickle of international PE firms looking at raising and investing funds in Mexico has evolved into a steady stream.

While Brazilian and Mexican pension funds are only investing in PE domestically, in Chile, Colombia, and Peru local pension funds, or AFPs, have been active LPs in global private equity, in addition to backing local managers in their respective markets.

Like in the case of Brazil, the availability of institutional capital has spurred the creation of domestic funds, particularly in the case of Colombia, where the country's six AFPs have backed a dozen or more local PE, infrastructure, and real estate funds over the last five years.

At the same time, the influx of global asset managers seeking to raise money from the AFPs has affected the broader investment ecosystem in these markets in important ways. It has attracted new industry players to the region, including funds of funds, placement agents, and specialized service providers such as lawyers and custodians. Pension funds have undertaken a dramatic learning curve and are LPs in several of the world's largest PE firms, contributing to the overall sophistication of the local investor base.

Finally, many GPs that have come to Latin America in order to raise capital have recognized the region as an attractive and relatively underdeveloped market for investments. As a result, there has been a sizable increase in the number of international firms coinvesting with local firms, opening local offices, or pursuing other strategies to access investment opportunities in the region.

However, in Chile and Peru, in particular, foreign PE firms face regulatory hurdles: securing commitments in Chile requires setting up a local feeder fund structure, and in Peru firms must win approval of the banking superintendent. These barriers

were put in place in order to protect workers' savings managed by pension funds, but in practice they add complexity and cost without shielding investors from risk.

### **Building an Ecosystem with Public Funds**

Governments in Brazil, Chile, Colombia, and Mexico have also aimed to cultivate new fund formation and investment by sponsoring funds of funds that invest alongside local institutional investors. This has been complemented by a range of targeted programs to educate local LPs and GPs and develop the entrepreneurial ecosystem.

The most established of these programs is INOVAR, hosted by FINEP, a government-owned agency under the Brazilian Ministry of Science and Technology. Since its creation in 2000, the program has committed nearly \$2.8 billion in capital to 32 funds and 80 companies, in addition to launching venture, seed, and IPO forums. Brazilian state development bank (BNDES) also sponsors programs that invest in funds and entrepreneurs.

The Multilateral Investment Fund (FOMIN), a trust fund of the Inter-American Development Bank, designed the INOVAR program alongside FINEP, and has worked with governments in Mexico and Colombia to replicate the model. Both countries sponsor funds of funds that back local managers and are expanding programs with the support of FOMIN.

In Chile, state development agency CORFO has sponsored a fund of funds since 2005, which coinvests alongside local and international GPs and LPs. Most recently President Sebastian Piñera has set out to make Chile a global hub of innovation and entrepreneurship, expanding on existing programs and resources available through CORFO. The new government's focus on innovation also inspired the launch of "Start Up Chile," a program that aims to generate 100,000 new start-ups in four years by attracting early-stage entrepreneurs to launch their businesses in Chile. The program has attracted a number of VC industry experts to the country to evaluate its potential for mid-to-long impact on the generation of new high growth business.

### **Conclusion**

The political, economic, and market trends that have been driving the most recent wave of PE investment in Latin America are not likely to be reversed any time soon.

Among analysts who have been following the region for decades, no one is predicting a return to hyperinflation, defaults, debt crises, or leftist uprisings in the economies where PE industries have taken root. The universe of institutional investors seeking exposure to Latin America as part of a broader emerging market strategy is likely to expand from what is still a relatively small base today. Business owners will continue to gain efficiencies through management and technological innovation, and at the same time that they move into new markets with products and services to meet growing domestic and global demand.

However, anyone investing on the ground in Latin America today will quickly identify the greatest constraint facing PE investors in the short- to mid term as

human capital. In 2012, there is still a relatively small pool of PE managers with established track records of raising, investing, and exiting funds and delivering solid returns to investors. Competition to form investment teams and staff portfolio companies in Brazil and Colombia, in particular, is intense, with compensation surpassing that of many developed markets. And the competition to hire extends to pension funds, family offices, lawyers, investment bankers, and a broad range of industry participants. Fortunately, this reality is driving a new generation of Latin Americans to pursue careers in their home countries, often after they complete MBAs in the United States and Europe, creating a new pool of talented professionals who combine a global business perspective with deep local networks.

The continued growth and consolidation of Latin America's still nascent private equity industry will depend upon the success of this new generation of fund managers, many of whom raised first funds in Brazil, Mexico, Colombian, Peru, and Chile over the last five years.

### Notes

1. As noted in chapter 3, according to the private equity country attractiveness index, some Latin American countries such as Chile (ranked 27 in the world), Brazil (36), and Mexico (38) have been steadily climbing in global rankings and are among the leaders in private equity in emerging markets.
2. Stock market returns in Latin American stock markets are among the leaders in emerging markets. For example, in the period between 2001 and 2007 (before the 2008 financial turmoil), Ibovespa recorded cumulative returns of 470.5 percent. Another regional stock exchange, the Mexican stock market index (Mexico IPC) increased over the same time period by 463.5 percent and recorded one of the smallest declines during the 2008 crises (a decline of only 24.2 percent). These stock market returns exceeded those realized in other leading emerging markets such as China (319.8 percent) and Poland (399.7 percent).

## CHAPTER 14

# PRIVATE EQUITY IN THE GULF COOPERATION COUNCIL

*Arindam Banerjee*

In the last few decades, opacity and inaccuracy of information coupled with closely held business structures have led to minimal research in private equity (PE) in the Gulf Cooperation Council (GCC) states (or countries). This chapter takes a closer look at the industry from the cyclical evolutionary pattern (waves) and probes into the numerous challenges facing the industry, which are both systemic in nature and unique to the region. Finally, it looks into the future of the industry and provides a checklist that is a prerequisite for future growth and development of the sector and can further improve the overall investment climate of the heavily hydrocarbon-dependent gulf states.

### **The Gulf Cooperation Council—Country Overview**

The Gulf Cooperation Council is a cooperative framework of six Gulf States: Bahrain, Kuwait, Qatar, Saudi Arabia, Oman, and the United Arab Emirates. It has a total population of approximately 43 million and its gross domestic product (GDP) per annum is estimated at just under \$1 trillion.<sup>1</sup> The region is primarily natural resource based with the largest proven crude oil reserves in the world. At present, the hydrocarbon sectors form a central pillar of the overall GCC economies with oil and gas currently representing approximately 73 percent of total export earnings, 63 percent of government revenues, and 41 percent of GDP.<sup>2</sup>

The region also ranks as the largest producer and exporter of petroleum. It plays a leading role in the world in general and the Organization of the Petroleum Exporting Countries (OPEC) in particular<sup>3</sup>. According to International Monetary Fund (IMF) projections, almost 90 percent of the region's revenue comes from the oil and gas sector.<sup>4</sup> As a result of the surging oil price, the GCC states enjoyed a record economic boom until late 2008, with the size of the GDP of the combined six states tripling to \$1.1 trillion during the period from 2002 to 2008.

### Business Environment in the Gulf Cooperation Council

Over the years, the GCC states have been ranked reasonably well in the “ease of doing business,” with Saudi Arabia consistently improving its business climate (see table 14.1).

Traditionally, the GCC member states have supported their economies with their homegrown oil wealth without much reliance on foreign wealth. It is only in recent times that the liberalized tax structures of these states have also started attracting inward foreign direct investments (FDI). Over the last two decades, FDI in the region has grown from a nominal figure of \$166 million in 1990, to \$39.9 billion in 2010, an increase by almost 240 times.<sup>5</sup> As earlier stated, the surge in FDI has been a recent phenomenon. Out of the total of \$294.9 billion of FDI received in the last two decades, \$284.0 billion came in the last decade, which is almost 96 percent, with a slight decline in the last five years that accounts for 79 percent of the total FDI received in the last two decades.<sup>6</sup> The governments in the GCC states have also shown heightened interest in attracting foreign capital by creating special economic zones, namely, the free zones<sup>7</sup> (these are tax-free economic zones), which are either sector specific or generalized, or sometimes both. UAE itself has more than 30 free zones.

### Evolution of PE in the Gulf Cooperation Council

#### Diversification of Asset Class

The 1970s witnessed a series of developments in the GCC states with the peaking of oil prices mainly resulting from the twin price shocks in 1973 (oil embargo) and 1979–1980 (Iranian revolution). The excess wealth contributed positively to the growth of both physical infrastructure and social services in the region. The euphoria was eventually brought to a halt by the sharp correction and consequent stagnation of oil prices at very low levels until the beginning of this century. The falling oil price led to a macroeconomic shock to the regional economies, resulting in a heavy reliance on government intervention to foster growth and job creation.

With the falling oil price, a couple of critical outcomes evolved. First, the Gulf States realized that they cannot afford the repeat of economic imbalance that might leave the region fragile in the wake of future probable oil shocks. As a result,

**Table 14.1** Ease of doing business in the GCC between 2008 and 2012

<i>Country</i>	<i>Saudi Arabia</i>	<i>United Arab Emirates</i>	<i>Qatar</i>	<i>Bahrain</i>	<i>Oman</i>	<i>Kuwait</i>
2012	12	33	36	38	49	67
2011	11	40	50	28	57	74
2010	13	33	39	20	65	61
2009	15	47	37	18	60	52
2008	23	68	NA	NA	49	40

*Source:* Doing Business Report 2012, International Finance Corporation, World Bank publications.

ensuring macroeconomic stability was an immediate need. Second, they also realized the need to work in cohesion in order to foster better trade and commerce. As a response to the former, governments of the member states initiated efforts to create and expand the nonhydrocarbon sector. Thus, diversification of the economies, which until then relied primarily on hydrocarbon, became a priority. As a response to the latter requirement, the GCC was formed in 1981 with the objectives of better coordination, integration, and interconnection between member states.<sup>8</sup> The low cost of hydrocarbons, the abundant liquidity, and the scarcity of a qualified domestic workforce stimulated the early progress of diversification during the 1980s, which mainly encouraged capital- and energy-intensive industries.

Nonetheless, falling global oil prices weakened the fiscal and external positions of the regional economies that called for significant changes in the macroeconomic policies. It also became evermore evident that maintaining the momentum required the involvement of the private sector and even foreign capital. As a consequence, by the 1990s, diversification started to become more broadly based on and supported by increasingly ambitious structural and institutional reforms.

The GCC private investment scenario can be broadly studied in cycles (waves). Wave 1 comprises the years dominated by the unorganized market of private investors and wealthy families, dating back from 1970 and continuing until 2005. Post-2005 can be considered as the wave 2 that witnessed the sudden surge in PE fundraising and growth in increased deal making. The buoyancy in the market came to a halt with the coming of the financial crises in 2008/2009. The third wave typically can be categorized as 2010 and beyond, which witnessed significant turmoil in the region with its epicenter in the Arab Spring starting December 2010.

#### Wave 1 (before 2005): Shaping of the Market for Private Investment

Traditionally, the Gulf states are rich in hydrocarbon, making them a source of private investment rather than a target destination. The surging oil prices have fueled some of the largest sovereign wealth funds (SWFs) in the region. Among the top 52 SWFs in the region, 13 are based out of the GCC, contributing to 34 percent of the share.<sup>9</sup> Of late, SWFs have been steadily investing in companies facing crises. Some of the notable investments by regional SWFs are summed in table 14.2.

Over the years, the private investments industry has become an important source of funds for start-up firms, middle-market firms, firms in financial distress, and public firms seeking buyout financing. But where did this all start?

The first wave of PE in the region belongs to the era when the regional economies supported an unorganized market for private investments. More precisely, until the late 1970s, wealthy families, industrial corporations, and financial institutions dominated the PE landscape in the region. This continued until the end of the decade. Since 1980, the region supported many leading global PE players who began managing much of the investment on behalf of institutional investors. With its favorable regulatory environment, strong macroeconomic fundamentals, and privatization activities, Egypt was a favored destination of most of the PE transactions in the Middle East. During the period between 1994 and 2004, active funds in the region grew from 8 to 26. In 2001, Bahrain's Emerging Markets Partnership

**Table 14.2** Investments by the Gulf funds (June 2007 to January 2008)

<i>Fund</i>	<i>Target</i>	<i>Value (\$ billion)</i>	<i>Holding (%)</i>
Kuwait Investment Authority	Citigroup	14.5	4.9
Kuwait Investment Authority	Merrill Lynch	6.6	NA
Abu Dhabi Investment Authority	Citigroup	7.5	4.9
Istithmar, Dubai	Standard Chartered Bank	1.0	2.7
Dubai International Capital	NSBC	1.0	0.4
Dubai International Capital	OchZiff Capital	1.1	9.9
Mubadala Development Company, Abu Dhabi	Carlyle Group	1.35	7.5
Qatar Investment Authority	London Stock Exchange	n/a	24
Qatar Investment Authority	OMX (Nordic Stock Exchange Stockholm)	n/a	10

Source: www.swf.org.

(EMP) raised almost \$1 billion.<sup>10</sup> In 2002, Rasmala<sup>11</sup> announced the region's first true management buyout (MBO) fund, when it facilitated the delisting of Aramex, a regional courier and logistics company, from the NASDAQ bourse. The deal was then valued at \$65 million and captured the attention of the investment community. By the time Aramex was relisted on the Dubai Financial Market (DFM) in early 2005, it became and still remains the benchmark and model for regional PE practitioners.

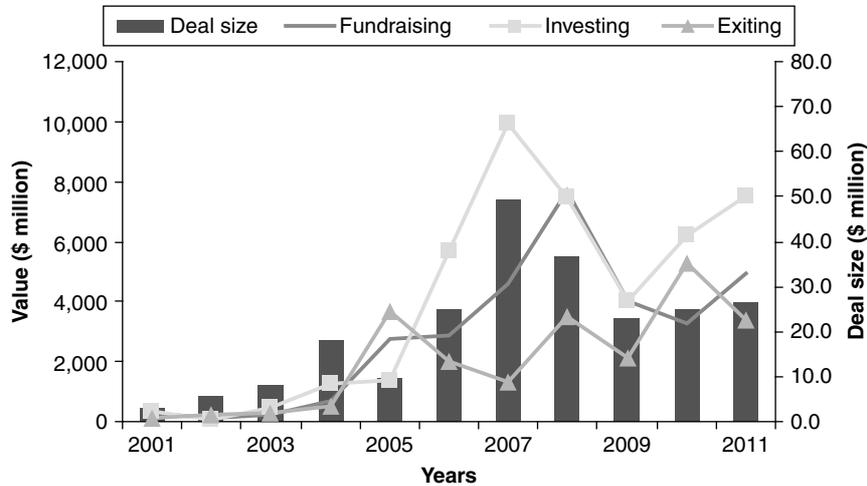
Since 2002, oil prices started rising from \$20 per barrel, at a compounded annual growth rate (CAGR) of 30–40 percent. Liquidity from petrodollars flooded the market, which was compounded by the repatriation of capital from the Western world following the 9/11 events. Part of the excess capital was channeled into the capital markets that grew at a CAGR of 100 percent between 2003 and 2005. Liquidity then flowed into real estate that witnessed a flood of announced mega real estate projects such as the “Palm” and “Dubai Land” in UAE and “King Abdulla Economic City” in Saudi Arabia during those years. In 2005, some of the excess liquidity moved into PE giving considerable boost to the industry (see figure 14.1 for investing, fundraising, and deal size statistics).

#### Wave 2 (2005–2008/2009): Market Uncertainties and Financial Crises

The first wave of the PE industry in the GCC was consummated in 2004 with a record number of PE funds launched and announced in 2005, and over 14 funds with a total of \$3.1 billion of commitments started their regional operations.

International PE funds, including the Carlyle Group, 3i, and CVC, which had until then considered the region solely as a source of limited partners, started looking for deal flow from the Middle East.<sup>12</sup> Middle East and North Africa (MENA)-focused funds alone raised almost \$16 billion from 2005 to 2010.<sup>13</sup>

In recent years, two major upheavals shook the foundations of the GCC states. On the one hand, the global financial crisis of 2008 slowed the region's buoyant economic growth, and on the other, the “Arab Spring” (awakening), which had



**Figure 14.1** Investing and fundraising in the MENA region between 2002 and 2011 (estimate).

Source: www.empea.org.

its roots in Tunisia, snowballed to Bahrain and rest of the GCC, destabilizing the regional economies.

With the coming of the global financial crises, the boom period of PE industry in the GCC came to a halt in 2009. Toward the end of 2008, oil prices collapsed, real estate prices tumbled, tourism declined, leverage dried, risk appetite was curtailed, and portfolio valuations were questioned. The still underdeveloped nature of the financial regulatory environment compounded the impact of the economic downturn coupled with the absence of proper bankruptcy and insolvency laws. The previously abundant liquidity dried up, and several companies started turning to PE firms for their financing needs.<sup>14</sup>

### Wave 3 (beyond 2009): The “Arab Spring” and the Current State of Local Economies

The Arab Spring had a significant effect on the regional business climate. The snowballing of the revolution across the region cemented the lasting impression that these regional economies are well connected. Additionally, the latest announcement of expanding the GCC to include Morocco and Jordan furthers the belief of regional integration.<sup>15</sup>

Post financial crises and recent regional unrest, the recovery in PE has been extremely slow, making it one of the hardest hit segments of the regional financial sector during the crisis. During the year 2010, there were a total of 13 recorded PE acquisitions in the GCC, down from 28 in 2009, 38 in 2008, and 44 in 2007.<sup>16</sup> Saudi Arabia and the UAE were the most active markets with five deals each. The most important sectors were real estate, power and utilities, and financial services.

The deal value aggregated \$211.4 million, as compared to \$353.8 million in 2009. However, the total PE transactions before the crisis were counted in billions of dollars. In 2007, the industry size reached \$6.7 billion, and in 2008 it totalled \$1.6 billion.

In the period ranging from 2008 to 2010, deals in the major GCC states declined with the exception of Saudi Arabia, the only country where PE transactions picked up in 2010. PE deals grew from a figure of one deal in 2009 to five deals in 2010, and the value increased from \$22 million to \$232 million over the same time period. A total of 18 deals were registered by the UAE in 2008, the highest in the three years. In contrast, by deal size, the UAE recorded PE transactions worth \$676 million in 2010 as compared to Saudi Arabia's \$22 million in 2010. Thus, it is inappropriate to determine the most dynamic GCC nation for PE deal making in MENA simply based on deal size.

### Challenges Facing the Region

#### Family Business

According to Saudi Arabia's basic law, "*The family is the kernel of Saudi society.*" In the GCC, family-owned businesses constitute 75 percent of the private sector economy and hire 70 percent of the labor.<sup>17</sup> Some of the leading family businesses in the region (see table 14.3 for details) are the Al Rajhi family (Saudi Arabia), Al Ghurair family (UAE), Al Futtaim family (UAE), Al Kharafi family (Kuwait), and the Kanoo family (Bahrain). Almost 48 percent of the families constitute for a little more than 60 percent of the region's entire wealth. Saudi Arabia leads the way followed by the UAE and Kuwait. The management styles of these family-owned businesses also differ widely and largely depend on the owner's religious affiliation ranging from authoritarian to consultative.<sup>18</sup> It appears that the size of family business in the GCC exceeds that of MENA (\$5.2 trillion versus \$4.5 trillion).

**Table 14.3** Notable family business in the UAE

<i>Family name</i>	<i>Country</i>	<i>Net worth (\$ billion)</i>
HRH Prince Alwaleed Bin Talal Al Saud	KSA	19.6
Mohammed Al Amoudi	KSA	12.3
Mohamed Bin Issa Al Jaber	KSA	12.0
Nasser Al Kharafi family	Kuwait	10.4
The Alshaya family	Kuwait	6.0
The Bukhamseen family	Kuwait	4.0
The Al Ghurair family	UAE	6.5
Abdullah Al Futtaim	UAE	5.1
Majid Al Futtaim	UAE	4.9
The Kanoo family	Bahrain	6.1
Almana family	Qatar	4.0
Mohsin Haider Darwish family	Oman	NA

*Source:* Forbes, Arabian Business, Al Masah.

Most of these businesses were founded in the 1950s and later, and thus a large number of them are managed by second-generation members of the family.

A couple of key factors contributed to the growth of family business and the subsequent escalation of power in the region: (1) a cultural preference (deeply rooted in Arab tradition) to first practice business within the family and then consider outsiders; and (2) firm political connections (an important factor for pursuing business in closed economies).

The relative closed economies favored regional family businesses in the past, but with economic liberalization, diversification of economies, and increasing competition, they are today facing challenges. They have realized that in order to compete and grow, they need to prepare for and face the challenges of globalization head-on. It is estimated that almost three-fourths of the family-owned businesses in the GCC are likely to move from the second generation to the third. It is further estimated that family businesses worth more than \$1 trillion will be handed down to the next generation within the next five to ten years.<sup>19</sup> “The transfer of control to a third generation means that a company formerly controlled by siblings with the same mother is now controlled by cousins, with different mothers, and weaker family ties and obligations.”<sup>20</sup> Most of these businesses are poorly managed and face cash flow problems. PE provides an excellent means for creating value through expertise and catering to their funding needs at various stages.

### Exit Options

Capital markets remain a key exit route for PE investments in most developed markets. Prior to the last quarter of 2008, the initial public offering (IPO) market in the GCC ran in excess of \$10 billion a year before coming to a standstill. Since then, the market has not revived. IPOs in the GCC in 2009 fell short of \$2 billion, only marginally exceeding that of the 2010 value. The year 2009 featured Vodafone’s \$952 million listing in Qatar, followed by Knowledge Economic City’s \$272 million issue in May 2010, Nawras’s (Omani Qatari Telecommunications Company) \$474.6 million Muscat listing in September, and Mumtalakat’s \$389.84 million sale of an 11.5 percent stake in Alba in October-November 2010.<sup>21</sup> During 2011, only nine GCC companies went public with an aggregate value of \$795.6 million, down by 54.9 percent when compared to the previous year. Having gained \$80 billion and \$90 billion in their market capitalization during 2009 and 2010, respectively, the GCC bourses tanked in 2011 with combined losses in their market cap of \$56 billion.<sup>22</sup> The GCC IPO scene has also revealed geographical incongruence, with Saudi Arabia being the only market to achieve a record quarterly activity throughout 2009–2010. In 2010, the eight issues in the kingdom made up 70 percent of the GCC total. In 2011, the country has witnessed only two IPOs worth just over \$200 million. The UAE and Oman have been the only other active regional markets.

The stressful secondary market environment, coupled with stringent foreign ownership laws, limits the developments of GCC capital markets. As a result, few PE firms have cashed out of Middle East investments. Of the 218 investments made by regional PE funds from 2004 to 2009, only 14 exited.<sup>23</sup> The lack of exits is also related to the fact that there have been fewer PE deals in the region because of the

length of time it sometimes take to complete a transaction. Buyers and sellers may take 12–18 months to work out details that include negotiating the price, completing due diligence, and complying with any conditions.<sup>24</sup> As per one of the recent surveys done by Zawya, IPOs would still continue to be a major challenge whereas trade sales would be the most attractive exit strategy. Only 13 percent of the respondents believe that the secondary market would be the most attractive exit option in 2011. G. Bala Subramanyan, Chief Investment Officer at M'sharie (a subsidiary of Dubai Investments PJSC), commented on PE in the GCC and the exit issues in the following manner: “Amid current uncertain economic conditions, regional PE companies face sharp value erosion of invested companies which indirectly hinder the speed of new investments. New fund raising has been extremely limited while access to credit to fund investments is also difficult with higher interest and tougher covenants. On the exit side, IPO is no longer an option in the near term, so also is exiting to strategic buyers given the limited visibility on business prospects. However, the number of secondary disposals, where a company is passed from one PE company to another, is increasing. In these circumstances, PE companies lay a strong emphasis on improving the performance of portfolio investments.”

### **Challenges Faced by the Gulf-Based Family Businesses**

Gulf-based families are relatively large by international standards, with the average family size almost double that in the United States and the United Kingdom. Large families potentially lead to conflicts and disputes that, in turn, could adversely impact their business. The recent credit defaults by Saad and Alghosaibi<sup>25</sup> have also raised questions on transparency for several family-owned businesses in the region. As a result, business houses are finding it difficult to avail easy credit from conventional sources such as banks and public markets. With growing competition, family-led businesses are finding it increasingly important to align their business practices on the lines of global benchmarks. Further, the accession of the GCC members to the World Trade Organization (WTO) has increased their challenge. The GCC was admitted to the WTO in the following order: Bahrain and Kuwait (January 1995), Qatar (January 1996), the UAE (April 1996), Saudi Arabia (December 2005), and Oman (November 2006).

Another challenge faced by family businesses relates to their unrealistic valuation of investments, which many analysts believe contributed to a general slowdown in PE activity in the region in 2008–2009.<sup>26</sup>

### **Deployment of Private Equity Capital**

On the basis of investment value, the most attractive sectors in 2010 were health care and power and utilities sectors, collectively accounting for 57 percent of the total transaction value (\$84 million of the total \$148 million). These sectors are expected to present attractive investment opportunities in the near future.

As observed in the previous paragraph, the underlying demand in GCC's health care sector is increasingly attracting PE investors. While no major mergers and acquisitions (M&A) were carried out, PE investments in the sector since 2005 stood at \$1.9 billion. Sample transactions in the health care sector are included in table 14.4.

**Table 14.4** Sample transactions in the health care sector between 2007 and 2011

<i>Year</i>	<i>Company name</i>	<i>Private equity firm</i>	<i>Country</i>	<i>Sector</i>	<i>Value (\$ million)</i>
2011	NMC Group	Centurion Investment	UAE	Hospitals	1,009.1
2011	NMC Group	Al Aseel Investment LLC	UAE	Hospitals	n/a
2011	Taiba hospitals	NBK Capital	Kuwait	Hospitals	n/a
2010	Al Noor Medical Company	Alchemist Health Care LLC	UAE	Hospitals, clinics, and pharmacies	272.2
2007	Saudi Tadawi Health Care Company	Abraaj Capital Limited	Saudi Arabia	Pharmacy	214.0

Source: [www.zawya.com](http://www.zawya.com).

### Conclusion

It goes beyond doubt that in the last decade, the regional PE industry has witnessed significant growth from almost ground zero level. However, PE as an asset class in the region is relatively new and compared globally, even smaller. In 2001, the share of emerging market PE was less than 2 per cent that grew to 10 percent<sup>27</sup> by 2008. Presently, in the region, there are around 150 funds with a dozen announced and six rumored. In 2008, total funds raised increased to more than \$6.4 billion.<sup>28</sup>

The opacity of reliable information majorly hinders the development of the industry in the region. Difficulties in obtaining authentic financial information is a key complaint posed by potential buyers in the region.

The future of PE in the region would likely depend on several generic factors, while some are specific to the GCC. Some of the factors that would contribute to the success of the industry could be as follows: traditional family business structures, willingness of the owners to part with their long-held equity stake, willingness of owners to take their business to the global level, willingness at the government level to promote small and medium enterprises (SMEs) and their need for seed and growth capital, harbingering best practices in business and sound corporate governance at the board level, maturity of regional public equity markets—from frontier to emerging status—regional stability and further integration, institutional reform and market liberalization, and succession issues facing family businesses.<sup>29</sup>

### Notes

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CHAPTER 15  
PRIVATE EQUITY IN SOUTHEAST ASIAN EMERGING  
ECONOMIES: AN INSTITUTIONAL PERSPECTIVE

*William Scheela, Edmundo Isidro, and Thawatchai Jittrapanun*

**Introduction**

Private equity or venture capital investing is a fairly recent but rapidly increasing phenomenon in the emerging markets of Southeast Asia (Deloitte & Touche, 2007; Ahlstrom and Bruton, 2006; Lockett and Wright, 2002). To date, most of the focus of venture capital research has been on the United States and Western Europe with only minimal research on venture capital investing in Asia (Gompers and Lerner, 2001; Harrison and Mason, 1992). Published research about Asian private equity investing has focused mainly on developed economies, such as Singapore (Bruton, Ahlstrom, and Singh, 2002), and China (Bruton and Ahlstrom, 2010). There has been minimal research analyzing the development of the venture capital industry in the emerging economies of Southeast Asia, a region that represents an increasingly important foreign direct investment (FDI) destination (*Asian Development Outlook*, 2011).

We have analyzed the development of the venture capital industry in three emerging Southeast Asian economies: Vietnam (Scheela and Nguyen, 2004; 2001), the Philippines (Scheela and Isidro, 2008; Scheela, 2006), and Thailand (Scheela and Jittrapanun, 2008). All three economies represent an interesting dichotomy as they are simultaneously characterized as exhibiting strong economic growth potential (*The World Bank East Asia and Pacific Economic Update*, 2010) that has recently attracted venture capital investments (*2008 Asian Private Equity 300*, 2007), in spite of the lack of fully developed institutions that are necessary to support venture capital investing (Lopez-Carlos et al., 2006). In this chapter we will present an integrated analysis of our research in these three emerging economies.

**Southeast Asian Emerging Economies**

Emerging economies have developed significantly large and growing markets, which have generated increasing attention and investment from multinational

**Table 15.1** Venture capital in emerging Southeast Asian economies in 2006

	<i>Philippines</i>	<i>Thailand</i>	<i>Vietnam</i>	<i>Singapore</i>
Venture capital pool (\$ million)	320	650	1,376	12,556
Number of private equity firms	21	19	15	128
Investments in 2006 (\$ million)	92	307	336	2,077

*Source:* 2008 *Asian Private Equity 300* (2007). Please note that no updated data could be obtained on these countries.

corporations (MNCs) in developed economies (*The Economist*, 2011). According to Khanna and Palepu (2010: 1), “The world is focused on emerging markets.” Within emerging markets, Southeast Asia represents one of the fastest-growing regions (*Asian Development Outlook*, 2011; *The World Bank East Asia and Pacific Economic Update*, 2010). More specifically, Vietnam, Thailand, and the Philippines have shown impressive growth domestic product (GDP) growth rates in 2010 growing to 6.8 percent, 7.8 percent, and 7.3 percent, respectively, and when combined with strong economic growth forecasts for 2011 and 2012 (*Asian Development Outlook*, 2011) represent a significant opportunity for private equity investors (McKinsey, 2011; *Preqin Special Report*, 2011). Relatedly, researchers have called for increasing research on venture capital investing in emerging Asian economies (Bruton, Ahlstrom, and Li, 2010; Bruton, Ahlstrom, and Obloj, 2008; Ahlstrom and Bruton, 2006; Bruton, Fried, and Manigart, 2005).

Venture capital investors are active in the Philippines, Thailand, and Vietnam as is shown in table 15.1 with funds ranging from \$320 million to \$1,376 million. While significant amounts of venture capital have been raised in these three emerging economies, compared to Singapore, these economies are still in their infancy with total venture capital country funds ranging from 2.5 to 11 percent of Singapore’s total venture capital. A possible explanation for this discrepancy of less venture capital being raised in significantly larger countries (than Singapore) could be the strength of the institutions in Singapore, which, as we will show, are lacking in the emerging economies of the Philippines, Thailand, and Vietnam.

### **Institutional Theory**

Institutional theory attempts to explain the impact that contextual systems have on organizational behavior and economic performance (Hoskisson et al., 2000; North, 1990). “Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction” (North, 1990: 3). Institutions, especially legal and financial institutions, tend to be more developed and transparent in developed economies compared to underdeveloped institutions in developing or emerging economies (Ramamurti, 2000; Pissarides, 1999). Emerging economies can be characterized by limited private savings, weak financial intermediaries, shallow stock markets, ambiguous property rights, and underdeveloped legal systems (Ramamurti, 2000; Peng and Heath, 1996). Organizations operating in emerging countries face increasing bureaucratic and information-processing costs because of the lack of fully developed institutions (Peng and Heath, 1996; North,

1990). More specific to venture capital, in emerging economies, transaction costs for private equity investing will be higher than in developed countries because of a lack of a formal institutional structure (Ahlstrom and Bruton, 2006; North, 1990). The lack of effective institutions can also negatively affect entrepreneurial ventures' start-up and growth potential in emerging economies (Acs and Autio, 2010; Zahra et al., 2000; Bohata and Mladek, 1999) to bring about a negative impact on the development of venture capital (Gompers and Lerner, 2001).

### Institutional Voids

Khanna and Palepu (2010) posit that emerging economies, in spite of increasing economic liberalization, still lack fully developed institutions, which they label "institutional voids." Basically, institutional voids exist when "institutions are either absent or under developed in an economy" (Khanna and Palepu, 2005: 1). Khanna and Palepu (2010) refer to these voids as a lacuna or ditch created by the absence of market intermediaries needed to effectively support market efficiency to minimize transactions costs. They further posit that "informal institutions have developed in many emerging markets to serve intermediary roles" in supporting transactions (Khanna and Palepu, 2010: 15).

There are significant institutional differences between developed Southeast Asian economies, such as Singapore, and developing economies, such as the Philippines, Vietnam, and Thailand (Lopez-Claros et al., 2006; Lockett and Wright, 2002). More specifically, in table 15.2 we computed an institutional score for both developed and emerging Asian economies and also, for comparison purposes, the United States. We selected key institutional rankings (business corruption, property rights protection, trust of politicians, and stock market and bank soundness) developed by Lopez-Claros et al. (2006) for their *Global Competitiveness Report 2006–2007*. We then computed the mean for each country from the five institutional variables to get an institutional score for each country. Emerging countries exhibiting low rankings/low institutional scores (48–77) include the Philippines, Thailand, and Vietnam, while developed countries exhibiting relatively high rankings and high institutional scores (11–25) are Singapore and the United States.

Clearly institutional differences exist between the five countries, with the United States and Singapore comprising a developed institutional cluster and the Philippines, Thailand, and Vietnam comprising a developing institutional cluster. The latter three countries face similar institutional problems of corruption, weak property rights, lack of trust of politicians, ineffective stock markets, and weak banks.

Do emerging economy venture capitalists, who operate in institutional voids, when attempting to do deals, face relatively more challenges compared to venture capitalists investing within developing economies? To answer this question, we attempted to calculate a venture capital score for each of the countries in table 15.2. We selected key institutional variables from the *Global Competitiveness Report 2006–2007* (Lopez-Claros et al., 2006) for each country and then computed the mean for each country across the five variables. The results are similar to the institutional score in that the developed economies ranked significantly higher (11.6–11.8) compared to the emerging economies (43–73). It appears that venture capitalists

**Table 15.2** Institutional analysis of selected Southeast Asian countries

<i>a Institutional ranking</i>						
<i>Country (rankings)</i>	<i>Business corruption</i>	<i>Protect property rights</i>	<i>Trust of politicians</i>	<i>Stock market</i>	<i>Bank soundness</i>	<i>Institutional score (mean rank)</i>
Philippines	81	70	106	40	80	75.4
Thailand	46	40	48	32	75	48.2
Vietnam	98	69	61	55	103	77.2
Singapore	7	11	1	15	21	11.0
USA	32	21	24	22	27	25.2

<i>b Venture capital ranking</i>						
<i>Country</i>	<i>Venture capital</i>	<i>Informal sector</i>	<i>Protection of minority shareholders</i>	<i>Time to start a business</i>	<i>Access to loans</i>	<i>Venture capital score (mean rank)</i>
Philippines	79	76	50	81	78	72.8
Thailand	42	42	35	48	47	42.8
Vietnam	65	50	59	86	87	69.4
Singapore	13	1	22	6	16	11.6
USA	1	28	16	3	11	11.8

Source: Lopez-Claros (2006).

Note: Please note that higher rank (1–125; 1=highest rank) in “business corruption” indicates business corruption has no impact; higher rank in “protection of property rights” indicates property rights are clearly delineated and protected by law; higher rank in the “trust of politicians” category indicates higher trust of politicians; higher rank in “stock market” activity indicates companies can easily raise money by issuing shares; higher rank in “bank soundness” indicates that banks are healthy with sound balance sheets; higher rank in “venture capital” activity indicates greater availability of venture capital for risky and innovative ventures; higher rank in “informal sector” activity indicates more business transactions are registered; higher rank in “protection of minority shareholders” indicates minority shareholders are protected by law; higher rank in “time to start a business” indicates fewer days to start a business; and higher rank in “access to loans” indicates it is easier to obtain a loan with no collateral.

operating in three emerging economies of Southeast Asia face more obstacles to do deals than do developed country venture capitalists. It also appears that the informal sector plays a much more significant economic role in emerging economies. It is therefore useful to analyze the investment strategies of venture capitalists operating in these emerging economies, which exhibit both institutional voids for doing business in general and, more specifically, for venture capital investing.

Specific to private equity in institutional voids, venture capital investing in emerging economies can be very challenging in spite of the strong economic growth rates. In analyzing the development of the venture capital industry in Southeast Asian emerging economies, our research question is: How can venture capitalists survive in an emerging economy that lacks the necessary fully developed institutions to support effective private equity investing?

### Research Methodology

Since 1998, we have been interviewing venture capitalists in Southeast Asia: five venture capital firms in Vietnam 1998–1999, two firms in 2004 and two more

in 2007; five firms in the Philippines in 2003 and two firms in 2010; six firms in Thailand in 2005–2006. Venture capitalists were asked to provide descriptive data about their respective investment strategy, fund performance, and investment environment. We used a structured interview format that was initially developed by Gorman and Sahlman (1989) for a study, via a mail questionnaire survey, of US venture capitalists. Because of the exploratory nature of this research, due to the formative stage of venture capital investing in Southeast Asia, we used the questionnaire to develop in-depth questions for face-to-face, structured interviews. Each interview took about an hour roughly spanning a range of 45–150 minutes.

### Venture Capital in Southeast Asian Emerging Economies

As previously analyzed in table 15.2, the Philippines, Thailand, and Vietnam collectively rank relatively low in having fully developed institutions necessary to support a vibrant venture capital industry. Yet, as is shown in table 15.1, venture capital investors are active in all three emerging economies. So, how do they survive in such unfriendly investment climates? We will report our findings for the three countries in terms of venture capital industry characteristics and challenges and investment performance.

#### Philippines

The Philippines has the smallest private equity market (venture capital pool) of the three emerging economies (see table 15.1), yet has the oldest venture capital presence of the three countries. Venture capital was formally introduced to the Philippines in the 1980s when relatively small bank-related venture capital funds (\$250,000) were established by the Philippines government. The first independent venture capital fund was introduced in 1987 by Hambrecht and Quist, a major American venture capital firm, when they set up a \$20 million fund. The first domestic venture capital fund was established in 1989 under the sponsorship of the Asian Development Bank, International Finance Corporation, Commonwealth Development Bank (United Kingdom), and Germany's Deutsche Entwicklung Gessellschaft (Scheela, 2006). While the *Asian Private Equity 300* report lists 21 private equity firms who are operating in the Philippines, our research has identified only 3–5 venture capital firms that are actively investing in unlisted small- and medium-sized enterprises (SMEs) during the past ten years.

