PRIVATE EQUITY IN EMERGING MARKETS

Exits from Aid, Steps Toward Independence

An ImpactAssets issue brief exploring critical concepts in impact investing

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Recent years have seen significant volatility in developed capital markets together with a roller coaster ride of returns. In contrast, investors in emerging markets have experienced lower volatility with more consistent financial performance. Likewise, private equity, while not immune to market forces, has delivered more stability and been less correlated to major public markets. By bringing these factors together — emerging markets and private equity — investors have been able to generate both stronger growth and lower volatility. Yet a new breed of private equity investor is adding a third element that not only boosts financial performance, but also delivers social/environmental impact. These investors are discovering that by building upon the decades-long experience of development finance institutions (many of which have used public funding to finance enterprise creation in emerging markets) they can deliver capital while pursuing sustainable, long term returns for investor and other stakeholders alike.

EMERGING MARKETS: THE LURE AND THE RISK

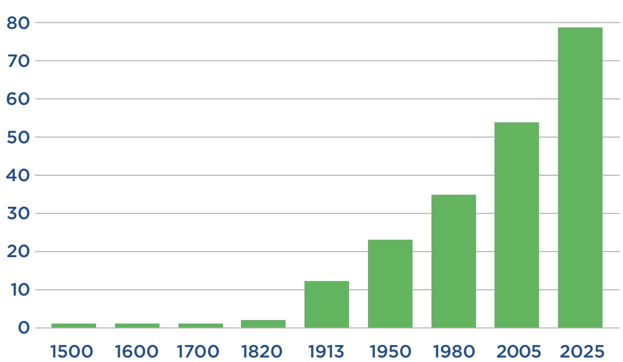
There was a time when many capital investors looked upon the territory beyond developed economies as a land unknown — fraught with risk and yet offering little assurance of return. Today, against the backdrop of significant mainstream capital market losses in 2008 and the prospect of low to no growth in developed economies in the near term, many investors—whether interested in impact or not — find themselves drawn to exploring investment opportunities in regions they had traditionally avoided. There are various reasons for this growth in emerging markets appeal; for the purposes of our conversation, we are interested in four:

- A Need for Capital
- The Opportunity for Growth and Returns
- Efficient Opportunities in Inefficient Markets
- The Impact Opportunity

A Need for Capital

While it may sound flippant to say it, regardless of national context, the majority of those who would be considered "poor" do not want to be so. Travel the streets of any emerging market city and one will witness the incredible entrepreneurial spirit among those seeking to better not only their own condition, but that of their families. This entrepreneurial drive has helped feed an overall improvement in business conditions which, in turn, has led to the growth of middle classes who have driven strong demand for goods and services that can be produced and/or distributed locally more efficiently and economically than abroad.

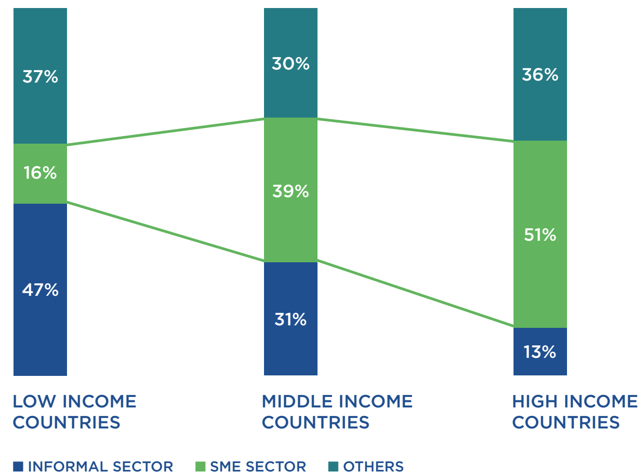
MIDDLE CLASS AS A % OF GLOBAL POPULATION



Source: Surjit S. Bhalla, *"Second Among Equals: The Middle Class Kingdoms of India and China"*, May 2007

To create more and better companies requires capital, experience and expertise, yet local financial markets are not sufficiently developed to provide efficient or sufficient capital to a growing class of entrepreneurs and company management teams. The bottom line is middle classes in societies around the globe are a growing percentage of the population and whether cause or effect, Small/Medium Enterprises (SMEs) are growing to satisfy their needs. To sustain this growth, there exists significant and fast growing demand for the capital necessary to sustain this growth.

