

Views from the Field: Taking Stock of 2012 and the Prospects for EM PE in 2013

As 2012 came to a close, EMPEA reached out to a number of the industry's leading practitioners to solicit their reflections on the year gone by, and to glean insights on the prospects for emerging markets private equity in the year ahead.

The Global Firms' Views



Paul Fletcher,
Senior Partner,
Actis

“2012 was an encouraging year for EM PE, with most investment themes continuing to show resilience. It was also reassuring to witness some of the political and economic risks, namely instability in Egypt and the much feared Chinese hard landing, playing out better than we hoped.

We expect to see more and more large financial buyers hungry to acquire EM PE mid-market investments. We feel quietly optimistic about India, providing the government's policy reforms take hold.

As ever for Actis, Africa remains an appealing capital destination with significant demand for infrastructure, and high quality products and services. In October 2012, Actis closed Sub-Saharan Africa's largest private equity real estate fund and we expect intense activity in this sector during the next 12 months.

Currency continues to be a significant point for consideration. We saw a 5–10% discount on U.S. dollar returns because of volatility in South African, Indian and Brazilian currency. It's a reminder to all of us to be mindful of managing this risk.



**Arif Naqvi, Founder
and Group CEO,
The Abraaj Group**

“2012 was, in my view, a year that consolidated the growth areas of our global economy. Investors and GPs are recognizing that the opportunity lies in what we at Abraaj call the 'global growth markets.' From Latin America through Africa to Southeast Asia, we can see the strengthening of the South-South economic corridor, where private equity is increasingly recognized as an important source to finance the growth that will occur as a result of these emerging dynamics. Look at Africa as an example of this trend as of late: a number of new funds have been launched to target that

vast continent. Seven of the 10 fastest growing economies in the world are in Africa—these are transformational shifts.

I have said this before, and I continue to maintain that we are privileged to be living through these transformational times. On the macroeconomic front, the biggest megatrend by far is the pace of expansion in the growth markets being higher than that in the developed world. Many of these markets are characterized by a growing consumer class with increasing consumption power. This in turn is creating the need for infrastructure, health and education services, housing, logistics and transportation. Private equity has a role to play across the board in this exciting landscape.

The main issue of concern will be how private equity creates long-term value and builds sustainable industries that will be equipped to succeed in the 21st century. This will entail robust governance and risk management systems, environmental and social strategies that are measurable and impactful, and an engagement model between the GP and LP that is founded on trust. Private equity can be a tremendous force for development; a catalyst for change through infrastructure development and employment as well as innovation. Indeed, I am convinced that private equity in the markets in which we operate belongs to Main Street and not Wall Street.



Sev Vettivetpillai,
Executive Chairman/
CIO, Aureos Advisers,
The Abraaj Group

“2012 has been an extremely formative year for growth market countries and regions outside of the more traditional BRIC nations. It has seen the emergence, out of the shadows, of a number of serious contenders on the private equity landscape. Most noticeable of these has been the rise of Sub-Saharan Africa. The continent has seen more than 20% compound growth in FDI

projects over the last few years and this figure is set to grow. With Brazil losing its shine, the Andean countries of Colombia, Peru and Chile have come to the forefront of many LPs' wish lists. With strong governance and attractive deal making, this region has seen a number of exits taking place, which in turn has led to a healthy flow of capital. A similar pattern has taken shape in Asia. With China not seeing the sort of private equity investment that it had seen previously, Southeast Asian nations have stepped up to fill the void.

2013 promises to be an eventful year, particularly in the markets we are focused on. We've already seen a number of homegrown GPs spring up in our markets over the last few years, but what has been interesting is the drive from GPs in developed markets that are attempting to make inroads in the markets we operate in to capture the inherent growth and opportunity, which is simply not present in the markets that they operate in—we see this trend accelerating in 2013. We have seen a seismic shift in the strengthening of the South-South private equity landscape. This is clear from Brazilian banks setting up shop in Africa to Indonesian firms exploring opportunities in the Middle East; South-South cooperation is becoming the norm and not the exception. We believe that 2013 will be a key year for further solidification of this trend.