We asked each venture capitalist to describe private investing in SMEs in the Philippines in terms of both the key characteristics and challenges and investment performance. A summary of their responses for 2003 (five most active firms) and 2010 (two most active firms) are shown in table 15.3.

Venture capitalists describe private investing in the Philippines as “still . . . immature,” that is, still being in the early stage of developing a significant venture capital presence. A mature industry exists when there are significant funds raised and managed by experienced venture capitalists. The developing Philippines' industry exhibits a small number of active key investors (the number of key venture capital firms decreased from 2004 to 2010) managing small investment funds (about \$20–30

**Table 15.3** Southeast Asian venture capital industry: Characteristics, challenges, and performance

Time period(s)	The Philippines <sup>1</sup>		Thailand <sup>2</sup>		Vietnam <sup>3</sup>	
	2003–2004	2010	2007	1998–1999	2004	2007
Characteristics	Entrepreneurs open to VCs Small fund and deal size No financial transparency Syndication among top VCs	Immature VCs Low technology focus Risk-averse institutional investors Limited VCs Small deal size	VC in transition Small deals Decreased corruption Inexperienced VCs	Misunderstood VCs Investment management	Small deals Poor returns Generalist investors Foreigners focus on state-owned firms	VC in infancy VCs must have strong local presence Exit execution
Challenges	Maintaining VC presence Limited IPOs No funding from institutional investors Few global innovations only focus on domestic market High entry valuation	Deal flow Misunderstood VC Hands-on investors active and close monitoring of investees Difficult to find LPs No experienced VCs	Deal flow Deal completion Due diligence Inexperienced VCs Exit execution	VCs' survival Deal flow Exit execution Limited transparency Poor investment climate	Limited larger deals No transparency Too many VCs Challenging due diligence Local government unclear about VC	Deal flow Weak legal infrastructure Reimmigration of locals
Fund Performance						
Below expectations	80%	0%	40%	100%	0%	25%
Meeting expectations	20%	25%	20%	0%	50%	25%
Above expectations	0%	75%	40%	0%	50%	50%

Sources: <sup>1</sup>Scheela (2006); Scheela and Isidro (2008); company interviews in 2010; <sup>2</sup>Scheela and Jittrapanun (2008); <sup>3</sup>Scheela and Nguyen (2001, 2004); company interviews in 2004 and 2007. Please note: LP; limited partners; VC, venture capital; VCs, venture capitalists; IPOs, initial public offerings.

million per fund) and doing small deals. While entrepreneurs have become familiar with venture capitalists (“less wary”), they are still perceived by venture capitalists as not fully understanding private equity. Venture capitalists express concerns about a lack of investee company transparency, which makes due diligence very important but time consuming and expensive. The lack of transparency is an issue with both venture capitalists and their institutional investors (i.e., limited partners, LPs). Institutional investors are perceived as being “risk averse,” especially foreign institutional investors who are hesitant to invest in the Philippines. Some venture capitalists are critical of local entrepreneurs’ lack of focus on high-tech investee companies. One Philippine venture capital firm has developed the strategy of investing into high-tech US investee companies that are founded by ethnic Filipino-Americans (typically in Silicon Valley), who will, as part of the investment deal, transfer/outsource some operations to the Philippines (Scheela, 2009).

The challenges facing venture capitalists are many. Finding good deals is increasingly difficult as is also finding experienced venture capitalists for deal networking and limited partners to invest into a Philippine country fund. Venture capitalists also face serious problems posed by government corruption and bureaucracy. It is also very problematic to exit via an initial public offering in the Philippines because of the small size of the stock market and the bureaucratic process involved in the listing of SMEs. Collectively, these challenges have made maintaining an investment presence in the Philippines very difficult. Because of the immature stage of private equity investing in the Philippines, venture capitalists must be hands-on, active investors and network with other venture capital investors to find quality deals (Scheela and Isidro, 2008).

As can also be seen in table 15.3, venture capitalists report increasing satisfaction with their investments from 2003 to 2010. Initially, they reported 80 percent of their investment funds performing below expectations, which is in stark contrast to 0 percent performing below expectations more recently. Because of the lack of fully developed institutions, venture capitalists in the Philippines have developed an effective investment strategy based on networking (informal sector) with other private investors, conducting in-depth due diligence and being very active, hands-on investors, which has resulted in improving financial returns (Scheela, 2006). Yet, maintaining a vibrant venture capital industry continues to be challenging.

#### Thailand

Similar to the Philippines, very little research has focused on venture capital in Thailand. Thailand was “ground zero” during the 1997 Asian financial crisis, and its impact on institutional development and subsequent venture capital activity was problematic; yet Thailand has bounced back and is now home to foreign and domestic venture capital firms (see table 15.1). Thailand’s venture capital industry clearly fits the developing status when compared to Singapore (refer to table 15.2). It has much more in common with the Philippines and Vietnam in terms of fund size, number of venture capital companies, and number of investments. While Thailand’s venture capital industry is significantly smaller than Singapore’s, it is the second largest of the three developing countries in this study. Similar to the

Philippines, not all Thai venture capital firms that are listed in various country venture capital directories are active private equity investors. Based on guidance from the Thai Venture Capital Association, we interviewed ten venture capitalists from the most active investment firms in Thailand.

As can be seen from table 15.3, Thailand shares some of the same industry characteristics with the Philippines in terms of a transitioning and restructuring industry, doing small deals, dealing with government corruption, and lacking experienced venture capitalists. The major challenge, finding good deals, is similar to that the Philippines as is the need to conduct in-depth due diligence. Exits are also difficult as is closing the deal because of the formative stage of the venture capital industry. Venture capitalists report 60 percent of their investment funds are meeting or exceeding expectations, which is more in line with the Philippines' assessment in 2010, yet 40 percent of the funds are not meeting expectations.

An investment strategy pattern may be emerging from these two emerging economies, that of venture capitalists struggling to do deals in institutional voids, yet being able to develop hands-on investment strategies that have resulted in fairly positive investment returns.

#### Vietnam

The venture capital industry is a recent investment phenomenon in Vietnam with the first venture capital fund being introduced to Vietnam in 1991. Until 1995, there was a gradual but consistent annual increase in the number of venture capital firms and the subsequent amount of venture capital invested in Vietnam. In 1996, venture capital activity plateaued primarily because of a lack of potential investments and the lack of an exit strategy via a domestic stock market. The impact of the Asian financial crisis exacerbated the decline in venture capital activity through 1999 (Scheela and Nguyen, 2001). Ultimately the venture capital industry was reborn with the introduction of a domestic stock market and the subsequent arrival of primarily foreign private equity firms (under the management of Overseas Vietnamese) that were both much more knowledgeable about Vietnam and had more experienced business executives than their private equity predecessors (company interviews, 2004, 2010; *2008 Asian Private Equity 300*, 2007).

While table 15.1 identifies 15 private equity firms operating in Vietnam, similar to the Philippines and Thailand, we identified a much smaller number of active investors. We were able to conduct three rounds of interviews with the most active venture capitalists operating in Vietnam: five firms (the actual population) in 1998–99, two in 2004, and two in 2007. As can be seen in table 15.1, private equity investors in Vietnam have developed the largest venture capital pool of the three countries in our study, but still only manage 11 percent of Singapore's investment pool.

As is shown in table 15.3, Vietnam shares many of the same industry characteristics and challenges as reported in the Philippines and Thailand. Private equity investors in Vietnam characterize their industry as having significant problems relating to poor financial returns, difficulty of managing investments, small deal size, difficult exits, and a lack of entrepreneur's understanding about venture capital. Challenges are also similar to the Philippines and Thailand: surviving, finding good

deals, weak legal institutions, lack of transparency, need for in-depth due diligence, and the lack of government understanding about venture capital.

Investment returns show promise with significant increases in reported returns (meeting expectations and reaching above expectations) in the two most recent time periods. Once again, in spite of the lack of fully developed institutions necessary to effectively support private equity investing, venture capitalists in Vietnam are able to develop an aggressive investment strategy to identify and manage their investee companies.

### Summary

Based on our interviews, a possible Southeast Asian emerging economy venture capital investment strategy may be developing for venture capital investors operating in the emerging economies of the Philippines, Thailand, and Vietnam. Clearly, all three economies have institutional voids that do not favor private equity investing, which resulted in disappointing financial returns in the initial stages of private equity investing. But with increased experience, venture capitalists in these three countries have been able to develop a hands-on, networking investment strategy that is proving to be successful.

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CHAPTER 16  
PUBLIC SUPPORT FOR VENTURE CAPITAL IN  
EMERGING MARKETS: AN OVERVIEW  
OF SELECTED COUNTRIES

*Barbara Rudnicka and Marek Dietl*

It is widely recognized in academic literature that small- and medium-size enterprises (SMEs) struggle with access to finance. Small- and medium-size enterprises are vulnerable, and very few manage to survive more than five years. Public authorities throughout the world, perhaps recognizing both the importance and the frugality of the SME, have created agencies and set up numerous business support and assistance measures to help the sector obtain better access to finance and to encourage business formation. Public intervention in improving access to finance is based on the assumption that significant imperfections exist within the marketplace that preclude the private sector from correcting these market distortions. Such structural government programs are aimed at closing funding gaps, which result when firms from the SME sector are unable to secure necessary capital.

Academic evidence from developed countries is at best mixed about the role of government assistance programs targeting the SME sector. The government concerns broadly include improving access to finance, stimulating innovation, and providing advisory services. In terms of access to capital, there is a growing sentiment among researchers that capital markets in developed countries are adequate for the SME sector, and that there is no need for government assistance programs. Some researchers argue that there is no empirical confirmation that these public programs translate into growth and prosperity for the SME sector, while others go further and state that government programs may actually disrupt the proper functioning of capital markets. Researchers also provide evidence to suggest that publicly sponsored private equity (PE) initiatives may displace private sector equity operators while providing an additional capital pool for firms; they also point to the poor and inconsistent performance of government-induced capital assistance programs.

The problem of access to capital becomes even more challenging in emerging markets, and we consider public intervention in this context.

In this chapter, we focus on two geographic regions, namely, emerging Asia (China and India) and Central and Eastern Europe (Poland and Hungary). The first two countries have the highest number of investments committed by government (GVC). The second set of countries joined the European Union in 2004, and in each, public support (which appears important to industry development) is rapidly evolving. We close the chapter with a summary and policy considerations.

### **Government Support for Venture Capital in Selected Emerging Economies**

In this section, we will take a closer look at four emerging economies and their approach to facilitating venture capital (VC) activity in their respective countries.

#### China

To understand the uniqueness of the Chinese venture capital market, we must focus on the legal and cultural aspects of the Chinese economy. In the West, profit maximization, efficiency, and public information disclosure are important factors for investors. In contrast, personal relationships, networking, and harmony are ranked highly in Asia (Ahlstrom and Bruton 2001; Chen 2001).

In China, there are about 42 million SMEs (including the self-employed ones); these account for 99 percent of all enterprises nationwide. SMEs in China make up 60 percent of gross domestic product (GDP) and play an important role in creating jobs, promoting technological innovation, developing new products, and generating tax revenues (Chen, 2010).

In the 1980s, the Chinese government began to create state mechanisms to boost the local VC industry. Due to the lack of experience among government officials and venture capitalists, most of these initial efforts failed. The China New Technology Start-up Investment Company, one of the most well-known venture capital firms in China, went bankrupt in 1997 (Xiao, 2002). However, in the late 1990s, the Chinese government developed a program called “Venture Capital Guidance Funds” designed to persuade local governments and institutions to create and develop “state” VC funds. By the end of 2000, 30 provinces, municipalities and autonomous regions in China, had opened pilot sites for the SME credit-guarantee system, established more than 200 credit-guarantee institutions, raised a guarantee fund of \$320 million, and contributed to the expansion and improvement of the credit environment for SME development (Hussain et al., 2006).

Government guidance funds have expanded in Beijing, Shanghai, Shenzhen, Chengdu, and Tianjin. Some second-tier cities with numerous private enterprises and industrial parks also adopted the trend to support local economic development. As a result, the so-called government-guidance fund is becoming a new platform for the VC industry and SME development. More government-guidance funds have been set up in developed eastern regions than in the less developed central and western regions. The fund amount averages \$160 million; the allotment of this to every sub-fund is between \$6 and 8 million, which appears to be not enough to attract large- or medium-sized VC or PE investment institutions. Most government-guidance funds impose strict restrictions on investment fields and industries (zero2ipo, 2010).

The underlying purpose of the guidance funds is to develop a self-sustaining technology-based VC industry, including a great number of excellent VC institutions with experienced management personnel. In China, there are three types of local government-guidance funds. The first type of fund is the one established independently by local governments (e.g. funds established by Zhongguancun Administration Council, Haidian District and Pudong New District). For example, the Beijing Zhongguancun Venture Capital Development Center had collaborations with 11 incubators and 26 VC companies; the total state commitment to this fund was \$80 million. The second type of fund is the one developed in cooperation between the local government and the China Development Bank. The China Development Bank offers “soft loans” at the equivalent finance rate for every government-guidance fund it involves. The third possible fund structure is the one collaboratively created by the local government and a large, state-owned VC (e.g., Shenzhen Innovation Investment Group, which sets up funds with local governments).

The process of establishing a guidance fund in China can be summarized as follows: local government offers capital to build a “mother fund” or offers to coestablish the fund with the National Development Bank or a large, state-owned VC; the management team that operates the “mother fund” is then responsible for choosing qualified foreign or domestic VC institutions to build “daughter” VC funds, which are then required to invest in technology-based SMEs (Zahao et al., 2010).

#### India

The VC market in India has a relatively long history, dating back to the 1980s when local and national governments became involved in the creation of VC funds (Dossani and Martin, 2002). The second stage of VC market development began when international VC funds entered the market, and regulations in the Indian financial market were liberalized (Sahai, 2009). The Internet bubble negatively affected the Indian VC market. In 1999, the VC market was booming, but in 2000, both the number of deals and deal values began to decrease (reaching a minimum of 56 deals for \$470 million<sup>1</sup> in 2003). Currently, there are approximately 300 PE and VC funds active in India; of these, 180 are registered with a financial regulatory body called the Securities and Exchange Board of India (SEBI). Deal volume has reached \$9.4 billion, and the number of deals is equal to 454. PE and VC investments in India are quite diverse. Excluding the real estate sector, the most important sectors include energy, manufacturing, clean technology, and India’s *spécialité de la maison*, software and Internet technologies (IT).<sup>2</sup>

The rapid development of the local VC industry in India has been catalyzed by public support programs. India has followed a three-tier approach to VC: central government sponsoring funds via fully controlled financial institutions; local (state) governments supporting funds via specially designed institutions; and state-owned banks investing in VC.

The most successful central government initiative has been the Technology Development & Information Company of India (TDICI). TDICI launched its first fund, Vecaus I (Venture Capital Unit Scheme), in 1989 and Vecaus II in 1991. The

impact of these two funds is twofold. TDICI was one of the most effective tools used to support the development of SMEs by public institutions in India, and the TDICI staff played an important role in the subsequent creation of private sector VC in India. In 1998, ICICI (a leading commercial bank) bought 100 percent of shares of TDICI and renamed it ICICI Venture Funds Management Company; this privatization provided a new impulse for development of the fund. Currently, ICICI Venture manages assets in excess of \$2 billion and provides financing to projects in all stages of venture capital, leveraged buyouts (LBOs), mezzanine financing, and real estate.

Another central government initiative was IFCI Venture Capital Funds. This institution has evolved from providing subsidized loans through financial support for commercialization of local technologies to a VC fund manager. Currently, IFCI runs three funds (high-tech, automotive, and clean technology) with capitalization of over \$150 million.

Two other interesting initiatives by local governments worth mentioning are Gujarat Venture Finance Limited (GVFL) and Andhra Pradesh Industrial Development Corporation Venture Capital (APVC). GVFL was created in 1990 as a joint venture between international institutions (including the World Bank), state-owned banks and corporations, and some private institutions. GVFL operated six funds, half of which closed with respectable internal rate of returns (IRR) between 13 and 15 percent (an outstanding result on the global scale and the best result in India). APVC was created by a local development agency but is now a joint venture with a commercial VC management company. Funds under APVC management are industry focused (i.e., biotechnology) or are invested in only during a certain stage of development (i.e., seed).

State-owned banks joined the government in sponsoring VC funds in 1989 and created CanBank Venture Capital Fund (CVCF) as a project of Canara Bank. Since then, CVCF has managed five funds and two have been closed. The funds are sponsored by the founding bank, but the investor base is growing and includes state-owned banks and private financial institutions. CVCF funds are not industry driven but their targets are generally SMEs.

Another bank-sponsored initiative is SIDBI Venture Capital Ltd (SVCL), created in 1999 and sponsored by the Small Industries Development Bank of India (SIDBI). SVCL manages two funds, both in disinvestment phase. The first fund was focused on IT and software and was fully sponsored by the government. The investor base for the second fund was much broader and included both state-owned and private banks. The overall strategy of the fund was to invest in early-stage companies and selectively provide second rounds of financing.

To sum up, India has over 25 years of experience in government intervention in the VC market. The main instruments have been fully sponsored government VC funds. The performance of these funds has been mixed, but there have been several success stories. Over time, the government-sponsored funds have been supplemented by funds established on the basis of public-private partnerships or privatized entities.

#### Poland

Overall, the level of innovation found in the Polish economy is moderate and even declining according to the European Union (EU) innovation scoreboard. At the

same time, Poland is one of the fastest-growing economies in the EU, demonstrating constant and uninterrupted positive GDP growth for the last 20 years and doubling the size of its domestic economy over this period. An interesting question is: How has Poland achieved outstanding economic results with such a poor focus on innovation? An even more interesting question is: How will Poland's economic growth be fueled in the future? One of the keys to the country's future prosperity is to unlock the potential of microfirms (firms with up to nine employees) and help them grow to become medium-sized companies. Microfirms currently represent 96 percent of all active enterprises in Poland.

One policy measure aimed toward facilitating the growth of micro- and small firms is the development of the flourishing VC industry. According to Eurostat, the Polish VC market is one among the least developed in the EU when measured relative to GDP. Furthermore, early-stage VC investments are low in absolute terms.

In 2005, the local policy makers decided to address the issue of the underdevelopment of the VC market by creating an "evergreen fund" of VC funds—Krajowy Fundusz Kapitałowy (KFK). KFK invests public funds along with capital from private investors (limited partners—LPs) into funds managed by private asset managers (general partners—GPs). The major benefit for private investors is lower risk and a higher rate of return due to a "distributions waterfall." The proceeds are first distributed to private LPs up to the amount they invested into the fund (this represents their capital protection); capital is then returned to KFK. Next, a hurdle rate is paid to the private investors; when it is paid in full, KFK obtains its own hurdle rate. Profits are shared proportionally to the stake in the fund between all investors and carried interest is distributed to the GPs (usually 20 percent).

The key objective of the KFK is to attract both private capital and successful asset managers to early-stage VC funds. The benefits for private investors are low risk and higher potential returns (in IRR terms). The motivation of asset managers to work with KFK is twofold: capitalization of an investment vehicle and easier fundraising. KFK can invest up to 50 percent of capitalization of any single fund. The economies of scale in the fund management business are substantial, and an option to double the size of the capital under management is very attractive. The protection offered to investors also makes fundraising much easier in the current fundraising climate. Such benefits have attracted one of the leading Israeli GPs, Giza Venture Capital, which manages one of KFK's portfolio funds.

KFK closed its first investment in 2008, so it may be too early to evaluate its impact and performance. As of the beginning of 2012, there are 14 funds in KFK's portfolio with a total capitalization of \$260 million. A few more funds will be added this year, and the total capitalization may even double. Equity gaps have been limited in Poland, but a weaker supply of attractive early-stage firms may negatively impact the development of the program.

There is some room for improvement with respect to the functioning of KFK. The major drawbacks of the mechanism are threefold. First, KFK invests in funds via "open calls for proposals"—on the given date, private placement memorandums (PPMs) are expected to be submitted. The best proposals are selected through a very rigorous selection process that can take up to two years to complete. Second, KFK commits to the fund only after private investors have made their commitments. Keeping the interest of investors and GPs high during a one- or two-year-selection

process can be challenging. Third, KFK, being an “evergreen fund,” should finance its future activities from returns. If returns are very hard to achieve, KFK bears much a higher risk and may not be allowed to coinvest with portfolio funds, limiting the potential for upside.

To sum up, the Polish government support system for VC is based on public-private partnership, which represents an optimal setup for the country. As building such intricate partnerships between government institutions, fund managers, and investors can be challenging, the long-term impact on the economy is difficult to foresee.

### Hungary<sup>3</sup>

According to the European Private Equity and Venture Capital Association (EVCA), total VC funds raised in Hungary accounted for only 0.07 percent of GDP in 2010. Still, Hungary is one of the leading countries in Central and Eastern Europe for venture capital exposure. VC funds come mostly from government-based sources (94 percent).<sup>4</sup>

The European Commission estimates that as of 2010, 99.9 percent of all Hungarian firms are SMEs; these firms produce 54.6 percent of value added and employ 71.7 percent of all workers.<sup>5</sup> In the aftermath of democratic political change, the Hungarian government recognized the potential of small firms and decided to create VC instruments focused on investments in domestic enterprises. In the 1990s, investments were made by the state-owned development bank, the Hungarian Development Bank (MFB). MFB provided funds to finance Hungarian industrial companies in need of reorganization, selected on the basis of economic policy and occasionally subjective considerations rather than on business rationale. MFB established 11 regional investment companies to finance smaller firms, with their registered equity exceeding \$27 million in 1998. MFB’s role in VC financing ended in 2000 (Karsai, 2004).

In 2004, Hungary entered the EU and gained access to new sources of capital. Using dedicated funds from the EU (through the so-called JEREMIE program) to eliminate market deficiencies in the area of financing, the Hungarian government undertook a more complete program consisting of three main characteristics: refinanced loan programs, credit guarantees, and VC.

The venture capital program has been operating since 2007 and is managed by Venture Finance Hungary (VFH)—a member of MFB Group. The program is financed by the EU (85 percent) and the Hungarian government (15 percent) and is focused on investments into early-stage, innovative projects that have a high growth potential, but may not be suitable for debt financing. VFH acts as a Fund of Funds (FoF). Capital resources are divided into two parts: a coinvestment program and a joint funds program. Both programs have special investment criteria, maximizing capital contribution to SMEs. Funds are designed to encourage the best VC managers to join the program. The fund manager’s compensation consists of a fixed fee based on the volume of the fund (maximum 3 percent of annual registered capital) and a success fee (i.e., carried interest). In 2009, VCF selected eight partners by open tender (one for the coinvestment fund, seven for joint funds). Total contributions are equal to \$130 million.

*Joint Funds*

VFH can acquire up to 70 percent of the joint fund at any given time while the fund exists. The contribution ranges between \$3 million and \$9 million. The share capital of the entire fund exceeds \$181 million. Joint funds are created to protect private investors. The loss equal to 5 percent of the subscribed capital is covered by the public owners, while further losses are allocated according to the following scheme: 70 percent from the public sector and 30 percent from the private sector. Private investors receive the whole upside above a given rate.

*Coinvestment Fund*

The coinvestment fund operates as an independent entity on a deal-by-deal basis with private investors. Private shareholders have rights only to an annual yield equal to a weighted average of the EU base rates. The coinvestment fund also bears the loss of the joint investment to the extent of 5 percent of net capital invested; the remaining loss is borne in proportion to the investments of both sides of the deal.

Recent data from September 2011 shows that these funds have invested \$44 million into 34 firms, mostly in the IT/electronics and biotechnology sectors (ten and four companies, respectively).<sup>6</sup>

**Implementing Tested Models in Emerging Markets: Policy Implications**

Some emerging economies are quickly catching up in regard to government support toward the VC market. Two out of four countries analyzed (Hungary and India) are fairly advanced; China and Poland are also progressing. However, compared to highly developed countries, there are major differences in how the public VC initiatives of emerging markets are designed.

We have defined four criteria for successful government involvement: flexibility, scope, the right incentives, and the efficiency and effectiveness of the selection process. The analyzed solutions do not score high on all four criteria. If the incentive scheme or flexibility is in line with market standards, then the selection process becomes very rigid. When flexibility is relatively high, the scope is too narrow (and so on).

Realizing these facts, one may be tempted to recommend a higher degree of public-private partnership or a less bureaucratic approach. There are numerous well-functioning public-private holding funds acting as funds-of-funds, direct investors, business angel coinvestors, and venture lenders; these holding funds have a clearly commercial approach to investing and usually invest alongside private investors in ventures managed by independent teams (both local and international) with relevant experience.

**Acknowledgments**

We are grateful to Marcin Tobor and other investment professionals at KFK for sharing their research and thoughts on how governments support and should support a local venture capital industry.

### Notes

1. Indian Venture Capital Association.
2. Own estimates based on "Reporting on Indian Private Equity and Venture Capital" by Indian Venture Capital Association, November 2010.
3. Based on: <http://mvzrt.hu>.
4. European Venture Capital Association 2011 Yearbook.
5. SBA Fact Sheet 2010/2011.
6. Based on [http://ec.europa.eu/regional\\_policy/conferences/jjj/doc/jeremie1\\_harsanyi.pdf](http://ec.europa.eu/regional_policy/conferences/jjj/doc/jeremie1_harsanyi.pdf).

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PART IV  
COUNTRY-SPECIFIC STUDIES OF PRIVATE EQUITY  
IN EMERGING MARKETS

CHAPTER 17  
THE EVOLUTION AND FUTURE OF  
PRIVATE EQUITY IN CHINA

*Sarah E. Alexander and Michael Casey, Jr.*

**Introduction**

There may be no better symbol of the evolution of private equity (PE) in China than Chinese fund manager Hony Capital's announcement in January 2012 that it successfully raised \$4 billion in capital for two new funds: \$2.4 billion for its fifth USD-denominated fund and RMB10 billion (\$1.6 billion) for its second local currency (RMB) fund. Hony Capital illustrates the profound transformations that have taken place in China in the last decade, including the rise of professional domestic fund managers, the growth of RMB funds, and the development of China's limited partner (LP) base.

The Chinese government has played a critical role in trying to develop an institutionalized domestic PE industry. The government understood that the problem facing Chinese companies was a finance gap, and it viewed PE as a means of financial intermediation that could provide long-term equity capital to help grow productive businesses. Over the last decade, the government adopted a variety of regulatory policies to catalyze the development of local fund managers, while fostering an environment where foreign fund managers could coexist with their local counterparts.

However, the rapidly evolving regulatory landscape and mushrooming of new funds has left ample opportunity for confusion and misunderstanding. The objective of this chapter is to clarify the Chinese market today by separating out the different types of PE activity taking place. In particular, the chapter highlights the range of foreign currency and RMB fund managers and, in doing so, represents EMPEA's effort to educate industry stakeholders on the investible market in China.

Clarification of the types of PE funds active in China, including delineation of institutional quality fund managers, will facilitate further capital flows—domestic and foreign—into the market. The chapter closes by exploring three trends likely to shape the future of PE in China: growing demand for the asset class, increasing levels of local LP participation, and professionalization paving the way for local Chinese investors to pursue cross-border and international opportunities.

### **Background**

China's PE industry has transformed over the last decade from one in which foreign firms dominated fundraising and investment activity, to one of coexistence (albeit not necessarily on equal terms) between local and foreign fund managers. This is largely a direct result of the government's effort to create an ecosystem that fosters the development of an institutionalized asset class that can provide long-term equity financing to Chinese businesses.

The government has used a trial-and-error system to test what works best in China, while balancing its desire for local firms to learn from foreign investors against the need to maintain capital controls and command of the economy. The PE market has evolved in three waves: from foreign managers raising foreign currency, to local managers raising foreign currency, to local managers raising local currency. These three structures coexist today, leaving plenty of room for confusion among market participants and observers.

In the first wave—toward the beginning of the last decade—foreign PE investors typically accessed the Chinese market through offshore holding companies. In these structures, Chinese companies received foreign capital injections offshore and sought to exit through an initial public offering (IPO) on an exchange outside of China.

Under this original structure, the bulk of the economics were going to participants outside of China. To reverse this trend and bring more PE activity onshore, the Ministry of Commerce (MOFCOM) restricted the ability of foreign fund managers to pursue such offshore-structured investments, requiring that investments (and IPO exits) be made in China. Simultaneously, to encourage the development of local fund managers, MOFCOM promulgated regulations that enabled venture capital funds in China to raise USD from non-Chinese LPs, with the fund still treated as local for purposes of investible companies and regulations. These funds were granted a capital account, which pierced the capital controls and gave managers approval to convert foreign currency into renminbi for investments.

In the third wave, beginning in 2006–2007, the government took additional steps to develop a local RMB industry by allowing select Chinese institutional investors, such as China Development Bank and the National Social Security Fund, to invest in local RMB funds. The government also permitted Chinese fund managers then managing foreign currency funds to raise RMB funds as well.

Additionally, the central government reiterated its support for provincial, municipal, and city governments to establish government-guidance funds and channel capital toward policy priorities. Finally, the government enabled foreign fund managers access to the RMB market through programs enabling joint ventures with municipalities and Chinese corporations. With the central government's weight behind the asset class, PE activity exploded.

### **The Chinese Market Today**

By most measures, China has emerged as the destination of choice for investors in emerging markets PE. In both absolute and relative terms, PE fundraising statistics

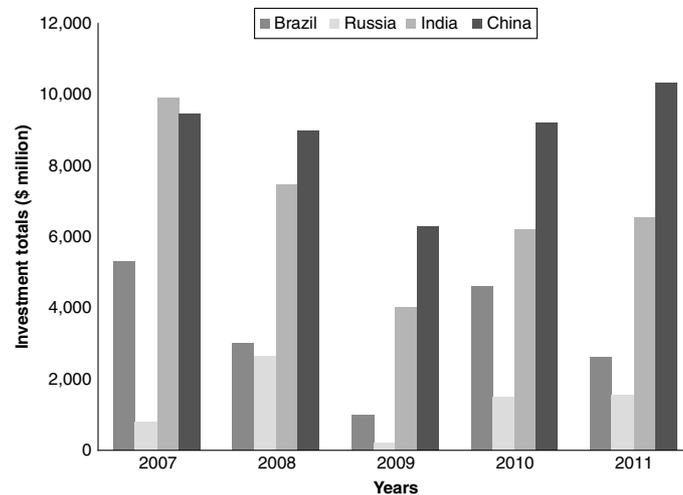
for China have been astonishing. Fundraising for China-focused PE funds has grown from \$3.9 billion raised by 28 funds in 2007 to approximately \$16.6 billion raised by 63 funds in 2011.<sup>1</sup> On a relative basis, in the last five years, PE funds dedicated to China have expanded from 7 percent to 43 percent of total funds committed to emerging markets PE.

On the investment side, aggregate annual deal activity in China went from a peak of \$9.5 billion in 2007, to a trough of \$6.3 billion in 2009, and rebounded to \$10.5 billion in 2011. Investment data from 2011 show that the value of investment activity in China represented roughly 40 percent of the total investments in emerging markets, and 50 percent of all investments made in the Brazil, Russia, India and China (BRIC) economies (see figure 17.1).

Some observers may look at our data and wonder why the fundraising and investment figures seem low. The principal reason is that EMPEA excludes from its statistics RMB fund activity that is primarily opportunistic trading capital in nature, and that in our view does not meet the traditional definition of PE, as explained next.

To illustrate, depending on the source, the number of PE funds in China ranges from the hundreds to the thousands (table 17.1). On the high side, global advisory firm PricewaterhouseCoopers recently estimated that China has about 3,500 PE funds—a figure on par with the total number of PE funds in existence globally—the majority of which are domestic (and by definition RMB-denominated due to currency inconvertibility).<sup>2</sup>

The Chinese investment consultancy ChinaVenture notes that 1,084 RMB funds have emerged over the last three years,<sup>3</sup> while local research company Zero2IPO notes that from January to November 2011, 171 PE funds and 295 VC funds were



**Figure 17.1** Private Equity Investment in China Relative to Brazil, Russia and India, 2007–2011.

Source: EMPEA.

**Table 17.1** Distribution of estimates of RMB funds in China

<i>Source</i>	<i>Estimate of # of RMB Funds</i>
PricewaterhouseCoopers	3,500
ChinaVenture	1,084*
Zero2IPO	466†
Asia Private Equity Review	163‡

*Sources:* Shen and Takada (2011); Lin (2011); Fu (2011); *Asia Private Equity Review: Greater China Edition* (2012).

*Notes:* While these estimates admittedly address different variables and time periods, their variance suggests that the definition of private equity and venture capital is not uniform within the Chinese market. \*RMB funds raised over last three years; † RMB PE and VC funds raised from January to November 2011; ‡ RMB funds raised in 2011.

raised in RMB.<sup>4</sup> The Centre for Asia Private Equity Research provides more conservative figures for 2011—their data show that 163 RMB funds were raised in the year (80 government-backed funds and 83 private-sector funds).<sup>5</sup>

These data all come from reputable providers, but the variance in the distribution speaks of a significant challenge for participants in, and observers of, PE in China: Which of these RMB funds are institutionally investible, or of institutional quality?

### An Overview of RMB Funds

EMPEA believes that of the (potentially) thousands of PE funds in China, only a handful of RMB fund managers are currently of institutional quality. To fit within EMPEA's definition of an institutional quality fund, a PE fund manager should be managing a *blind pool of third-party capital* and taking an *active management role in private companies*. Moreover, professionalized fund managers should exhibit competence in back office functions, including processes, controls and risk management, and they should understand how to manage investor capital in a portfolio context.

EMPEA researched the spectrum of participants in RMB funds to establish a methodology for tracking fundraising and investment data for institutional-quality fund managers in China. We did so because we believe clarifying the market's participants will help to educate institutional LPs on the investible universe of fund managers operating in China, and to support the development of best practices that will professionalize and institutionalize the asset class.

The RMB fund market today consists of foreign and domestic fund managers (table 17.2). The foreign fund managers are of institutional quality and have a demonstrated track record. They often partner with local or municipal governments (e.g., Shanghai Blackstone Equity Investment Partnership) or Chinese businesses (e.g., Carlyle and Fosun Group).

Domestically, fund managers may be broken down into five categories. They populate a spectrum from professional, established fund managers with a demonstrated track record, to inexperienced entrepreneur-backed funds that have more of

**Table 17.2** Overview of the RMB fund landscape

Sponsor	Fund Characteristics			Sponsor Characteristics		Examples
	Size	LP Base	LP Influence	Objective	Team	
<b>Foreign</b>						
Commercial GP	> RMB500m (\$80m)	Third-party capital	Blind pool	Financial return through active management	Professional	Yes, over at least one fund Carlyle; TPG; Blackstone; Morgan Stanley
<b>Domestic</b>						
<i>Commercial Fund Manager</i>						
w/ USD Fund	> RMB500m (\$80m)	Third-party capital	Blind pool	Financial return through active management	Professional	Yes, over at least one fund Hony Capital; CDH; Legend Capital; DT Capital
w/ RMB Fund(s) Only	Typically > RMB200m (\$32m)	Third-party capital	Typically Blind pool	Financial return through active management	Professional	Yes, over at least one fund Tiantu Capital; Cowin Venture Capital; Jiuding Capital
<i>Financial Institutions (Banks/Securities Co./Insurance Co.)</i>						
w/ USD Fund	Typically > RMB500m (\$80m)	Third-party capital	Typically Blind pool	Financial return; Develop skill set and track record	Professional	Sometimes CITIC Capital; CITIC PE Funds Management; Everbright Group
w/ RMB Fund(s) Only	Typically > RMB200m (\$32m)	Typically internal funds used to build track record	Captive	Develop skill set and track record to raise third-party capital	Semi-experienced	Sometimes China Merchants
<i>Corporate</i>						
Typically > RMB200m (\$32m)	Corporate innovation fund; sometimes simply the CEO's investment fund	Captive	Captive	Financial return; Identify potential acquisition targets	Semi-experienced	Negligible Fosun; Teda; Shenergy; Huaneng; Shanxi Coal
<i>Government-backed</i>						
Typically > RMB200m (\$32m)	Government	Captive	Captive	Policy objective	Inexperienced	Negligible Bohai IIF; Jinpu IIF; Jilin National Biotechnology Venture Capital Fund
<i>Entrepreneur-backed</i>						
Typically RMB100m (\$16m)	High-net-worth Individuals	Investment Committee	Investment Committee	Financial return through asset flipping	Inexperienced	Negligible Coal miners; real estate tycoons

Sources: Emerging Markets Private Equity Association; interviews with leading private equity fund managers, fund formation lawyers and funds-of-funds based in China. Please note: government-guidance funds typically act as fund-of-funds.

a hedge fund approach than a PE one, and are designed to cater to high-net-worth investor needs for liquid, short-term investments. In between, one finds a varying degree of government or state-owned enterprise (SOE) involvement—in some cases, the SOEs themselves create their own PE arms. We review the categories of RMB funds run by domestic managers next.

#### Commercial GPs

These fund managers most closely resemble traditional PE investors. They typically manage blind pools of third-party capital, and seek financial returns through active management of portfolio companies. Some of the more established and professionalized commercial funds manage parallel USD and RMB funds. Most of these qualify as institutional quality funds. Examples of commercial GPs include: Hony Capital, CDH, DT Capital, and Legend Capital.

#### Financial Institutions

These funds typically seek to create their own captive PE arms, sometimes managing third-party capital (though not necessarily a blind pool). Some funds begin by using their own institution's capital to develop a track record, which can subsequently help them raise third-party capital later. For the more established investment banks, their differentiating characteristic is access to deal flow. Many of these funds solely manage RMB funds, though some managers, such as CITIC PE Funds Management and CITIC Capital, also manage USD funds. Some of these financial institution funds are of institutional quality. Examples of financial institution funds include: CITIC Private Equity Funds Management, CITIC Capital, China Everbright Group, and China Merchants China Direct Investments.