SME CONTRIBUTIONS TO GDP:
As middle class grows, SME sector is expected to grow

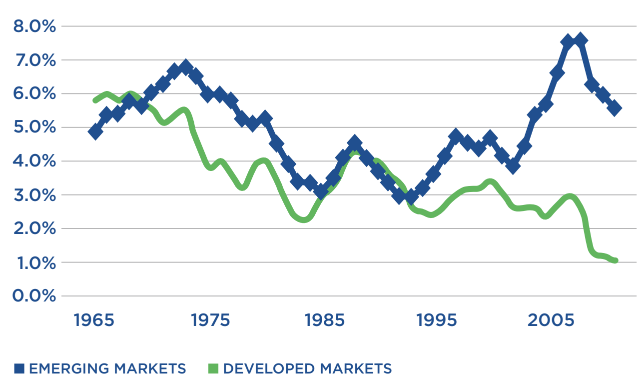


Source: *Small an Medium Enterprises Across the Globe: A new Database, Ayyagan, Beck & Demirguc-Kunt, the World Bank Development Group, August 2003:"Venture Capital for Development" Patricof & Sutherland, August 2005*

The Opportunity for Growth and Returns

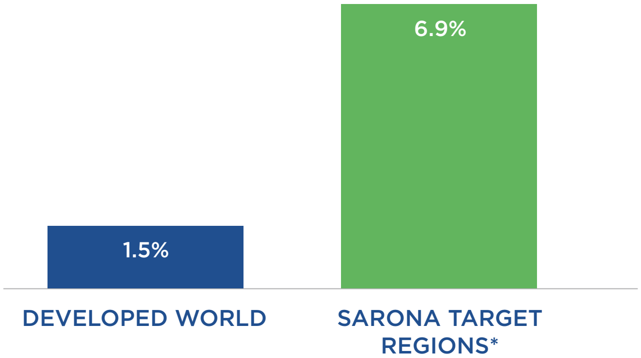
The story is well known: emerging markets have outperformed and are expected to outperform developed markets for the foreseeable future. While the International Monetary Fund (IMF) predicts growth rates of between minus and plus 1% in developed economies, the average expected growth for emerging countries over coming years is projected to be in the neighbourhood of 6%.

GDP GROWTH RATES HAVE DIVERGED



Source: World Bank (2011)

2000–2030 FORECAST GDP ANNUAL GROWTH RATES



*Sarona target regions include Africa, Developing Asia (excl. China), Central and Eastern Europe, CIS (excl. Russia), Latin America, and Middle East

Source: Citi Investment Research (2012)

An important component of this GDP growth is the SME sector. Traditionally, one has heard the frequently voiced objection that SMEs carry great risk. Yet, the most recent crisis within developed capital markets has demonstrated this is not necessarily the case. Indeed, markets in developed economies have suffered much higher volatility than many frontier and emerging markets and are now also facing significantly lower growth prospects. Excessive debt levels have been associated with high volatility and increased credit risk. The International Finance Corporation (IFC) examined 604 companies in its emerging markets portfolio (excluding financial institutions) and found that the median Debt to Equity Ratio was 0.33 while the average was 0.74. This is a far cry from European and USA ratios that have recently run around 3.

Efficient Opportunities in Inefficient Markets

Another consideration for many investors is that virtually by definition, emerging capital markets are "inefficient" in the financial sense. This means they lack transparency, financial liquidity and reliable access to information. These factors are compounded by significant structural blockages that inhibit the flow of capital. While a downside for those not positioned to take advantage of these challenges, these conditions also create opportunities for smart, knowledgeable, thoughtful and experienced investors who can put money to work with the expectation of achieving returns in excess of those available in efficient markets.

