



## **HIGHER RETURNS, HIGHER RISK ~ Private Equity Investment in Emerging Markets**

February 6, 2006

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Record breaking levels of Private Equity (“PE”) investment is flowing into some of the world’s fast-growing Emerging Markets (“EM”). As a result, recently the first Global Emerging Market Private Equity Association Forum was held in London in December 2005 attended by over 300 people from over 50 countries demonstrating investors increasing interest in EMs.

While historically many PE investors have stayed away from EMPE because the returns have been low in comparison to those available in developed markets. But that situation is changing rapidly and EM PE funds are starting to deliver higher returns. For example according to the CAMBRIDGE ASSOCIATES' EM PRIVATE EQUITY INDEX, ‘for the year ending June 30, 2005, aggregate returns to investors in the 169 funds in the Cambridge database totalled a very attractive 22.1%.<sup>i</sup>’ Sarah Henderson, Executive Director of the Emerging Market Private Equity Association has cited ‘increased competition in the US and Europe resulting in narrowing return expectations, improvement in legal and regulatory frameworks in some markets and improvement in exit environment and returns<sup>ii</sup>’ as key drivers of this spectacular growth.

It should come as no surprised that the most attractive EM for PE investment is China, with the most popular sectors being IT, telecoms and IC. In fact, total investment for 2005 as reported by Zero2IPO was a staggering \$1.057 billion invested over 233 enterprises in 2005. As a result of this hotbed of activity foreign PE firms have rushed to quickly establish a physical presence in China in order to take advantage of its huge domestic market, large pool of low cost engineering talent, technological innovation and fast growing economy. The downsides: China’s complex and developing legal and accounting systems, and inconsistent regulations and of course—it’s still a communist country.

Hot on China’s heels is India. According to TSJ Media, a research firm which tracks PE investment into India, nearly \$2.2 billion was invested in Indian firms by private equity investors in 2005. The sectors, which received the most PE investment, were the IT, manufacturing and healthcare and life sciences sectors. India has a huge base of entrepreneurial and intellectual talent, a business-friendly government (the largest democracy in the world) and the 2<sup>nd</sup> largest English speaking population in the world. Along with these pros, there are definitely cons: poor infrastructure and bureaucracy.

The attention Central and Eastern Europe attracted during the introduction of ten new countries to the EU in May 2004 has continued with achievement of a number of successful exits. The preparation required for accession introduced a number of

political and economic changes, which resulted in more attractive business environments. Increased investor interest led to the region attracting 547 million euros in investment (excluding Russia) in 2004 according to the European Venture Capital Association.

Eastern Europe including Poland and Hungary, Romania and the Czech Republic all have developed private equity markets and it has been estimated that by the end of 2005 800 million euros had been raised for investment in the region<sup>iii</sup>. There have also been announcements by the Carlyle Group and Draper Fisher Jurvetson about launching new funds in the region; Carlyle is currently raising \$400m for a dedicated Central and Eastern European fund it is launching and DFJ has linked up with TechInvest, a Ukrainian base technology-focused VC firm to create a \$50 to \$80 million fund, which will fund Ukrainian and Russian start-ups.

Russia, with its incredible natural resources, scientific prowess and one of the fastest-growing economies in the world at 6% GDP growth, investors are increasingly showing interest in once again investing in the former Soviet Union. In the past corruption and economic instability and an unpredictable business environment have kept away many investors. However with the introduction of a Corporate Governance Code and significant improvements to the tax system and minority shareholder rights, which have helped create a more stable business environment, along with increasing returns many investors are changing their negative perceptions of Russia. 'The Russian Private Equity & Venture Capital Association estimates that at the end of 2005, approximately \$1 billion had been raised for investment'<sup>iv</sup>.

### **Financing stage**

The majority of private equity investment in EMs is growth capital with management buy-outs growing in popularity. Venture Capital experts have noted that a lack of early stage venture capital exists in EMs. For example in India, according to TSJ Media, January – November 2005, only 6% of PE investments were early stage through 19 deals, unchanged from the same period in 2004.

Most foreign PE funds feel that they are already taking on a higher level of risk as they are investing in an emerging market and so prefer to back established companies with strong financials, market presence and solid management that are perceived to be lower risk than start-ups whose business model is untested.