#### Corporate

These managers typically launch captive corporate innovation funds and/or vehicles to identify potential acquisition targets. In some cases, however, the CEO or chairman/founder of the firm may use the company to establish a fund to make investments that may or may not be related to the core business. Select corporate funds may be of institutional quality. Examples of corporate funds include: Fosun, Teda, Shenergy, and Huaneng.

#### Government Backed

These funds are typically national, municipal, city, or local government-backed funds launched to foster innovation or attain a policy objective. The government entity may place strategic or other priorities above returns or the management quality of the GP. The bulk of these funds are not of institutional quality. Note that these funds are different from the joint ventures that foreign fund managers establish with government entities. Examples of government-backed funds include: Bohai Industrial Investment Fund, Jinpu Industrial Investment Fund (GP Capital), and Jilin National Biotechnology Venture Capital Fund.

### Entrepreneur Backed

These funds are formed as a consequence of successful entrepreneurs—wealthy coal miners (“mei lao ban”) and real estate tycoons, for example—seeking to capitalize upon public-private multiple arbitrage opportunities. These funds typically pursue pre-IPO deals and exercise little to no active management. The trading-style character is more akin to a hedge fund approach than true PE. Frequently, they use their own capital, or that of close associates, and invest on a deal-by-deal basis. The objective is to multiply capital quickly through high IPO valuations. Note that there are exceptions for certain entrepreneur-backed funds. For example, industry sources note that Yunfeng Capital, the fund launched by Jack Ma—founder, chairman, and CEO of Alibaba Group—is an institutional quality fund.

From a fundraising perspective, the trading funds pose little challenge to institutional-quality GPs raising capital from local institutional investors. In effect, there is a bifurcation in the market between professional PE fund managers and inexperienced, smaller RMB funds:

- The former category consists of managers competing for capital from a handful of institutional-quality anchor investors; an illustrative example would be Hony Capital, whose recent RMB fund is reported to have raised capital from the National Social Security Fund (NSSF)—China’s reserve fund to support future social security needs—and China Life Insurance Company.
- The vast array of entrepreneur-backed trading funds tend to raise capital from high-net-worth individuals, who according to industry sources are not necessarily passive investors.

In November 2011, the National Development and Reform Commission (NDRC) issued a new regulation (Circular 2864) mandating that all funds with at least RMB500 million (\$80 million) in assets under management (AUM) register at the national level. Any fund manager seeking capital commitments from NSSF will have to meet this AUM threshold and be registered with the NDRC. This regulation should help local institutional LPs distinguish professional fund managers from the pre-IPO trading schemes, and is a step in helping to institutionalize the asset class.<sup>6</sup>

Nevertheless, from an investment perspective, the proliferation of PE funds can present significant challenges for foreign and domestic general partners (GPs). Proven PE investors with a commitment to value creation retain a competitive advantage in partnering with entrepreneurs seeking to build better businesses. However, the new breed of pre-IPO, short-duration RMB funds can skew market pricing and may risk tainting the overall industry if some of these less-experienced funds blow up.

Moreover, the entrepreneurs themselves have a significant say in which type of capital they accept. The legal and regulatory environment facilitates the quick deployment of RMB funds, effectively putting USD funds at a relative disadvantage for investing in certain companies; this is particularly the case for local funds managing local capital. Foreign GPs, for example, which use the Qualified Foreign Limited Partner (QFLP) program to make their GP commitment in RMB, operate at a disadvantage, as the fund is still treated as foreign, which places restrictions on

investments in certain industries. Additionally, RMB funds may list their investee companies through onshore exchanges, which have historically offered higher valuations than those found in offshore markets.

### **Looking Forward—Three Trends Shaping the Future of PE in China**

Despite growing pains, PE in China retains a promising future. While there likely will be a shakeout among entrepreneur-backed and first-time funds in the short term, three overarching trends support the long-term professionalization and development of the asset class: growing demand for PE from companies and LPs; increasing levels of local LP participation; and professionalization paving the way for Chinese GPs and LPs to pursue cross-border and international opportunities.

#### **Trend One—Demand for the Asset Class Growing**

The first trend of the future of PE in China is that demand for the asset class is likely to grow due to pull and push factors. On the pull side, Chinese private companies will continue to face a finance gap and will seek PE as a source of capital. On the push side, there is likely to be increased demand from LPs—both foreign and domestic—for PE exposure in China.

From the company perspective, despite rapid, substantial, and ongoing reforms, China's financial sector remains bank-dominated and relatively underdeveloped. The banking sector, which itself is dominated by SOEs, serves primarily as a tool for the Chinese government to channel capital toward preferred businesses (typically SOEs) and policy priorities.

A 2011 survey revealed that 35 percent of privately owned enterprises in China had not obtained bank loans, compared to 20 percent among SOEs, while 48 percent of small- and medium-size enterprises (SMEs) had no bank loans compared to 19 percent for large companies.<sup>7</sup> Despite the creation of an SME Board in 2004 and the launch of ChiNext—a Shenzhen-based exchange for growth enterprises—in 2009, public equity markets remain out of reach for most Chinese businesses. In the bond market, commercial paper issued by SMEs (SME Collective Notes) represented 0.08 percent of total bonds outstanding in 2011, while commercial paper more broadly represented 7.45 percent of the total.<sup>8</sup>

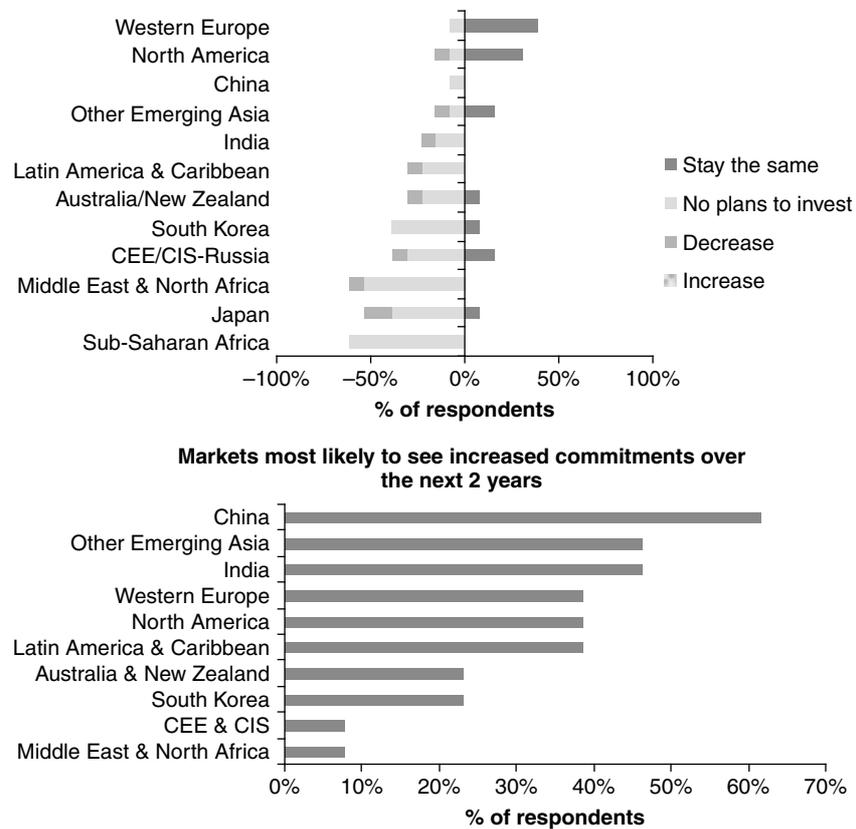
Recent moves by the People's Bank of China to constrain liquidity to dampen inflation expectations will likely exacerbate this finance gap. In turn, demand for PE investment among entrepreneurs and private sector companies is likely to increase.

From the institutional investor perspective, EMPEA and Coller Capital's most recent LP Survey data show that China is the second most attractive market for GP deal making (behind Brazil), and that 78 percent of all LPs expect annual net returns of 16 percent or more for emerging Asia-focused PE funds over the next three to five years, the highest among all regions. Moreover, 40 percent of LPs indicated that they planned to increase their exposure to China, the largest expansion in commitments across the emerging markets.<sup>9</sup>

Amongst Asia-based LPs, a recent EMPEA report reveals that 62 percent of them plan to increase their commitments to China over the next two years—the largest

allocation of any emerging market region or country—while roughly 90 percent of LPs expect returns greater than 16 percent for China-focused funds, with one-third expecting net returns greater than 21 percent (see figure 17.2).<sup>10</sup>

This appetite for exposure to PE in China makes sense. On the one hand, academic research suggests that correlations between economic growth and stock market returns are unproven, so LPs seeking to tap growth dynamics in the emerging markets need exposure to a variety of asset classes.<sup>11</sup> On the other hand, even if the correlations between growth and returns were tight, foreign LPs seeking exposure to the China market face a number of restrictions on putting their money to work in the country. To access the RMB-denominated “A-share” market, foreign investors must first receive a license as a Qualified Foreign Institutional Investor (QFII) from the China Securities Regulatory Commission, which is under a quota. Even



**Figure 17.2** Anticipated changes to USD value of Asian LPs' PE fund commitments over the next two years.

Source: EMPEA Special Report: Asian LP Sentiment toward Private Equity. Edited by Nadiya Satyamurthy. January 2012. Available at [www.empea.org](http://www.empea.org).

then, of China's estimated 5 million companies, only 2,354 were listed on onshore exchanges as of February 2012.<sup>12</sup>

Moreover, as Jim O'Neill, Chairman of Goldman Sachs Asset Management, has argued, China's growing companies—like those in many emerging markets—may best be accessed through PE. This is due partly to a relatively thin free float in public equities, but also to the fact that the government controls large portions of listed equities.<sup>13</sup> PE fund managers can therefore leverage their local knowledge and expertise to broaden the opportunity set for their investors.

As one of the pioneers of PE investing in China put it succinctly in a recent comment to EMPEA, "Every Board of Directors, CEO, CIO, and pension officer must consider China as a destination for all asset classes—regardless of the structural risks, regulatory changes, valuation volatility, capital imbalances, RMB competition, cases of fraud, GP instability and corporate governance opacity. The overall growth, consumption shift, industrialization, and urbanization in China are part of too great a macro event for LPs in PE programs to ignore."<sup>14</sup> LPs seem to agree.

#### Trend Two—Increasing Levels of Local LP Participation

The second trend shaping the future of PE in China is the growing participation of local LPs in the asset class. In recent years, the Chinese government has adopted a number of regulatory policies that facilitate the development of a professionalized local LP base.

Beginning in 2008, NSSF obtained approval from the State Council to invest in PE funds that are registered with the National Development and Reform Commission (NDRC). Two years later, the China Insurance Regulatory Commission permitted local insurance companies to invest up to 5 percent of their total assets in PE.

Still, there are very few institutional quality LPs in China—LPs that are primarily motivated by long-term financial return and are willing to invest passively in a blind pool. Many market participants believe that NSSF is the sterling example of a professional LP in China, and an example for local LPs to emulate. In an interview with the authors, a managing director at one of the leading commercial funds in China noted that the status of China's LP base is one of the biggest misperceptions that outside observers have of the market. "There are very few pockets of LP money in China," he said, "Without an anchor investor like NSSF, the only other way to get to scale is if you have the insurance companies or corporates behind you, and very few of the insurance companies or corporates are actually professional LPs looking to deploy capital as a 'passive' LP."

The bulk of the money being raised for RMB funds comes from retail investors and governments. On the retail side, high-net-worth individuals and a number of trust companies, which pool retail capital for investments, have been making commitments to PE to generate yield at a time when real estate investments are constrained, and fixed income and public equity returns are low.<sup>15</sup> Regulators have started to clamp down on this activity in light of recent fraudulent fundraising schemes, which may end up reducing the pool of noninstitutional capital available for PE.<sup>16</sup>

On the government side, an array of city and municipal governments, government-guidance funds—effectively government-sponsored funds-of-funds—and industrial parks allocate capital to PE funds to further policy objectives. These investments deviate from the traditional concept of passive LP investment and are typically captive in nature.

Despite its complications, the Qualified Foreign Limited Partner (QFLP) pilot programs in Beijing and Shanghai, which enable a limited number of foreign institutional investors to commit to RMB-denominated fund managers, could serve as a short-term stopgap for professional fund managers seeking to raise capital from foreign institutional-quality LPs. Over time, however, we believe the LP base in China will adopt best practices and become more professionalized, thereby enabling the development of a viable system for nonbank financial intermediation.<sup>17</sup>

#### Trend Three—Professionalization Paving the Way for Chinese Investors to Pursue Cross-Border and International Opportunities

The final trend is that the growing professionalization of Chinese GPs and LPs will enable cross-border and international investment opportunities. Hony Capital CEO John Zhao has disclosed that cross-border investment will form one of the core strategies of Hony's latest USD fund, as the firm seeks to help Chinese companies expand overseas and assist foreign companies entering China.<sup>18</sup> Hony Capital executed its first cross-border transaction in 2008, when it joined a consortium of financial sponsors to facilitate a Hony portfolio company's acquisition of Compagnia Italiana Forme Acciaio S.p.A., an Italian concrete manufacturer.

We expect to see more of these cross-border transactions in the years ahead, and for other fund managers, such as CDH and CITIC, to pursue them. We also expect more local fund managers to begin raising foreign currency funds.

Most market observers are well aware of the efforts of China Investment Corporation (CIC), the Chinese sovereign wealth fund whose mandate is to focus on overseas investments, to invest its portfolio in a range of non-Chinese equity, fixed income, PE funds, and infrastructure projects. However, other Chinese LPs, such as NSSF, are reported to be evaluating fund managers for PE investments abroad. Moreover, in February 2012, Shanghai International Group, the investment affiliate of the Shanghai government, established Sailing Capital International, an RMB50 billion (\$7.9 billion) fund to facilitate outbound investment.<sup>19</sup>

Two new funds suggest there will be additional avenues for Chinese investors to tap international opportunities. The first, A Capital's RMB3 billion (\$475 million) China Outbound RMB Fund (a joint venture with the Beijing Municipal Bureau of Financial Work) seeks to raise capital from Chinese institutional investors, as well as private and state-owned companies, and channel equity investments to European companies that can provide win-win partnerships with Chinese strategic investors.

Similarly, RIT Capital Partners' joint venture with Beijing-based Creat Group, J. Rothschild Creat Partners, is an approximately RMB5 billion (\$792 million) fund for outbound investments. The fund will raise capital from Chinese companies,

with the proviso that the State Administration of Foreign Exchange (SAFE) must approve each transaction on a case-by-case basis.<sup>20</sup> While these funds might not meet the strict definition of managers of a blind pool of third-party capital using active management to improve private companies, they may portend a future trend.

Yet as alluring as this trend is, and as intuitive as it may seem for Chinese companies to buy recognized brands, market access, and marketing and distribution capabilities abroad, the short-term challenges are significant. On a relative basis, Chinese companies suffer from a paucity of management talent. The challenges of sourcing deals, identifying synergies, and managing postmerger integration are quite significant. Industry sources note that in developed markets, research suggests that more than 50 percent of mergers and acquisitions (M&A) activity in the end does not create positive synergies. As one local fund manager asks, “How much higher is this hurdle when your acquirer is a Chinese company?”

### Conclusion

The pace of change in China makes it exceedingly difficult for investors outside—and even inside—the region to understand the market. In some ways, the rapid evolution of the PE market in China presents one of the greatest challenges to the long-term viability of the asset class in the country. EMPEA is working to provide greater transparency on the amount and types of PE activity taking place in China, and in doing so, we hope to provide fund managers and LPs a greater understanding of the investible market.

As Chinese PE houses raise foreign currency funds—recent examples include Shenzhen Cowin Venture Capital, Jiuding Capital, and Sino-Century China Private Equity Partners, all of which are now raising their first USD funds—and as they begin to pursue cross-border and international opportunities, by necessity they will need to adopt the international standards of transparency and governance that the pioneering Chinese funds, such as Hony Capital and CDH, adopted early in their development. In addition, there will need to be a level playing field for foreign funds participating in China—regardless of the currency in which their funds are denominated.

EMPEA will continue to serve as a source of intelligence and provider of industry best practices to foreign fund managers investing in China, Chinese PE firms investing at home and abroad, and LPs seeking to understand how China compares to other emerging market opportunities. In doing so, we hope to play a helping role in enabling PE to become a professionalized and institutionalized asset class in China.

### Notes

1. For EMPEA’s methodology, country-specific fundraising totals only capture single-country funds, not country allocations or targets from regional or global funds. By definition, this implies a conservative—and likely underrepresented—estimate of private

- equity fund commitments to China, and it explains, in part, the delta between fundraising and investment totals for China.
2. Samuel Shen and Kazunori Takada, "Sun Setting on China's '3,500' Private Equity Funds," *Reuters*, December 16, 2011.
  3. Ibid.
  4. Ada Lin, "China VC Market Doubles Fundraising & Investment in Jan-Nov 2011, Closing 1,301 Investment Deals." Zero2IPO Research Center. December 30, 2011. See also: Fiona Fu, "First 11 Months of 2011." See PE Investments Exceeding RMB23.80B." Zero2IPO Research Center. December 16, 2011.
  5. "Signs of the Time." *Asia Private Equity Review: Greater China Edition*. January 2012 (p. GC-15).
  6. Recent reports disclose that the revised "Securities Investment Fund Law," which will govern private equity funds in China, is in the final stages of approval with the State Council. If the law is passed smoothly, China's private equity industry will enter a new stage of development and become more institutionalized.
  7. Morgan Stanley Research, "Greater China Economics: Issues in Focus." December 9, 2011, p. 49.
  8. China Central Depository & Clearing Company. Available online at: [http://www.chinabond.com.cn/jsp/include/CB\\_EN/marketdata/document\\_en.jsp?sLmId=137&sId=0202&sBbly=201112&sMimeType=0](http://www.chinabond.com.cn/jsp/include/CB_EN/marketdata/document_en.jsp?sLmId=137&sId=0202&sBbly=201112&sMimeType=0).
  9. EMPEA/Collier Capital Emerging Markets Private Equity Survey 2011. EMPEA and Collier Capital. April 2011. Available at: [www.empea.org](http://www.empea.org).
  10. EMPEA Special Report: Asian LP Sentiment toward Private Equity. Edited by Nadiya Satyamurthy. January 2012. Available at [www.empea.org](http://www.empea.org).
  11. For research on the correlation between growth and returns, see Elroy Dimson, Paul Marsh, and Mike Staunton, "Economic Growth," in the *Credit Suisse Global Investment Returns Yearbook 2010*, pp. 13–19. Available at: [http://www.london.edu/newsandevents/news/2010/02/Credit\\_Suisse\\_Global\\_Investment\\_Returns\\_Yearbook\\_2010\\_1077.html](http://www.london.edu/newsandevents/news/2010/02/Credit_Suisse_Global_Investment_Returns_Yearbook_2010_1077.html).
  12. The number of registered and unregistered firms in China is virtually impossible to measure. One scholar, Kellee Tsai, claims there are over 29 million private businesses in China. See "China's Complicit Capitalists," *Far Eastern Economic Review* (Jan/Feb 2008).
  13. Jim O'Neill, *The Growth Map*, New York, NY: Penguin. 2011, p. 210.
  14. Philip Bilden, Senior Advisor, HarbourVest (Asia) Ltd. Quoted in EMPEA Special Report: Asian LP Sentiment toward Private Equity. Edited by Nadiya Satyamurthy. January 2012. p. 11. Available at [www.empea.org](http://www.empea.org).
  15. For more on trust companies and their role in private equity in China, see: KPMG, "Mainland China Trust Survey 2011: Expanding the Reach of China's Financial Sector." Available online at: <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/China-Trust-Survey-201107-4.pdf>.
  16. See Alvina Yuen, "China Targets Illicit PE Fundraising." *Asian Venture Capital Journal* 18 (January 2012).
  17. For example, some reports indicate that local pension funds in China may begin investing in public equities. Over time, this could help local pension funds develop into professionalized LPs and viable investors in private equity. See "Local Pension Funds Expected to Invest in Chinese Stock Market: Report." *Xinhua*, January 19, 2012.
  18. Hsiang-Ching Tseng and Drew Wilson, "Breaking Boundaries." *PE Asia*, February 1, 2012.
  19. Feng Jianmin, "Biggest Yuan Fund Launched in Shanghai." *Shanghai Daily*, February 17, 2012.
  20. Nicholas Donato, "Still a Closed Door." *PE Manager*, May 10, 2011.

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CHAPTER 18  
PRIVATE EQUITY AND VENTURE CAPITAL  
IN BRAZIL: DRIVERS, EVOLUTION,  
AND OBSTACLES

*Antonio Gledson de Carvalho*

**Macroeconomic Environment in Brazil**

The Brazilian private equity and venture capital (PEVC) industry experienced a sharp rise at the break of the twenty-first century. Such growth is due to the building of capacities in the industry and also due to a myriad of developments occurring at the macroeconomic level. This section elaborates on these elements.

*Macroeconomic Stability.* During the 1980s and part of 1990s, Brazil experienced two-digit monthly inflation rates. The macroeconomic stability achieved at the beginning of this century (inflation rates of about 5 percent per year) was initiated in 1994 with the Real Plan. It brought inflation rate from about 50 percent down to less than 0.5 percent per month. Since then, monetary stability was threatened on several occasions, for example, during the currency crises in Mexico (1995), Asia (1997 and 1998), Russia (1998), Brazil (1999), Argentina (2001), and over the years 2001 and 2002, with the forecast of a leftist candidate being elected for president. In all these opportunities, the commitment to stability was assured. The perception of monetary stability as a fact emerged only after the early years of the leftist government of President Lula da Silva (2003 and 2004). Since then, inflation has been maintained at rates near 5 percent per year (see table 18.1). An important milestone on the pathway to macroeconomic stability was the attainment of the investment grade in 2008.<sup>1</sup> It caused foreign investments to reach a record \$34.5 billion in 2007<sup>2</sup> and \$45 billion in 2008, more than twice its previous values (see table 18.1).

*Resumption of economic growth.* The Brazilian economy had been stagnant for several decades. One consequence of macroeconomic stability was the resumption of economic growth. The average GDP growth had been 3 percent per year in the 1980s, 1.6 percent in the 1990s, and 2 percent in the 1999–2003 period. Between 2004 and 2010 the average growth rate was 4.5 percent per year, in spite of the global recession derived from the financial crisis. The resumption of economic growth has been very important to enhance the deal flow for PEVC.

**Table 18.1** Brazilian macroeconomic evolution between 1999 and 2009

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
GDP growth (percent)	0.2	4.3	1.3	2.6	1.1	5.7	3.1	3.9	6.0	5.2	-0.3
Inflation (percent)	8.9	6.0	7.7	12.5	9.3	7.6	5.6	3.1	4.5	5.9	4.3
IPOs	1	1	0	1	0	7	9	26	62	5	6
Bovespa traded volume (\$ billion)	86	95	65	39	71	114	172	281	677	590	747
Foreign investments (\$ billion)	28.5	32.7	22.4	16.6	10.1	18.1	15.1	18.8	34.5	45.0	25.9
Pension funds (\$ billion)	69	79	72	65	78	96	137	175	258	191	296

Sources: De Carvalho et al. (2006), ABDI (2011), and BMF&Bovespa for data on trade and IPOs.

Notes: All values reported refer to the end of each year. Data on inflation and foreign investment were collected at the site of the IPEA. Data on pension funds were collected from the Brazilian Association of Private Pension (ABRAPP). Data on IPOs and volume were collected at the Stock Exchange of São Paulo (Bovespa).

*Development of capital markets.* The maturity of the Brazilian stock market was achieved mainly with the creation of Bovespa's<sup>3</sup> premium markets. According to De Carvalho and Pennacchi (2011), a major obstacle for the development of capital market in Brazil was the little protection offered to minority shareholders (use of nonvoting shares, low level of disclosure, and other poor corporate governance practices). In 2000, Bovespa created three new listing segments: Novo Mercado and Corporate Governance Levels I and II. To be listed on one of these segments, the company needs to commit to a set of corporate governance practices. These markets have matured since 2004 with a wave of initial public offerings (IPOs). Between 2004 and 2009 the proportion of companies listed on one of these new markets jumped from 12 percent to 38 percent of the listed companies. The volume of trade at Bovespa that averaged \$71 billion a year over 1999–2004 jumped to \$671 billion per year over the 2007–2009 period (see table 18.1). The IPO market that had been virtually nonexistent (only six IPOs between 1996 and 2003) emerged. From 2004 to 2009 there were 115 IPOs (see table 18.1). One should also observe that the IPO market remained active even after global financial crisis broke out in 2008, although much more selectively.

*Emergence of the pension fund industry.* By 2001 the existing retirement system was fully state operated. Active workers made contributions to the state based on their current wages. The state used these contributions to pay the pensions of retirees based on the wages that they received at the time of retirement. Only a few large state-owned enterprises had pension funds. The aging of the population and increase in life expectancy led the state model of retirement to bankruptcy. As consequence, in 2001 the model had to be reformed: retirement age went up, and a cap for pensions was established at about \$1,400 a month. This led Brazilians to seek supplementary retirement through private pension funds. Since then this industry has been growing rapidly. From 2001 to 2009,

the value of pension fund assets more than quadrupled from \$72 to \$324 billion (Abrapp, 2011).

*Improved income distribution and poverty reduction.* One of the main weaknesses of the Brazilian economy up the 1990s was widespread poverty and income concentration. In 1999 the proportion of the population below the poverty line was 35 percent. The Gini index that measures income concentration was 0.59 (compare this to Uruguay–0.45; Russia–0.37; South Korea–0.32; and the United States–0.41). Since the mid-1990s, the Brazilian government created and intensified social policies for income redistribution and poverty alleviation. The total value of benefits increased from \$151 million in 2004 to \$632 million in 2009. This caused the proportion of the population below the poverty line to fall to 21.4 percent in 2009, and the Gini index, to 0.54. Policies for the extension of credit to the low-income population were also important. For example: payroll loans,<sup>4</sup> created in 2004, reached \$8 billion in January 2010. As a result of the resumption of economic growth and better income distribution, 32 million people moved from the lower class to middle class (CPS-FGV, 2010). The increasing purchase power of low-income population is now creating demand for several products targeted at this segment. Many PEVC funds have been focused on low income; for example, large-scale low-fee universities, building and construction, and low-income consumption goods.

*Highly entrepreneurial population.* Brazil has strong entrepreneurial culture. On an average, 500,000 new companies are created each year (DNRC, 2005). The report by GEM (2004), which measures total entrepreneurial activity,<sup>5</sup> ranked Brazil in the seventh place. Brazil presented a high absolute number of entrepreneurs (15.4 million prospective entrepreneurs or new business owners), second only to the United States. The same study also reports a high number of opportunity entrepreneurs (motivated by the perception of a specific market or niche opportunity), vis-à-vis the number of entrepreneurs by necessity (motivated by lack of other opportunities or income). Roughly half of the 15.4 million of new entrepreneurs are in the first group.

*Sophisticated technology capabilities.* Brazil achieved technological excellence in a number of areas including: (1) agricultural biotechnology—development of new varieties of cotton, soybeans, wheat, and sugar cane tailored for different kinds of lands and climates and with high resistance to pestilence; (2) aeronautics industry, which is internationally competitive; (3) development, extraction, and transportation of deepwater oil; (4) genetics research; (5) capability to fully enrich uranium; (6) development of renewable energy, such as ethanol, biodiesel, and biomass; (7) development of hardware and software for telecommunications, optical fiber, production of satellites, and software for information technology; (8) steel production technology; (9) banking technology; and (10) automotive technology, urban passenger transport, and internationally competitive cargo transport.

## **The Brazilian Private Equity and Venture Capital Industry**

### Industry Evolution

*Commitments.* PEVC is relatively recent in Brazil but has been rising sharply (see table 18.2). Between 1999 and 2004, commitments grew at 9 percent per year from

**Table 18.2** Brazilian private equity and venture capital evolution

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Committed capital (\$ billion)	3.7	4.9	5.0	4.7	4.8	5.6	7.2	13.5	22.7	28.1	36.1
Committed capital (percent of GDP)	0.63	0.77	0.91	0.93	0.87	0.97	0.82	1.24	1.66	1.70	2.33
Number of managing organizations (percent per year)	-	-	-	-	-	71	-	-	-	127	144
VC backed IPOs	-	-	-	-	-	5	8	17	19	1	4
Number of funds	-	-	-	-	-	97	-	-	-	181	239

Source: De Carvalho et al. (2006) and ABDI (2011).

Notes: All values reported refer to the end of each year. Data on inflation and foreign investment were collected at the site of the IPEA. Data on pension funds were collected from the Brazilian Association of Private Pension (ABRAPP). Data on IPOs and volume were collected at the Stock Exchange of São Paulo (Bovespa).

\$3.7 to \$5.6 billion. More recently, from 2004 to 2009, the growth rate was near 50 percent per year, reaching \$36.1 billion in 2009. This fast rise can be explained by the macroeconomic stability, attainment of investment grade, and the graduation of the PEVC industry, mainly through a wave of IPOs between 2004 and 2007. Taken as proportion of GDP, the growth in commitments represents an increase from 0.63 percent in 1999 to 2.33 percent in 2009. Compared to countries where PEVC is more developed, such as the United States (3.7 percent of GDP) and the United Kingdom (4.7 percent), one can see that there is still room for continued growth.

Commitments are concentrated across managing organizations (MOs). In 2009, the 15 largest MOs in terms of committed capital managed 63 percent of the aggregate commitments (ABDI, 2011). The five largest MOs managed 31 percent of the commitments. The 15 top MOs averaged \$2.3 billion under management, whereas each of the remaining 139 MOs averaged \$180 million.

*Portfolio.* Another evidence of the industry rise is the number of portfolio companies (PCs) (see table 18.3). It increased from 306 PCs in 2004 to 502 in 2009. There was also a change in the focus of investments, with an increase on private equity vis-à-vis venture capital. The proportion of PCs that received their first investment in the VC stage dropped from 67 to 47 percent, while the proportion of PE investments went from 33 to 53 percent. The relative increase in PE may be due to the increase in commitments and the rise of exits through IPOs, as conjectured by Jeng and Wells (2000). Surprisingly, investments in seed capital and start-ups that require relatively small capital investment fell from 11.8 and 23.5 percent to 7.6 and 13.2 percent, respectively.

In terms of industrial sector, investments are also very concentrated, even though the concentration has been falling (see table 18.4). The most invested sectors have been changing. Table 18.4 shows that between 2004 and 2009 the participation of five main sectors declined from 70 percent to 63 percent of the PCs. The IT sector remains as the most invested, but its share fell from 30 percent to 20 percent. The

**Table 18.3** Stage of portfolio companies at the first round of finance in Brazil

Stage	2004		2009	
	Number of firms	Percent of portfolio	Number of firms	Percent of portfolio
Venture capital	204	66.7	203	46.9
Seed capital	36	11.8	33	7.6
Start-up	72	23.5	57	13.2
Expansion	96	31.4	113	26.1
Private equity	102	33.3	230	53.1
Late stage	42	13.7	186	43.0
Other stages	17	5.6	17	3.9
PIPEs	43	14.1	27	6.2
Without information	0	–	69	–
Total	306	100	502	100

Source: De Carvalho et al. (2006) and ABDI (2011).

Notes: Distribution of portfolio companies in December 2004 and 2009 according to the stage where it received the first finance round, *seed capital*: preoperational stage, *start-up*: the structuring stage of the business when the products aren't sold; *expansion*: expansion of the activities of a company that already sells its products; *late stage*: the company that has a stable growth rate and positive cash flow. *Other Stages*: includes acquisition finance (capital to acquire other companies), mezzanine (stable companies with growth potential), management buyout/in (contribution for the acquisition of control), bridge finance (capital prior to IPO), turnaround (capital for companies with operational and/or financial difficulties), and PIPE (private investment in public equity) investment in companies already listed on stock exchanges.

sectors with highest growth were: construction (from 3 percent to 14 percent) and energy and fuels (from 2 percent to 11 percent). The growth of the energy sector is related to the growth in this market. Brazil will be the seventh largest energy market in 2030 (EYT-FGV, 2007). To meet the growing demand for energy, it will be necessary that the supply of energy increase at 3.3 percent per year over the next three decades. Furthermore, Brazil is one of the leading countries in the development of clean energy. The growth of investments in building and construction is related to factors such as expansion of mortgage lending (from \$1.6 billion in 2002 to \$14 billion in 2007 according to EYT-FGV, 2008); increase in the income of the poorest; and chronic housing deficit (7.8 million homes in 2005, according to EYT-FGV, 2008).

Investments are also geographically concentrated in a few Brazilian states (ABDI, 2011). The south and southeast regions of the country comprise a vast majority of the portfolio with 387 companies (92 percent of the PCs) in 2009. Investments are concentrated even in some states inside these regions, for example, São Paulo had 57 percent of the portfolio.

*Exits.* The means of exiting investments has been changing over time. Table 18.5 reports exits in the PEVC industry from 1999 to 2009. At the beginning (1999–2004) there were several failures: buybacks and write-offs represented approximately 50 percent of the exits. Ribeiro and De Carvalho (2008) associate this high number of failures to investments in the dotcoms during the late 1990s. Subsequently (2005–2009) the number of failures decreased: buybacks and write-

**Table 18.4** Sectors of activity of portfolio companies in Brazil

Sector	2004		2009	
	# of firms	Percentage	# of firms	Percentage
Electronic and IT	92	30.0	103	20.5
Construction	9	2.9	69	13.7
Energy and fuel	7	2.3	56	11.2
Diverse industries	52	16.9	55	10.9
Communication	28	9.1	33	6.6
Retail	21	6.9	26	5.2
Agribusiness	8	2.6	25	4.9
Transport and logistic	18	5.9	20	3.9
Food and beverages	12	3.9	19	3.8
Infrastructure	9	2.9	19	3.8
Financial services	10	3.3	16	3.2
Medicine and cosmetics	8	2.6	15	2.9
Biotechnology	10	3.3	14	2.8
Diverse services	6	1.9	10	1.9
Education	3	0.9	8	1.6
Entertainment/tourism	9	2.9	7	1.4
Extractive industry	2	0.6	7	1.4
No information	2	0.6	0	0.0
Total	306	100	502	100

Source: De Carvalho et al. (2006) and ABDI (2011).

Notes: Number and percentage of portfolio companies aggregated in December 2004 according to the leading economic sector of activity. For multisector companies, we considered only its main activity.

**Table 18.5** Exits from investee businesses in Brazil

Exit Mechanism	Year										
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
IPO	–	–	–	–	–	5	8	17	19	1	4
Secondary sale	1	18	5	4	5	4	6	12	10	16	10
Trade sale	4	13	8	6	6	15	4	6	12	27	11
Buyback & Write-off	3	5	30	20	13	14	6	7	7	17	12
Total	8	36	43	30	24	38	24	42	48	61	37

Source: De Carvalho et al. (2006) and ABDI (2011).

Notes: Number of business exits conducted annually according to the mechanism used in the 1999–2009 period. Not including PIPEs (private investment in public equity). It is important to note that the number of business exits is not necessarily equal to the number of companies, in general it is different. For example, a company invested in two PEVC funds is computed as two businesses.

offs represented only 23 percent of the exits. Exits through IPOs began only in 2004. This was a milestone for the Brazilian PEVC industry, because it showed its capacity to perform the complete investment cycle. Between 2004 and 2009 there were 115 IPOs in Brazil, 54 of which were of PEVC-backed companies.

## Industry Structure

*Managing organizations.* The number of MOs with their offices in the country increased from 71 in 2004 to 144 in 2009, and the number of funds, from 97 to 239 (De Carvalho et al., 2006; ABDI, 2011). Similar to countries in which PEVC is well established, independent organizations are emerging as the predominant form of MO. Affiliates to financial institutions or the state were important in the past, but their presence has been declining. In 2009, independent organizations represented 85 percent of all organizations. Financial institution affiliates that were 28 percent in 2004 declined to 12 percent, and state affiliates from 3 percent to 1 percent. A similar picture emerges when one considers capital commitments: independent organizations represent 80 percent; financial institution affiliates declined from 38 percent to 16 percent; and state affiliates maintained their share at approximately 3 percent. Interestingly, one should note the near absence of corporate ventures: four funds in 2004 and only two in 2009.

MOs of Brazilian origin are predominant. The participation of domestic organizations remained stable between 2004 and 2009 with nearly 75 percent of the organizations and 60 percent of the commitments. The participation of North American organizations decreased from 14 percent to 2 percent (from 10 to 3). However, in terms of commitments the fall was not so sharp: from 31 percent to 18 percent. Organizations from Europe increased from 6 percent to 16 percent (from 3 percent to 9 percent in terms of commitments).

*Qualified and experienced professionals.* De Carvalho and others (2006) analyzed the profiles of PEVC managers as of 2004.<sup>6</sup> They found that Brazilian managers are highly qualified: 3.5 percent of managers hold a doctorate degree, 55 percent hold an MBA or LL.M., while over 73 percent have undergone some form of postgraduate study. Managers with background in administration, economics, or accounting comprise more than 90 percent of the total. A large part of the managers (36 percent) come from the financial sector. However, executives from nonfinancial companies, who typically have experience similar to developing and executing business strategies (CEOs, entrepreneurs, consultants, and business angels), represent more than half of the total number of managers.

*Funds legal structure.* In the United States, limited partnerships (LPs) are the most appropriate legal structure for PEVC funds (Sahlman, 1990). Its main advantage is that profits are not taxed at the partnership level. Each investor collects tax on profits at their own tax rate. Thus, pension funds, major investors in PEVC, do not collect tax on their PEVC investments. In Brazil there is no legal structure such as limited partnership. PEVC funds have used diverse legal structures. De Carvalho et al. (2006) show that the holding company structure was the most widely used fund structure. Limited partnerships structured in other country were also commonly used. However, the holding structure in Brazil has two important shortcomings for PEVC: profits are taxed at the holding level, and there are limits to the appropriation of tax shields generated by losses on unsuccessful investments. To circumvent these limitations, Comissão de Valores Mobiliários<sup>7</sup> (CVM) established investment funds—FIP and FMIEE<sup>8</sup>—that allow complete appropriation of tax shields and investors to collect income tax at their own tax rates. In 2009 investment funds structured as FIP or FMIEE amounted to 42 percent of the funds; holdings, 13 percent; and

as LP incorporated in other countries, 26 percent (ABDI, 2011). One of CVM requirements for FIP and FMIEE funds is the use of arbitration panels for settlement of conflicts: 76 percent of funds use arbitration panels (ABDI, 2011).