The Impact Opportunity

The opportunity in emerging markets for investors seeking financial returns as well as social/environmental positive impact is significant. On a local level, providing capital to grow more and better companies leads to the creation of more jobs and opportunities for local suppliers and possibly more local buyers. This, in turn, has the potential to generate greater tax revenues, which holds the promise of supporting the delivery of better national services. Increased financial empowerment also positions citizens to demand greater government accountability (the reverse of "No Taxation, No Representation"), while more jobs generate greater income and increased spending power—all of which translates into families better able to educate their children, receive greater access to superior healthcare, and so on. There is a large, well-priced opportunity to focus on "impactful" sectors such as education, healthcare, affordable housing, clean energy, and enabling technologies; sectors that can, and are, already changing the lives of millions both directly and indirectly.

On an international level, the opportunity lies in the possibility of reducing the instability reflected in the global gap between those who have and those who have-not, between North and South, between the resource-rich socially-poor and the western economies. In addition, as discussed at greater length below, thoughtful private equity investing has the potential of reducing developing nation dependence on aid and charity, particularly important at a time when mainstream donors are reducing grant flows.

These four factors: capital appetite, promising returns, market inefficiency and impact opportunity, combine to provide investors with a strong motivation for broadening their portfolio beyond traditional markets and focus on growth opportunities in emerging markets through a selected, diversified and ESG[1] minded approach. Furthermore, while liberalization of capital controls has had mixed results for receiving countries at the macro-economic level, it has allowed investors to participate in the economic growth at the micro-economic level by investing in companies that have outperformed. Finally, it is encouraging to note that investors are, in fact, hearing the call: the Institute of International Finance estimates that $910 billion flowed from private investors into emerging markets in 2011 compared to $580 in 2009.[2]

PRIVATE EQUITY: A SOLID FINANCIAL AND OPERATIONAL CASE

Private equity investing has a specific role to play as a vehicle for creating sustained impact — but before exploring that concept, one must first understand why traditional private equity, as an investment strategy, is of interest to so many investors. Let's explore a few of the reasons PE has become a popular option.

To begin with, ***PE offers patient capital with control features and alignment of interests.*** Private equity investors identify and select companies with the intention of holding them for long periods of time to make strategic and operational improvements as well as adding capital. Contrary to investors in listed, public equity, PE investors (most often through funds, but also as individual actors) take control of and work to align the interests of a company, its management and the investors. While investors in liquid securities have often proven to be "fickle," chasing returns around the globe on the basis of short-term results, private equity investors are, by definition, looking for longer term opportunities. Management of publicly traded firms are often under pressure to generate quarterly improvements, often at the expense of longer term strategic changes. These factors lead to a double negative: companies are not always managed for long term growth and capital flows are often highly volatile, distracting managers of companies from what should be their primary objective of running the business and building value.

Secondly, private equity offers investors ***multiple levers of added value***. In general, good PE Investors aim to add value in a variety of ways *(please see chart below):*

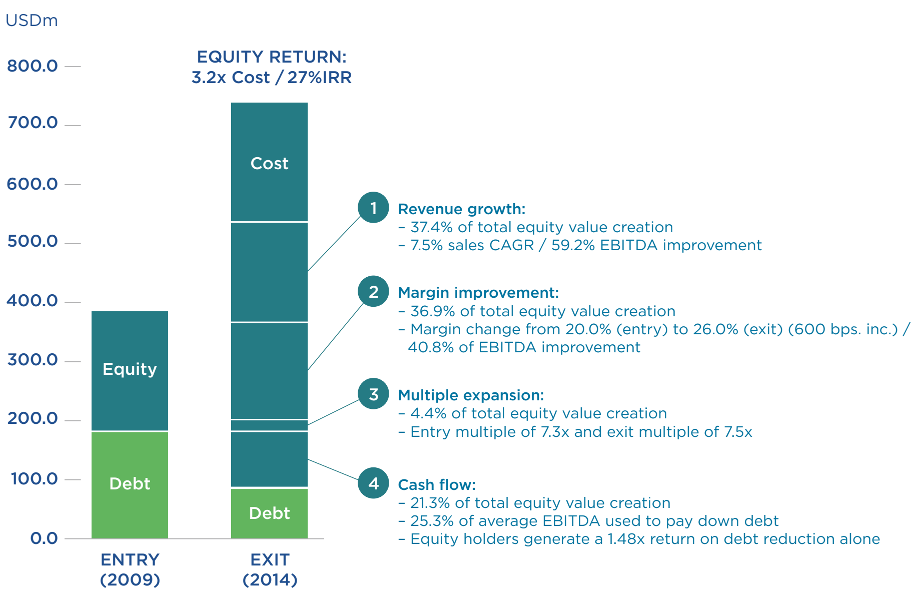
- Buying well;
- Focusing the strategy;
- Optimizing the capital structure;
- Improving operations, increasing revenues and improving margins; and
- Exiting successfully.