Growth market private equity GPs and LPs are in the privileged position to be key drivers in the development not only of the companies and funds that they invest in but also in building stronger, sustainable markets that in turn benefit the overall health of the global financial ecosystem. Taking the wider picture into account when investing is not only good for the communities that they benefit, but also generates stronger returns to our investors. We have demonstrated this over the last 10 plus years and we are seeing more players in the private equity space focus on sustainable investment, which in turn leads to sustainable growth. I imagine 2013 will only lead to a greater focus on this; and so it should.

The Founder's View



Roger S. Leeds,
Professor, Johns
Hopkins University,
SAIS

“The recent EMPEA data on fundraising and investment (through Q3 2012) is both surprising and worrisome. Not only has the asset class stopped growing since the financial crisis, but it appears to be going in reverse, at least temporarily. Unless Q4 numbers sharply increase, 2012 fundraising and investment totals will be below 2011 levels, and barely 50% of the peaks achieved in 2008. Moreover, penetration rates (as a % of GDP), also appear to be declining. Although it's too early to conclude that this surprising downturn represents a long-term trend, the numbers are not encouraging.

The EMPEA data, coupled with anecdotal evidence from a broad range of fund managers and LPs, also suggests another possible trend that should catch the attention of those who believe private equity serves as a critically important financing tool for countless worthy companies that otherwise would have limited or no access to growth capital. Indeed, it is worth recalling that this premise was a key driver that propelled the founding of EMPEA back in the early 2000s. The latest EMPEA figures, however, strongly suggest the industry is becoming less diverse and more concentrated—fewer and fewer, larger and larger fund managers, investing primarily in a number of very large firms in a small number of countries. Consider, for example:

- Asia captured 56% of total fundraising and more than 60% of total investment; and the label “Emerging Asia” is somewhat misleading since the PE activity in the region is dominated by just two countries: China and India.
- The “Latin America” data tells a similar story. Brazil continues to dominate, attracting more than 90% of new PE investments in the hemisphere, and seven of the top ten Latin American fund closings were Brazilian.
- Overall, six funds accounted for more than 50% of all emerging markets fundraising in the first three quarters of 2012, and 13 funds comprise about 75% of the total.
- Anecdotally, everyone who is reading this knows from personal experience that most LPs interested in the asset class are writing larger checks to fewer fund managers.
- The collateral consequences of this pattern are predictable: larger individual funds seek to deploy larger amounts of capital per deal. With a limited number of eligible companies residing at the top of the private sector pyramid, competition intensifies and valuations increase. And of course we know what that portends for downstream returns. This trend, if it continues, is unsustainable!
- Finally, although not part of the EMPEA data, we know anecdotally that at the same time LPs are becoming more selective about where and with whom they invest, they also are putting increased pressure on fees and other terms. This is one explanation for why many of the largest fund managers are diversifying away from private equity. Listen, for example, to a senior KKR partner, quoted in the Wall Street Journal: “The game now is to grow assets rather than to grow carried interest.”

It is premature to suggest an irreversible trend, and obviously there are notable exceptions to all of the above. Nevertheless, the signs are worrisome. We can only speculate about the consequences for the asset class if activity continues to become more concentrated and less diversified. But the signs are discouraging for those who believe that a key driver for emerging markets private sector development is the provision of scarce long-term capital, as well as expertise, for countless mid-size companies. Perhaps emerging markets private equity is mirroring the historical pattern we see in many industries: growth and maturity lead to consolidation—fewer and fewer, larger and larger players. But if this is the inevitable result, the private equity development impact will be sacrificed.