*Compensation.* GPs' compensation usually has two components: management fee and carried interest. The basis for the management fee usually differs across investment and postinvestment periods (De Carvalho et al., 2006; ABDI, 2011). During the investment period, the most common basis is the capital commitment (55 percent of the funds in 2004 and 63 percent in 2009). For the postinvestment period, there has been an increasing use of the market value of investments (from 29 percent to 45 percent) and the cost of investments (from 12 percent to 27 percent). The use of commitments in the postinvestment period declined from 38 percent to 12 percent of the funds. In 2004, the most frequently used management fee was either 2 percent or 2.5 percent of the basis (used in 41 percent of the funds). Also, in 2004, 62 percent of the funds used carried interest of 20 percent. The most common model (used in 39 percent of the funds) provided carried interest of 20 percent and a management fee of either 2 percent or 2.5 percent.<sup>9</sup>

### **Brazilian Idiosyncrasies**

#### Private Equity and Venture Capital without Debt Finance/ No Buyouts/Shared Control

In Brazil, commercial banks do not provide long-term loans (see the section on obstacles to PEVC later). Because of the lack of long-term credit, buyouts are not the typical PEVC transaction in Brazil. Moreover, the need for risk diversification prevents GPs from investing large amounts in a single PC. These two facts combined explain why the GPs in Brazil frequently cannot acquire full control in their PCs. De Carvalho and others (2006) report that PEVC investors took part in the controlling group of only 115 (35.3 percent) of the 325 deals in portfolio in 2004. In only 21 percent of the deals they acquired full control. Deals with no participation in the control represented 26.2 percent.

The lack of full control (not only in the case of minority participation) is usually compensated by the acquisition of some special rights. ABDI (2011) reports that in 2009, 61 percent of the deals embedded some special rights. The most common rights were: the right of veto in cases of mergers and acquisitions (95 percent of the deals), on the investment budget (91 percent), on the annual budget (86 percent), on indebtedness (86 percent); preemptive rights in case of capital increase (46 percent), drag-along right in case of exit (15 percent), and guarantee on investment return<sup>10</sup> (23 percent).

#### Limited Partners in the Investment Committees

Another idiosyncrasy of the Brazilian PEVC industry is the participation of LPs in the investment process. This occurs mostly through their presence in investment committees. For example: De Carvalho et al. (2006) report that the investment decision in 57 percent of the funds (representing 25 percent of the overall capital

committed in the industry) requires the approval of an investment committee composed of GPs and LPs. For 14 percent of the funds, the investment decision requires unanimity in the committee.<sup>11</sup> In some cases LPs have a voice even on the exit decision: for 32 percent of the funds (17 percent of the committed capital) the investment committee decides on the exit, and for other 29 percent (16 percent of the capital) LPs and GPs do it together.

The participation of LPs in the investment process by itself is not without sense. Axelson et al. (2009) portray the financial structure of PEVC funds as a mechanism to mitigate the incentive problem between GPs and LPs: when the deal flow is bad, GPs would rather invest in little promising companies than return capital to LPs. This problem can be mitigated if LPs force GPs to require the approval of banks as in the case of levered buyouts. This can be attained by establishing covenants that prevent GPs from fully funding an investment, for example, by limiting the amount to be invested in a single portfolio company. This mechanism is not feasible when long-term debt is not available because deals cannot be levered, and consequently banks do not sanction GPs decisions. This is the case in Brazil. In such cases, investment committees staffed with LPs or their representatives constitute an alternative to circumvent the absence of long-term debt and creditors' referral. To our knowledge, De Carvalho et al. (2012) is the only study to examine the effect of LP participation in the investment process. They found that funds with investment committees, when compared to those without it, present an inferior performance.

Historically, the prevalence of investment committees can be linked to the role of the state in the development of the PEVC industry. The Brazilian state was very active in fostering the development of competences in the industry. De Carvalho et al. (2006) report that in 2004, domestic institutional investors, most of which are pension funds of state-owned enterprises, contributed with 22 percent of the commitments in the industry spread over 39 funds. The state-owned enterprises contributed with 7.2 percent spread over 27 funds. For reasons that we do not explore here, the state as investor demands participation in investment committees. In the opposite direction, sophisticated investors do not invest in funds with investment committees.<sup>12</sup>

#### Obstacles for Private Equity and Venture Capital in Brazil

In this section we discuss some of the main obstacles in the development of PEVC in Brazil. We conclude this section presenting some results on the perception of Brazilian PEVC managers on the main obstacles.

*Chaotic tax system.* One of the main obstacles for doing business in Brazil is its fuzzy tax system. This creates the need for clarifications from the authorities. An average firm needs to comply with 3,207 tax procedures and on every working day, the authorities create 46 new tax procedures (IBPT, 2010). The tax burden is also considerably high. Taxes are not based on value added. A single component of the final product is taxed several times along the production chain (taxed when sold as final product and also taxed when sold as an input). As consequence, some activities are overtaxed, depending on how segmented the production chain is. FIESP

(2010) estimates that the average tax load of the transformation industry represents 59.8 percent of the industry GDP. World Bank (2012) reports that the total tax rate as a proportion of the profit in Brazil is 67 percent, much higher than in other countries (Mexico, 53 percent; China, 63 percent; India, 62 percent; Korea, 30 percent; Russia, 47 percent; and the United States, 47 percent). Finally, the overall tax burden in 2009 was 33.7 percent of its GDP (compared to Mexico, 17.4 percent; China, 21 percent; India, 12 percent; Korea, 25.5 percent; Russia, 24 percent; and the United States, 24 percent).

The complexity of the tax system imposes indirect costs on firms. In Brazil, on an average, a firm spends 2,600 hours to pay taxes (World Bank, 2012). This same indicator for Mexico is 347 (China, 389; India, 245; Korea, 225; Russia, 290; and the United States, 187). FIESP (2011) found that 9 percent of the firms affirm to have a lawsuit against the state to recover undue taxes, while 9.2 percent report to have a lawsuit contesting tax payments. Finally, in 2007, the Brazilian subsidiary of Dow Chemicals had 25 employees in its tax administration department, twice as many as in Argentina, Mexico, Venezuela, and Chile combined (FIESP, 2011).

*Tax evasion and informality.* Two of the main consequences of a fuzzy tax system are tax evasion and informality in business. IBPT (2009) estimated that fiscal evasion in 2009 represented 25 percent of the sales of all Brazilian companies (the same number was 32 percent in 2000 and 39 percent in 2004). Furthermore, there are evidences that tax evasion occurs in 65 percent of small firms, 49 percent of medium firms, and 27 percent of large firms. An annual survey conducted by the Brazilian government (IBGE, 2011) reports that informality in the labor market has been around 50 percent in the past decade.

*Corruption.* This is a serious obstacle for doing business in Brazil. Such problem is even more binding when rules, such as taxation, are not precise. The Corruption Perception Index<sup>13</sup> of 2011 computed by Transparency International ranks Brazil in the seventy-third position. However, this is a problem affecting most of emerging markets seen that China is ranked 75, India (95), Russia (143), and Mexico (100). Korea (rank 43) is an exception.

*Lack of long-term credit.* In Brazil, commercial banks supply only short-term debt (Souza-Sobrinho, 2003). The only source of long-term debt is the National Bank for Economic and Social Development (BNDES). However, BNDES credit lines are limited in value and dedicated to specific purposes such as infrastructure, incentives to export and import, and acquisition of domestically produced machinery and equipments.

ABDI (2011) presents the opinion of 84 MOs concerning the main macroeconomic obstacles to the development of PEVC in Brazil (see table 18.6). The numbers by themselves are not meaningful. However, when compared to each other, they allow an overview of the main obstacles. One can observe that there is very little disagreement concerning the importance of tax burden and high interest rates. Employment regulations, informality in business corruption, and availability of loans are also important, even though some disagree with it. Other factors such as politics, quality of entrepreneurs, macroeconomic environment, and criminality do not seem to be serious obstacles.

**Table 18.6** Importance of macroeconomic obstacles to private equity and venture capital in Brazil

<i>Obstacle</i>	<i>Agree</i>	<i>Indifferent</i>	<i>Disagree</i>
High tax burden	90%	5%	5%
High interest rate	85%	9%	6%
Employment regulation constraints	70%	20%	10%
Informality in business	70%	15%	15%
Corruption	66%	19%	15%
Loan availability	58%	21%	2%
Instability of public policies	53%	28%	19%
Politics environment	38%	23%	39%
Quality of entrepreneurs	38%	13%	49%
Macroeconomic environment	29%	13%	58%
Criminality	23%	44%	33%

*Source:* ABDI (2011)

*Notes:* Opinion of private equity and venture capital managers concerning the main macroeconomic obstacles to the development of PEVC in Brazil. The sample consists of 84 managing organizations representing 58 percent of all organizations with office in the country.

### Conclusion

PEVC in Brazil has been a fast-growing industry that has already achieved scale and maturity. Furthermore, there are several elements favorable to its continuing development: (1) critical market size—GDP of near \$2 trillion and a population of near 200 million, as of 2010; (2) active market for IPOs; (3) growing pension fund industry; (4) high entrepreneurial activity in the country; (5) little regulation to limit entrepreneurship; (6) a reasonable number of PEVC managers with track record; (7) history of exits showing capacity to realize the full investment cycle; and (8) favorable attitude of regulatory authorities with respect to the continuing development of the industry.

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### Notes

1. Standard & Poor's on April 30, 2008 and Moody's on September 22, 2009.
2. Most of it came in anticipation of the investment grade.
3. São Paulo Stock Exchange.
4. Employees pledge their wages as collateral to loan.
5. TEA is defined as the proportion of the workforce between 18 and 64 years, which actively seeks to be engaged in the creation of a new business or is working in a new business that has been operating for less than 42 months.
6. Unfortunately, ABDI (2011) does not analyze this aspect.
7. Brazilian security and exchange commission.

8. Fundos Mútuos de Investimentos em Empresas Emergentes (FMIEE) established through ICVM 209 on March 25, 1994 and Fundos de Investimentos em Participações (FIP) established through ICVM 391 on July 16, 2003.
9. ABDI (2011) does not provide comparable data for 2009.
10. The most common guaranties are: invested capital plus stipulated return in the case of sale (79 percent), liquidation (36 percent), and dividends payment (36 percent).
11. ABDI (2011) reports that in 2009 for 65 percent of the funds new investments required approval of the investment committee. However, it does not report their importance in terms of committed capital.
12. Sophisticated LPs say that they choose PEVC funds based on the track record of their GPs, not on the skill of the other LPs.
13. Available at <http://cpi.transparency.org/cpi2011/results/#CountryResults>,

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## CHAPTER 19

# CONTOURS OF RUSSIAN PRIVATE EQUITY

*Maria Musatova*

### **Introduction**

The private equity industry in Russia dates back to 1993, when EBRD Board of Directors approved a program of regional venture funds. Since then, the industry has evolved and seen new fund managers appear, evolve, and some of them disappear, and has been shaken by two damaging financial crises, which have led to regrouping of fund managers and consolidation of existing funds. We take a closer look at the last nearly 20 years of industry development and consider the taxonomy of fund managers working in the country. The chapter considers Russian private equity industry in light of BRIC (Brazil, Russia, India, and China) counterparts and considers possible explanations behind recent fundraising trends. The market structure of the private equity industry is discussed. We discuss the landscape and diversity of Russian private equity and venture capital industry, along with the recent steps of the Russian government to reinvigorate the industry.

### **Russian Private Equity among BRIC countries**

The recently introduced IESE VCPE country attractiveness index compares nations on how attractive they are to a private equity investor. The index takes into account an array of specific indicators including economic, social, and political factors and human capital, and tends to be highly correlated with the actual private equity fundraising figures. According to the index, Russian private equity was 51 percent as lucrative for investors as the US private equity in 2011, placing it ahead of Brazil but behind India and China. Compared to the previous year, the ranking showed an improvement in investors' sentiment toward the country (see table 19.1).

Presumably, solid ranking together with its year-on-year improvement in comparison to Brazil, would correspond to a rise in fundraising figures (table 19.1). However, it was not true for Russia, and despite an improvement in Russia's score on the index the total fundraising figure was slipping further down in 2010 year on year, as the fund managers struggled to secure commitments in a challenging business environment. Actual performance continued to differ from rankings in 2011,

**Table 19.1** Attractiveness of venture capital and private equity in BRIC countries

	<i>Brazil</i>	<i>Russia</i>	<i>India</i>	<i>China</i>	<i>Total</i> (\$ million)
<i>Private Equity Country Attractiveness Index</i>					
2010–2011	48.7	51.1	61.4	72.3	
2009–2010	34.6	38.0	40.9	48.5	
<i>Fundraising statistics (\$ million)</i>					
2011 (third quarter)	4,465	60	2,883	12,885	20,263
2010	1,078	75	3,268	7,509	11,931
2009	401	455	3,999	6,617	11,472
2008	3,589	880	7,710	14,461	26,640
2007	2,510	1,790	4,569	3,890	12,759
<i>Governance indicators</i>					
Political stability	0.05	-0.89	-1.31	-0.77	
Rule of law	0	-0.78	-0.06	-0.35	
Control of corruption	0.06	-1.07	-0.52	-0.6	
<i>Median investment size (\$ million)</i>					
2011 (third quarter)	62	5	13	20	
2010	56	10	11	15	
2009	56	4	10	12	
2008	100	15	15	20	
Country average	68.5	8.5	12.25	16.75	

Source: The Global Venture Capital and Private Equity Country Attractiveness Index (<http://blog.iese.edu/vcpeindex>); Emerging Markets Private Equity Association ([www.empea.net](http://www.empea.net)); Worldwide governance indicators, World Bank Institute (<http://info.worldbank.org/governance/wgi/>).

as investors ramped up their allocation to Brazil almost fourfold as compared to 2010, whereas the fundraising figure for Russia remained unchanged.

According to some key macroeconomic indicators, Russia has a strong foothold compared to other emerging economies including public debt (where Russia is lowest among BRIC countries), GDP per capita (highest among BRICs), growth in consumer spending over the past ten years (highest among BRICs), among others. It appears that the recent positive economic news did not have the expected effect on investors, and fundraising figures imply that institutional investors voted based on political instead of economic factors (review table 19.1). The risk of adverse changes to legislation that could affect business activities, negative political developments, bureaucratic barriers for business, and concerns over corruption occupied the minds of investors and discouraged them from Russia. According to worldwide governance indicators, all the BRIC countries have seen political stability deteriorate in 2008–2010, with one notable exception—Brazil. Brazil has been the only country to have transcended into a positive zone of the index. Russia and Brazil have seen improvements in the rule of law over these three years, while India has worsened its position, and China has remained constant. On control of corruption, China and India have continued to decline. Russia remained constant, while Brazil improved, a trend that was apparently welcomed by investors.

On yet another metric comparing nations on the penetration of private equity investments, the share of private equity investments in GDP, Russia is again lowest

among other BRIC nations. Between 2008 and 2010, the average share for the country trailed 0.09 percent, while China and Brazil recorded penetration rates of 0.17 percent and 0.15 percent, respectively, and India held a significant lead with 0.46 percent. However, even for India the ratio is half that of the United States, the most developed private equity industry to date (0.87 percent). Slow penetration of the private equity of investments is further exacerbated by a small investment volume. According to EMPEA, median investment size in private equity transactions was \$8.5 million in Russia between 2007 and quarter three, 2011, the lowest among the BRIC nations (see table 19.1). A poor penetration rate of private equity investments in Russia suggests, however, a huge growth potential for the industry, as long as the country can overcome the current negative reputation and attract substantial interest of institutional investors.

Russian authorities have long recognized the gap and set their sight on achieving US-like level of venture capital and private equity penetration through the introduction of several initiatives in the recent years. In February 2011, Russia announced plans to establish a \$10 billion Russian direct investment fund (RDIF, formally established in June 2011). To mitigate the international investors' apprehension in entering the country and remedy their lack of local presence, the Russian government will coinvest all transactions in the fund. The minimum investment size through the RDIF will be \$100 million, with the government coinvesting \$50 million. It will focus on dynamic sectors with good growth prospects, such as telecoms, pharmaceuticals, food retail, and infrastructure. However, it remains to be seen whether the fund will maintain a strategy on achieving high returns instead of serving the political interests of the state. Another challenge might be in finding quality transactions of an appropriate size: to date, independent private equity funds have clinched deals with a median size far below \$100 million.

The Russian government has acknowledged the importance of focusing on innovation and developing a knowledge-based economy, with a long-term goal to wean off overreliance on natural resources. Russia has a large R&D sector (as measured by the number of research staff per capita), but its output is comparable only to that of China, largely due to missing links between public and private R&D (Desai and Goldberg, 2008). To reinvigorate the industry and build infrastructure for attracting investors into R&D, an initiative to set up Skolkovo as a science and technology innovation center near Moscow quickly took off the ground. Skolkovo will focus on five key sectors: (i) new fuels and energy-saving technologies; (ii) nuclear energy and nuclear technologies; (iii) aerospace technologies including GLONASS (Russian equivalent of GPS); (iv) medicine and pharmaceuticals; and (v) strategic IT including supercomputers (PWC, 2011). Furthermore, the government has launched a number of formal initiatives to provide various tax breaks for innovative private enterprises. The risk with tax incentives, however, is that instead of spurring innovations they can lead to distorting tax-avoidance behavior (Desai and Goldberg, 2008).

On the legal front, Russia has recently enacted a number of important laws related to capital markets, aiming to protect investor rights in a better manner and align more closely with international legislative practices. The country was quick to introduce cutting-edge legislative initiatives that took the West decades to formulate. Among important legislative initiatives are an insider trading law that came

into effect on January 27, 2011, and amendments to the Russian Securities Market Law regarding permission for foreign securities to be listed on Russian exchanges.

While legislation is moving fast, there remains room for improvement, especially in the areas of law implementation and enforcement. For example, the country needs to accept the authority of the courts rather than showcase political will. Furthermore, the investment community is eagerly expecting Russia to reinforce the alternative dispute resolution mechanism. Given that the court decisions may be driven by political reasons, strengthening the alternative dispute resolution can empower the country with an efficient and transparent tool to resolve commercial disputes, particularly in resolving international disputes.

Political and legal risks remain high on the scorecard of international investors, and it is unclear whether the establishment of RDIF, Skolkovo, Rusnano (a state-owned company focusing on nanotechnology), other government-sponsored developments, and an overall course toward an innovation-based economy will successfully mitigate them. However, there is an expectation that these measures will galvanize the investment climate, together with an incrementally growing recognition of increasing global linkages of Russia in the global economy.

At the time of writing, increasingly large political demonstrations may lead to further trepidation from international private equity investors. The impact of these remains to be seen throughout the rest of 2012. The stock market in the last quarter of 2011 has been negatively affected by the Duma elections. However, depending on presidential election outcomes, further market volatility may be limited in 2012.

Despite the fact that deficiencies in the political sphere do provide part of the answer on global private equity allocations, lackluster interest of international investors toward Russia is largely attributable to institutional factors, like the peculiar structure of capital markets.

### **Russian Private Equity Industry: 20 Years in the Making and Funds Taxonomy**

According to industry experts, there are well over 30 private equity fund managers that include Russia in their investment strategy. This group represents an extremely diverse mix of country-focused, regional, and opportunistic global players in addition to government-sponsored funds. Within these, one can further distinguish “classic,” or “institutional quality” fund managers, separate sector-specific funds from generalists, or distill funds that currently have “dry powder” (money available for investment). Notwithstanding, the vast majority of these funds tend to focus on investing in small- and medium size companies with fundamentally sound business models, which require growth financing for further development.

European Bank for Reconstruction and Development (EBRD) seeded private equity and venture capital in Russia in the mid-1990s, providing approximately \$312 million for the establishment of 11 regional venture funds (RVFs)<sup>1</sup>. The primary objective of the program was to establish the infrastructure for making private equity investments in the Russian regions, supply equity capital to small- and medium-sized companies throughout the country, and ultimately build up the case for viability of the asset class in the country in order to attract the interest of

private investors (*EBRD Report*, 2006). At that time, there was hardly any expertise in fund management, and the impetus of the establishing RVFs was to develop a class of experienced private equity managers. Out of seven fund managers, not all proved to be equally apt and committed to the business of fund management, and the 1998 financial crisis brought further distress to the industry. Among the fund managers who overcame considerable operational difficulties and proved to be successful in adding value to the portfolio companies were Quadriga Capital and Norum. In the mid-1990s, two more managers emerged—Baring Vostok, Russia Partners. These fund managers went on to become industry leaders. These fund managers survived in the challenging business environment, and went on raising follow-on funds.

During the same period, the US government infused \$440 million in the establishment of the US Russia Investment Fund (1995), managed by Delta Private Equity Partners. The fund's mission was to promote the development of a free market economy in Russia by providing investment capital to potentially high-growth companies. After accomplishing its primary mission, a successor private fund, the Delta Russia Fund, was founded.

Alongside these fund managers, independent fund managers began to emerge, such as Mint Capital, Aurora Investment Advisors, and so on. These fund managers relied on their own proprietary circle of investors and sometimes went on raising a follow-on fund with these limited partners (e.g., Scandinavian pension funds). Captive funds and quasiprivate equity funds, sponsored by financial-industrial groups, continued strengthening their clout. These groups were generally owned by high-net-worth individuals such as Renova (Mr. Vechselberg), Alfa (Mr. Friedman), Sistema (Mr. Yevtushenkov), Basic Element (Mr. Deripaska), Millhouse (Mr. Abramovich), and Interros (Mr. Potanin). These financial institutions may not fully follow accepted fund criteria and best industry practices, such as limited fund life or transparency, because they have sufficient sources of capital already, and attracting foreign institutional money therefore does not form part of their agenda. Hedge funds began to appear from 2007. As an example, Moore Capital participated in Transcontainer's \$300 million pre-IPO at the beginning of 2008. Global private equity funds did occasionally venture into the market but, in contrast to other BRIC countries, global fund managers struggled to establish a Russian presence and failed to set up a local office. They instead limited their exposure to doing selective transactions at opportune times (the notable exception being TPG, who opened a local office in Russia in 2007).

Further challenges to the industry have been brought about by the recent economic crisis, which resulted in substantial write-offs on investments made not so long ago, at the peak of the crisis. These write-offs encouraged funds to be thoroughly reviewed for their investment strategy, hurt fundraising efforts, and led to further reshaping of the industry. In 2009, restructuring of the Renaissance Private Equity Fund led to a spin-off of Elbrus Capital with its own investment team and dry powder, which was later on invested into telecom and media companies, among others. Elbrus Capital sought to attract \$180 million in 2010. The financial crisis also led some firms to collaborate further, such as Delta and UFG who combined their Russia offices in 2009.

The impact of the crisis was certainly felt by institutional investors who witnessed contraction in portfolio valuations of the funds supported, and endured sensitive discussions with fund managers on portfolio restructuring. Though returns data are extremely scarce, EBRD provides comprehensive data free of survivorship bias for the funds the bank has backed (table 19.2).

Gross IRR for the overall portfolio has seen a decline of 4 percent since the peak of economic growth in 2007 (data include funds in Central Eastern and Southeastern Europe, and Russia/CIS). However, the returns on fully exited investments remained the same over four years, largely because of lack of exits due to the negative environment. Overall, performance shows a strong record of double-digit returns achieved for the basket of funds, including those in Russia. A successful record of investing in Russian private equity funds strengthens the case for emerging markets and suggests a possibility of replicating the returns by other institutional investors.

At present, the fundraising climate for private equity funds in Russia remains profoundly challenging. As international investors have turned away to other markets and focused on restructuring their own portfolios, the role of local capital has become more amplified. Albeit short and fragmented, private equity track record in the country started affecting the recognition of private equity as an asset class, and sophistication and openness of investors has also improved. Participation of Russian banks and corporate investors in funds capital is gradually picking up as they are demonstrating increasing interest in private equity as an asset class.

Though the crisis triggered the increasing importance of local investors, international financial institutions played a salient role in backing funds as never before. EBRD remains the largest institutional investor in private equity in Russia.<sup>2</sup> According to its data, the share of participation of international financial institutions and government agencies in fund capital rose to 64 percent in 2010, as compared to a 31 percent average between 1992 and 2009. According to publicly available data from the EBRD website, there are now seven institutional Russian private equity funds at various stages of internal approval (see table 19.3). Among funds achieving closings during 2009–2011 are UFG Private Equity Fund II, Volga River Growth Fund, United Capital Partners Fund II, and Russia Partners Technology Fund. This suggests that Russian private equity industry is showing signs of recovery.

The composition of Russian funds by types remains undiversified, with the majority of local funds falling into the private equity group, along with only two

**Table 19.2** Summary of EBRD gross returns: CEE/SEE and Russia/CIS

	2007	2008	2009	2010
Overall portfolio	21.50%	18.15%	17.30%	17.01%
Fully realized	20.29%	20.87%	20.50%	20.12%
Partially realized	32.29%	27.15%	23.30%	26.33%
Unrealized	22.94	-2.89%	0.62%	6.09%

Source: EBRD website retrieved on February 01, 2012 ([www.ebrd.com](http://www.ebrd.com)).

**Table 19.3** EBRD's commitments to Russia-focused funds post-2008 financial crisis

<i>2009–2012 YTD fundraising</i>	<i>Targeted fund size (\$ million)</i>	<i>EBRD commitment (\$ million)</i>	<i>EBRD decision status</i>
Almaz Capital Russia Fund I	100	33	Signed (October 2009)
Baring Vostok Private Equity Fund V and Supplemental Fund	1,000 + 250	100	To be signed in 2012
CapMan Russia II Fund	175	50	To be signed in 2012
Elbrus Capital Fund II	500	50	To be signed in 2012
Volga River Growth Fund	250	50	Signed (April 2011)
Russia Partners Technology Fund	250–300	75	Signed (September 2011)
United Capital Partners Private Equity Fund II	250	50	Signed (February 2012)
Prometheus Capital Partners Fund I	350	50	In pipeline

Source: EBRD website retrieved on June 01, 2012 ([www.ebrd.com](http://www.ebrd.com)).

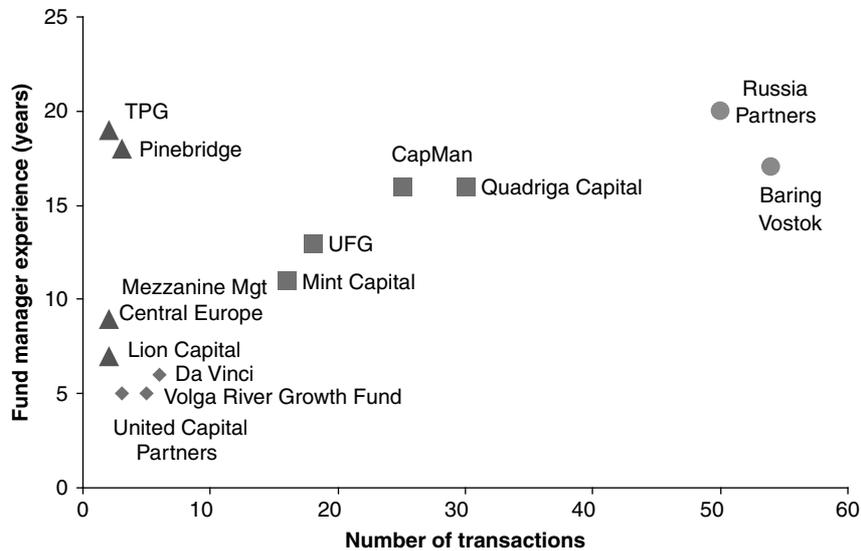
institutional venture funds and a handful of buyout funds working in the country. Mezzanine financing is not yet developed in the country although the first Russian mezzanine fund, the Volga River Growth Fund, has achieved first closing. In international capital markets, distressed/special situations funds and mezzanine funds are an established feature, as they fill in a specific niche. Alpha Russia and CIS Secondary Fund, and EQ Private Equity/Amanda Capital remain the only institutional fund-of-funds actively working in the country.

The current landscape of Russian private equity industry comprises several broadly defined categories of funds, a closer look at which may offer additional insights into institutional constraints that impede development.

#### Established Fund Managers

A very small number of established fund managers have accumulated a solid track record in the industry (top-right cluster on figure 19.1). Such managers have raised a number of follow-on funds, successfully managed an array of portfolio companies, and achieved significant returns for their investors. The majority of funds in this group have benefited from the continuous support of its cornerstone investor, EBRD. Participation of EBRD in the fund facilitated mobilizing of other investors, both Russian and foreign, institutional and private, and was instrumental in helping fund managers achieve fund closing at its targeted size. The bank was pivotal in improving the standards of transparency and in the institutionalization of these fund managers through monitoring, setting operational and financial benchmarks, and requiring implementation and maintaining compliance with reporting, integrity, environment, and social policies. The fund managers, backed by EBRD, have become the institutional leaders of the Russian private equity scene and gradually have built up their own investor base.

A manifest of the fund manager maturation is the closing of the first Russian billion dollar fund in 2007 (Baring Vostok Private Equity Fund IV). Naturally,



**Figure 19.1** Composition of fund managers in Russia.

*Source:* Author calculations based on publicly available information.

this strong position makes these funds stand out and alienates them from the rest of the Russian fund managers (as is obvious from figure 19.1). These funds, though well-known to their circle of limited partners, remain largely unfamiliar to a broader community of institutional investors. Breaking into the new investor hemisphere will remain a challenge.

#### First-Generation Fund Managers

First-generation fund managers are currently “on the road,” raising their first fund. Additionally, some of the fund managers in this group have experience in fund management, though their earlier funds were not managed as institutionally backed funds. Although they might be raising their second fund, the majority of institutional investors will consider them as first-generation teams. Newly formed or restructured fund managers would also fit in this group. The biggest hurdle for first-time fund managers is to achieve the first close, which is the key for improving visibility on the fund and furthering of the investment pipeline. The average fund size for a first-time fund manager is usually between \$100–300 million in Russia, with higher amounts being problematic to target due to lack of market recognition and experience as an investment team. Western institutional investors are oftentimes unwilling to invest into the first-generation teams with an insufficient track record. A lack of familiarity with first-generation fund managers and the possible immature stage of development of private equity industry overall in the country, lead to a humble size of their first fund. Local investors in Russia appear unprepared to invest

more than \$50 million in a single transaction to a fund of \$250–400 million. At the same time, Western investors, especially pension funds and endowments, would probably consider an average single investment starting from \$100 million. Thus, Russian funds find themselves in a “catch 22” position: they are often too small to spark the interest of foreign investors, but simultaneously unable to raise a substantially larger fund due to lack of track record as a team.

At the same time, the individual investment experience in the Russian business environment of the fund members, as well as their ability to originate transactions through their own network, is often quite extensive. Individual team members have worked together and accumulated strong advisory and principal investment track record, before establishing a limited partnership. About 20 years of transition in Russia gave sufficient time to raise a cadre of Western-educated managers who held high-profile positions in organisations such as investment banks or consulting companies both in Russia and abroad. First-generation fund managers would cluster in the bottom-left corner of the graph. An example of a successful first-generation team is the Volga River Growth Fund. The funds that are either still seeking commitments from investors, or have postponed fundraising plans due to the economic crisis, include Elbrus, Prometheus, Da Vinci, and Aton Capital Partners. Among this category of managers, we will see who survives over the next 1–2 years.

#### In-Betweeners

“In-betweeners” is a variegated group of funds that was established in the mid-2000s and has had a mixed industry track record so far (center positions on the graph). Some fund managers in this group have already successfully raised several funds and established their reputation in the market and with their limited partners, but still have not accumulated enough track record to aim for a larger fund size like the institutional leaders of the market. Fund managers in this group are expected to strengthen their position in the future (Mint Capital, CapMan/Norum). Over time, as the graph suggests, some of the “in-betweeners” should begin to turn into institutional leaders or leave the market.

#### Global Funds

Global funds opportunistically invest in Russia on occasion, or include Russia as one of the regions of operation (clustering along the Y axis). These funds target the higher end of medium-sized companies in consumer sectors, and tend to chose leverage buyouts as their investment strategy. These funds adopted fly-in approach, and do not have a local presence in the country. Accession Mezzanine Capital II LP provided mezzanine financing for the expansion of Star Galaxy, chain of family entertainment centers, in September 2008. Together with Lion Capital, AMC II financed the leveraged buyout of Nidan Soki (juice producer) in 2007.

Financial industrial groups are excluded from the current analysis. However, their presence in the market is certainly felt by classic private equity funds. Especially in times of economic growth, funds in the country faced tough competition for potential investments. Since these groups have substantial local knowledge and

connections, competing with them for a potential company was akin to bidding against a more informed party. With the financial crisis, the wealth of these groups was reduced significantly, and their emphasis turned to regrouping and redefining the financial strategy. Despite the crisis, they remain well capitalized and well connected, and their presence should not be discounted.

The Russian venture capital landscape is largely undeveloped though rapidly evolving, with a very small number of dedicated venture capital funds, such as Almaz Capital Russia Fund I and Russia Partners Technology Fund. At the same time, the sector is represented by specialist technology investment companies that invest in both Russian and international technology projects (Digital Sky Technologies). Furthermore, a number of private equity funds selectively invest in the telecommunications and high-tech sector as part of their generalist investment strategies. International venture funds are actively beginning to have more interest in the Russian maturing Internet landscape. Venture capital is primarily focused on investments in Internet developments, telecommunications, and technologies. Cleantech and biotech are less attractive due to little demand locally for such products or services (BVCA, 2010). The government has recently stepped in to fill in the void, with activities of the aforementioned Rusnano, the introduction of the Skolkovo imitative, and the establishment of venture fund-of-funds such as the Russian Venture Company (RVC, with an authorized capital of \$983 million). The idea behind the creation of RVC was to spur the development of the Russian venture capital industry and provide significant capital contributions to local venture funds. Established in 2007, RVC has participated in seven venture capital funds to date: VTB-venture fund, Bioprocess Capital Ventures, Maxwell Biotech, Leader—Innovations, Tamir Fishman CIG Venture Fund, C-Group Ventures, and New Technologies. In 2009, RVC set up a \$68 million fund, dedicated to seed and start-up investments. This early-stage fund works with a network of venture partners throughout Russia, to facilitate the selection of innovative projects. Overall, the contribution of the Russian Venture Company to those eight funds came to \$383 million, while the remainder of the funds' capital was committed by private and commercial investors. As of December 2011, these ten funds cumulatively invested about \$300 million into 101 companies across Russia. In February 2011, RVC launched two more funds focusing on investments in the pharmaceutical and infrastructure sectors, bringing the total number of funds under management to 12.

Leveraged buyouts (LBOs) are a marker of market maturity, and to date there have only been two mega transactions that correspond to a classic LBO model: the \$500 million acquisition of Nidan Soki by Lion Capital in 2007 and the \$540 million acquisition of Russian Alcohol jointly with CEDC, a Polish group. There are only a few dedicated Russian buyout funds that perform buyouts on a much smaller scale. The Russian market is quite fluid and a vast majority of private equity transactions can be classified as growth/expansion. According to EBRD data, between 2007 and 2009 (first half), all fund closings for Russia-focused funds were for funds that specialized in growth/expansion investment stage. To contrast, funds in the more mature market of Central and Eastern Europe spread their focus between buyouts (26.8 percent), growth (53.7 percent), and other.

Fund managers in Russia maintain flexibility and are ultimately attuned to market conditions. While a typical private equity investment period lasts three to five years,<sup>3</sup> on average, there are cases when significant returns can be warranted if the fund manager deviates from the mainstream, utilizes his insight into portfolio companies, and carefully times the exit decision. The Russian private equity industry demonstrates that there are many successful exits with a ten-year investment period, and some after as short as two years. Arguably the most successful private equity exit in Russia to date was the May 2011 flotation of Yandex.

Back in 2000, Baring Vostok Capital Partners acquired a 35.7 percent stake in the company together with UFG Capital Partners and other funds in the country, and had been patiently waiting for momentum to reap some 800x cash-on-cash return on the investment (Snow et al., 2011). It may never be revealed why Baring Vostok waited for so long, and how it managed to convince investors to hold on to the investment. Timing proved to be of essence: in the early 2000s Yandex was still gaining market recognition as the leading search engine in Russia. However facing increasing competition from Google was a stimulating factor for Baring not to wait forever. On the other side of the spectrum is a strategy of quicker company turnaround, which would nevertheless provide for value addition not through financial engineering, but operational and fundamental improvements. An institutional fund was recently launched with a five-year term and an investment period of three years. Consequently, the average holding period for a portfolio company would likely be up to two years. However the fund manager maintains that improvements in financial and operational management and reporting, such as introduction of IFRS and transforming present business structures to transparent and clear corporate structures with clear divisions of responsibilities, will provide for a meaningful return over the brief investment period.

### Summary

Russia certainly remains an untapped market for international private equity players, especially given the crowding of other BRICs as evidenced by fundraising statistics. As competition in other BRICs increases, there's increasing reason to believe that Russian private equity will get more traction. Ten-year pooled net returns for private equity in Central and Eastern Europe and Russian funds have outperformed the benchmark index MSCI EM, private equity in Asia (ex-Japan), Latin America, and the United States (Cambridge Associates data as on June 30, 2011). With achieved net returns of 18.33 percent, which are only 1 percent behind the returns for funds in Western Europe, Central and Eastern Europe, and Russia, private equity provides a lucrative opportunity for investors, commensurate with the risks. Five-year net returns indicate stronger performance than the industry in developed markets, along with S&P and MSCI, but 2–3 percent behind other emerging markets. However, global funds are largely deterred from establishing local office by political factors and the presence of local financial-industrial groups in the country. For local funds, many of which are first generation, the challenge to raise their first fund is oftentimes insurmountable due to lack of recognition in the market and smaller targeted fund size (as compared to other BRICs), and funds often rely on the support

of its primary cornerstone investor, EBRD. Appearance of funds that operate on the whole spectrum of investment strategies and utilize all financing types will bring a significant contribution to the further development and diversification of financial markets in Russia and the CIS.

Russian authorities have taken a steady course in transforming the country into a favorable place for investments. They recently pledged to make a 100-position spurt up in the *Doing Business* rank from 120 in 2012 to the twentieth. The Government has allocated substantial financial resources to a number of development agencies and programs, including Rusnano, a network of regional venture funds, the Russian Venture Company, and most recently the launch of the \$10 billion RDIF. Significant opportunities for infrastructure investment are coming up with the 2014 Winter Olympics in Sochi and the 2018 World Cup, providing a significant boost to investment over the next eight years, particularly but not exclusively in infrastructure (PWC, 2011). These infrastructure investment programs will encourage greater public private partnerships and attract more FDI, which could help limit government borrowing.