A successful company is the shared objective of investors and managers: after an average holding period in emerging markets of around 5-7 years, exits are often made to strategic buyers who value the attributes that have made the company successful and believe they will continue to allow it to grow.

Thirdly, investors are drawn to a PE strategy because they are comforted by the maturity of the industry. It is a ***proven investment strategy that has*** repeatedly ***secured premium returns.*** There is conclusive data from multiple sources regarding the ability of PE to generate attractive returns. The widely held expectation is that a high quality, well-diversified PE portfolio should be able to outperform a listed market index such as the S&P500 or the MSCI Emerging Market index by 300-500 basis points on an annual basis. The key to this performance lies in the identification, selection and access to those PE managers that have the experience and qualities necessary to generate the sought after outperformance. We would argue that due to the alignment of interests in the structure of PE deals, the premium returns of PE benefit all stakeholders. And excess returns

OPERATIONAL IMPROVEMENT MEASURES ARE KEY FOR PRIVATE EQUITY VALUE CREATION

Average expected value creation of investment opportunities in Partners Group Buyout Portfolio (2009-2011)

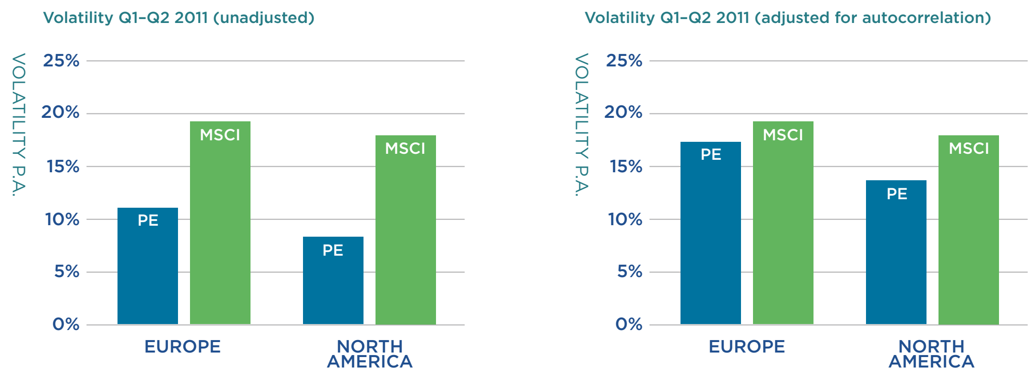


Note: Understanding private equity's outperformance in difficult times," Partners Group Research Flash, January 2012.

Source: Partners Group data

are not always linked to additional risk. Recent research by Partners Group into its own portfolio of companies, shows that the ***volatility of a private equity*** (buy-out in this case) ***portfolio is lower*** than corresponding market indices in Europe and North America.