The LP's View



Maninder Saluja,
Co-Head, Emerging
Markets Private
Equity, Quilvest Group

“2012 has been, and 2013 will continue to be, a complex, yet exciting time for emerging markets private equity. Despite global macro volatility and slower growth leading to locally nuanced challenges, the overall long-term domestic consumption opportunity well-suited for private equity continues in most developing markets.

As the fundraising environment continues to be challenged, GPs are feverishly working their portfolios to prove their ability to return capital. As the capital markets have generally been tepid for new offerings, trade sales and dividend recaps have become a more important part of all GPs' liquidity strategies. GPs are also forced to hone their strategies and differentiate themselves through their value-added capabilities.

This disruptive period is also allowing for uniquely constructed funding models and increased activity in value-driven strategies such as secondaries, distressed, credit and co-invests. There is also a fair amount of arbitrage that exists given the sometimes increased visibility on underlying portfolios—somewhat commonly referred to as “pregnant primaries.”

The decision to go beyond the core emerging markets of China, Brazil and India, with allocations to peripheral and frontier markets, has taken on increased importance in nearly everyone's portfolios. Within Latin America, the Andean region has blossomed; Africa has seen the entry of the global giants in addition to the already well-placed local groups; and the peripheral and frontier markets of Asia continue to see increased deal volume and a growing number of managers. In addition, middle market leveraged control deals across developed Asia continue to provide a complimentary risk-reward profile to that found in minority deals in higher growth companies across developing economies.

The View from Russia



Michael Calvey,
Founder and Senior
Partner, Baring Vostok
Capital Partners

“Like in many other countries, the stock market was volatile in Russia this year, so fair market values of PE portfolios fluctuated from quarter to quarter. However, most companies grew and increased their net profits substantially, so the intrinsic value of most PE portfolios clearly increased compared to last year.

We expect Russian growth in 2013 to decelerate but still be reasonably healthy overall. The combination of reasonable growth and weak capital markets means that 2013 will probably still be a better time for buying than selling assets. However, strategic buyers (some foreign, but increasingly Russian) continue to be willing to pay full values for top quality businesses.

There are plenty of global macro issues to worry about in 2013, but these are difficult to predict and outside of most people's control anyway. So the key issue for both LPs and GPs to really spend time thinking about in 2013 should be the sustainability of PE returns assuming a prolonged global economic crisis—in other words, can attractive returns be realistically achieved in your country/industry with today's growth rates without additional leverage or margin expansion?

The View from Asia



Andrew M. Ostrognai,
Partner, Debevoise &
Plimpton LLP

“2012 was very mixed. In Asia at least, many exogenous events seemed to be shading investor perceptions, so that the focus was not always on the bright spots here, but rather on the dark spots elsewhere.

I view the outlook for 2013 as much more positive. The United States seems to be recovering, Europe seems to be finding a way forward, and China is returning to form. This is all good news for managers and investors in Asia, the market I serve.

Which issues should be at the top of LPs' and GPs' minds in the new year? Know your manager, and know your investor. For investors, in Asia it is becoming clearer who the leading managers are, and why. And for managers, it is also becoming clear which investors are good partners for the long haul.



Rebecca Xu,
Co-Founder and
Managing Director,
Asia Alternatives
Management LLC

“For Asian private equity, 2012 has turned out to be a year when “the tide goes out...” This happens slowly given the nature of this asset class. We have seen many funds not able to return capital to investors as expected due to challenged portfolio companies with declining earnings. This will be top of mind when investors evaluate GPs' performance in their next round of fundraising. As a result, not all funds in the market will gain investors' support.

Overall, we expect 2013 to be a better year than 2012 in terms of liquidity and public market exits, but the first half will likely still be challenging. On the other hand, asset pricing in many Asian markets will remain relatively soft for the foreseeable future, thus affording potential attractive opportunities for investors. 2013 could potentially turn out to be a strong vintage from an investing point of view.