Furthermore, after 18 years of negotiations, Russia completed an agreement to enter the WTO in December 2011. Membership has finally allowed Russia to become a fully integrated member of the international community and given access for Russian firms to global capital markets. In the meantime, Russian capital markets have become a valid route for raising capital, with the public equity market reaching high capitalization (68 percent of GDP, according to the World Bank). The merger of two major Russian stock exchanges, RTS and MICEX, in December 2011, created a solid ground for the emergence of a global exchange platform. With ongoing efforts to turn Moscow into an international financial center, there is a growing expectation that the environment for investments is rapidly improving.

### Notes

1. Despite the name, investments were targeting growth/expansion stage and not early-stage or seed financing.
2. With total commitments of \$3.6 billion to the Russia/CIS and Central and Eastern Europe since inception (data retrieved in December 2010).
3. According to EBRD data, average holding period of company in portfolio for Russia/CIS-focused funds is 5.5 years.

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CHAPTER 20  
PRIVATE EQUITY IN SOUTH AND  
SUB-SAHARAN AFRICA

*David Lingelbach*

**Introduction**

Over the past few years, optimism about Africa's economic prospects has grown. Six of the top ten fastest-growing economies in the world have been African during the period 2002–2011, and over that time Africa has grown more rapidly than East Asia (*The Economist*, 2011). Seventeen economies—ranging from Burkina Faso, Ghana, and Mali in West Africa to Ethiopia, Rwanda, Tanzania, and Uganda in East Africa to island states such as Cape Verde, Mauritius, Sao Tome and Principe, and Seychelles, and Botswana, Lesotho, Mozambique, Namibia, South Africa, and Zambia in southern Africa—have grown on average by 3.2 percent per annum from 1996 to 2008, offering a contrast to the mainstream view of the region as war- and disease-ridden, ill governed, and stagnant (Radelet, 2010). A growing middle class, improving telecommunications, 30 peaceful transfers of power, and rapidly expanding foreign direct investment—increasingly from China—are contributing to this growth-fueled trend.

With this optimism has come increased interest in investment activity, particularly in sub-Saharan Africa. As the continent's largest and best-developed economy—and home to its oldest stock exchange—South Africa captured the initial attention of investors as emerging markets became popular in the 1990s. The (relatively) peaceful transition from apartheid to an African National Congress (ANC)-led government in 1994 and the moral leadership during this transition provided by Desmond Tutu, Nelson Mandela, and others, have created a positive sentiment in the minds of investors about the South African economy. However, this sentiment not been able to boost South Africa's long-term economic growth rate beyond 2 percent. Significant barriers to increasing that growth rate include high structural unemployment (officially at 25 percent) and an economic structure dominated by local multinationals facing little or no competition. With one of the highest real equity rates of return in the world from 1900 to 2002 (Dimson, Marsh, and Staunton, 2002), South Africa has been an attractive investment destination for

investors despite these challenges, especially those prepared to bear the risks associated with the “windfall” nature of its economy (de Kiewiet, 1960).

Arguably, the most significant change in the South African economy since the 1980s has been the relative growth of the financial sector, which expanded from 6.5 percent of GDP in 1994 to almost 20 percent in 2009 (Marais, 2011). \$750 billion in assets are managed by South Africa’s insurance, pension, and mutual fund industries, over twice the country’s GDP (Sharma, 2012). Private equity (PE) investment has grown along with the financial sector. In this institutional setting, private equity activity has consisted mainly of development and buyout investments in private companies, rather than seed, start-up, and early-stage investments characteristic of venture capital (VC).

This chapter considers the PE phenomenon in South Africa and, to a lesser extent, elsewhere in sub-Saharan Africa. PE has a long history in the region, dating to colonial activity in the nineteenth century. Despite its longevity, or perhaps because of it, PE activity has waxed and waned in South Africa. We will consider the processes that affect the industry’s dynamics and the implications for the industry’s future development.

The study of South African PE is significant for both theoretical and practical reasons. From the theoretical perspective, few studies of PE investment in developing and emerging economies exist. Thus, this brief survey contributes to our understanding of the global PE phenomenon. Most of what we believe we understand about PE is based on data collected in developed economies with strong property rights, relatively adequate minority investor protection, and open access orders in which political and economic opportunity are available to most citizens. Yet, most of the firms in the world today are based in economies where none of these conditions exist in great abundance. As is the case more generally with the study of organizational change in marginal settings (Tsoukas and Chia, 2002), research on PE in developing and emerging economies such as South Africa offers the potential of better understanding how the PE phenomenon emerges, grows, and changes. For practitioners, growth in South Africa and a number of other sub-Saharan African economies has increased the opportunity set for PE investors and businesspeople for whom corporate restructuring is central to their business strategy.

Before proceeding further, a word on sources is necessary. The academic literature on PE in South Africa is rather thin, limited to a handful of articles that describe various features of the industry. Data for these articles and other studies are mostly collected by, through, or with the assistance of the Southern Africa Private Equity and Venture Capital Association (SAVCA), the national industry association. As in other studies of national-level PE industries, the reader must be cautious in the conclusions arrived at from association-related data.

### **Economic and Political Background**

The emergence of PE in South Africa has been driven by a variety of factors. PE activity has existed since Cecil Rhodes’s consolidation of the diamond and gold mining industries beginning in the 1870s. Rhodes was assisted in that effort by Alfred Beit, a German financier active in the South African diamond business. Together they

completed the 1889 merger from which DeBeers Consolidated Mines—the world's largest diamond producer—emerged.

Modern PE investment in South Africa has been shaped by the country's economic structure, in particular, the dominance of five business groups—Anglo-American/DeBeers, Rembrandt, Sanlam, Old Mutual, and Liberty. This corporate structure is similar to that found in continental Europe, Japan, South Korea, and the United States prior to the Great Depression. These groups are notable for several reasons. First, until recently they have controlled the bulk of the market capitalization on the Johannesburg Stock Exchange. Second, these groups have remained controlled by shareholders in the form of a few individuals holding minority interests, rather than being controlled by managers as is typical in the United States. Third, ownership of these groups—as opposed to control—rests largely in the hands of local retirement funds and insurance firms. Fourth, while diversified, these groups have financed their horizontal integration largely with internal finance. Fifth, these groups' green-field investment activities have largely substituted for a vibrant local VC industry. Sixth, these groups' controlling shareholders have been notably effective in creating shareholder value—despite the discredited conglomerate structure—much like Warren Buffett has accomplished. Seventh, these groups have selectively divested to black-controlled investment groups or, through group-controlled banks, financed black-controlled holding companies (Kantor, 1998). Since the fall of apartheid, the resultant unbundling of these groups, along with the transfer of listings to overseas exchanges, and the emergence of black-controlled business groups, have changed this corporate structure to some degree, but not fundamentally altered its distinctive nature (Chabane, Goldstein, and Roberts, 2006).

Such a corporate structure changes the opportunity set available to PE investors. For example, hostile takeovers are much more difficult to complete than in other markets. PE investment strategies must be aligned with the interests of these groups, which, in the postapartheid era, saw a need to support the ANC-led power structure through divestment. Financial engineering and other forms of value creation employed by PE firms to improve corporate performance have limited utility in a market environment with many value-maximizing controlling owners, such as Nicholas Oppenheimer (DeBeers), Anton and Johann Rupert (Rembrandt, and now Richemont, Remgro, and Reinert), and Donald Gordon (Liberty).

Following the early PE-related developments in the diamond industry, PE activity waned until the late 1970s. In 1979 Anton Rupert—one of South Africa's most successful Afrikaner entrepreneurs—created the Small Business Development Corporation (SBDC) to provide financing, training, and advice to small manufacturing firms, both white- and black owned (Esterhuysen, 1986). The South African government became a 50 percent owner of SBDC in 1980, with the remaining 50 percent owned by Rupert and other white businessmen. While SBDC initially emphasized debt finance and property rental, its successor—Business Partners—is one of the largest PE investors (measured by number of investments) in South Africa today.

By the mid-1980s, international sanctions against the apartheid regime caused multinationals to divest their local operations. Many of these operations held local monopolies—although ones that did not challenge the existing business

groups—resulting in significant free cash flows. Consequently, they were attractive targets for buyout. Although local interest rates were high at the time (approximately 16 percent), returns on capital of 25 percent or greater could be realized using a mixture of equity and debt financing from local banks. South Africa's four largest commercial banks at that time were pioneers in establishing leveraged buyout (LBO) financing during this period (KPMG and SAVCA, 2001).

This opportunity was seized by emergent PE firms, the most notable of which were Ethos and Brait. Ethos was founded in 1984 by André Roux. Roux was trained at Barclays Development Capital in the late 1970s and early 1980s. Originally named FirstCorp Capital Investors, Ethos was renamed in 1998. Ethos's first fund—Buy-out Fund I—was capitalized at \$100 million as a captive of First Merchant Bank and operated from 1984 to 1991. Its second fund was raised in 1992 and managed \$34 million on behalf of third-party investors. Ethos raised a third fund in 1996, totaling \$171 million, and a fourth, capitalized at \$358 million, in 1998. A \$40 million technology fund was raised in 2002 (Roux, 2005). Its fifth and largest buyout fund—capitalized at Rand 5.5 billion—was closed in 2006 (Ethos, 2012). By contrast, Brait was established in 1991 and listed on the Johannesburg Stock Exchange in 1998. Brait's first significant transaction was its 1992 purchase of Grant Andrews, an office furniture retailer (Cranston, 2011).

### Regulation

Regulation of the South African PE sector is relatively light. The major applicable laws include the South African Companies Act, the Collective Investment Schemes Act, the Competition Act, and the Income Tax Act. Fund organization depends on the nature of the sponsor. Captive funds are often structured as locally incorporated firms or trusts. Independent funds are usually established as partnerships (Pinnock and Butler, 2005).

The following are some of the major legal considerations for PE investors:

- Section 38 of the Companies Act limits the ability of firms to provide financial assistance for the acquisition of its shares or those of its holding company, complicating the LBO structure commonly used in the United States. However, holding companies can assist in the purchase of the shares of its subsidiaries (Pinnock and Butler, 2005).
- Section 197 of the Labor Relations Act limits the ability of private equity investors to reduce the acquired firm's workforce postacquisition. If a firm is transferred as a going concern to new owners, the employees—and their accrued rights and employment history—are transferred as well (Pinnock and Butler, 2005).
- Section 34 of the Insolvency Act allows creditors of a selling firm to execute against a judgment on the selling firm's assets for up to six months after the sale of the firm to new owners, unless required legal notices are made (Pinnock and Butler, 2005).
- The Securities Regulation Panel's Securities Regulation Code on Mergers and Takeovers applies to certain larger private equity transactions and requires that

certain formalities and rules of fair play would be observed, including, in some cases, offers to minority shareholders. Larger transactions may need to obtain approval under the Competition Act (Pinnock & Butler, 2005).

#### Taxation

South Africa's taxation system is residence based, rather than source based. Firms pay a flat tax of 28 percent on income, plus a secondary tax on companies (STC) of 12.5 percent on any dividends declared.<sup>1</sup> Trusts are taxed at a flat rate of 40 percent. A vesting trust's income is taxed at the level of its beneficiaries, while income from discretionary trusts is taxed at the level of the trust. Section 11(I)(e) of the Value-added Tax Act allows that the transfer of a going concern to new owners will generally be taxed at 0 percent. Tax structuring of PE transactions is significant and may address (1) investment enterprise form, (2) taxable recoupment, (3) tax deductibility of interest expense, (4) reclassification of equity as debt for tax purposes when using preferred shares, and (5) capital gains tax impact, and transfer and stamp duties (Pinnock and Butler, 2005).

PE funds typically establish dual fund structures (on- and offshore) to eliminate local taxation for foreign investors. These offshore funds must seek deal-by-deal approval from the Reserve Bank for their investments in South Africa. Recent legislation will eliminate the need for this dual fund structure.

#### Exchange Control

Until recently, exchange controls have been an important limitation on PE activity in South Africa. Investment by South Africa-domiciled PE funds outside of South Africa, Namibia, Lesotho, and Swaziland is subject to a one-time approval by the Reserve Bank of South Africa and no longer requires deal-by-deal approval. For PE investors, the principal issue has been the requirement for potential foreign buyers of their investments to obtain these approvals, limiting exit liquidity through an increase in regulatory uncertainty. The control regime—an artifact of the apartheid regime maintained by the ANC government to control to white capital flight—is now in the process of being relaxed (Sharma, 2012).

#### Pension Fund Allocation

Until recently, South African pension funds were limited to holding no more than 5 percent of their assets in unlisted securities (Pinnock and Butler, 2005). However, the Financial Services Board changed Regulation 28 of the Pension Funds Act in 2011, allowing pension funds to invest up to 10 percent of their assets in PE and up to 15 percent of their assets in PE and hedge funds combined. However, many pension funds are already over the new 15 percent limit, as their offshore investments are often in hedge funds (Cranston, 2011).

### Impact of Black Economic Empowerment

Black economic empowerment (BEE) has had a major impact on PE activity in South Africa. BEE consists of legislation (the Broad-Based Black Economic Empowerment Act) and industry-based charters applicable to the mining, oil/petrochemical, and financial services industries. BEE requirements include specific minimum requirements for black equity and asset ownership, employment, and procurement, all implemented over specific time frames.

Black, black-empowered, and black-influenced PE funds managed 64 percent of total funds under management in 2010, compared with 22 percent in 2003 (when BEE initiatives began in earnest). Of the Rand 10.4 billion in investments made in 2010, at least Rand 4.8 billion (46 percent) were in investees that were black, black-empowered, or black-influenced (KPMG and SAVCA, 2011).<sup>2</sup>

For PE, BEE has required funds to look for BEE-qualified investors. Increasingly, these investors must be substantial and not just front operations. Since many of the largest PE firms are white-owned or -controlled, alliances between these firms and BEE-qualified investors have now become central to their growth strategy.

PE investment can be treated as BEE qualifying if the following requirements are met:

- More than 50 percent of the exercisable voting rights associated with the equity through which a PE firm owns a firm are held by black people;
- More than 50 percent of a PE firm's profits accrue to black people;
- The fund manager is a black-owned company, as defined by the BEE Code;
- Over ten years a PE firm must invest more than 50 percent of its funds invested in black-owned businesses that have at least 25 percent direct black ownership (KPMG and SAVCA, 2011).

### The South African Private Equity Industry—Scope and Characteristics

Measured by the South Africa-based full members of SAVCA, the PE industry numbered 86 organizations as of December 31, 2011. SAVCA's most recent industry survey is based on data from 71 firms representing 83 funds (KPMG and SAVCA, 2011). The industry is divided into five major categories, as indicated in table 20.1.

**Table 20.1** Structure of South African private equity industry

<i>Category</i>	<i>Number of Firms, 2010</i>	<i>Funds under Management, 2010 (Rand billions)</i>
Independent	53	45.8
Captives—Financial Services	17	34.1
Captives—Government	5	12.9
Captives—Others	10	4.8
Total	85	97.6

The dynamics of the industry can be illustrated as follows in table 20.2:

**Table 20.2** Dynamics of the South African private equity industry

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Capital under management (Rand billions)	34.7	35.9	37.0	39.3	9.7	42.5	59.3	86.3	109.3	105.4	97.6
Capital under management (\$ billions)	4.6	3.0	4.3	5.9	7.0	6.7	8.4	12.6	11.6	14.2	4.7
Nominal GDP (\$ billions)	132.9	118.5	111.1	168.2	219.1	247.1	261.0	286.2	275.3	282.8	363.7
PE/GDP (%)	3.5	2.5	3.9	3.5	3.2	2.7	3.2	4.4	4.2	5.0	4.0
New investments (Rand billions)		2.4	3.5	4.3	6.5	4.5	6.9	26.1	18.9	7.2	10.4

Sources: KPMG and SAVCA (2001–2011), [www.worldbank.org](http://www.worldbank.org), [www.oanda.com](http://www.oanda.com)

While the industry structure has shifted somewhat over time, captive PE firms continue to represent a majority of industry funds under management. As noted by SAVCA, this structure is different from that observed in developed countries, where most PE activity is driven by private firms.

Independent PE firms are similar in mission and strategy to those PE firms found in the United States, and are unaffiliated with another economic structure. They raise funds from a variety of investors that are typically interested in PE investment, such as pension funds and other private institutional investors. The role of independent PE firms has gradually increased from 37 percent of total funds under management in 2001 to 47 percent in 2010, briefly reaching 50 percent in 2007. Brait is an example of an independent PE firm that has remained so since its establishment—it is the first PE firm to be listed on the Johannesburg Stock Exchange.

Captive PE firms associated with other financial services entities are tied by ownership to local banks and insurance companies. The first PE fund in South Africa—Ethos—began as a captive of a local merchant bank, although it has subsequently become independent. Current captive PE firms are associated with banks such as Rand Merchant Bank (RMB), Nedbank, and Standard Chartered, insurance companies such as Sanlam, and diversified financial services firms such as Old Mutual. The role of finance-related captives has expanded from 14 percent of total industry funds under management in 2001 to 35 percent in 2010.

Captives associated with the government continue to be a significant percentage of the PE industry. While the percentage of total industry funds has fluctuated over the period 2001–2010, it has remained between 11 percent (2009) and 20 percent (2001). Other captive PE firms are privately held, such as Business Partners.

Foreign PE firms are a significant presence in the South African market. Most of these are linked to large international independent firms, such as Actis (a spinoff from CDC) or Carlyle, and maintain local offices. A few international PE firms—such as Bain Capital in its 2007 acquisition of Edcon—have been active in the local market, but do not maintain an office there.

## Investors

The single largest investor in South African PE funds remains foreign-aid agencies and development finance institutions (DFIs). For example, in 2009, these investors provided 41 percent of the Rand 3.8 billion raised that year, while in 2010, 34 percent of funds raised were from these sources (KPMG & SAVCA, 2011). Other large investors in the industry are local insurance firms (17 percent of funds raised in 2010 and 14 percent in 2009) and pension and endowment funds (mainly foreign), which invested 16 percent of total funds in 2010 and 19 percent in 2009. Other significant investors include family offices (which increased their investments substantially in 2010), corporates, funds-of-funds, and banks. The foreign percentage in PE fundraising was 63 percent in 2010, up from 50 percent in 2009. However, South Africa is still the largest source of cumulative funds raised as of 2010, representing 40 percent of funds raised but not yet returned to investors. This compares with 22 percent for the United States and 13 percent for the United Kingdom (KPMG and SAVCA, 2011).

## International Comparisons

In comparison to the BRIC countries, South Africa's PE activity—as measured by fundraising—remains relatively modest (see table 20.3).

In comparison to these economies, South Africa's relative importance peaked in 2003, when it represented 44 percent of fundraising. Thereafter, its weight has decreased, particularly since the expansion of the Indian and Chinese PE industries, beginning in 2005.

## Types of Investment Activity

Private equity activity in South Africa can be divided into three stages: venture capital (seed, start-up, and early stage), development capital (expansion and development), and buyout capital (leveraged buyout or buyin, and replacement capital). Most of the industry's activity has been concentrated in the development and buyout stages. Over the period 2009–2010, for example, 5 percent of investments by cost were made in venture capital, 76 percent in development capital, and 19 percent in buyout activity. When measured by the number of investments (to correct for the smaller

**Table 20.3** Private equity fundraising in BRICS countries, 2002–2010 (\$ billions)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
South Africa	0.2	0.7	0.4	0.3	2.1	2.2	1.1	0.5	1.5
As % of total	25	44	19	4	18	15	4	4	11
Brazil	0.3	0.2	0.5	0.2	2.1	2.5	3.6	0.4	1.1
Russia	0.1	0.2	0.2	1.3	0.2	1.8	0.9	0.5	0.1
India	0.1	0.2	0.7	2.7	2.9	4.6	7.7	4.0	3.3
China	0.1	0.2	0.3	2.2	4.3	3.9	14.5	6.6	7.5
Total	0.8	1.6	2.1	6.7	11.5	15.0	27.8	12.0	13.5

Source: Adapted from KPMG and SAVCA (2011), which is based on EMPEA data.

size of venture capital transactions), 16 percent of the investments were in venture capital, 67 percent in development capital, and 17 percent in buyouts (KPMG and SAVCA, 2011).

#### Investment Strategies

Mining is the centerpiece of the South African economy (Marais, 2011). Consequently, developments in that industry shape PE opportunities more than perhaps any other factor. Sixteen percent of the PE industry's portfolio was invested in mining and natural resources at yearend 2010, and some of the largest transactions in 2009 and 2010 involve mining-related firms. However, the bulk of PE activity takes place outside of the mining industry, including in infrastructure (44 percent of investments in 2010), manufacturing (14 percent), and banking/financial services/insurance (10 percent) (KPMG and SAVCA, 2011).

#### Performance

Performance statistics for a small but representative sample of independent later-stage PE funds is reported in Missankov, Van Dyk, Van Biljon, Hayes, and Van der Veen (2008). These funds have vintages ranging from 1992 to 2003. The average IRR was 35.7 percent with an average standard deviation of 13.7 percent. On average these funds outperformed a wide variety of benchmarks, including South African equity, small-cap, bond, cash, and property indices. This outperformance ranged from 8.3 percent (versus South African small caps) to 24.7 percent (versus South African cash). The average Sharpe ratio of these funds was 2.01, exceeded only by South African cash at 9.04. These returns are significantly uncorrelated with other asset classes, including South African equity (average correlation coefficient = 0.10), South African small caps (0.11), and global equity (0.06). While this particular study suffers from some limitations, it indicates that South African independent PE displays attractive performance characteristics.

The sources of this performance are not well understood at present. Earnings growth and earnings multiple expansion are correlated with South African PE returns, but how these are achieved by PE investors are not known (Van Niekirk and Krige, 2009). In other markets, syndication has been a significant source of value creation for PE investors, but syndication levels among South African PE funds remain low in comparison to US and European funds (Bent, Williams, and Gilbert, 2004). South African PE funds add value to their investments mainly through strategic insight, changes in compensation and incentive structures, and providing access to additional capital (Leach, 2011).

#### Key Transactions

The largest PE transaction in South Africa took place in 2007, when a Bain Capital-led group acquired clothing retailer Edcon for total funding of Rand 27.1 billion. The ten largest transactions over the past five years are listed below in table 20.4:

**Table 20.4** Largest South African private equity transactions, 2006–2010

<i>Name</i>	<i>Year</i>	<i>Total funding (Rand millions)</i>	<i>Industry</i>	<i>Investment type</i>	<i>Equity provider(s)</i>
Edcon	2007	27,132	Retailing	LBO	Bain Capital Barclays Private Equity Absa Capital Private Equity
Alexander Forbes	2007	8,982	Financial and risk services	LBO	Actis Africa Ethos Harbourvest Capital International OTPP CdpQ
Primedia	2007	7,300	Media	LBO	Brait
Consol	2007	6,600	Glass packaging	LBO	Brait OMIGSA Sanlam Private Equity Harbourvest Capital International
Alstom	2006	5,160	Electrical engineering	LBO	Actis Old Mutual Private Equity Tiso Kagiso Ethos Old Mutual Private Equity Tiso
Idwala	2006	2,937	Industrial minerals, lime	LBO	Absa Capital Private Equity
Enviroserv Holdings	2006	2,201	Waste management	MBO	Pamodzi Reserve Fund I
Rand Uranium	2009	1,945	Gold and uranium mining	Later stage expansion capital	First Reserve
Alexander Forbes	2009	1,850	Financial and risk services	Replacement capital	OTPP Ethos Actis
Steinfurn	2007	1,580	Furniture manufacturing	LBO	Absa Capital Private Equity

Sources: KPMG and SAVCA (2008, 2009, 2011).

### Venture Capital

South Africa's venture capital (VC) industry remains a minor part of the total PE activity. The industry was established in the late 1990s with significant public sector investment, but then stagnated in the face of weak public-private cooperation (Lingelbach, Murray, and Gilbert, 2008). During its early years, VC investment represented a significant part of total PE activity. For example, 25 percent of all PE investments were VC-related in 2000 and 2002, but this level fell to 2 percent by 2007 (Lingelbach, 2009).

Over the period 2001–2010 Rand 4.4 billion (\$664 million at yearend 2010 exchange rates) was raised for VC investments. However, technology-oriented investments (the usual target of VC investors) represented 6 percent of the investments made during the period 2009–2010 and 7 percent of the PE industry’s total portfolio on average over this period. Of the 20 largest disclosed PE/VC transactions during 2009–2010, only one was in a seed, start-up, or early-stage investment (KPMG and SAVCA, 2011).

While a VC club was established in Johannesburg in the mid-1980s, the first formal VC fund—Technifin—was not established until 1992. A joint venture between two state-controlled organizations, Technifin focused on technology commercialization. After making 3–4 investments, it ceased operations in the late 1990s. By 1999, approximately Rand 400 million was available for start-up financing from funds, financial institutions, and business angels (Stillman et al., 1999). The first private VC fund—HBD—was established in 2000 by Mark Shuttleworth, a local entrepreneur who had recently sold his company to Verisign. In that year, the Department of Trade and Industry decided to accelerate the formation of the VC industry through investments by the state-controlled Industrial Development Corporation (IDC) in nine funds. IDC’s investment totaled Rand 594 million, while these funds raised a total of Rand 1.596 billion. IDC’s first round of investment in these funds (2000–2001) focused on technology investing, while the second phase included both technology and nontechnology investing. In 1999 SAVCA was also established as the industry association.

Since the acceleration of the industry’s development in 1999, VC investment activity has remained stagnant, as indicated by table 20.5:

A total of Rand 6.96 billion has been invested in seed, start-up, and early-stage firms during the period 2000–2010, with an average of Rand 633 million invested each year. Annual investment levels have been volatile, with declines in activity following the global stock market declines in 2000 and 2008.

A challenge for South African VCs has been to attract institutional investors, who have focused on later-stage PE funds involved with black economic empowerment. Until 2013, VC activity is expected to focus on local firms with proprietary technology, as well as investments outside of South Africa. In 2013, expanded telecommunications capacity may lead to another wave of VC investment. Due to low local valuations reflecting conservative investors, many VC exits are expected to take place via sale to foreign buyers, despite exchange controls (O’Conner, 2010).

**Table 20.5** Seed, start-up, and early-stage investment in South Africa, 2000–2010

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Seed, start-up, and early-stage investments (Rand millions)	875	288	875	516	390	495	966	510	1,134	288	624

Sources: Adapted from KPMG and SAVCA (2001–2011).

VC performance has been difficult to assess. One study has reported an average gross IRR of 15.7 percent for three technology funds with vintages ranging from 1999 to 2001. However, these IRRs are unrealized and thus subject to the accuracy of the valuation methodology applied (Missankov et al., 2008).

### **Angel Investing**

Angel investing in South Africa remains extremely limited, especially given the large number of dollar millionaires in the country. Over the period 2001–2010, at least Rand 100 million (USD at December 31, 2011 exchange rates) in angel investments have been made in South Africa (SAVCA and Venture Solutions, 2010). According to startup firms that have sought angel investment and VCs that have invested in the South African technology sector, approximately five angel investors can be considered as active at present. A few active angel investors also exist in Ghana, Nigeria, Kenya, and Tanzania. South Africa's first formal angel group—AngelHub—was established in 2011 (Pretorius, 2011).

### **The Impact of Private Equity Activity**

Rigorously measuring the broader social impact of PE is difficult. PE investments may contribute—positively or negatively—to economic growth, employment, and social policy. PE firms may also impact a society's political system in a variety of ways, including through their influence on government policy.

While no rigorous academic studies of PE's impact on the South African economy exist, one industry-affiliated survey of 327 firms receiving PE investment over the period 2005–2009 reached the following conclusions:

- PE-backed firms increased worldwide employment by 9 percent, compared with 4 percent for Johannesburg Stock Exchange (JSE)-listed firms
- Domestic employment of these firms increased by 10 percent, versus 1 percent for all firms in South Africa
- These firms grew sales by 20 percent, compared with 18 percent for JSE-listed firms
- Pre-tax profit growth for PE-backed firms was 16 percent per year, compared with 14 percent for JSE-listed firms
- Exports for these firms grew by 31 percent per year on average, compared with 24 percent for South Africa as a whole
- R&D expenditures for PE-backed firms grew by 7 percent per year on average, versus 1 percent for JSE firms (SAVCA and DBSA, 2009).

This study suffers from several limitations, including selection bias (survey response was voluntary), survivor bias (companies surveyed were survivors), and lack of control for industry and firm size (PE-backed firms may be in industries with different growth characteristics and are generally smaller than listed businesses). Nonetheless, the sample size is large in comparison to the industry's total number of investments.

Another, smaller unpublished study weighted toward the IT sector found that, while PE-backed South African firms had higher sales growth after PE investment in comparison to similar JSE-listed firms, postinvestment average annual employment was 1 percent in South Africa and –1 percent worldwide, compared to a preinvestment growth of 21 percent in South Africa and 23 percent worldwide (Schlotke and Seaward, 2004).

### **Private Equity Elsewhere in Sub-Saharan Africa**

PE activity elsewhere in sub-Saharan Africa is growing from a small initial base of activity and is concentrated in regional funds investing across a variety of countries, such as Actis (22 sub-Saharan African investees ex-South Africa as of March 31, 2011), Aureos (five Africa-specific funds), and Zephyr (managing three sub-Saharan Africa funds with USD 735 million under management). The African Venture Capital Association (AVCA) was established in 2000, registered in Cameroon in 2002, and, after moving its headquarters from Cameroon to South Africa, has now settled in Kenya. AVCA currently has 45 members, of which a significant number are South African organizations, development finance institutions, and investors (AVCA, 2012).

The size and scope of the industry is difficult to determine. One study indicated that, from 1996 to 2006, \$991.1 million in VC investments were made in sub-Saharan Africa, of which 42 percent were in South Africa, 40 percent in Zambia, 12 percent in Tanzania, and the remainder in Kenya, Nigeria, Ghana, and Sierra Leone (Li and Zahra, 2012). In 2005, AVCA estimated that the African venture capital industry had \$12–15 billion under management (James, 2007). Excluding South African funds from this figure, an estimate of \$5.3–8.3 billion is obtained. However, this number includes funds located in North Africa, which are believed to represent a significant percentage of this estimate. Based on a review of AVCA members' websites, total funds under management by 24 sub-Saharan Africa PE funds (ex-South Africa investments) as of yearend 2011 are estimated at \$5.4 billion. This figure is expected to grow, as several recent Africa-specific PE funds have raised record amounts and been oversubscribed, and as cross-border merger and acquisition activity expands significantly (World Bank, 2012).

### **Conclusion and Some Predictions about the Future**

This chapter began with an optimistic vision of sub-Saharan Africa and a more guarded one for South Africa. These latter challenges suggest some of the constraints on the further development of the South African PE industry. High unemployment could lead eventually to political unrest leading to a transition away from ANC dominance and to a period of political instability, adversely impacting PE returns. Lower commodity prices would lower economic growth prospects and increase risk, reducing the prospects for PE fundraising and exits. A return to global recession would have similar effects. Given that South Africa is projected to grow more slowly than the rest of sub-Saharan Africa through 2013 (World Bank, 2012), PE activity is also likely to shift over time to the rest of the continent. On a brighter note,

the eventual transition of the South African economy to more competitive product and service markets could lead to an uptick in PE activity facilitating the resultant corporate restructuring.

Other sub-Saharan African economies are likely to develop significant PE industries in the coming years. Given its size and past number of PE and VC transactions, the Nigerian economy is the most likely to experience a significant increase in PE activity. Ghana and Kenya may also eventually develop active national PE industries.

We still do not know very much about the PE industry in South Africa. For example, why have captives remained dominant fund structures, rather than independent funds? Given the loosening corporate structure, why have there been so few hostile takeovers? What has been the impact of black economic empowerment on private equity performance?

Looking ahead, it seems likely that cross-border PE activity will continue to grow. With the recent relaxation in exchange controls, it also seems possible that this activity will be both inward (foreign PE funds investing in South Africa, such as Bain Capital's Edcon transaction) and local funds investing elsewhere on the continent. A second prediction is that South Africa's share of total PE investment among the BRICs seems likely to increase. The industry is sophisticated by international standards and has a much longer track record than the Chinese and Indian industries. The accumulated knowledge in the South African PE industry is likely to pay dividends for it and its investors in the years ahead.

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### Notes

1. STC is in the process of being phased out.
2. This figure excludes investments made by captive funds owned by the government.

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CHAPTER 21  
PRIVATE EQUITY IN INDIA IN  
THE CONTEXT OF EMERGING ASIA

*Darek Klonowski*

Over the last decade, India has shown a strong commitment toward democracy, stabilizing its political system, and encouraging market liberalization and deregulation. In addition, India has been more accommodating to international investors, including the private equity asset class. Private equity investors are drawn by not only strong economic growth (averaging about 8 percent per annum in the last decade), but also robust entrepreneurship, a growing middle class and disposable income, and increased consumerism.

The objective of this chapter is to provide a brief description of private equity in India and underline some of the historical and social antecedents of the industry. In the first part of the chapter, we provide an overview of private equity in emerging Asia in order to describe a broader context for our subsequent discussion of private equity in India. In the second part, we focus on specific parts of the private equity investment process, namely fundraising, deal generation and screening, investing, and exiting. The analysis is concluded with an overview of the legal infrastructure in India as this area represents one of the main areas of concern to local private equity firms.

**Private Equity across Emerging Asia**

Emerging Asia is one of the fastest-growing economic regions in the world. Growth in the region has been fueled by its large populations, a rapidly growing middle class (demanding modern goods and services), high rural-to-urban migration (significant disparities exist between cities and rural regions), and a robust entrepreneurial culture.

Private equity in the region has seen robust growth over the last decade, especially since 2006, when \$22.5 billion was raised for the entire region (a threefold increase from 2005). Fundraising saw a significant increase in 2005, reaching \$15.5 billion (a fivefold increase from 2004). Investing peaked in 2007 with \$30.3 billion invested. Peak fundraising was achieved in 2008 (\$40.0 billion). The private equity

industry in the emerging Asia region is diverse. Each country appears to have one or more unique specializations or qualities (i.e., China, manufacturing; India, services, information technology; and Thailand, agriculture). The region includes the two “big elephants,” China and India; these countries tend to overshadow other destinations such as Indonesia, Singapore, or Malaysia. Annual private equity investment into India and China is equal to \$14.1 billion, accounting for 70 percent of the regional private equity investment. Mid-market countries like Indonesia, South Korea, Singapore, and Malaysia command an annual private equity commitment of between 1 and 4 billion dollars. These markets are often characterized by strong economic growth (countries in this cluster have weathered the recent financial crisis well), more developed capital markets (Malaysia, for example, has nearly 1,000 listed firms), and strong foreign direct investment inflow (for example, Indonesia reached a level of over \$12 billion in 2010). The third cluster of countries (Vietnam, Thailand, and the Philippines) is perceived to be less attractive by private equity firms; these countries are regarded as “frontier regional markets” (less than ten deals are completed annually in each country), even though profitable deals have been executed in these countries in the past. Countries in this third cluster are often perceived to have less developed institutional infrastructure. One of the attractions of these destinations is the relatively low valuations found within them—entry and exit multiples may be more spread apart than in other countries in the region, allowing for multiple expansions at the time of exit and the ability to make operational and financial improvements to the investee firm. Each country in this cluster receives less than \$1 billion of private equity capital on an annual basis.

In 2010, fundraising in emerging Asia continued to dominate the fundraising story across all emerging markets, accounting for 60.1 percent of total fundraising in emerging markets and 6.9 percent of global fundraising. The cumulative capital pool in the region has grown to \$172.1 billion since 2001. China accounts for the lion’s share of the fundraising for the emerging Asia market with annual fundraising equal to \$5.4 billion—nearly twice the amount dedicated to India (\$2.6 billion). Average annual fundraising for the market in the last decade has been equal to approximately \$17.2 billion. The average value of a new fund is equal to about \$0.7 billion. While incumbent firms with a track record of deploying capital continue to raise new funds, it has been more challenging in recent years to raise first-time funds in the region. The largest fundraising efforts dedicated to the emerging Asia region prior to the recent financial turmoil included TPG (\$4.3 billion raised in 2008), CVC Capital Partners (\$4.1 billion in 2008), and KKR (\$4.0 billion in 2007). The largest fundraising activities in 2010 and 2011 were successful closures by Baring Private Equity (\$2.5 billion), the Carlyle Group (\$2.5 billion), CDH Investments (\$1.5 billion), Hony Capital (\$1.5 billion), and 3i (\$1.5 billion).

Investing opportunities in the emerging Asia region involve a wide range of sectors, including energy generation and distribution, health care, technology, manufacturing, automotive, consumer goods and services, agriculture, and so on. The most active sectors are industrial and manufacturing, consumer goods and services, technology, banking and financial services, and media. On an average, local firms deploy \$15.1 billion of private equity across 480 deals (the average deal size is equal to \$31.6 million). Local private equity firms experience a wide range of challenges.

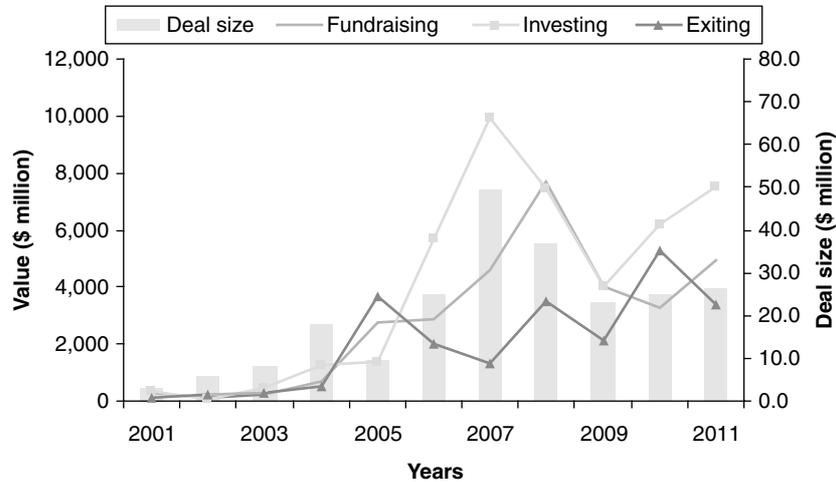
The first of these relates to deal pricing. Local private equity firms often struggle to meet their partners' expectations. Competition for deals is intense and comes from many sources: existing players, newly created funds, multinational corporations, and so on. In addition, in some countries (for example, Malaysia and the Philippines) there is a tradition of large domestic holdings or conglomerates trading portfolio firms between each other, effectively crowding out private equity. Moreover, high valuation expectations are fueled by capital markets, which have generated exceptionally strong returns in the last few years, and especially in the period between 2001 and 2007, prior to the last 2008 financial crises (i.e., India's Sensex—621.9 percent; China's SSE Composite—319.8 percent, Indonesia's Jakarta Composite—700.3 percent).