PRIVATE EQUITY PERFORMANCE SHOWS LOWER VOLATILITY THAN PUBLIC EQUITIES
Volatility of buyout performance for different regions measured against relevant MSCI's



Source: Bloomberg (NDDUE15 Index in EUR, NDDUNA Index in USD), Partners Group analysis based on Thomson Reuters data (Cash Flow Summary Report for Western Europe and North America buyouts; Q2 2011)

Finally, PE has merits simply due to the fact that traditional, sophisticated ***investors are familiar*** with the private equity model and its basic structure. One should not underestimate the challenge of approaching investors with an offer to invest in emerging markets. However, PE may be viewed as the most appropriate way to catalyse long term private capital to areas where large institutional investors have not yet played a role and where they are most needed. Considering the significant obstacles facing impact investment asset managers, a PE model, simply by being familiar to institutional investors, could possibly reduce at least one of the many objections.

PRIVATE EQUITY IN EMERGING MARKETS: VALUES ENHANCE PROFITS

While PE is a respected investment strategy for many asset owners and managers, we should note that North American PE has sometimes been characterized by practices such as Leveraged Buy-Outs (LBOs) with excessive levels of debt, "Strip & Flip" strategies, and balance sheet engineering with a variety of unintended consequences. While private equity affects people and communities, the impact has not always been positive, at times leaving people jobless and communities poorer. These practices have often resulted in PE gaining a poor reputation among the public and governmental actors as well as with those entrepreneurs and investors oriented towards building long term value.

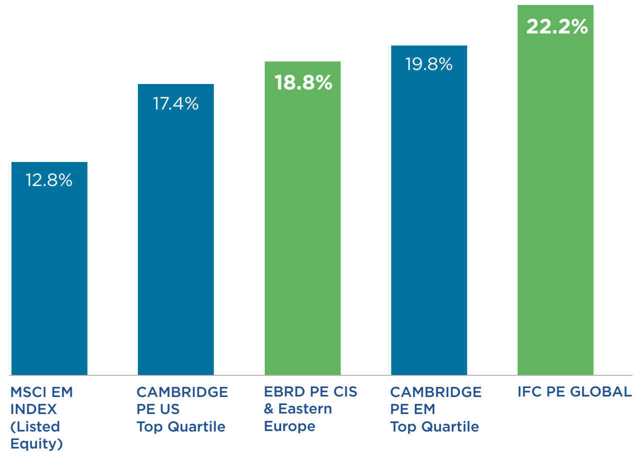
In contrast, the experience and practices of PE in developing countries has been considerably different. Lower liquidity, resulting from a relatively less-developed banking industry and a dearth of secondary trading markets, means

LBOs are almost non-existent. Therefore, many frontier and emerging market PE firms are focused upon building companies rather than simply restructuring them for quick re-sale. And many small to mid-market companies generally offer a lot of room for improvement and professionalization, thereby allowing PE firms to add great value to companies in their portfolios.

It is interesting to note that Development Financial Institutions (DFIs) such as International Finance Corporation (IFC), the Dutch FMO Entrepreneurial Development Bank, CDC in the UK, various regional development banks and others, have been instrumental in building the PE industry in frontier and emerging markets, and have done so with a strong focus on environmental, social and governance (ESG) practices. Without them, the PE industry in developing countries would not exist. We believe that the ESG conditions attached to DFIs' capital have played an important role in shaping a more sustainable private equity investment approach, an approach that is now accessible through a new group of intermediaries ready to attract private capital. This strategy has proven to not only develop a strong ESG culture in these markets, but has also enabled some DFIs to achieve financial returns that are very competitive with top quartile market performance *(please see chart at right)*. The US government's Overseas Private Investment Corporation (OPIC) has recently allocated about $300 million to privately owned PE firms active in frontier and emerging markets with the explicit objective of generating attractive financial returns while

FINANCIAL RETURNS ACHIEVED BY LARGE DFIs: IFC AND EBRD

Two long term successful PE investors compared to others in emerging markets



- Performance data from January 2000 to June 2011
- US$ pooled end-to-end returns, net of fees, expenses and carried interest
- IFC data excludes debt, real estate and infrastructure funds while EBRD date excludes property funds
- MSCI data matches IFC cash flows invested/divested and not EBRD cash flows
- Cambridge data matches vintage years of IFC Private Equity

also having a positive impact on the community and/or the environment. The six managers selected are: Sarona Asset Management (the first fund of funds ever supported by OPIC), and five direct primary funds: Latin Idea, Investment Fund for Health in Africa, Mano Cap, MPOWER Ventures, and Terra Bella. All six PE firms believe in the potential to add strong and progressive ethical, social, and environmental values to their companies' corporate cultures, so as to create champions that outperform both financially and socially.