Liquidity and exit are certainly on top of LPs' minds, and therefore should be on top of GPs' minds too. In the small- to mid-sized buyout markets of Japan and Korea, recent trade sale exits have helped investor liquidity, thus supporting continued interest of investing in these markets. In China and India, the IPO and public exit window has been narrow and will remain so for the near future. In such markets, companies with robust and defensible earnings are best-positioned to achieve liquidity and exits when the market improves.

The View from India



Archana Hingorani,
Chief Executive Officer
& Executive Director,
IL&FS Investment
Managers Limited

“2012 will be characterized as the period when reality and expectations began to catch up with each other. It has been a period of introspection for both GPs and LPs. While the opportunities in the region remain compelling, despite a moderation in growth, the process of a strategy rethink is ongoing. The result could reshape the PE industry in many regions.

Early 2013 should see a reversal of the interest rate cycle in India. This would drive investments back into the region, and coupled with policy changes being announced with regular frequency over the last few months, would significantly improve sentiment. A natural outcome would be an increased focus on exits and showcasing returns, which in turn would provide a strong base for a revival of fundraising plans by late 2013.

High regional growth and exciting sectoral developments do not necessarily translate into high returns, which are more a function of a manager's ability to deliver value all along the entry-exit cycle—both LPs and GPs will pull over this key 2012 takeaway. While retaining regional exposure, LPs should therefore look to redefine their partnerships. GPs will need to give a hard think to their ability to craft entry-exit strategies as also go-to-market strategies, as and when the market does open up in 12–18 months. Both sides also need to deliberate on the sustainability of the “25% target” return.



Sanjay Nayar,
Chief Executive
Officer, KKR India
Advisors Pvt. Ltd.

“The volume of private equity investments in India was fairly low in this calendar year as compared to the investments in 2011 and 2010. However, there has been a turnaround in investor sentiment and long-term investors continue to bet on the Indian growth story. The strategic investors have always liked India and continue to do so as India is a huge consumption market, most sectors are underpenetrated and the companies have strong growth potential that has yielded huge returns in the past.

As we look ahead, if there is a turn in sentiment and Indian businesses begin to invest again in real assets, they will need capital. We will see a lot more demand for private capital. In that context, there will be a lot more investment opportunities in the future to really build world-class companies, especially in the consumer-facing and infrastructure-related industries.

Which issues should LPs and GPs be thinking about in 2013? First, businesses need to consider what are the realistic growth rates that they would like to realize. Second, PE firms need to gauge if Indian companies are ready to embrace private equity with all the operational value add they can offer, to become better and more efficient: both more capital efficient and more operationally efficient. Lastly, watch out for currency fluctuations to see if deals are feasible and profitable.

The View from Brazil



Piero Minardi,
Managing Director,
Gávea Investimentos

“In Brazil, there was a lot of activity and, with the capital markets closed, we still see solid deal flow coming from private companies. I expect growing activity in these markets as emerging markets will keep posting growth and demanding long-term capital.

Looking ahead, LPs will definitely need to enhance their understanding of each market, their particularities and their players in order to get ready to deploy capital (or to increase their exposure) into these markets. With a low-rate environment in the United States and Europe for the foreseeable future, LPs will have to look more and more to EM PE as a source of higher returns. GPs, for their part, must be prepared to deal with LPs who will be looking for advice and long-term relationships for investing in illiquid strategies in emerging markets.

The Special-Situation Investor's View



Robert Petty,
Managing Partner
and Co-Founder,
Clearwater Capital
Partners

“ In 2013, the Asian private equity world will continue to benefit from solid capital flows anchored by the low absolute rate environment in the United States, Europe and Japan, as well as the search for uncorrelated returns. Asia continues to be underweight in pension plan portfolios worldwide as compared to the region's expanding contribution to global GDP; its growing domestic consumption alone will continue to support positive capital movements. Moreover, these capital flows will not target China alone. While from the regional perspective China will

still be the largest piece of the pie, capital flows will be diversified across the region, as well as across strategies. Credit is getting more attention these days given its attractive yield characteristics. We expect the public market rebound to help sentiment in the PE world, but we suspect it will still be a better investing market than an exit market, though, of course, on a company by company basis.