Although each local private equity firm wishes to develop a proprietary deal flow (which involves nurturing local business and political contacts), in about 40 percent of the situations, private equity firms are forced to participate in auction-like opportunities (about 40 percent of deals are proprietary). In addition, deals take a long time to complete (12–18 months). Evidence suggests that incumbents have better access to deals due to a wider network of advisors, political connections, industrial relationships, and so on. There is also the issue of due diligence. Many firms operate with two or three sets of financial numbers (one for the taxman, one for investors, and one for internal management)—financial reports are often designed to limit tax liabilities, and the accounts lack transparency. Lastly, there are challenges related to the political environment. Government can determine who gets access to firms, influence approval processes, restrict foreign participation in certain sectors, and can interfere even in public listings. These weaknesses in the political environment often translate into an opaque institutional infrastructure (i.e., laws, regulations, requirements). Examples of recently completed private equity transactions include an expansion investment of \$1.1 billion by Goldman Sachs Private Equity into Taikang Life Insurance (a leading Chinese insurer), an investment of \$1.0 billion by Providence Equity Partners into Television Broadcasts Ltd. (a Chinese media operator), the buyout of PT Matahari Putra (an Indonesian retail chain) by CVC Capital Partners (equal to \$0.9 billion), and an expansion investment of TPG and KKR into China International Capital Corporation (a financial holding).

Exits have been challenging in the emerging Asia region, especially in the largest private equity markets—China and India. The general sentiment (expressed by over 90 percent of local firms) is that private equity firms will continue to exit through public listing; this poses numerous challenges to private equity firms, as local exchanges are often dominated by state-owned firms, are less receptive to smaller private sector listings, and are characterized by poor liquidity, weak regulation, and suboptimal disclosure. If an IPO fails as an exit option, other options may be difficult to find. Strategic investors are reluctant to assume a minority ownership stake in an entrepreneurial business; trade investors prefer full control of the venture.

### **Private Equity in India: Awakening the Giant**

While India has experimented with private equity since the mid-1960s, the industry did not develop until the mid-1990s; in fact, it still continues along its



**Figure 21.1** The evolution of private equity industry in India between 2001 and 2011 (estimate).

Source: EMPEA (2011), Bain & Company and IVCA (2011).

developmental path. International investors believe that in the next five to ten years, India is expected to become the largest private equity market in the world (see figure 21.1 for an overview of key private equity statistics). In 2010, private equity penetration (expressed as a ratio of private equity investments divided by annual gross domestic product, GDP) in India was equal to 0.44 percent, placing India as the absolute leader in the emerging markets (Brazil—0.23 percent; China—0.16 percent; Russia—0.10 percent) and trailing not too far behind destinations with the most advanced private equity industries like the United States (1.13 percent) and the United Kingdom (0.91 percent).

#### Private Equity Fundraising

Since 2001, international and domestic investors have committed \$31.4 billion to the Indian market through fundraising initiatives. Average annual fundraising is equal to \$2.9 billion. Fundraising was relatively weak until 2004 (the 2001–2004 average was equal to \$336 million), but then exploded in 2005 (the 2005–2009 average was equal to \$4.4 billion). A strong positive trend in fundraising continues post the 2008 financial crises, with \$3.3 billion of raised capital in 2010 and \$4.9 billion in 2011 (the two-year average between 2010 and 2011 is equal to \$4.1 billion, almost at par with the strongest period in India's fundraising). It is estimated that there are about 370 private equity firms currently focused on India. The market consists of foreign firms, local corporations, local banks and financial institutions, and wealthy individuals.

India benefits from fundraising initiatives dedicated to India directly or initiatives that cover the entire region. The most recent fundraising dedicated solely to

India included 3i (\$1.5 billion), ENAM (\$750 million), Nalandia Capital (\$475 million), and Matrix Partners (\$300 million). Region-wide fundraising activities included TPG (\$4.3 billion), CVC (\$4.1 billion), KKR (\$4.0 billion), and Baring Private Equity (\$2.5 billion). The most notable feature on the fundraising front is the fundraising initiatives undertaken by well-known local entrepreneurs (for example, Tata Capital Private Equity, Tata Capital/Mizuho).

#### Deal Generation and Evaluation

Deal generation in India is relationship driven. No foreign entrant has been able to develop a strong deal-generation strategy with a proprietary deal pipeline. The majority of deals come from referrals (i.e., investment bankers, financial institutions, intermediaries), with internally generated deals accounting for about 25 percent of total deals. Most deals hail from a mix of auction-based scenarios and proprietary deal flows (increased fundraising has spurred even more competitive tender auctions), with the majority of deals occurring at below the \$20 million level. Local practitioners observe that few deals are ultimately completed from among the reviewed cases; this is due to a combination of problems such as poor management, inadequate financial reporting, corporate governance issues, and excessive valuation expectations.

Screening and evaluating potential investee firms can be challenging in India. Many private sector and public firms lack strong corporate governance, sound financial reporting systems, and independent oversight. Private owners of potential investee firms also tend to “hoard” information on the firm’s financial performance, market, competitors, products and services, and future business strategies; they are also reluctant to share their full business plans with potential partners.

#### Investing Activities

Investment activity in India has been steadily on the rise since 2001, rising from \$320 million in 2001 to an estimated \$7.5 billion in 2011 (the highest level of private equity investment occurred in 2007 at \$9.9 billion). The total amount of investment is estimated at \$60 billion across 2,000 deals. The average deal terms have also increased from approximately \$3 million to \$26.4 million over the same time period (deal size has since declined from a peak level of \$49.5 million in 2007). Growth and expansion projects account for the majority of the deals; investments made into public firms represent about 25 percent, while buyouts account for less than 5 percent. The main investment theme is to build dominant local firms and strong exporters. The primary sectors receiving financing include financial services (25 percent), media and telecoms (20 percent), and manufacturing (15 percent). India has strong competitive advantages in health care, pharmaceuticals, and biotechnology; it also has a strong competitive advantage in high-technology sectors (i.e., information technology, process management, application development). Future investment projects will likely relate to infrastructure (i.e., ports, airport, roads, railway, power generation and distribution, and so on); this investment will be needed to sustain the country’s strong economic growth.

There are multiple challenges facing the private equity industry in India. First, many of the most successful firms have been developed as family-run conglomerates (i.e., Tatas, Ambanis, Birlas). These family-built businesses are reluctant to work with private equity firms, as they already have sufficient capital and possess strong local operating experience. Interestingly, large domestic conglomerates are looking to affect acquisitions abroad, rather than look for investment opportunities domestically. Although many entrepreneurs in India speak English, have spent a considerable amount of time working in the West, and understand Western investment mentalities and the value-creation process, many are reluctant to give up control of their business, allow external directors onto the board, or work with external advisors. Local business owners are also reluctant to dispose of their businesses or their controlling interest in them. Private owners also prefer not to sell a majority stake in their firms. Such problems may further be exacerbated by noncompliance with shareholders' agreements. In addition, deal intermediaries have found it relatively easy to list local firms on the public market or obtain debt financing. Second, local private equity practitioners note that entry valuations in India are excessive. Such valuations are fueled by the robust growth seen in the public market as noted before; expectations have not had an opportunity to "reset." Third, private equity firms often complain that managers have too much freedom—they can too easily diverge from the strategic plans, operational mechanics, and methods of financing recommended by private equity managers. Last, the competitive nature of the industry often causes private equity firms in India to complete deals before first creating a full business plan.

Examples of the most recently completed private equity deals in India involve infrastructure (for example, an expansion investment of \$200 million by Macquarie Group and the State Bank of India into GMR Airports; a buyout deal of Diligent Power, a power generation and distribution firm, by Warburg Pincus valued at \$150 million; a syndicate investment of \$425 million into Asian Genco), banking and financial services (an expansion deal of \$700 million by Bain Capital into Hero Investments; TPG's \$220 million investment into Shriram Pacific), and information technology (a buyout of Patni Computer Systems by Apax Partners).

It is expected that infrastructure projects are likely to attract significant private equity capital, driven by local infrastructure needs and local private equity firms' desire to employ capital at higher increments. Other attractive sectors may include health care, education, and technology, consumer goods, and financial services.

### Exiting

While fundraising and investment activities in India have been sizeable, exits have been inconsistent, cyclical, and, largely, unbalanced (see figure 21.1). The period between 2001 and 2008 has been characterized by steadily increasing realization value from about \$97 million in 2001 to about \$3.5 billion in 2008 (with a peak of \$3.7 billion in 2005). During the earlier part of this period of time, trade sales to strategic investors were the most predominant exit route accounting for between 40 and 50 percent of the realized exit value. Later in the period (in 2007 and 2008), realization values from trade sales, initial public offerings (IPOs), and secondary

sales were more or less spread in equal proportion. It is important to note that balanced exit options are important to local private equity firms as they generally try to optimize value across various exit options in terms of timing and value. The composition of the existing trends reversed in 2009, where IPOs became the most predominant exit route accounting for more than 50 percent of the exit value. The value of exit realization reached its historical peak of \$5.3 billion in 2010. The limited number of exits raises questions about the viability of long-term returns for private equity participants in India. The most well-known recent exits include the sale of Paras Pharmaceuticals (a health care company; exit value = \$726 million) by Actis and Sequoia Capital, the sale of Infosys Technologies (an IT business processing venture; \$400 million) by ChrysCapital, and the sale of SKS Microfinance (financial services business; \$359 million) by a local private equity syndicate.

Public listing can be achieved on one of the two main exchanges in Delhi and Bombay (shares are normally co-listed on these exchanges). The public exchanges jointly list about 7,000 firms; approximately 50 new firms are listed every year. About 23 local exchanges are spread across India, with most of them located in major urban centers (many of these local exchanges are being consolidated). Offshore options for listing shares for Indian firms include NASDAQ and the NYSE. There are also plans to introduce a local exchange board for small and medium-sized enterprises,

It is important to note that a “hot” stock market could play the dual role of foe or friend to the private equity industry. This has certainly been the case in India. The public market can be an especially formidable competitor to the private equity industry in “bull” economic times, and the benefits of bringing on a hands-on investor are not immediately apparent to business owners. Indian entrepreneurs, often driven by pricing considerations, often overlook the drawbacks of a public listing, which include the potential for a rapid depreciation in value, costly disclosure requirements, adherence to the exchanges’ rules and regulations, and so on. Of course, the situation is reversed when the stock market is experiencing a downturn.

#### Regulatory Environment and Private Equity

India has relative political stability—its governments may change frequently, but the general course of reform is continuous from one government to the next. India also has a democratic government committed to curtailing regulatory regimes, reducing corruption, lifting foreign investment restrictions, and creating a positive investment climate. While India has focused on developing a well-functioning institutional infrastructure (i.e., commercial and civil laws, protection of property rights, market regulations, and a democratic political process), the progress made in many areas has been slow—strong legal frameworks require equally strong enforcement.

Private equity firms participate in the market through their local subsidiaries or through offshore vehicles established in countries with favorable tax treaties (i.e., Cyprus, the Netherlands, Mauritius, Singapore, and so on). Investors can also seek approval to establish their activities as foreign venture capital investors or to register with the local securities commission (an investor is not allowed to operate in private or public markets through one entity—two separate legal entities are required). The activities of private equity firms fall under India’s regulation acts, which outline

the limitations and procedures related to investment activity (i.e., limitations on foreign investment in certain sectors, restrictions on allowable ownership percentage for private firms, the percentage requirement for investing in private sector firms in India, a percentage threshold limit to affect takeovers, and so on). Investments into most sectors do not require any prior regulatory approval. Local corporate laws are for the most part well developed, but some legal contracts can be difficult to enforce because of the country's inefficient court system—procedures such as bankruptcies, liquidations, arbitrations, or other legal disputes can take years to implement. Protection of property rights appears to be stronger than in China, but still lags behind Western standards. Many idiosyncrasies related to taxation also exist, especially with respect to the application of capital gains (i.e., private versus public companies and long-term versus short-term investments). The local taxation system creates a poor environment for private equity deals, with unclear and inconsistent tax pass-through application.

### Conclusion

The private equity industry in India is set to grow and reach higher fundraising and investing levels in the future, especially when Indian economic fundamentals, rural-to-urban migrations, and increased consumerism are expected remain vibrant and strong. In spite of some concerns related to “capital overhand” or undrawn “dry powder,” the resurgence of strong interest from strategic buyers, the stock market corrections, and “resetting” valuation expectations on the part of local entrepreneurs are likely to unwind the concern. If this proves not to be the case, the competition for deals is likely to intensify, thereby increasing entry valuations and diminishing returns.

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CHAPTER 22  
IS PRIVATE EQUITY IN EMERGING MARKETS  
COMING OF AGE? EVIDENCE OF THE  
MEXICAN PRIVATE EQUITY MARKET

*Roberto Charvel*

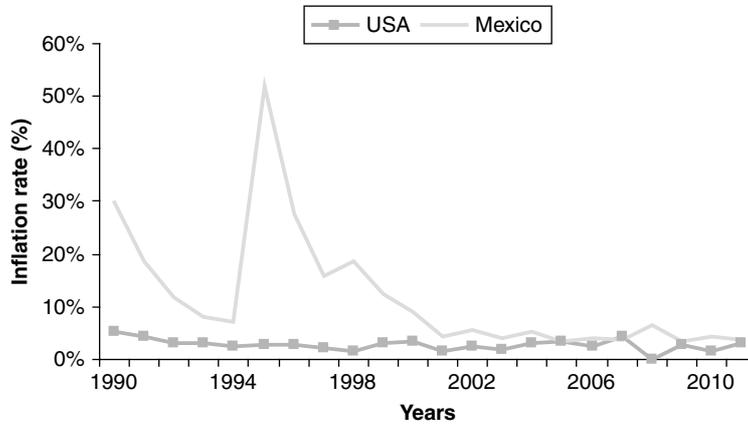
**All the Common Places: Why Is Private Equity Not Working in Mexico?**

For many years, practitioners and private equity enthusiasts have tried to explain why the private equity industry has not taken off in some emerging markets. There are several areas that have somewhat been addressed by different schools of thought over the years. Most of them focus on the same variables. The next paragraphs will try to address some of these theories. After that, I take a different approach by trying to disregard most of the preconceived ideas of why private equity has not worked in some emerging markets (and specifically in Mexico) and propose a new way of looking at the problem.

Macroeconomic Environment: A Long-Lasting Hangover  
after the Tequila . . . Crisis

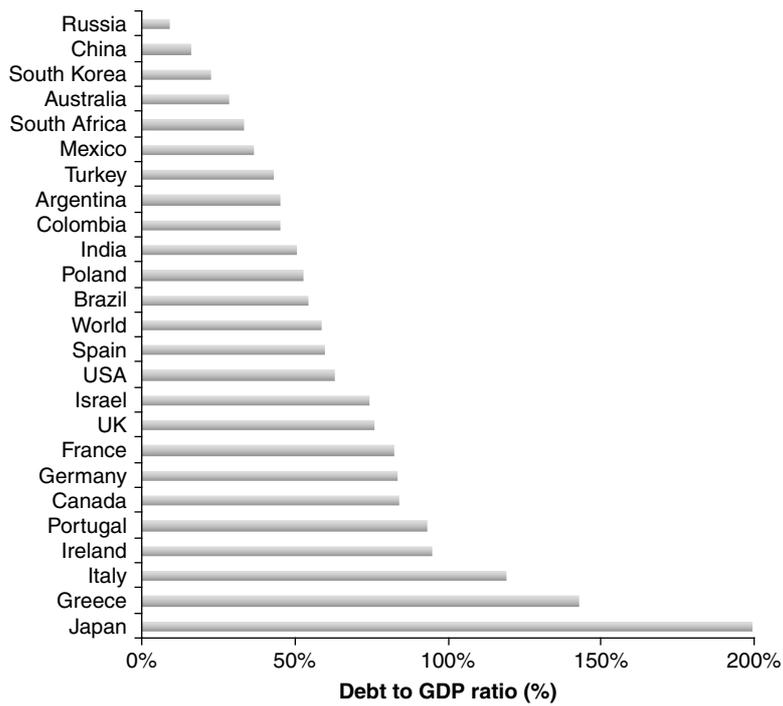
Many of the readers of this book may not necessarily be familiar with the macroeconomic performance of Latin America and Mexico in particular. The generalized conception is that emerging markets have a poor macroeconomic environment. However, this has been changing over the past ten years. For those of you who enjoy reading *The Economist*, you may remember when the Economic Data section used to separate emerging markets from developed economies. They decided to merge the data after J. P. Morgan's Emerging Markets Bond Index (EMBI) was almost unrecognizable when compared to the performance of sovereign debt pricing in developed countries.

One of the objectives that Mexico has been able to achieve since 1995 is to have a very positive macroeconomic environment. Inflation (see figure 22.1) and interest rates have been in the single-digit region for more than ten years. Even more, the government's leverage in Mexico is under control when compared to developed nations such as the United States, Japan, Italy, or Spain to mention a few of them (see figure 22.2).



**Figure 22.1** The rate of inflation in Mexico and the United States.

Source: US Department of Labor and information for Mexico from INEGI.



**Figure 22.2** Debt to GDP ratios for selected countries.

Source: CIA World Fact book with information from 2010.

Most Mexicans and surely all of those in business know about the positive economic environment, but this may not be the perception outside of Mexico.

It is likely that foreign institutional investors know little or nothing about some of these variables, and they probably focus most of their attention on the exchange rate (see figure 22.3), which has underperformed not only against hard currencies but also against some of its peers in the region. An insightful article in *The Economist* edition in December 2011<sup>1</sup> points out why the peso has underperformed other currencies in the last years. *The Economist* focuses on four main reasons. First, the US and Euro debt problems have scared investors away from exotic currencies. However, this would not explain why the peso has underperformed when compared to the Brazilian real, for example. The second specific reason for the underperformance of the peso is related to the fact that the Mexican economy is more closely linked to the US cycle than any other emerging market. Bad news in the US seems to hit the peso harder. In the third point, *The Economist* states that traders use the peso as a hedge for the region as it is the only currency in Latin America traded around the clock. Lastly, it is argued that the Mexican Central Bank has been less proactive in intervening in the markets to manipulate the currency.

Last time I read a textbook on economic theory, it stated that liquidity for a currency was a good thing not a bad one. In the short term, being traded in the futures market in Chicago has punished the Mexican peso. Growing up in the times when Mexico experienced so many economic crises, I remember my economics professors saying over and over that the central bank's job was not to manipulate the currency but rather to focus on having low inflation overtime. In summary, the peso has been underperforming for doing what should be done. This trend will probably be reverted in the long term.

In the 1990s, many renowned academics proved that macroeconomic variables had an impact on the private equity cycle. Most of them focused on and proved the negative



**Figure 22.3** Mexico's exchange rate (pesos per \$)

impact of a bad macroeconomic environment on new commitments to private equity funds (for further discussion see, for example, Gompers and Lerner [1998], Black and Gilson [1999], Jeng and Wells [2000], and Balboa and Marti [2001]).

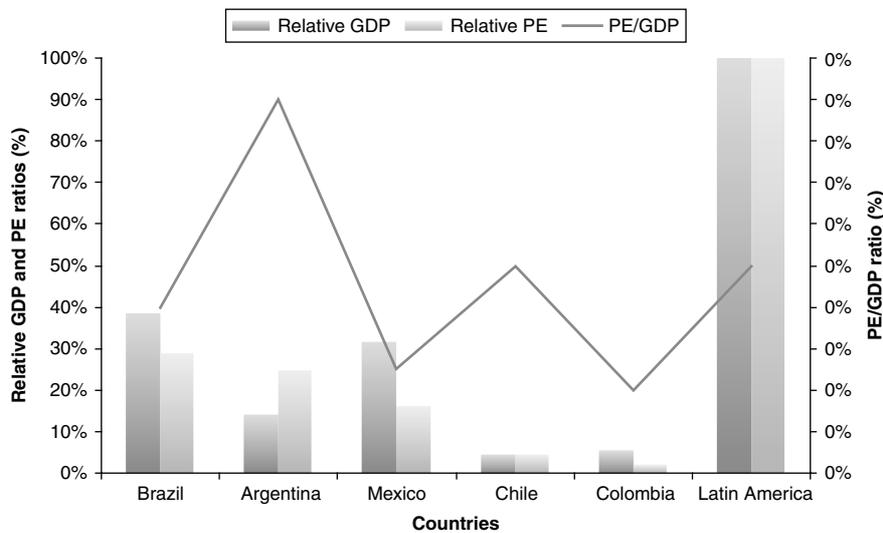
Merely having a good macroeconomic performance is not sufficient to have a strong private equity market: Mexico is the example of that. However, a bad macroeconomic environment does not stop capital flows from going into a market in the short term either. Argentina has attracted much more private equity investments than Mexico with a significantly worse macroeconomic environment (see figure 22.4).

#### Rule of Law? What for If You Could Buy Your Way Out?

The second area that is usually debated about has to do with issues related to the legal framework. Most people state that the legal environment and all its institutions have had a negative impact on the growth of the economy, and specifically in the creation of an entrepreneurial environment.

The legal-related problems include several areas such as the lack of rule of law and the existence of corruption, the inefficiency of the courthouses, and the lack of protection of rights due to poor enforcement of contracts.

The issues related to the lack of implementation of the rule of law are likely the reason why there is corruption, no accountability, and why investors (or regular people)



**Figure 22.4** Private equity investments relative to GDP in Latin America.

*Source:* Economist Intelligence Unit; VELA (private equity flows for Argentina, Brazil, Chile, and Colombia).

*Note:* The GDP column shows the GDP of the country relative to Latin America's GDP from 1990 to 2006. The private equity flows show the country's private equity share of private equity investments in Latin America from 1990 to 2006. The average PE/GDP for Latin America is larger than expected as it includes regional investments that are not easily allocated to any one country. Abbreviations include: PE—private equity; GDP—gross domestic product.

feel they can't enforce their contractual rights. In 2000, Mexico had a new party elected after more than 70 years of the same ruling order. Unfortunately, the opportunity to start over and create a country with the rule of law as a pillar was lost. Since 2000 the government has been led by the same new party with little or no change on this topic.

A significant body of literature on the impact of laws and institutions has been written in the last 20 years—from Nobel Laureate Douglass C. North to the new school of thought known as Law and Finance led by La Porta (1997). The basic idea is built over the findings that describe how the legal origin of a country has an impact on financial markets and economic performance. La Porta and others (1997) focused their research on poor minority shareholder protections in French civil law countries (of which Mexico is part) compared to those of common law countries. Djankov and his collaborators (2003) found that common law countries are able to enforce contracts better than countries with other legal origins. Lerner and Schoar (2004) found that in law enforcement and French civil law nations, private equity groups rely on majority ownership rather than contractual provisions to protect their interests. The legal and institutional framework plays a role on the performance of private equity markets. But is there something we are missing?

Where this body of literature may become obsolete is when we compare the private equity industry in Mexico with other countries having a similar performance in terms of the rule of law variables, but different dynamics in private equity development. Brazil and China appear to have even worse legal infrastructure compared to Mexico while having sufficient more robust private equity industries. In other words, there is clear evidence of large private equity markets regardless of how strong their legal environment is.

Allen and others (2005) were among the first academics to notice and document a counterargument. China has been able to outperform countries with better legal governance, thus portraying a counterexample to the findings in the law, institutions, finance, and growth literature.

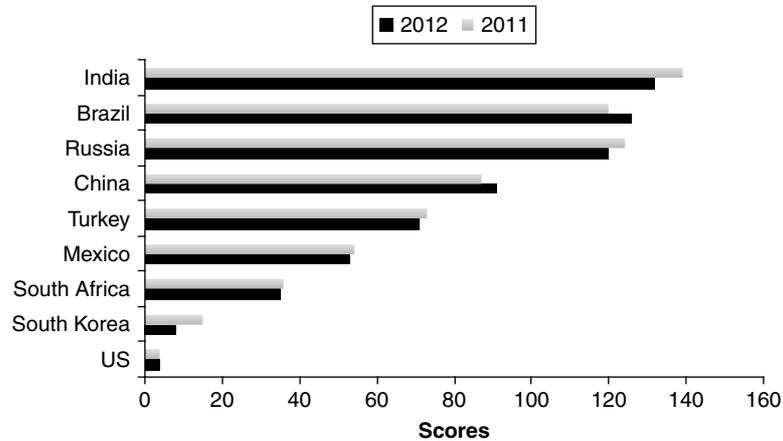
It is safe to conclude that the current legal framework in Mexico does not help the growth of the private equity industry. However, due to the evidence of the growth of the private equity industry in countries with similar legal frameworks, it can be concluded that the legal environment is not sufficient condition for the industry not to take off either.

#### “It's Simply Impossible to Do Business in Mexico”

Most people perceive Mexico to be a country with many problems that negatively impact the business arena. These problems go from the current violence in the country that is fighting a war against organized crime for the first time in its history, to poor infrastructure and a bureaucratic environment.

In the last few years, several thinktanks and multilateral banks have developed different methodologies to measure how the ecosystem in a country may impact the business activity. Among the best-known methodologies is the one developed by the World Bank, and it is called *Doing Business Report*.

Some countries that can be considered as underdogs, such as Mexico, have been almost obsessed about increasing their ranking in the *Doing Business Report* since



**Figure 22.5** A comparative performance on ease of doing business for selected countries.  
 Source: Doing Business Report, World Bank, 2011 and 2012.

the early 2000s. As you can see in figure 22.5, the World Bank perceives that doing business in Mexico is significantly easier than in other countries such as Brazil, Russia, India, South Africa, and China, who have been the economic champions of the last years.

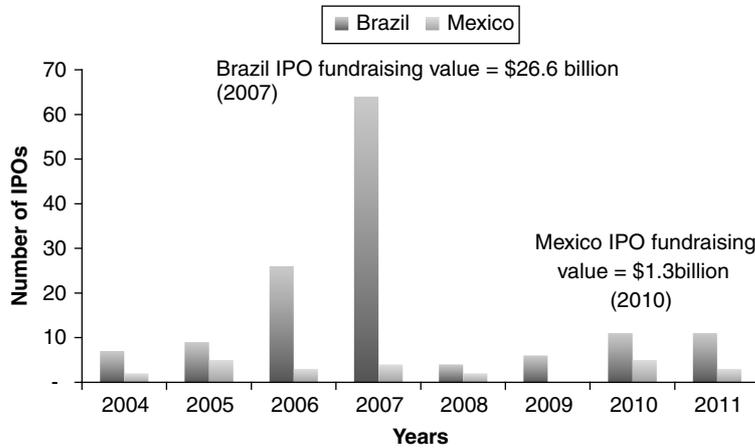
In other words, even when the perception of doing business in Mexico may be negative, in reality, the situation is not as challenging as the World Bank has documented it. However, having a positive business environment doesn't seem to be having a positive impact on the private equity industry in Mexico. Even more, countries with bad business environments—as described in the previously mentioned World Bank's framework—have strong private equity markets, so this variable can also be disregarded as an explanation for the incipient private equity markets.

#### The Problem Is in the Ridiculously Small IPO Market

The IPO market in Brazil has been one of the most active ones at the beginning of the twenty-first century. By comparison, the Mexican IPO market has distinguished itself by being almost nonexistent (see figure 22.6).

Without a doubt, a robust IPO market has a positive impact on the private equity cycle. Black and Gilson (1999) and others have already proven that. Part of the success of the Brazilian private equity markets can potentially be tracked down to this argument. However, there are at least two examples that can prove that IPO markets are not required for an active private equity industry.

The first argument has to do with the book called *Start-Up Nation: The Story of Israel's Economic Miracle*, which was written by a graduate school classmate of mine. Israel has been able to reach pop-star status in the private equity arena even with a small or almost inexistent IPO market. The reason is that markets are global and not necessarily local. Portfolio companies from venture capital and private equity



**Figure 22.6** The number of IPOs in Brazil and Mexico.

Source: Bovespa and BMV. Vander Capital Partners analysis.

funds have been able to access the IPO in the United States, not in Israel. In other words, even with a poor IPO market, Mexico could access exits in more active public markets. Just like Israeli technology firms reach IPOs at Nasdaq, in Mexico there are close to 300 early-stage mining firms that have been able to raise capital through IPOs and secondary offerings in the Toronto Stock Exchange as they would not be able to raise money in the local exchange.

The second argument is a comparison between the real estate markets in Brazil and in Mexico. During the first decade of the twenty-first century, Mexico became the darling for private equity funds focused on real estate or those investing in real estate. Private equity funds were incredibly active even financing publicly traded real estate firms. Prudential Real Estate Investors was able to raise, invest, and successfully liquidate several funds that were coinvested at the project level with GEO and URBI: two publicly traded housing developers. However, in Brazil, real estate funds have not been as active as they have been in Mexico. The reason is simple: housing developers were able to raise financing directly from the public markets. During the first decade of this century BOVESPA, Brazil's stock exchange saw several firms becoming public and not needing to necessarily access private equity investments. This is very strange. Active public markets actually compete with private equity investments. In some cases active private equity markets could actually negatively affect the private equity industry.

### So What Is the Point?

Being Attractive Is Everything, or Is It?

Everyone who has tried to raise a fund knows that institutional investors usually follow a "herd mentality" behavior. If a large or recognized investor goes into a fund,

the other investors will follow shortly. This does not only happen at the fund level, but also at the country or region levels.

If you try raising a fund from foreign institutional investors, and you are presenting a Latin American opportunity, it appears that their interest is currently only in Brazil. This was not always the case. At the end of the 1990s, Argentina and Mexico had their time as well, as is described next.

At the beginning of the twenty-first century, CalPers—the world largest pension fund and one of the most visible institutional investors—decided to move to Mexico from its Latin America allocation of capital to North America for private equity funds focused on real estate. This changed the game dramatically.

By 2003, one of the first two funds to ever invest in Latin America's real estate market was able to perform an exit with a 34 percent IRR in dollar terms by selling an industrial and office portfolio to CalPers. Soon after that, CalPers invested in several real estate investment managers targeting the Mexican real estate markets. Then on, CalPers, other large US private and public pension funds, as well as European (PGGM), Middle Eastern (ADIA), and even the Far Eastern (GIC) investors underwrote the Mexican market.

CalPers's sudden interest in Mexico not only was helpful in bringing liquidity to the first funds investing in Mexico, but brought several other large investors into the market. By the mid-2000s, all major real estate private equity funds had offices in Mexico. These included Apollo Real Estate, Black Creek, ING Clarion, LaSalle Investment Management, O'Connor Capital Partners, Prudential Real Estate Investors, Walton St. Capital, and even Carlyle had a satellite office. This environment radically changed after the 2008–2009 global crises, especially when institutional investors from developed nations stopped pouring commitments into Mexican real estate.

Unfortunately, for the regular private equity or venture capital industries in Mexico, they were not championed by foreign institutional investors such as those who supported the real estate market. It is likely that this should be irrelevant in the future.

The problem with private equity in emerging markets is that they rely too much on the willingness of foreign institutional investors rather than rely on internal sources. If a country is attractive (like Brazil has been for the last decade), then, things are great. However, if foreign investors perceive a country as uninteresting, it is very unlikely that they would underwrite or invest in these markets, as their peers are not doing so. The biggest reason why it is difficult to do private equity investments in Mexico is not the business environment or the lack of pipeline; the problem is the difficulty to raise money from foreign institutional investors on a consistent basis.

#### Mexico's Biggest Flaw

The second point that most people seem to overlook when trying to explain what makes private equity in Mexico so difficult is the lack of financing. In mature private equity markets, investment management firms leverage their portfolio companies apart from generating value through active management. In Mexico they can only rely on their management skills, as debt financing is almost nonexistent.

A recent study<sup>2</sup> shows how the Mexican banking systems is not only relatively small when compared to other emerging markets, but it also provided more financing to firms as a percent of the GDP before its last economic crisis in 1994<sup>3</sup>, than now. The total portfolio of bank loans to firms in Mexico added up to \$85 billion, which is almost irrelevant in an economy that is over 1 trillion dollars.

Without access to capital, private equity funds may not be able to reach their expected returns, and firms in general may not be able to finance their growth in an efficient way. The lack of financing is not only hurting firms and private equity investments, but also holding back Mexico's economic growth.<sup>4</sup> Debt is one of the much-needed supports that private equity needs in order to get higher returns to its investors.

### **So How Does the Future of the Industry Look? Actually, Not Too Bad**

There are several reasons why banks do not provide debt financing to firms in Mexico. First, there is the difficulty in enforcing legal contracts in Mexico. Banks providing loans may not be able to enforce contracts to get their loans back, or the legal process may be too long and destroy value through the process. The reason why private equity firms are more likely to abide by the law is twofold. There is a reputational issue—private equity firms would not like to be perceived by future investors as companies that do not cover their commitments with banks or other institutions. Additionally, private equity firms in emerging markets have so little access to financing from banks, that they are really focused on building a long-term relationship with banks so that they are eventually able to move from growth capital investments to leverage buyouts. Second, Mexican firms may lack good corporate governance and transparency, a situation that increases the risk to banks for sanctioning loans. This together with the previous point increases the risk to banks when providing loans in Mexico. Third, banks only provide loans to firms that are capitalized. This is not something wrong; this is just the way banks work.

How can the economic cycle solve this without having to go through an impossible process of reforms to be approved by a congress that has not been able to pass a single major reform since 1997? How can the market help debt financing reach firms to finance their growth and the growth of the country? The answer is to have more private equity, which has more tolerance for risk and is more flexible in structuring deals in legal terms. Private equity firms have supervision by institutional investors that bring best practices in fields like corporate governance, and their investments capitalize firms that make them more likely to get debt financing from banks.

At this point you may think this chapter is going around in circles. As has been pointed out previously, inadequate private equity is potentially due to a lack of debt financing and due to reliance on foreign institutional investors. In this last part we have focused on pointing out that in order to solve the lack of debt financing there should be more private equity. In other words, the presence of debt financing may be a necessary condition for the private equity cycle, but debt financing to firms may only be jump-started by the presence of private equity.

This would leave only one problem standing. The real problem of why private equity in Mexico has not taken off is the reliance of the industry on commitments from foreign investors, and the fact that Mexico is not perceived as an attractive destination for institutional investors who usually adopt a “herd mentality” behavior, but there is good news. First, Mexican savings reached almost \$500 billion or 44 percent of GDP by 2010. Savings had been growing at 14 percent CAGR in the last ten years. Mexican institutional investors accounted for \$306 billion of all the savings, and it was expected to grow to \$625 billion by 2018. The largest institutional investors were private pension plans that followed the Chilean design and had accumulated \$120 billion since 1997. Additionally, Mexican institutional investors have an overweight on Mexican government bonds as well as on public debt from firms. For example, private pension plans had 61 percent allocated to Mexican government bonds by 2010. No wonder why the OECD raised a flag on May of 2011. The OECD published a report that showed that after 45 years of a professional career, the pension of a Canadian worker would be 63 percent of its last salary. This number is 47 percent in the United States, and only 25 to 38 percent in Mexico. Moreover, as of 2010, in Mexico, a new private equity vehicle called CKD was able to raise several private equity funds. Most of these funds were either real estate or infrastructure funds with a few of them being private equity pure play funds. They had raised \$2.7 billion or 2.2 percent of assets under management by private pension funds. In reality, the exposure to private equity was smaller as not all the money in CKD was from private pension plans.

From previously mentioned trends, private equity in Mexico seems to be in good shape. It is only a matter of time for Mexican institutional investors to increase their allocation to alternative assets and the problem presented in this chapter would be solved.

A recent article (see Charvel [2012]) estimates that if Mexican institutional investors were to allocate 5 percent of their assets into alternative assets (hedge funds, private equity, infrastructure funds, real estate funds, and venture capital) this would add up to \$28 billion of commitments that could be invested in 121 funds.

This argument can actually be extrapolated into other emerging markets. The shape of the private equity industry in emerging markets will change completely when they stop relying on foreign institutional investors to finance their funds. Many of the typical academic arguments would also stop being quoted over and over. Local institutional investors have already underwritten the difficulty of conducting business in their local market and are already familiar with the issues related to the lack of the rule of law. They also understand the macroeconomic cycle better than someone sitting in a desk in New York or London, who has never visited the country.

### Notes

1. “Mexico’s Plunging Peso. ¡Arriba, arriba! A Wobbly Currency Has Not Hurt Growth for Now.” *The Economist*, December 08, 2011.
2. Charvel, Robert, “The Road Map for Private Equity, Venture Capital and Hedge Funds in Mexico. Alternative Assets as an Accelerator of Credit to Firms in Emerging Markets.” *The Journal of Private Equity* 15 (Spring 2012), forthcoming.

3. Musacchio Haber.
4. Debt to real estate transactions is probably not as bad as in other Latin American nations, and this can also explain the development of these types of strategies in Mexico. Banks seem to look for collateral (the real estate asset) and underwrite rents (the debt repayment source) rather than providing loans to corporations.

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CHAPTER 23  
PRIVATE EQUITY AMID EVOLVING MARKET  
INSTITUTIONS: THE CASE OF VIETNAM

*Markus Taussig, Matthew Schwarz, and Kenneth Chin*

**Introduction**

Vietnam provides a compelling illustration of the myriad pros and cons of private equity (PE) investment in emerging economies. The country has experienced two decades of rapid economic growth, driven in large part by substantial foreign direct investment and an appropriate export-oriented focus on comparative advantage in labor-intensive manufacturing. Institutional change has been extraordinary in many respects, including a dramatic reduction in barriers to entrepreneurial entry and a rapid increase in capitalization of the domestic stock market. Vietnam observers also consistently struggle to put their finger on something intangible or cultural: “Scrappy is an understatement for the Vietnamese brand of entrepreneur,” begins one essay on “Vietnam: The Next Frontier” (Fannin, 2011). For these reasons, Vietnam now frequently comes up in discussions of the world’s most promising emerging economies. Making the picture even more compelling, the influential International Finance Corporation argues that the country’s PE market is still underserved.