Although efforts are being made in these markets to change this situation, for example discussions were held at the WEF Chinese Business Summit in 2005, as to how to develop and grow early-stage companies. Those that took part included foreign and Chinese venture capitalists, academics, and entrepreneurs. Recommendations such as better entrepreneurship education and improving corporate governance practices have been given to the Chinese Government for review.

### **Deal generation**

In EM, as in developed markets, the quality of the investment proposals is determined by the quality of your network of referrers. Developing working relationships with investment bankers, accountants, leading entrepreneurs, academics, R & D

institutions and lawyers, is key in order to source suitable prospects for venture capital. In fast-growing EMs such as China and India, many U.S PE firms have opened local offices or partnered with local VC firms in order to develop in depth local knowledge and build strong local networks.

Another factor that may affect deal flow is local cultural customs<sup>v</sup>. In some EMs, local cultural norms may clash with the private equity model. Many companies in EMs are family-owned with a traditional (and often conservative) organic growth model they may be unused to decision-making processes including 'outsiders' as well having to be accountable to those 'outsiders'. So, even though they may require access to capital, they may ultimately decide to choose another route.

As in developed markets, there are certain places in EMs that have become known for premium quality deal flow. In India, the best places for deal flow include Bangalore; the "Silicon Valley of India," for IT and IT-enabled services, Delhi, for software services and telecom deals. In China, Beijing is noted for software and communications and Shanghai for online gaming and semiconductors.

### ***Screening/Evaluation of Deals***

The criteria used by PE investors to screen investments in EMs are pretty similar to those used in developed markets: experienced management team that has the ability to execute, a large, growing market and available exit opportunities. There are a number of other factors that PE investors in EMs need to assess when screening investments. For example the likelihood of a military coup or outbreak of civil war, currency stability and inflation, possible changes to the tax and legal regimes. All of which could have a potentially negative effect on an investment.

The importance of conducting due diligence on potential investments in EMs cannot be understated particularly in those EMs with poor corporate governance practices and unstable legal and regulatory systems. For example in some EMs, establishing the true owner of a company or identifying 'hidden liabilities' may be difficult due to them being held in offshore vehicles. The costs of conducting due diligence exercise can also be prohibitive in EMs with poor basic infrastructure. Especially when accounting records and other key information are kept in many different sites.

### **Portfolio Management**

PE investors in EMs must take a more active role in managing their portfolio companies than in developed markets in order to realise the value in their investment. Poor corporate governance is commonly found in many companies in EM and often cause problems for emerging market private equity investors. Many companies in EMs are family-owned and resistant to change, they may be used to making only decisions within the family. They may be unwilling to work with non-executive directors and may have little regard for minority shareholder rights. This can cause major problems for PE investors. So for many PE investors, the willingness of the owners to adopt better corporate governance practices can be a key factor in determining whether or not to pursue an investment. Aside from the general aspects of portfolio management such as attending regular board meetings and reading financial

reports, establishing good corporate governance practices and strong financial control is crucial.

## **Exiting**

In spite of the increasing numbers of IPOs and trade sales in many EMs, generally few channels exist for exit opportunities. There are a number of reasons for this including unpredictable business environments, political and economic climates and financial markets. Because of the difficulty of exiting, many PE investors thoroughly screen each new investment proposal and determine at the outset a number of possible viable exit opportunities before deciding whether to pursue the investment or not.

## **Conclusion**

To recap: the cons of investing in EMs are inconsistent regulations, poor infrastructure, lack of financial transparency and bureaucracy are for many PE investors outweighed by the pros—which are high economic growth rates, technological innovation, availability of higher quality workers, experienced EM fund managers, less competition and possible higher returns. Of course, this is not the case in all EMs however many PE investors are still wary of the much slower-developing EMs, where there may be a higher likelihood of an outbreak of civil war, a small private sector, poorly educated workforce *etc.* However, the private equity investment flowing into some of the fast-growing EMs is forcing improvements in corporate governance practices as well as positive developments in their tax, legal and accounting structures which can only lead to the development of more stable and investor-friendly business environments and greater economic prosperity.

## **Notes**

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<sup>i</sup> EMPEA 4Q 2005 newsletter

<sup>ii</sup> Presentation to African Venture Capital Association (2005)

<sup>iii</sup> Real Deals December 2005

<sup>iv</sup> EMPEA Q3 2005 newsletter

Viewpoint – World Bank Group (1998)

EM Private Equity Association.

TSJ Media

Business-standard.com

Zero2IPO

Ernst and Young

Deloitte and Touche