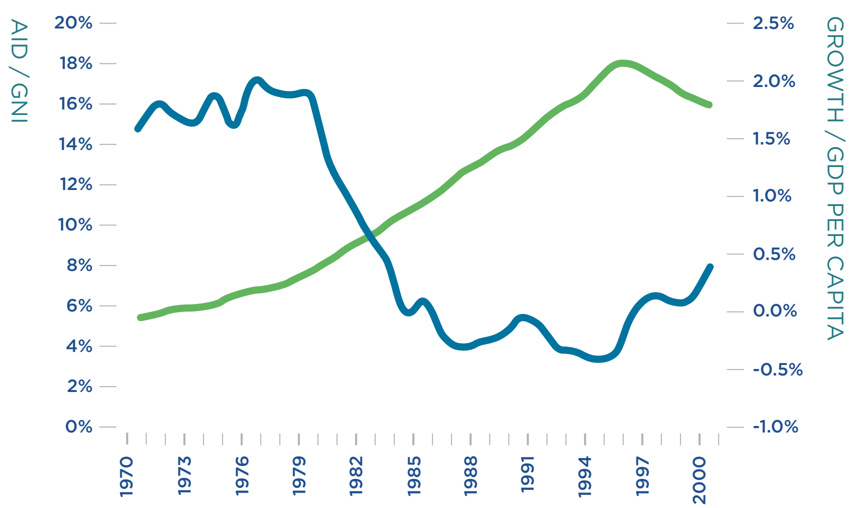
Such competitive outperformance is seen both in a company's top-line and bottom-line growth as well as in the pricing of its eventual exit to a strategic buyer. The logic is simple: progressive values that treat suppliers, employees, customers and community as valuable partners strengthen stakeholder loyalty and company performance. Likewise, creating companies that achieve world class standards of excellence in ethical, social, environmental, and governance spheres, significantly enhances their attractiveness to prospective acquirers.

PE investors who include impact as part of their strategy are not only focusing on the goods and services of the sectors in which they operate. They also add an explicit focus on applying best practices throughout the investment process. Often, traditional investors argue there is a trade-off between financial returns and Impact. We would argue that in the case of PE in emerging markets SMEs, investors have the opportunity to participate in a virtuous circle: the more progressive the business, ethical, social and environmental strategies employed by a company, the more positive the community impact and, in turn, the greater the likelihood of a financially successful company and exit strategy.

MAXIMUM IMPACT: MOVING FROM AID TO INVESTMENT

When considering investing in emerging markets, it is easy to mistakenly think one is managing in a new frontier where none have dared tread—yet many of the most promising emerging market investments build upon the legacy of aid and development funding. While playing a critical role in rescue and relief, today many are challenging the role played by aid programs and their long-term value in addressing critical issues for developing nations. The flow of aid has not been correlated with economic growth.

AID AND GROWTH 1970–2000
10-year moving average



Source: ECIPE Analysis of World Development Indicators Online

Over the last decades, aid and charity have had numerous negative consequences—consequences that have been widely discussed elsewhere.[3] While beneficial and even essential in certain circumstances, aid can also:

- Foster dependencies;
- Distort markets;
- Misalign incentives;
- Decrease tax revenues;
- Result in "fickle" capital flows;
- Undermine accountability between government and citizens;
- Yield impact that is NOT scalable or sustainable; and
- Deflect human talent resources toward non-profitable and therefore non-sustainable organizations.