All this notwithstanding, legitimate investor concerns remain. “Vietnam Is Hot, Don’t Get Burned” headlined a *Businessweek* article describing the atmosphere around the 2005 inauguration of a \$100 million venture capital fund by International Data Group—previously the manager of perhaps the most successful VC fund in the early days of China’s PE market development. Not long thereafter, the stock market did crash and took some investors with it. Despite improvements, institutional realities alone provide ready explanation for why Vietnam is not yet home to a robust PE industry. Vietnam is at the bottom of most indices measuring the strength of market institutions (e.g., those of the World Bank, Heritage Foundation, Transparency International, International Country Risk Guide). The country’s government still espouses Marxist-Leninist ideology and remains actively—and unsuccessfully—involved in industrial policy.

Furthermore, the industries in which foreigners have fared best in Vietnam are not the same higher technology industries in which growth-oriented PE has

traditionally been most successful. Instead, foreign investors have favored labor- and natural-resource-intensive industries, where Vietnam has a clear comparative advantage. The most successful foreign investors have also tended to come from other East Asian countries with extensive experience doing business in similarly challenging institutional environments. For good reason, PE firms generally shy away from countries with these characteristics (Guler and Guillen, 2010). But Vietnam's sustained rapid economic and private sector growth is certainly complicating the normal calculus for fund managers and limited partners alike, resulting in the buzz that surrounds Vietnam today.

In this chapter, we describe the brief history of PE in Vietnam and outline its current state. We then consider what lessons can be drawn from the Vietnam experience for understanding the prospects and likely the future shape of PE in other emerging economies. In particular, we consider how aspects of the business environment such as rapid economic growth, weak contract enforcement, and institutional change differentially affect PE firm behavior and performance.

### **Vietnam's Business Environment**

Optimism regarding Vietnam's PE market is fundamentally rooted in the population's entrepreneurial capacity and the government's increasing reliance on it to drive economic growth. The year 2000 saw the introduction of a much-lauded second company law that dramatically cut the costs of registering a private company and signaled the government's acceptance of the legitimacy and value of entrepreneurship in society. This was then followed closely by a bilateral trade agreement with the United States in 2001 and the opening of a stock market in 2002. These milestones were then capped off with Vietnam's accession to the WTO in 2007, a landmark achievement given the depth and scope of reforms involved.

The result was an explosion in the number of new domestic private companies and a significant shift in the formal private sector's contribution to GDP. Importantly, growth in the number of new firms came almost exclusively from the registration of corporate ownership forms. Moreover, whereas leading domestic private companies were overwhelmingly focused on low-margin export markets before the second company law, Vietnam's most successful entrepreneurs are today increasingly focused on rapidly growing and underserved domestic markets (Taussig, 2009). As in China, it is apparently increasingly "glorious to be rich."

Vietnam's economic transition process has usefully been compared to that of Taiwan (Riedel and Tran, 1997). As was true in Taiwan, state-owned enterprises (SOEs) have been slow to privatize, but the strength of private sector activities is rapidly reducing the weight of their contribution to the economy. In Taiwan, the state sector eventually became irrelevant, and privatization was then easy to pull off. Unfortunately in today's Vietnam, though, it is not yet clear whether the political sway of SOEs—and their closely related cousins, partially privatized SOEs—is waxing or waning. What is not in question, though, is that—as was true in Taiwan—the move away from state planning has led to far more efficient focus on the country's key competitive advantages. Benefitting from proximity to the Chinese market and East Asian production networks, a deep reserve of low-cost labor, and a relatively

stable political regime, export growth has been a consistently strong driver of more general economic growth. Furthermore, the decision of high-tech giants like Intel and Hon Hai to locate major new hubs in their respective internal production networks in Vietnam offers hope that growth can extend beyond the basic inputs of labor and commodities and into more innovative segments.

A more pessimistic view of business in Vietnam takes into account stubborn weaknesses in government institutions, ranging from property rights and the enforcement of contracts to the education system. Much of the economic activity in Vietnam falls under the catchall category of the informal sector (Tenev et al., 2003; Malesky and Taussig, 2009). Even in the formal economy, the weakness of corporate governance norms and protection of minority shareholders leads to a dominance of family business practices and other shady norms. Actual corporate governance laws are typically complied with in name only, not in spirit, leaving essentially no real controls in place to guard against related party transactions or other conflicts of interest for top management (Freeman and Nguyen, 2006).

Substantial improvements in the short to medium term are hard to imagine. The system of large general corporations—once (unconvincingly) said to be modeled after the Korean *chaebols*—remain largely unaffected after years of serious reform efforts by some in the government. As a result, the long-running VinaShin scandal serves as a constant unfortunate reminder of the continued prevalence of bad policy decisions and corruption at all levels. In this context, occasional news of high-profile arrests on charges of corruption tends to be met by ordinary Vietnamese with cynical questions of who the accused forgot to pay. Several high-profile cases in 2011 of fraudulent reporting by listed companies that had previously received the blessing of top accounting firms further illustrate the widespread nature of the information asymmetry problem.

To some degree, of course, such institutional issues can be seen as simply part and parcel of doing business in any emerging economy. And given the institutional problems, perhaps it is similarly not a great surprise that Vietnam has also been struggling with macroissues such as inflation and the clarity of its currency exchange policy. Inflation, which was brought down from triple-digit levels as a key part of the high-growth policies of the 1990s, has been more volatile since the mid-2000s. Food prices, in particular, have been volatile, and government responses to external price shocks and inward capital flows have vacillated between inadequate and extreme—with examples of the latter including allowing money growth to hit near 50 percent in 2007, or banning rice exports in 2008 due to high world prices. The persistent and significant gap between money in the formal banking system and the population's substantial savings can be partially blamed on inflation issues, but also is another case of insufficient reliance on market mechanisms, as it indicates deposit rates should be higher.

Even more discouraging in some ways is the current state of Vietnam's education system—something that was widely seen as a competitive advantage earlier in the country's reform process. But high-profile cases wherein ambitious foreign investments had to be scaled back due to insufficient local talent—highlighted by the struggles of Intel—have exposed education as a serious constraint on growth (World Bank, 2008). As with other government responsibilities, education has clearly not

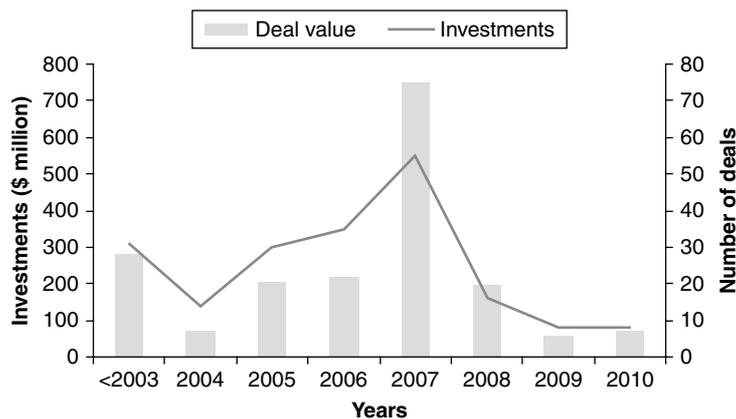
kept pace with the country's rapid economic development. Given the clear signs of high demand, Vietnam's education sector has actually attracted substantial interest from private investors. But government has proven both reluctant to allow the private sector in and slow or unable to take any concrete actions to address the challenges itself.

In summary, despite some major improvements, macro and institutional concerns will continue to present serious challenges to the traditional PE business model for some time. As a result, it is left to firms themselves to figure out ways to develop capabilities for substituting "institutional voids" (Khanna and Palepu, 2011). The glass half full lesson from this is that weak institutions can be thought of like most other forms of entry barrier, meaning that there are tangible benefits to being one of the few firms that do this successfully. While evidence is scarce, research on the relationship between institutional voids and firm performance does, in fact, indicate a positive relationship—that is, greater voids correspond to greater firm returns (Amit, Deng, and Villalonga, 2010; Taussig, 2011a).

### Vietnam's Nascent PE Industry

Despite global and local turbulence, overall trends in Vietnam's PE market remain largely positive. IFC reports that \$1.8 billion was invested into almost 200 Vietnamese companies by major PE fund managers between 2003 and 2010. The number of PE investments skyrocketed in 2007, as PE firms capitalized on investor enthusiasm fueled by a rapidly growing stock market to raise new funds (see figure 23.1). In keeping with global trends for emerging markets PE fundraising, the following years then saw a significant reduction in the number of deals.

The players that make up Vietnam's PE industry include both locally and regionally based firms. Vietnam is now home to at least seven major domestically based



**Figure 23.1** Private equity investment value and number of deals in Vietnam between 2003 and 2010 (through November).

Source: Grant Thornton (2010).

PE firms that have raised (or are in the process of raising) multiple country-specific funds (see table 23.1). Of these, though, only Mekong Capital, VI Group, and BankInvest are pure structure private equity players, as the others are also heavily involved in public equities and real estate investments. A newer PE-only investor is Red River Holdings. In a sign that optimism still trumps pessimism in the country's industry, four of the seven on the list were raising new funds in 2011. The list does not include the earlier mentioned IDG group, which is also making noise about a follow-on fund. It additionally does not include Indochina Capital, which went from one of Vietnam's most prominent fund managers at the height of the stock market to the very unusual step of having its PE fund liquidated by investors. And it, too, is said to have a follow-on fund in the pipeline.

The firms that have brought the Vietnamese PE industry into global headlines, however, are more internationally recognizable names that have invested into larger individual deals through regionally oriented funds. TPG got the PE industry's biggest splash exit when it entered, listed, and exited the privatized telecom giant FPT within a span of several months, wisely and narrowly avoiding the bursting of the stock market bubble in early 2008. While there were some fences to mend due to local frustrations about the lack of sustainable value added, TPG clearly served its investors well. TPG then also invested in the holding company for fish sauce processor Masan, which subsequently also benefitted from a record \$159 million deal in 2011 that saw Kohlberg Kravis and Roberts take a 10 percent stake in their consumer products subsidiary. Other regionally oriented players clearly paying attention to Vietnam include Goldman Sachs, Navis, Lombard, Actis, and Aureos Capital.

These recent big deals notwithstanding, the average size of PE deals in Vietnam remains quite small at approximately \$5 million. A limit on size is the lack of leveraged buyout (LBO) deals, due largely to inefficiency of the local banking system (Malesky and Taussig 2009a; Freeman 2005). The obstacles to LBOs also include caps on foreign ownership in certain industries. Average deal size has steadily risen (from about \$1 million between 2005 and 2006 to about \$5–7 million between 2006 and 2010) and the expectation is that it will continue to do (to \$10 in the next five years) so as ownership restrictions are further relaxed and opportunities for investments in additional industries open up.

**Table 23.1** Key characteristics of major private equity funds in Vietnam

<i>Fund name</i>	<i>Capital under management (\$ million)</i>	<i>Deal sizes over time (\$ million)</i>	<i>Number of local staff</i>	<i>Major known limited partners</i>
Mekong Capital	283	1.5 → 4.4 → 8	+20	FMO
Dragon Capital	245	5–10 → 15	+10	IFC
VIGroup	211	5 → 10	25–30	IFC
VinaCapital	504	6 → 18 → 23	+15	Danish pension funds
BankInvest	450	10	12	n/a
Prudential	363	15	6	International
JACCAR	270	10–15	15	French family offices

Source: IFC (2010).

Major fund managers achieved 150 full and partial exits over the period of 2003 to 2010. High valuations in the domestic stock market led to numerous exits via stock listings. Stock exchange listings during periods of investor exuberance are certainly easier to execute than trade sales to global buyers. The latter involves painstaking due diligence by potential buyers and, as a result, it is more challenging to create demand-side pressure to push up the price. But as, especially, recent times in Vietnam have shown, heavy reliance on stock market listings is not likely to be a sustainable long-term strategy. In fact, broader research on emerging economies indicates that trade sales are the most common mode of exit in emerging markets PE and, furthermore, that emerging markets PE returns are actually not at all correlated with local stock market movements (Taussig, 2011b). This relates, of course, to the immature and illiquid IPO markets typical of emerging economies (as described in more detail for the case of Mexico in Chapter 22).

Perhaps surprisingly at first brush, what the evidence does show is that PE returns in emerging economies are instead strongly correlated with movements in the US stock market. As with related findings showing that FDI flows are highly correlated with S&P500 Index in the United States, what this appears to show is the powerful sway that the sentiment of multinationals at any particular time has on the fate of emerging economies (Baker et al., 2005). In the particular case of PE in emerging economies, a key overarching issue affecting performance appears to be whether funds happen to have exit-worthy deals in their portfolios at times when MNCs' pockets are deeper.

The importance of global conditions notwithstanding, however, country-specific factors have clearly also contributed to the ups and downs of Vietnam's PE industry. Although Vietnam's experience with the market economy is not that long, the country's PE industry has already experienced multiple boom-and-bust cycles. During the country's initial transition in the early 1990s, a first generation of PE investors was quick to enter, eager especially to invest into privatizing SOEs. Half a dozen funds raised nearly \$400 million during this period<sup>1</sup>—quite a substantial amount when seen in the context of both the infant state of emerging economy PE, in general, and the virtually nonexistent nature of a corporate private sector in Vietnam, in particular, at the time. Privatization of SOEs and establishment of new private corporate entities, however, proved painfully slow in the 1990s, leading funds to losing strategies such as investing into start-ups managed by foreigners. Emerging economy guru Mark Mobius's fund, in turn, refashioned itself into a pan-Asian fund. By the onset of the financial crisis in 1997, most had exited the market. Of the early entrants, only Dragon Capital survived to enjoy the second boom. Mobius understudy Chris Freund also subsequently returned to start up Mekong Capital.

Domestic regulations have also played a role in the industry's development. Vietnam's current tax legislation of investment vehicles is still underdeveloped, and as a result, most funds are established outside of Vietnam as listed funds. Investment funds structured as offshore vehicles cannot raise capital from both offshore and onshore investors. The current tax code provides two methods for calculating tax on foreign investment vehicles: (i) corporate income tax and (ii) foreign contract tax. Under the corporate income tax, income earned from selling or

transferring ownership of Vietnamese companies or securities from a foreign entity to a Vietnamese company is subject to a capital gains tax of 25 percent. Under the foreign contract tax regime, foreign entities that carry out business or derive income from Vietnam are subject to a 0.1 percent tax on the value of the sale transaction. The existence of two separate tax methods is cause for confusion when exiting transactions. Court rulings have not made the interpretation any clearer: “Several rulings have been issued . . . however these are not definitive as there are rulings which contradict this interpretation” (KPMG, 2010).

A current proposal to change regulation of investment vehicles that may take effect in 2012 would allow offshore managers to establish 100 percent owned subsidiaries in Vietnam. If the proposal is approved, foreign fund managers will be able to establish domestic vehicles that are taxed at the domestic securities investment rate, and will be able to raise onshore and offshore money. The ability to domicile funds locally would facilitate trade sales by simplifying ownership transfers to domestic corporates without having to create special purpose vehicles. Among other relevant legal improvements still needed are regulations on insider trading and credible surveillance by the State Securities Corporation.

### **Overcoming Institutional Obstacles**

As noted earlier, the weakness of institutions in areas such as property rights and contract enforcement has to be taken as a defining feature of doing business in Vietnam. For PE firms, weakness of institutions means different things at different times, depending on where the firm is in the investment cycle. Specifically, early in the life of a fund, PE investors are focused on identifying and coming to mutually agreeable terms with local firms that stand out both for their high growth potential and for their preparedness to share this growth with an external investor. Later in the life of the fund, in contrast, when the focus turns to exiting investments, it becomes increasingly important that PE firms carry legitimate status vis a vis the global buyers that determine the demand pressure on exit price. In short, there are returns when operating as a buyer and then returns to being more global when transitioning to the role of seller.

Beginning with the task of identifying the high growth potential investees, PE firms need to accumulate local knowledge and local networks in order to understand and rank the quality of the local firms. The same local knowledge and networks are also crucial to not only ex-ante assessment of whether potential investees are sufficiently long-term-oriented to allow outside investors to share in subsequent winnings and attractive presentation of the value propositions of the collaboration to those investees, but also effective ex postmanagement of communication and other aspects of the relationship after investment.

Because of greater understanding by governments around the world regarding the value of economic integration, the threat of direct and full expropriation of assets is no longer what it once was. But more indirect threats remain plentiful (Henisz and Zellner, 2010). In the case of private equity, the main risk derives from the ease with which emerging economy firms are usually able to shift around numbers in their financial statements in ways that depress the returns to minority shareholders.

Stories abound of investees who come to feel that their PE investors have not actually added value at a level that justifies a full sharing in the benefits of growth and so simply adjust their financials to ensure they pay out only what they see as fair, for example, a more debt-like return rate. The key to avoid this is naturally a combination of carrots and sticks, wherein investors foster reputations for both adding real value and understanding the means of informal recourse that local firms use to substitute for missing institutions.

In terms of fostering their reputations for truly adding value, PE investors are becoming increasingly “hands on” with their investee companies. Purely PE-oriented firms in Vietnam such as Mekong Capital and VI Group are particularly explicit in their dedication of significant resources to training executives in production and marketing, establishing effective reporting systems, and developing long-term strategic plans.<sup>2</sup> Mekong Capital Founder Chris Freund argues: “The fundamental challenge of successful private equity investing in Vietnam is getting capable senior management teams in place.” Freund points to Vietnam’s relatively underdeveloped private and foreign-invested sectors to explain why the challenge looms even larger in Vietnam than elsewhere: “Companies like FPT and Masan Group have been so successful in part because they have done an effective job at building their culture and their management teams.”<sup>3</sup> Signs are that more active involvement in investee affairs is spreading: in a 2011 survey, 57 percent of fund managers expressed intent to increase hands-on involvement with portfolio companies, with the majority focusing either on restructuring or strategic planning (Grant Thornton, 2011).

The incentive to improve middle management capacity within investee companies goes beyond value creation (through better operational performance and higher profitability). PE investors need reliable information on the company, key decisions, and performance metrics. The historical preference for Vietnamese entrepreneurs to treat ventures like family enterprises has produced a preponderance of top-heavy middle market corporations, making communication between shareholders and executives difficult. PE investors now find themselves in the frustrating position of needing to communicate with the CEO to obtain even the most basic information. “Middle management doesn’t have the level of authority that you see in other markets,” says Nikhil Singh of Indochina Capital, “It’s very hard to work with management teams because they have no power and limited access to information” (Insight Vietnam, 2011).

Many of the challenges to mobilizing capital in Vietnam involve corporate governance. In spite of its WTO accession agreements, Vietnam has yet to institutionalize widespread appreciation for and adoption of world-class corporate governance standards. In its 2011 corporate governance scorecard for Vietnam, the IFC described corporate governance in Vietnam as “minimalist.” Of particular concern to PE investors is the widespread tendency among Vietnamese CEOs to refuse equal treatment of minority investors. A senior executive from one of the local PE firms commented on the state of corporate governance within Vietnam: “We have a very long road ahead of us . . . I guarantee you if you surveyed senior management teams and boards of various companies, they do not know what the basic principles

of corporate governance are. The one definition they certainly do not get is the equitable treatment of shareholders” (Insight Vietnam, 2011).

PE investors are trying to overcome weaknesses in corporate governance themselves. Many have introduced disclosure systems, hired prominent accounting firms to produce periodic financial statements, and assigned their own internal accounting teams to help investee companies produce financial data. Coinvestment also serves to mitigate the transaction costs created by firms’ weak corporate governance. When the IFC coinvested in one of the PE funds managed by VI Group in September 2008, it conditioned its support on the GP’s ability “to help portfolio companies adopt better practice in corporate governance” (International Finance Corporation, 2008). Anecdotal evidence also suggests that IFC coinvestment lessens the risk of management misappropriating assets, given the IFC’s stellar reputation in Vietnam.

For the quite locally embedded firms that have done most of the PE investing in Vietnam to date, and that are the focus of most of the discussion in this chapter, the challenge of overcoming institutional weakness may actually be more significant at exit than it is at entry. Vietnam’s public equity markets remain too underdeveloped for most deals to realize value through IPOs. International listings, in turn, are complicated by the weakness of most companies’ corporate governance structures. Looking beyond just PE invested companies, only three Vietnamese companies, in total, have attempted to list overseas.<sup>4</sup> All three ultimately failed.

The failure to be on international listings speaks of the healthy skepticism with which foreign markets view the corporate governance of Vietnamese firms. As with the issue of institutional voids, in general, this situation can again be seen from either a glass half empty or glass half full perspective. The more optimistic perspective for PE firms is that there is clearly an opportunity for respected intermediaries to step in, do the required due diligence and development work, and then supply markets with Vietnamese firms that convincingly stand out for their high-quality corporate governance.

The problem, in this regard, for the most active and experienced PE firms in Vietnam is their relatively limited networks and reputations outside of the country and the resulting limitations on their ability to convincingly certify the value of their investees to relatively uninformed buyers. Mekong Capital’s Freund grudgingly admits: “Our biggest gap is in maximizing valuation on exits. Trade sales to foreign trade buyers and overseas listings are basically the best exits and probably global or regional PE firms have more capacity for doing that on a more consistent basis” (Taussig, 2011b). Regional players like TPG and KKR are, of course, far better positioned in this regard.

### Conclusion

After two waves of consolidation following the Asian financial crisis and the bursting of the Vietnamese stock market bubble, the PE industry in Vietnam currently features a handful of relatively small domestically based and larger regionally based fund managers competing for a limited number of deals. Domestically based funds seem at a substantial advantage in identifying gems in the rough and working

through context-specific challenges, while more regionally oriented managers bring about much-needed global prestige and resources needed at exit. The composition of the market reflects both on the promise of the Vietnamese economy and the challenges to doing business in light of significant institutional weaknesses. Shallow managerial capacity, persistent macroeconomic turbulence, and weak corporate governance standards compound the challenges to PE investment in Vietnam.

As a result of these challenges, many global leaders continue to watch from the sidelines. While this clearly limits the volumes of PE capital in Vietnam, it also creates opportunities for those firms with the domestic experience and established domestic networks to execute deals with limited competition. The key to overcoming institutional obstacles appears to be a substantially more intensive “hands-on” approach with investees. For the managers willing and able to do this, lower levels of competition are beneficial. Moving forward, though, the challenge for reform-minded Vietnamese policy makers is to introduce institutional and regulatory reforms that will bring the economic benefits of attracting the full array of PE investors.

### Notes

1. Six funds entered in 1994: Dragon Capital, Finansa, Franklin Templeton, Lazard, Vietnam Beta, and Vietnam Fund.
2. The framework that guides the engagement between Mekong Capital’s deal partners and investee company executives was profiled in a Harvard Business School case. Dubbed “Vision Driven Investing,” the framework guides the development of strategic plans, performance targets, solutions to operational challenges, and executive coaching between Mekong Capital and its investee companies.
3. Email exchange between the authors and Chris Freund, January 31, 2012.
4. Cavico, an infrastructure and engineering design company, Vina Milk, a state-owned dairy products conglomerate, and Hoang Anh Gia Lai, a diversified industrial conglomerate.

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CHAPTER 24  
A REVIEW OF PRIVATE EQUITY  
FINANCING IN NIGERIA

*Daibi W. Dagogo*

**Basic Facts about Nigeria**

Nigeria, with an estimated population of 160 million, is undoubtedly the most populous African country and indeed the largest assemblage of black population in the world. Nigeria's economic outlook in recent times appears promising with rising telecom density, consolidated ITC infrastructures and capabilities, enduring democratization, gradual reforms in key sectors, especially the recent attempt to completely deregulate the downstream petroleum sector by the removal of fuel subsidy, and more. While Nigeria's population sets it up as a destination for foreign investors, in the past, the country's incidence of poverty—54 percent in 2007 (Central Bank of Nigeria, CBN Annual Report, 2007) —disturbing reports of corrupt practices, lack of transparency in governance, and its rather volatile business environment paint it somewhat gray, or project a measure of asymmetry. No doubt, current efforts to improve the situation, such as increasing demand capacity, reduction of unemployment rate currently at 21 percent, creation of safer nonrestive business environment to improve manufacturing capacity utilization rate currently estimated as 55 percent, (National Bureau of Statistics, 2010), and so on, simply suggest setting the agenda for active private sector participation especially in the nonoil sector. Nigeria is one of Africa's largest oil and gas producers, and produces 3.3 percent of the world's oil supply (NBS, 2010). Surprisingly, average GDP growth in the five years 2006–2010 in the oil sector is –2.76 percent, whereas it is 8.94 percent for the nonoil sector (CBN Annual Report, 2010). It is the third largest economy in Africa, after South Africa and Egypt.

In order to get back on track after three decades of economic mismanagement, especially under the military regime, the Nigerian government had introduced reforms in almost all its sensitive sectors: banking, agriculture, communication, petroleum, financial, and so on. Each set of reforms directly affects the capital market. For instance, in order to reduce the negative

impact of corruption on the economy, the following anticorruption agencies were set up: Economic and Financial Crimes Commission (EFCC), Independent Corrupt Practices Commission (ICPC), and Extractive Industry Transparency Initiative (EITI). EFCC tackles financial crimes, ICPC takes care of corruption and sharp practices in public offices, and EITI is to ensure greater transparency on revenue data from petroleum and other mineral resources.

### **The Nigerian Capital Market**

The Nigerian capital market is statutorily regulated by the Security and Exchange Commission (SEC). Established by Act no 71 of 1979, SEC is an independent, nonpartisan and quasijudicial agency (Eleh, 2004), and the provisions of the act establishing it have been amended as indicated in the Investments and Securities Act (ISA) no 45 of 1999. What is known as SEC today started as Capital Issues Committee in 1962, which was an ad hoc body set up by CBN with no statutory powers to oversee capital market activities. This was later renamed Capital Issues Commission in 1973 with an empowering decree to exercise statutory powers. With each stage of development, its role became broadened while its objective of protecting investors remained the focus.

In addition to the administration of decree 45 of 1999 (ISA), SEC also executes other statutory enactments that relate to investments and securities in Nigeria such as the Company and Allied Matters Decree of 1990 and Trustees Investments Act 1957 and 1962. SEC also publishes a set of rules and regulations to ease the execution of some provisions contained in the enabling decree, following which it submits annual reports to the Federal Ministry of Finance. Arousing and sustaining the interest of Nigerians to develop an orientation of saving and investment have become SEC's greatest challenges, as ignorance and apathy contribute largely to poor investment culture in the Nigerian economy. This is not surprising as Nigeria's adult literacy level up to 2010 still shows a disappointing 70 percent (CBN Annual Report, 2010). The combined effect of ignorance, apathy, unemployment, and poverty in the case of Nigeria suggests that a lot is expected from government and its agencies to educate and empower the public. Section 8 of ISA 1999 mandates SEC to register all securities proposed to be offered for sale to or for subscription by the public, all stock exchanges, registrars, investment advisers, securities dealers and their agents, collective investment schemes, and private equity funds. Although it is necessary to provide the baseline of the Nigerian Stock Exchange as it defines one of the exits for private equity investments, this chapter gives a descriptive analysis of private equity and venture capital activities in Nigeria as well as reports on the institutional framework provided by SEC or other agencies while performing their statutory role of protecting investors and developing the frontiers of the capital market.

The Nigeria Stock Exchange (NSE) is a self-regulatory organization first registered as "The Lagos Exchange" in 1960. Today, it maintains trading floors in Lagos, Abuja, Port Harcourt, and Kaduna. The statutory functions of NSE as implied in its object clause are: to facilitate the purchase and sale of funds, stocks and shares, to

control the granting of a quotation, to regulate the dealing members and their clients, and so on. The settlement and delivery system in the Nigerian Stock Exchange is the Central Securities and Clearing System (CSCS). It is particularly interesting to note that the Second-tier Securities Market (SSM) was created in 1985 as a means of encouraging small- and medium-sized enterprises (SMEs) to raise funds from the stock exchange. Ojo (1998) noted that as SMEs are usually unable to fulfill all the conditions for a conventional listing on the stock exchange, it was thought that an alternative second-tier exchange with less stringent conditions and entry requirements would be highly beneficial to the economy. Some of the basic differences between the two tiers are as follows: the first tier requires the applicant's five years trading record, not less than 25 percent of the issued share capital must be made available to the public, no limit to the amount that can be raised depending on borrowing powers of the company, and shareholders must not be less than 500. For the second tier, three years trading record was required, 10 percent of the share capital was to be made available to the public, a ceiling of 5 million Naira was placed on fund raising, although this was subject to review, and the number of shareholders was not to be less than 100. Incidentally, due to inefficiency, SSM was scrapped in 2009 to give way for the Alternative Securities Market/Private Placement Exchange (ASEM/PRIPLEX).

#### **Milestones in Private Equity Development in Nigeria**

After a series of unsuccessful attempts to grow the SMEs sector as a springboard for building large enterprises and ensuring active private-sector participation in the economy, an appraisal of past financing windows for SMEs was initiated by CBN (Sanusi, 2003). Facts that emerged from the appraisal showed that finance was not the only or most important constraint to SME development, that the previous SME financing windows were debt based, and more importantly, entrepreneurship and managerial skills were also ranked as equally essential as finance (Oyekanmi, 2003; Dagogo and Ollor 2009). Besides, a comparison of debt and equity revealed that equity financing is preferred for business fledgling as this involves less strain on cash outflow, and that the implication of no collateral or security is that equity investors "do not sleep with both eyes closed," indicating that they are more committed to ensuring business success. This finding led to the introduction of Small and Medium Enterprises Equity Investment Scheme (SMEEIS), which was eventually approved by the bankers committee and officially launched in 2001 (see table 24.1 for bank involvement in SMEEIS). SMEEIS, thus, became the launch pad for private equity or formal risk capital investing in Nigeria, and although no records of business angels or other forms of informal risk capital investors were available, we cannot dismiss the fact that they existed. Meanwhile, African Capital Alliance (ACA), a leading private equity firm in Africa, was the first independent private equity firm to open a business office in Nigeria with a fund size of \$35 million in 1998 using its Nigerian subsidiary—Capital Alliance of Nigeria (CAN). Closely following the commencement of SMEEIS, six domestic venture capital firms were registered by SEC and predominantly funded by the participating banks in line with the SMEEIS's guidelines.

**Table 24.1** Cumulative investment by banks under SMEEIS up to 2009

<i>Year</i>	<i>Number of projects</i>	<i>Amount disbursed (\$ million)</i>	<i>Amount set aside (\$ million)</i>	<i>Fund utilization rate (%)</i>
2004	173	60.0	182.5	33
2005	187	60.5	199.4	30
2006	248	109.9	246.6	45
2007	302	136.4	241.4	57
2008	332	168.1	271.1	62
2009	333	182.0	271.1	67

*Source:* Banking Supervision Department, Central Bank of Nigeria.

### **SMEEIS and Enterprise Development in Nigeria**

Given that private equity encompasses traditional investments outside publicly quoted investments such as buyouts, venture capital, angel investing, mezzanine financing, and so on, this section will discuss venture capital, as SMEEIS was characteristically venture capital. In years past, the term “venture capital” served as the generic term for business angels, mezzanine equity, and institutional investments in the early stages of business. It was even more so especially in Nigeria where such terms as *business angels* and *mezzanine equity* are relatively novel. It is however convenient in this context to view venture capital as “a professionally managed pool of equity capital” (Hisrich and Peters, 1998). Venture capital as a distinct area of intellectual discourse is relatively new in Nigeria. Not surprising, there is an apparent dearth of research evidence concerning the industry and its impact on the economy. Accordingly, this analysis adopts an eclectic framework using several institutional research reports locally and from private equity industry across the globe.

Venture capital cannot be discussed in Nigeria without the mention of SMEEIS. Though defunct, it served as the avant-garde of the concept of venture capital as an asset class (Sanusi, 2003). Second, the scheme led to the formation and registration of private equity and venture capital firms that have become independent firms, raising funds from institutional and international organizations for investment, the same way America’s Small Business Investment Corporations (SBICs) and India’s Industrial Development Bank (IDBI) advanced development of venture capital in their countries in the 1950s and 1980s, respectively (ISA No 45 of 1999; Nuechterlain, 2003; Pandey, 1996)

The specific objectives of the scheme included: (a) facilitating the flow of funds for the establishment of new SMEs as well as the reactivation, expansion, or restructuring of existing ones, (b) stimulating economic growth, developing local technology, and generating employment, (c) and providing financial, advisory, technical, and managerial support. Similarly, the funds were available to businesses in the real sector and related services, excluding distributive trade and financial services. Equity investment under the scheme was in form of fresh cash injection or conversion of existing debts owed to a participating bank into equity. Banks participated by establishing subsidiaries to operate the scheme on their behalf or indirectly through

a venture capital company (Sanusi, 2003). For this, banks channeled 10 percent of their profit-after-tax through CBN to the venture capital firms. Essentially, the bank playing this role is better described as a limited partner in the venture capital firm, while the venture capital management is the general partner. The responsibilities of the parties were as follows:

1. Government was to provide stable regulatory and legal framework, adequate physical infrastructure, prudent fiscal regime, and enabling legislation such as 100 percent investment allowance for the 10 percent contribution made by bank, reduction of tax paid by SMEs to 10 percent, raising the pioneer status of SMEs to five years, and exemption of divested funds under the scheme from capital gains tax.
2. CBN was to ensure sound financial system, liaise with the Federal Ministry of Finance to ensure that the required tax incentives were granted, monitor the implementation and gather statistics to quantify the impact of the scheme, articulate clear guidelines for the implementation of the scheme, liaise with SEC to facilitate and simplify the registration of venture capital operators, ensure banks comply with the guidelines of the scheme and penalize erring banks in accordance with the penalty stipulated for noncompliance, prepare the annual progress report, disseminate information on the scheme to SMEs and the larger public, and provide data for the review of the scheme after five years.
3. The banks were to provide funding for equity investment in SME, comply with the guidelines of the scheme, report on the activities of the scheme on a quarterly basis to CBN, and build the capacity of managers and technical experts that would render services to their portfolio SMEs.
4. The venture capital firms (or general partners) were to manage equity investment in SMEs on behalf of banks, report on the activities of the investment to the banks on a monthly basis, provide strategic support (technical and managerial) to their portfolio companies to minimize the risk of the investment, exit the investment at the instance of the bank, but not later than five years after the investment, register with the Securities and Exchange Commission (SEC), and comply with the guidelines of the scheme.
5. Entrepreneurs were to ensure prudent utilization of funds, provide monthly financial and operational reports to the investing banks, and comply with the guidelines.
6. SEC was to facilitate registration of venture capital operators, provide enabling environment for the operation of the capital market, and liaise with other arms of government to reform the capital market to ensure that SMEs have access to the market while investors have access to exit windows.

Before reviewing the implementation of the scheme up to its demise in 2009, some issues emanating from the framework above need to be settled: First is the exclusion of distributive trade from the list of businesses eligible for consideration. This was in large part due to low value-added profile of distributive trade in the economy, hinging on its propensity to encourage imports, and attract more funds from the

banking sector than operators in the real sector could get. In other words, it could crowd out funds available for real sector investment. It was therefore considered diversionary in the system, and would lead to a weak industrial base. If the essence of this scheme was to rebuild the country's dwindling productive sector, then diversions such as this must be excluded.

However, if we examine its structural functionality, it no doubt will be accepted as an essential function in the economic system. This also presupposes that for the system to remain efficient, the components must have the capacity to balance out their roles efficiently. This argument projects the importance of marketing (the distributive function) as an indispensable function of the economy, creating values where there were none, and using innovation and marketing research to expand markets and dictate the pace and dimension of production in the economy. The exclusion of distributive trade therefore paints the picture of a manufacturing corporation without the marketing department.

Of interest is the type of industrial development the nation hoped for, given (a) its strengths and weaknesses, and (b) the new digital world order. Some countries started out with low-technology industries, and then branched out to high-technology industries after consolidating their human, financial, material, and entrepreneurial resources (e.g., Malaysia and China). Others started out at once with high-technology industries (e.g., Japan and Taiwan). Nigeria's low-income population, abundant low-skilled labor, and primary raw material resources dictate that its leverage is in labor-intensive low-technology industries. However, the proportion of Nigeria's highly skilled labor, professionals in the Diasporas, the petroleum resources available, and the entrepreneurial culture of the southeastern Nigerians point toward capital-intensive high-technology industries.

A lot was also expected of government to provide the right systemic structure. Looking at it in a different way, business enterprises operating in countries whose success stories are told regularly did not operate in paradise. Entrepreneurs in those countries only identified their leverages given the available systemic structures and took advantage of them. For example, Taiwan's fiscal environment is not attractive, but the country operates one of the best venture capital industries in Asia with over a 100 venture capital firms, leveraging their strength in the production of semiconductors and the like (Nuechterlein, 2003); and with all the industrial prowess of Germany, its economy is still one of the most regulated in Europe with high capital gains taxes and inflexible labor laws. South Korea still maintains high entry and exit barriers for businesses, while China is still plagued with the communist mind-set in spite of its record economic growth.

The exit mechanism seems more like a mandatory stipulation than an optional pathway for the banks. Although it is clear that the banks did not have a perpetual stake in the business, their exit was predicated upon the entrepreneur's ability to buy out the bank's share in the business. While this depends on the cash flow of the business, it is ambiguous to state that "the bank shall exit after partnering with the entrepreneur for at most five years" (SMEEIS Guidelines, 2001). In view of the early stage of venture capital in Nigeria and the need for industries to formulate a winning model for private equity investment, many industries were actually up to a slow start.

### **Nigeria as an Emerging Market for Private Equity**

Many scholars believe the world is in an age of global capitalization, a concept that explains the free movement of capital across international boundaries, especially from the wealthy to the developing nations (Lamb, 2007). Today, new capital markets reflect both standards of global best practices and local influences. For instance, Poland's pension investment system, the high-tech heavy Tel Aviv Stock Exchange, and the Ukrainian corporate bond market are all local markets with rapidly evolving legal, regulatory, and procedural standards. Performance in these markets is increasingly a reflection of strategic actions of large companies in Russia, Brazil, China, India, or South Africa, and decreasingly on decisions in London, New York, or Switzerland (Lamp, 2007; Lerner et al., 2009; Nuechterlain, 2003).