In the credit world, the long-term trend of disintermediation of banks in the corporate debt market will continue across all major Asian markets. Today, banking systems are focused largely on solving growing NPL problems and complying with the Basel III capital guidelines, as well as dealing with shrinking deposits and slower corporate earnings growth. In this environment, tighter bank lending conditions are inevitable, and will lead to

the emergence of non-bank players to fill the “liquidity gap,” thus creating a number of unique opportunities for dedicated players with onshore lending capabilities. We believe onshore high-yield lending to mid-market players with strong collateral will be compelling over the next few years.

We also expect the problems of specific company stress and distress to continue. This year, every major economy in Asia has had at least one—and in many cases more than one—high-profile company debt issue trade down dramatically on the announcement of negative earnings news, surprise corporate/operational issues or sectoral problems. These idiosyncratic credit events will persist as the earnings environment remains challenged, especially in the traditional manufacturing and export industries, which have been impacted by increasing labor costs, weak export demand and overcapacity. Consolidation will naturally occur, which will be healthy in the long term, but will create company and sectoral stress through the next episode. The combination of these factors will create a favorable environment for “credit pickers” focused on deep fundamentals and sector analysis. Despite a reasonable overall growth environment in Asia, and possibly trending higher stock markets, the risk/reward thinkers will continue to find value in credit opportunities in the Asian markets.

The Advisor's View



Philip Bass,
Global Private
Equity Markets
Leader, Ernst &
Young

“ 2012 saw a continuation of the volatility that has characterized the global macroeconomic environment of the last several years. With the slow recovery and political uncertainty in the United States, the continued evolution of the sovereign crisis in Europe, and the once-in-a-decade political transition in China, macro conditions challenged developed and emerging markets alike. Developed markets saw GDP growth slow even further in 2012 to 1.3% from an already anemic 1.5% in 2011. Over the same period, growth in the emerging markets slowed from 6.2% to 4.9%.

However, while the overall environment was challenging across the board, 2012 saw increased interest in the emerging markets by GPs and LPs alike. Dry powder for emerging markets is at an all-time high and LP allocations to these economies have increased. Most interesting was the continued expansion of private equity capital to the next tier of developing economies, including the Andean region of Latin America; expansion to the broader Asia-Pacific region, including Malaysia, Indonesia and Vietnam; Turkey; and, Africa.

Across these markets, private equity firms are partnering with entrepreneurs to transform companies into market leaders and drive growth. Our recent study, **Dynamic Growth: Value Creation in Latin America**, done in conjunction with EMPEA, analyzed exits in Latin America and found that 80% of revenue growth during PE ownership was attributable to organic growth, with entrepreneurs benefitting from private equity's experience in areas such as geographic expansion, product development and new pricing strategies.

As 2013 begins, we see a continued maturation of private equity across the emerging markets. More than 87% of investors we surveyed in our Global Private Equity Capital Confidence Barometer expect to maintain or increase their exposure to key emerging markets. Regulators' gradually increasing comfort levels should free up additional capital from local pension funds, insurance companies and other institutional LPs.

With volatility ever-present, PE firms must be more disciplined than ever. LPs are seeking well-seasoned teams with strong track records, robust local networks, and the ability to execute in changing environments. Firms with the ability to effectively source high quality deals, conduct thorough due diligence, and implement operational improvements will be the winners in the coming years.

Private equity in the emerging markets is well past its tipping point, supported by four pillars: the growth of the middle class and the concurrent rise in consumerism; significant under-penetration of private equity investment relative to mature markets; a persistent financing gap for entrepreneurs and family companies; and, growth rates at multiples of two to three times what developed markets are expecting. PE in the emerging markets should remain strong not just in 2013, but well into the foreseeable future.