A review of venture capital financing of business start-ups in the United States, Europe, and Asia highlighted some critical factors that determine the shape of private equity in emerging markets. The factors include: attractive fiscal and legal framework, stock option plans to attract and retain talents, pool of management experts and business strategists that can support entrepreneurs to run venture-capital-backed companies, linkages with research institutions, intellectual property rights, efficient exit mechanisms for investors, a second chance to entrepreneurs whose businesses went bankrupt, an appropriate framework for the participation of venture capital limited partners, corporate venturing, and research and development to promote high-technology industries without downplaying the strategic importance of the low-technology industries in our economy (Nuechterlain, 2003). In a nutshell, these factors put together or in some combinations represent the relative measure of attractiveness of a given private equity market. In another study, Meerkatt and Liechtenstein (2010) found that the most attractive markets for investors are determined not just by their economic size, as measured by GDP, but also by the relative sophistication of their socioeconomic environments, including their regulatory and legal systems. Besides, the applicable business model for success would also differ from those that served the private equity industry in the developed markets. The race to emerging markets by the world's largest private equity firms has been stepped up so that approximately one-fifth of the global market, equivalent to \$231 billion, was earmarked for emerging markets. Also, an Emerging Market Private Equity Association (EMPEA) report indicates that two-thirds of limited partners in developed economies planned to increase their exposure to emerging markets in 2011. The key drivers for this phenomenal interest in emerging markets are: superior GDP, impressive net returns, greater resilience to the current financial crisis, and an increasingly attractive socioeconomic environment.

Since the inception of the civilian regime in 1999, Nigeria has witnessed significant changes in its economic, social, and political structures, as an emerging market in Africa. These changes have created excellent investment opportunities in multiple asset classes like public equities, private equities, and debt. In the index of the country's attractiveness for limited partners, Groh et al. (2011) outlined six socioeconomic factors that are determinants of vibrant private equity markets: economic activity, depth of the capital market, taxation, investor protection and corporate governance, human and social environment, and entrepreneurial culture.

Using these indicators, Nigeria ranked sixty-fourth in the 80 countries ranked worldwide, and sixth out of the eight African countries ranked. However, when this is compared with the ranking in 2007, Nigeria gained two steps upward from the sixty-sixth. Despite this low rating, it is an attractive market because of its entrepreneurial culture and its large population for consumer products. Similarly, the recent banking consolidation and reform of the asset management industry have created a world-class financial services sector. The country is also active in the merger and acquisition process, especially in the banking sector.

No doubt, Nigeria's greatest challenge is to upgrade its infrastructures, but this represents an opportunity for private-equity backed entrepreneurs or other major development finance institutions. The successes recorded investing in oil and the boom in the mobile communication sector are proof that offshore investors can successfully launch their businesses in Nigeria and expand to other countries such as Ghana in the West African subregion.

### **Private Equity in the Nigerian Context**

The Investment and Securities Act (ISA) No 45 of 1999 provides for the registration and regulation of venture capital funds and mandated SEC to register and regulate the activities of the venture capital firms. Section H6 paragraph (a) rules 282 and 283 of the regulation guiding the operation of collective investment schemes includes venture capital funds (see section 8g of ISA) as part of collective investment funds, referring to it as special funds. Others in this category are mutual funds, unit trusts, *esusu* schemes (a traditional form of cooperative finance). Two highlights are noted below relating to the requirements for authorization and the contents of prospectus.

#### **Requirements for Authorization**

An application for authorization should be filed by the fund manager on form SEC 6A along with two copies of the draft prospectus, two copies of the draft trust deed, letters of consents from the prospective parties to the venture capital scheme, and two copies of the partnership agreement between the fund providers and the venture capitalist. Such an agreement shall state that the fund provider is a limited or non-active partner, that the venture capital firm shall be known as the general partner, and that the venture capital firm shall participate in the management of investee or portfolio firm. Other requirements include a copy of the certificate of incorporation of the venture capital firm, two copies of the memorandum and articles of association, detailed information of the fund provider or stated sources of fund, two copies of the technical and management agreement between the venture capitalist and the portfolio company recurrently filed for each proposed investment, two copies of the scheme of arrangement (or term sheet) between the limited partner and the venture capitalist on the one hand and between the venture capitalist and the entrepreneur (beneficiary) on the other hand, a commitment to settle the authorization fee of 1 percent of the fund, and any other material information. An application for registration of the venture capital fund shall contain such information as the name of the

proposed fund, year of commencement of business, the vintage year, general nature or area of investment interest, expected yield, sworn undertaking to file monthly reports with the commission, and a reviewable registration fee.

#### Contents of Prospectus

Rule 283 dealing with the contents of prospectus provides that the prospectus shall among others contain a summary of the issues including key performance forecast of the deal, the placement offer, directors and parties to the issue, and the name and details about the fund user (portfolio firm). The tripartite arrangement of the venture capital process involves the venture capital firm, limited partners, and entrepreneurs. The venture capital firm raises funds from limited partners such as pension funds, mutual funds, insurance funds, and so on. They evaluate, screen, and structure investment deals with entrepreneurs. They also design and execute exit strategies such as sale, initial public offer (IPO) merger, acquisition, leveraged buyout, management buyout, alliances, and so on. The limited partners negotiate with the venture capital firms considering payback period, internal rate of return, securitization, disbursement pattern, and so on. And the entrepreneurs project their upside potentials as they promote the investment opportunities existing in their new, young, and innovative firms. Due diligence is guided by the portfolio's ability to demonstrate existence of market monopoly, franchise, intellectual property rights, and technology breakthrough. Also required is information relating to expected period of investment before harvesting and exiting, projected five years financial status of the venture capital firm, and such other materials that may be stated by the SEC from time to time.

#### Structure and Context

Fraser-Sampson (2010) described due diligence in private equity investment as involving two processes. First is the investment analysis involving the critical evaluation of the markets, industry, finances, suppliers, customers, management, and other contextual issues that cumulate into a decision to invest or not. Second is the process involved in identifying and thoroughly investigating specific issues emerging from information supplied, such as company history, business plan, résumés, and so on. However, the difference between these two processes is becoming blurred as private equity investors evaluate both general and specific issues at the commencement of investigation, bearing in mind that the essence of due diligence is to focus on each issue (general or specific) until it is resolved or at least reasonably resolved and clearly characterized as strength, weakness, opportunity, or threat. Sahlman (1987) also developed a framework for investment analysis in entrepreneurial firms using four critical success factors: people, opportunity, deal, and context (Gompers and Sahlman, 2002). The first factor raises issues such as identifying experienced players, matching experience with opportunity, and assessing the strengths and weaknesses of people involved on all sides of the transaction. The second factor showcases the nature of opportunity, existence of sustainable competitive advantage, unease of replication or poaching of opportunity, timing of exploitation of opportunity,

investment milestones, and so on. The third concerns structuring of the deal, taking into account incentives, contingencies, steps taken to minimize moral hazard, raising money, reward for downside risk, and all those implicit as well as explicit contractual relationships between the parties to the deal. The fourth factor concerns identification and treatment of contextual issues such as assessment of competition, government policies, technology, economic conditions, and so on. Finally, Sahlman (1987) proposed a construct that demonstrates how the four variables are inter-related and linked to form one big picture, which he referred to as the “concept of fit.” For instance, the following questions help explain the concept of fit: Do the people have the requisite skills and experience to exploit the opportunity? Does the deal provide the proper incentive to all players given the necessity of their input and the levels of their skills? And will the context change the nature of the opportunity (Gompers and Sahlman, 2002)?

This framework is considered appropriate in analyzing Nigerian private equity investment, first because it is applicable to every subset of private equity and its investee firms, and second because it encompasses all the other procedural and institutional frameworks discussed earlier. Nigerian private equity industry undoubtedly experiences a dearth of professionals. This is to be expected as the industry is still in its infancy, with barely one decade of activity compared to other emerging markets in Asia and South America that have recorded well over 20–30 years of active private equity participation (Nuechterlain 2003; Groh et al., 2011). Short supply of professionals is true of the private equity firms as it is true of their entrepreneurial investees. Lack of experience, therefore, constitutes a major setback and tends to blur the potentials of viewing private equity as an asset class in the face of burgeoning debt market and public equity asset class. The concept of private equity still remains novel even to some financial administrators let alone entrepreneurs seeking start-up or growth funds. Apparently, in a society daunted by other asset classes that have thrived for over five decades, taking up a career in private equity does not only seem risky but is also difficult to embrace as very few private equity firms operate in Lagos (the financial seat of Nigeria) without offices in other regions or states. It is therefore appropriate to widen as well as deepen the knowledge of private equity processes both within the financial sector and in our educational institutions such as those offering special training programs for practitioners, and designing special curriculum for the study of private equity in tertiary institutions by carving a private equity pathway in finance programs.

The next factor is opportunity. Nigeria is the second largest economy in sub-Saharan Africa with its private equity accounting for about 10 percent of the region’s private equity capital (Ogunro, 2009). With a population of about 160 million, GDP growth that averaged 6.7 percent in five years (2006 to 2010), a remarkable entrepreneurial culture, and a number of reforms instituted to reduce investment risk, Nigerian private equity asset class sure offers great opportunities in a broad range of rapidly growing businesses in the following sectors: information and communication technology, hotel and tourism, real estate, oil and gas, entertainment, marine, agriculture, food processing, education, and financial services. These opportunities have arisen as a result of remarkable changes in the structure of the Nigerian economy that led to improved corporate governance and legal structure. For instance,

an intricate part of the Investment and Securities Act (ISA 1999) was the removal of the restriction (section 7) imposed on foreigners to invest, transfer, and sell stocks in Nigeria (Obebe, 2008). Similarly, to ensure speedy resolution of disputes arising from investment transactions, the Investment and Securities Tribunal (IST) was established under section 247 of the Investments and Securities Act 2007 to interpret and adjudicate on all capital market, investment, and pension matters. Also, there is an opportunity in the reduction of transaction cost in Nigeria. For instance, recently, the SEC revised the transaction cost of the primary market for equities from 6.92 percent to 4.32 percent. Further reductions are expected as there is improved data transparency in a growing number of markets.

Third, deal structuring is perhaps the most sensitive part of the private equity process. The rule of the game despite the classical philosophy of capitalism is to encourage a win-win situation. Often, Nigerian private equity deals are frequently in venture capital, buyouts, and restructuring. Private equity deals in Nigeria are usually structured between general partners and limited partners on the one end as well as between the general partner and the issuer on the other hand. The liability of the general partner for all the debts and obligations of the fund is unlimited, whereas the liabilities of the limited partners are limited to the funds contribution. There are six indigenous venture capital general partners registered with SEC (see table 24.2). Recall that in Nigeria, until recently, the term “venture capital” had received a wider meaning than is applied elsewhere, to the effect that it assumes the equivalence of private equity. In reality venture capital is a subset of private equity, and therefore these six firms, though registered as venture capital general partners, undertake management buyout deals, buyin deals, acquisitions, and other forms of restructuring. In addition to SEC-registered venture capital firms and institutional investors doing business as general partners and limited partners, respectively, there are also other private equity firms and limited partners promoted by Nigerian entities that are established outside Nigeria in offshore jurisdictions like Mauritius, British Virgin Islands, and Cayman Islands with the aim of realizing tax benefits. An example is African Capital Alliance (ACA), a major private equity firm investing in African and particularly in West Africa with \$650 million under its management.

Recently, there has also been a growing presence of foreign private equity firms investing in Nigeria, particularly, subsidiaries of international development finance organizations like Actis, Norfund, Aureos, IFC Asset Management Company, Makeda Fund, GroFin Nigeria, Vectis Capital, Swedfund, and Emerging Capital Partners. An average exit for a private equity investment in Nigeria is five years. As part of the deal, the private equity firms seek a dominating role in the management of investee firm. In fact, the guidelines for the operation of SMEEIS specifically assigned the position of finance director to the private equity firm. The following exit windows are used: initial public offerings, trade sale, secondary buyout, and acquisition. In a bid to create an efficient exit for investors in the SME sector, the Nigerian Stock Exchange scrapped the inefficient second-tier securities market (SSM) and amended some of the prelisting rules. A new market known as Alternative Securities/Private Placement Exchange (ASEM/PRIPEX) commenced operation in 2009.

**Table 24.2** Private equity firms operating in Nigeria

	<i>Name of fund</i>	<i>Profile</i>
1	First Funds Ltd	\$25.9 million under management; invests in growth and later stages; Investment outlay of \$161,000-\$387,000 per project; 32 portfolio firms under management; wholly owned subsidiary of First Bank PLC (one of top three banks in Nigeria); set up to manage First Bank's 10 percent PAT contribution toward SMEEIS; SEC-registered.
2	IBTC Ventures Limited	\$3.2 million under management; invests in early-stage financing Wholly owned subsidiary of Stanbic IBTC Bank; set up to manage IBTC's preconsolidation 10 percent PAT contribution toward SMEEIS, SEC-registered.
3	SME Manager	\$25.4 million under management; invests in early-stage and growth financing. The Nigerian subsidiary of ACA set up to manage the funds of a consortium of 12 preconsolidation banks participating in SMEEIS; SEC-registered.
4	Diamond Capital	\$30.0 million under management; invests in early and later stages, MBO; Subsidiary of Diamond bank PLC; SEC-registered.
5	Unique Ventures	\$15.4 million; Independent private equity operator; SEC-registered.
6	Cowry Asset Management	\$9.5 million; Independent private equity operator; SEC-registered.
7	Norfund	Invests in private enterprises in Africa, South America and Balkan countries Norwegian DFI.
8	Aureos Capital Ltd	Invests in change-of-control transactions, MBOs, expansions and acquisition; targets between \$2 to \$10 million for portfolio firms; a subsidiary of Norfund.
9	Makeda Fund	\$4.8 billion under management with over 100 investment professionals located across emerging markets; interested in women-owned SMEs in Africa with Nigeria as its core focus.
10	GroFin Nigeria	Invests in start-up and growth stages, offers enterprise development services.
11	Vectis Capital	\$82 million under management; Athens-based private equity firm focusing on West Africa.
12	Swedfund	Targets Swedish companies wishing to establish in new markets or to finance expansions. Invests in Swedish companies operating in Nigeria; with over 200 portfolios in 33 countries.
13	Emerging Capital Partners	The first private equity firm to raise \$1.2 billion to invest exclusively in Africa; had about 50 portfolio firms as at 2008; successfully exited from 20.
14	African Capital Alliance	Very active in Nigeria; \$650 million under management; invests in acquisition, expansion, growth, MBO, Private investment in public Equity (PIPE), replacement and strategic partnership; Notable portfolio firms are MTN, Etransact, Cornerstone Insurance, Capsea, etc.
15	Actis	Very active in Nigeria; Portfolio firms include: \$25 million investment in UAC; \$134 million investment in Diamond Bank; \$40 million investment in Palms Shopping Mall; acquired majority share in Mouka Ltd, leading producer of Foams and Mattresses; \$43.2 million investment (with AIG African Infrastructure Fund) in Starcomms the fourth largest telecommunication firm in Nigeria; Divested from Starcomms and UAC after 3 years.
16	IFC Asset	A subsidiary of international Finance Corporation that focuses on Africa.

Sources: SEC, EMPEA, AVCA, CBN, Sundry VC firms.

Finally, the contextual challenges facing Nigerian private equity firms are numerous, some of which are: legal and institutional support structures, monetary and fiscal policies of government, political considerations, social values, ethics, and technology. A brief examination of the legal context is presented here. While private equity firms can attract high-net-worth individuals to raise funds, the amount involved from such sources may seem insignificant compared to institutional sources, and besides, the cost of the fund may also be more. However attracting these institutional funds and sophisticated investors with a lower cost of fund may not come so easy as a result of the statutory restrictions imposed by the Banks and Other Financial Institutions Act (BOFIA) Cap B<sub>3</sub> Law of Federal Republic of Nigeria 2004, the Insurance Act Cap I<sub>17</sub> Law of Federal Republic of Nigeria 2004, and the National Pension Commission's Regulation on Investment of Pension Fund Assets (Pension Regulations). Banks are also restricted, upon the provisions of BOFIA, from acquiring or holding any part of the share capital of any financial, commercial, or other undertaking, subject to certain exceptions as it was applicable under SMEEIS, that is to say, where such investment is aimed at promoting the development of a preferred sector. When granted approval to invest in SMEs or agricultural businesses, such investments shall not exceed 20 percent of the bank's shareholders funds and not more than 40 percent of the investee firm's paid-up share capital (Ogunro, 2009).

### Conclusion

Nigeria's dream of becoming one of the top 20 nations in the world by the year 2020 is not an illusion. Active private equity participation would contribute to realize this dream. The participation will not only be by Nigerian domestic investors but also by the enthusiasm of international investors, especially those investing in Fortune 500 and S&P 500 companies that are watching out for alternative destinations in Africa, as Korea, China, and Singapore get overheated. Nigeria should therefore rent a place in the international market by ensuring that her systemic structures are world class, enabling her to compete with India, China, Brazil, South Africa, and other key players in the emerging market. This also improves the country's attractiveness to pool large sums of private equity funds from limited partners into the country. Overreliance on oil revenue cannot lead the country to vision 20–2020.

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## ABOUT THE AUTHORS

**Abdella Abdou** is an associate professor in the Department of Economics at Brandon University, Manitoba, Canada. He teaches courses in microeconomics, public finance, health economics, labor economics, and economic development. His research interests include the impact of privatization on the economic performance of developing and emerging economies, and economic development in Africa.

**Sarah E. Alexander** is the founding president and CEO of EMPEA, a global, non-profit association that promotes the development of the private equity and venture capital asset class in emerging markets. Prior to joining EMPEA, Ms. Alexander was a private equity investor in Asia with Emerging Markets Partnership (now EMP Global). Previously, she was with the World Bank Group, where she designed new initiatives for private sector participation in development finance. Earlier in her career, she worked with the US Department of State managing international trade and financial policies, including US policy toward transition economies in Eastern Europe. She began her career as a foreign policy adviser in the US House of Representatives. Ms. Alexander received an MBA from Harvard Business School, an MPA from Princeton University's Woodrow Wilson School, and a BA in history, *summa cum laude*, from Emory University.

**Cate Ambrose** is president and executive director of the Latin American Private Equity & Venture Capital Association (LAVCA). LAVCA is a not-for-profit membership organization dedicated to supporting the growth of private equity and venture capital in Latin America. Its membership comprises over 130 firms, from leading global investment firms active in the region to local fund managers from Mexico to Argentina, which controls assets in excess of \$50 billion directed at capitalizing and growing Latin American businesses. Ms. Ambrose speaks and writes regularly on a range of topics related to public policy and private investment in Latin America, and is a regular commentator on *CNN En Español*. She is also a special advisor to the board of AMEXCAP, the Mexican Private Equity and Venture Capital Association. Ms. Ambrose holds an MPA in international economic policy from Columbia University, and a BA in Latin American studies from St. Lawrence University and the University of Madrid.

**Arindam Banerjee** is an assistant professor at SP Jain School of Global Management, Dubai (a *Financial Times* 100 business school), and teaches at both their Dubai and Singapore campuses. At SP Jain, Banerjee conducts core finance courses in corporate

finance and financial statements, and specialization courses such as decision making under uncertainty, venture capital and private equity, and wealth management for both its global MBA program and executive MBA program. In his seven years of academic career, Banerjee has edited 12 books and two journals, authored around 50 articles and several case studies. Additionally, Banerjee has been a mentor to leading industry projects with several leading regional companies such as Emirates Airlines, National Bank of Abu Dhabi, National Bank of Dubai, Qatar Insurance, and international companies such as Nokia–Siemens, Deloitte, Dun & Bradstreet, and HSBC. Banerjee is also a recipient of outstanding research awards from the Government of Dubai and Dubai Financial market (erstwhile NASDAQ—Dubai). Banerjee's keen interest lies in foreign direct investments, private equity, and financial history. He can be contacted at arindam.banerjee@spjain.org and arin\_006@yahoo.com.

**Richard T. Bliss**, PhD, is an associate professor in the Finance Division at Babson College in Wellesley, Massachusetts. Prior to that, he was on the faculty at Indiana University, and he has taught extensively in Central and Eastern Europe, including at the Warsaw School of Economics, Warsaw University, and the University of Ljubljana in Slovenia. He is currently a visiting faculty in the Technical University of Denmark's Certificate in Entrepreneurial Leadership Program in Copenhagen and a member of the Babson team helping to develop and deliver the curriculum for the Goldman Sachs 10,000 Small Businesses Program.

With publications in the areas of corporate finance, entrepreneurship, and banking, he has an active research agenda. His work has been published in the *Journal of Financial Economics*, *Derivatives Quarterly*, and *The Journal of Small Business Management*, among others. His book, *Entrepreneurial Finance: Strategy, Valuation & Deal Structure*, coauthored with Janet Kiholm-Smith and Richard L. Smith, was published in April 2011 by the Stanford University Press.

**Nick Callinan**, Founder, Managing Director, Collins Hill Private Equity Services, has been an active participant in the venture capital and private equity markets throughout its development years from the early 1980s as the industry spread from the United States to around the world. He was a pioneer of the industry in his native Australia where he established one of the first funds in 1984. The management group he founded continues today. In the early 1990s, he moved to Europe and set up and managed the Advent International regional funds in the emerging markets of Central and Eastern Europe. Later, he established a global IT venture capital fund for Shell. In 2004 he returned to emerging markets, helping Société Générale in Paris to establish regional funds in Central and Eastern Europe and in North Africa. After 25 years, Mr. Callinan can be considered a private equity industry entrepreneur and expert as he has himself founded and operated or actively assisted others in starting and managing, numerous private equity operations around the world.

He now lives in Melbourne, Australia, and advises international clients on private equity.

**Carolyn Campbell** is a managing director, founding partner, and general counsel of Emerging Capital Partners (ECP), a leading private equity fund manager focused

on Africa with over \$1.8 billion under management. Ms. Campbell is a member of ECP's executive committee and investment committees. She provides management oversight of the firm's operations and investments and serves on several portfolio company boards. Campbell was previously a senior associate in White & Case's Warsaw, London, and Washington, DC, offices.

Campbell was an associate professor at George Washington University National Law Center, lecturing on international negotiations. She is a member of the Council on Foreign Relations. She graduated *summa cum laude* from the University of Connecticut with a bachelor's in Economics and French, and a master's in economics. She received her JD from the University of Virginia Law School and a PhD from Oxford University in political economy.

**Michael Casey, Jr.** is a senior associate in EMPEA's Research Department. Prior to joining EMPEA, he worked as an associate at Ergo, a research and strategy consulting firm, where he advised private equity, hedge fund, and corporate investors across the emerging markets. His previous experience includes several years at the US Department of Defense. Mr. Casey holds a BA from Mary Washington College, and an MA in international relations and economics, specializing in international finance and emerging markets, from the Paul H. Nitze School of Advanced International Studies (SAIS) at Johns Hopkins University.

**Roberto Charvel** is a managing partner and founder of Vander Capital Partners, a firm focused on investing in early-stage ventures. Previously he was vice president and head of business development for Prudential Real Estate in Latin America, as well as head portfolio manager for five funds that added up to \$1.5 billion of equity commitments. He also worked at O'Connor Capital Partners as an associate and as an analyst at McKinsey & Company. Roberto taught the first course in venture capital and private equity in Mexico at ITAM (from 2003 to 2009) and then at IPADE Business School where he designed the first specialized private equity program in Mexico. In 2009 he worked at Endeavor in New York, where he launched the Center for High Impact Entrepreneurship (C-HIE). He has been an Endeavor mentor since 2004. Mr. Charvel received an MBA from Harvard Business School.

**Kenneth Chin** holds an MBA from INSEAD and a BA in economics/finance from Rutgers University. Previously, he had worked at the Private Equity and Investment Funds group at the International Finance Corporation (IFC) where he was responsible for evaluating new deals, and supervising private equity investments. He has extensive experience in South East Asia, South Asia, and Latin America, and championed the department's initiative for tracking the development impact of IFC's fund investments.

**Douglas Cumming**, JD, PhD, CFA, is a professor of finance and entrepreneurship and the Ontario Research Chair at the Schulich School of Business, York University. His research spans areas that include entrepreneurship, entrepreneurial finance, venture capital, private equity, IPOs, law and finance, market surveillance, and hedge funds. He was promoted to the position of coeditor of *Entrepreneurship Theory and Practice* in 2011, and has been a guest editor for special issues of

*European Financial Management, European Journal of Finance, Journal of Business Ethics, Journal of Corporate Finance, and Strategic Entrepreneurship Journal.* He has published 80 articles in leading refereed academic journals since completing his JD/PhD in 1999. Since 2007 he has published 56 articles in leading journals that include the *Journal of Financial Economics, Review of Financial Studies, Journal of Banking and Finance, Journal of International Business Studies, Journal of Business Venturing, Entrepreneurship Theory and Practice, Research Policy,* and the *Economic Journal*, among others. As well, he is the coauthor of books with Elsevier (2009) and Oxford (2012), and the editor of two handbooks with Wiley (2010), three handbooks with Oxford (2012), and two handbooks with Springer (2012). He is a top-ranked author at SSRN and RePEc based on downloads and citations, and has won numerous academic awards. He has consulted for a number of private and governmental organizations in North America, Europe, and Australasia.

**Dr. Daibi W Dagogo** is a lecturer at the Rivers State University of Science and Technology, Port Harcourt, Nigeria. He received his doctorate degree in finance from the same university specializing in entrepreneurial finance, and has participated in several research studies in venture capital financing and SME development in Nigeria. He is also a consultant in enterprise development at the Centre for Corporate Policy and Strategy Research, Port Harcourt, Nigeria. The center is actively involved in research in entrepreneurship development, and corporate turnaround, with funds from major oil companies operating in the Niger Delta region of Nigeria and UNDP (sixth and seventh country programs).

**Rajeev Dewan** is a senior associate with WeirFoulds LLP, one of Canada's oldest law firms, where his practice is focused on two principal areas: (a) advising Canadian entrepreneurs and high-growth companies on all facets of corporate and securities law, with a particular emphasis on public offerings, private placements, mergers and acquisitions, financial services regulation, and PE and venture capital financings; and (b) advising Canadian and international clients on cross-border transactions in and from Canada with emerging markets, specifically in relation to structuring and implementing foreign investment, joint ventures, and strategic alliances, and establishing business operations.

Previously, Rajeev worked in the United Kingdom and the Middle East. He has significant transactional and regulatory experience in Canadian capital markets and a range of international experience in relation to IPOs, mergers and acquisitions, and PE transactions in the Middle East, India, and Africa. Specifically, Rajeev worked with the legal team involved in the second largest outbound investment by an Indian company and advised a Middle East PE firm on various buyout transactions in Kuwait, Saudi Arabia, and the United Arab Emirates.

**Marek Dietl** is a deputy investment director at KFK. He is also an assistant professor at the Warsaw School of Economics (WSE). He earned his MA in economics at the WSE and his PhD at the Institute of Economics of the Polish Academy of Sciences. During his PhD studies, he was a junior fellow at the University of Glasgow. Marek has extensive business experience in consulting and venture capital. Marek has served as a nonexecutive board member for multiple companies.

**Antonio Gledson de Carvalho** is professor of finance at Fundação Getulio Vargas/ São Paulo Business School. Professor De Carvalho received a BA and an MA in economics from University of São Paulo, and an MS in mathematics and a PhD in economics from the University of Illinois at Champaign-Urbana. He was professor of economics at the University of São Paulo from 1988 to 2005, board member of the Self-Regulatory Board of São Paulo Stock Exchange, and vice president of the Brazilian Financial Society. As consultant, he participated in the group that proposed the creation of Bovespa's Novo Mercado. His research focus is on capital markets, corporate governance, and private equity and venture capital in Brazil.

**Dr. Alexander Groh** is professor of finance at EMLYON Business School, France. His research focuses on VC and PE, and includes valuation issues, performance measurement, and socioeconomic determinants for the development of vibrant VC and PE markets. He is involved in management training courses for the European Venture Capital and Private Equity Association (EVCA), and works for Quadriga Capital, a Frankfurt and St. Petersburg based private equity fund, since 1996.

**Edmundo Isidro** is chairman and president of the Philippine Venture Capital Investment Group in Manila, Philippines. Mr. Isidro was also CEO of one of the largest food and diary MNCs in the Philippines. Currently, Mr. Isidro is active in facilitating investment deals between private investors and SMEs, and recently organized the Philippine Business Angel Network. Mr. Isidro received his MBA from the University of Minnesota and completed the advanced management program at Harvard University.

**Sofia Johan**, LLB (Liverpool), LLM in international economic law (Warwick), PhD in law (Tilburg), is the extramural research fellow at the Tilburg Law and Economics Centre (TILEC) in the Netherlands and also adjunct professor at the Schulich School of Business, York University. Her research is primarily focused on law and finance, sovereign wealth funds, market surveillance, hedge funds, venture capital, private equity, and IPOs. Her work has been presented at the *American Law and Economics Association*, the *European Law and Economics Association*, the *European Financial Management Association*, the *American Economic Association* meetings, and other leading international conferences. Her recent publications have appeared in numerous journals including the *American Law and Economics Review*, *Journal of Financial Economics*, *Journal of Banking and Finance*, *European Financial Management*, *European Economic Review*, and *Entrepreneurship Theory and Practice*, among numerous other journals. She has coauthored the book titled *Venture Capital and Private Equity Contracting* and has a forthcoming book on hedge fund regulation in 2012. Prior to her PhD, she was legal counsel for a derivatives clearing house and the head legal counsel at the largest government-owned venture capital fund in Malaysia. She has also consulted for a variety of governmental and private organizations in Australasia and Europe.

**Thawatchai Jittrapanun** is commissioner for the National Broadcasting & Telecommunication Commission in Bangkok, Thailand. Previously, he was chairman of the Bachelor of Arts Program in economics at Chulalongkorn University in

Bangkok. Dr. Jittrapanun's research focuses on private equity investing in Thailand. Dr. Jittrapanun is responsible for developing an annual macroeconomic database and index for the Thai government. Dr. Jittrapanun received his PhD in finance from the University of Alabama.

**Darek Klonowski**, PhD, is professor of business administration at Brandon University. Klonowski worked in the private equity and venture capital industry for 15 years, making investments throughout Central and Eastern Europe (CEE). Most notably, he worked for Enterprise Investors, the largest and most successful private equity fund in the CEE region. Klonowski has also advised multiple clients on asset allocation strategies in Central and Eastern Europe. His most recent books on private equity and venture capital include *The Venture Capital Investment Process* (2010) and *Private Equity in Poland: Winning Leadership in Emerging Markets* (2011). His academic publications have appeared, among others, in *Journal of Private Equity*, *Venture Capital: An International Review of Entrepreneurial Finance*, and *Journal of Applied Corporate Finance*.

**Dr. Heinrich Liechtenstein** is associate professor of financial management at IESE Business School, Barcelona—University of Navarra, Spain. His areas of interest are entrepreneurial finance, venture capital and private equity, wealth management, and family strategies. He is active in several supervisory and advisory boards of family holdings and foundations, as well as in a private equity firm.

**David Lingelbach**, BS, MS (Massachusetts Institute of Technology), PhD (Exeter), is an assistant professor of entrepreneurship at the Merrick School of Business, University of Baltimore, and professorial lecturer at the Nitze School of Advanced International Studies, Johns Hopkins University. His research focuses on entrepreneurship and entrepreneurial finance in emerging and developing countries. Prior to becoming an academic, he worked in international finance, where his positions included being the CEO of the first venture capital fund in postcommunist Russia and the head of Bank of America's businesses in the former Soviet Union. The founder of four start-ups, he has advised the World Bank, the Asian Development Bank, and several national governments on entrepreneurship and venture capital development.

**Lucy McNulty** is Asia editor at Euromoney Legal Media Group's *International Financial Law Review (IFLR)*. Based in Hong Kong, she covers banking and project finance, capital markets, and corporate and regulatory developments across Asia Pacific.

With a team of journalists based in London, New York, and Hong Kong, *IFLR* combines a daily-updated website, e-mail bulletins, a monthly magazine, and regular web seminars and events, to provide lawyers specializing in international finance in banks, corporate, and in private practice with a market-leading information service.

**Saeed Moshiri** is an assistant professor in economics at St. Thomas More College, University of Saskatchewan, Canada, where he teaches macroeconomics and energy economics. He has also taught undergraduate and graduate courses in macroeconomics

and econometrics in University of Manitoba, University of Winnipeg, Memorial University of Newfoundland, and University of Allame Tabataba'i. His areas of research are economic growth, information technology, applied econometrics, and energy economics. He has published papers in international journals such as *Journal of Forecasting*, *Computational Economics*, *Economic Journal*, *International Review of Applied Economics*, *the Energy Journal*, *Information Systems in Developing Countries*, and *Iranian Economic Review*.

**Maria Musatova** is a research fellow at the Institute of Economics and Industrial Engineering, Siberian Branch of Russian Academy of Science, Novosibirsk. She is also an associate professor at Novosibirsk State University (NSU). Her professional fields of interest are corporate governance, M&A, private equity, and venture capital. She has published a number of papers on these topics. Maria holds a PhD from Novosibirsk State University.

**Joseph Quinlan** is managing director and chief market strategist at US Trust, Bank of America Private Wealth Management. In this role, Joe oversees the development and implementation of macroinvestment strategies. His research is frequently cited in such media venues as *Barron's*, *The Wall Street Journal*, and the *Financial Times*.

Mr. Quinlan lectures on finance and global economics at New York University and Fordham University. He also regularly lectures at various universities around the world. In 1998, he was nominated as an Eisenhower Fellow. Presently, he is a senior fellow at the Paul H. Nitze School of Advanced International Studies of Johns Hopkins University, Washington DC, and a senior fellow at the German Marshall Fund in Brussels, Belgium.

In 2006, the American Chamber of Commerce to the European Union awarded Mr. Quinlan the 2006 Transatlantic Business Award for his research on US-Europe economic ties. In 2007, he was a recipient of the European-American Business Council Leadership award for his research on the transatlantic economy.

Mr. Quinlan regularly debriefs legislators on Capitol Hill on global trade and economic issues. He is a board member of Fordham University's Graduate School of Arts and Science and serves on Fordham University's President Council.

He is the author, coauthor, or contributor to 15 books. His most recent book, *The Last Economic Superpower*, was released by McGraw Hill in November 2010. He has published numerous articles on economics, trade, and finance that have appeared in *Foreign Affairs*, *the Financial Times*, *The Wall Street Journal*, and *Barron's*. He regularly appears on CNBC, Bloomberg television, PBS, and other media venues.

**Barbara Rudnicka** is an investment manager at KFK. During her professional career, she worked in one of the leading Polish venture capital funds and was responsible for the evaluation of investment proposals. She is a certified investment advisor in Poland and a CFA level II candidate. Barbara is a PhD candidate at the Wroclaw University of Economics.

**Petra Salesny** is managing partner at Alpha Associates and a cofounder of the firm. Alpha Associates is an independent private equity fund-of-funds manager and advisor based in Zurich, Switzerland, and the leading private equity fund-of-funds

manager for Central & Eastern Europe and Russia/CIS. The Alpha team has made and managed more than 80 primary fund investments, secondary fund investments, and direct coinvestments in the CEE and CIS region since 1998. Alpha is the second largest private equity fund investor in the CEE region after the European Bank for Reconstruction and Development (EBRD). Petra graduated from the Law School of Vienna and holds a Master of Laws from New York University School of Law and a PhD in law from the University of Basel.

**William Scheela** is professor of business administration at Bemidji State University, which is part of the Minnesota State University System. Professor Scheela's research focuses on the development of the private equity industry (venture capital and business angels) in the emerging economies of Southeast Asia. Professor Scheela received his PhD in strategic management from the University of Minnesota's Carlson School of Management and has also taught in Hong Kong, the Philippines, and Vietnam.

**Matthew Schwarz** is a Citicorp Wriston scholar at the Fletcher School of Law & Diplomacy at Tufts University, specializing in international finance and international political economy. He is the recipient of numerous academic honors, including the Robert B. Stewart Prize for Outstanding Student at the Fletcher School. Prior to graduate school, Matthew served as a Fulbright scholar in Vietnam, where he helped to coordinate "Project 30," a regulatory reform initiative supported by the Government of Vietnam, the International Finance Corporation, and the United States Agency for International Development. In addition to his academic work, Matthew has held positions with the Brookings Institution, the international law offices of Baker & McKenzie, the United States Department of the Treasury, and the Center for Emerging Market Enterprises at the Fletcher School. In September 2012, Matthew will enroll in the MBA program at Harvard Business School, where he intends to focus on emerging markets' private equity.

**Markus Taussig** is an assistant professor with the strategy and policy group at the National University of Singapore's NUS Business School. His research and teaching focus on how strategy is shaped by context, with particular focus on emerging economies. Markus received his DBA in strategy at the Harvard Business School and his MA in international economics and Southeast Asian Studies from Johns Hopkins' School for Advanced International Studies. He also worked in Vietnam for over 10 years, designing and implementing surveys of local private entrepreneurs, auditing state-owned enterprises, and engaging in a couple of entrepreneurial ventures with mixed success.

**Jeffrey Towson** is an investor, professor, and best-selling author specializing in global value. He is currently managing partner of the Towson Group, an investment firm based in Riyadh and Shanghai. Prior to this, Mr. Towson served as head of direct investments for Middle East North Africa and Asia Pacific for Prince Waleed, nicknamed by *Time* magazine as the "Arabian Warren Buffett". Waleed's distinctions include: being the world's fourth richest person (2004, *Forbes*), the largest foreign investor in the United States, the largest shareholder of the world's largest bank (Citigroup, 2007), and the world's second largest media owner after Rupert

Murdoch. Mr. Towson is also a fellow at Cambridge University Judge School of Business and is co-head of the Chinese investment and strategy courses at Peking University Guanghua Business School (Beijing) and the China Europe International Business School (Shanghai).

**David Wilton** is chief investment officer and manager, Global Private Equity with responsibility for IFC's investment program in emerging market funds globally. David is a member of the Pension Finance Committee of the World Bank Group, chairman of the Advisory Board of the Emerging Markets Private Equity Association (EMPEA), and was acting CEO of the IFC Asset Management Company in its establishment phase. Earlier in his career David managed the Private Equity and Real Estate portfolios of the World Bank Pension Fund. He joined the Funds Department of IFC at its inception in 2000 and has been responsible for turning around the portfolio and developing the funds strategy. Please refer to [www.ifc.org/funds](http://www.ifc.org/funds) under the Presentations tab for information on IFC's experience in investing in emerging market private equity.

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