Part of the reason for these negative consequences is that the relationship of giver-receiver is inherently imbalanced. As such, voices out of the developing world have called for slowing or stopping the flow of aid and instead investing in people and companies in these countries. A business investment relationship, where each party needs the other, is inherently more equitable than that of giver-receiver. Those who raise donations for developing countries — indeed, those who raise donations for investment funds in developing countries — risk doing great disservice to the people of those countries. Investors should be careful not to promote a public image of people in developing countries as needy of charity. Such an image denigrates poor people and undermines their ability to stand beside others as equals.

To achieve real impact — to truly move the needle for the poor — we must focus not on what feels immediately "warm and fuzzy", but rather on what may often initially appear to be rather distant from impact: mainstream capital markets. Indeed, positive impact for a hypothetical couple living in a rural community in a Latin American country — call them "Jose and Maria", may best be achieved by not focusing on Jose and Maria. By focusing on local capital access and microfinance strategies alone, those concerned with financial inclusion and economic development may inadvertently neglect the larger opportunity posed by mainstream capital markets. This is because many poor people are entrepreneurs by necessity, not choice, and many would rather have a job than another few chickens to sell. For instance, when senior managers of Sarona Asset Management have, in their travels, asked poor farmers what their dreams are, the response is usually that their children go to school and get a good job so they don't have to toil in the fields. And the truth of the matter is that jobs are most often created by SMEs in the middle, not micro or large businesses at either extreme of the business development continuum.

There is a place for small-scale farming, local enterprise development and SME expansion—and indeed, the world needs a continuum of economic development. Yet to date, many within impact investing have tended to focus upon the micro-enterprise end of the spectrum to the neglect of executing investment strategies that offer the potential to grow the entire economic eco-system. It is for this reason we must seek to understand the critical role of macro capital flows and public policy necessary to enhance those flows. To achieve impact in billions of micro situations, we must not ignore the macro context. A healthy society offering economic mobility needs a strong diversity of micro, small, medium, and large businesses. For lasting positive impact, we must include SMEs, large businesses and publicly traded capital markets as part of a holistic impact investing framework and strategy.

At the same time, we must be clear that advocating for increased investment capital and market-based strategies is not enough to move "beyond aid." To achieve deep and sustainable impact that doesn't simply bring greater riches to those who are already wealthy (and thereby increase the gap between rich and poor) we must work towards building a healthy society. Our efforts at attaining "impact" may be fleeting if they are not themselves sustainable and broadly felt. This requires engagement by governments to establish a public policy framework—an enabling environment—that helps ensure economic growth benefits to all of society.[4]

CHALLENGES OF IMPLEMENTING AND CAPTURING THE OPPORTUNITY

While there are clearly significant potential benefits for investors exploring emerging markets, it is also clear there are challenges to actually deploy the money so needed by local entrepreneurs. These include, at a minimum:

- Current market uncertainties that will potentially reduce risk appetite of investors;
- Increased regulation and capital requirements for financial institutions (Basel II & III);
- A lack of impact investing experience/knowledge among traditional institutional investors;
- The domestic bias of many U.S.-based investors;
- An unwillingness among some investors to take/increase illiquidity exposure;
- Lack of incentives to shift portfolio allocations;
- The brief history of PE investing in these countries, lack of explicit or relevant track records and other fund level concerns; and
- Immature impact measurement tools.

Despite these and other concerns, the promise of impact investing in emerging markets is one which should not be ignored. There are and will remain real, profound opportunities for investors to generate meaningful performance—financial return with social and environmental impacts—and these opportunities should be a part of every impact investor's strategy.

CONCLUSION

There is a growing belief in a model that can substitute aid and achieve a stronger, more sustainable growth pattern in countries that need it most.

Investors have recognized the failings of the western financial system which culminated in the 2008 crisis. At the same time, donors and philanthropists are also realizing the shortcomings and unintended consequences of poorly deployed, long-term aid policies.

"PE Impact Investing" is a new name for a timeless activity: deploying patient capital to good companies and nurturing them to become excellent in all their interactions. Aid is appropriate in crisis circumstances, but investment capital provides opportunities amongst equals, restores dignity to the receivers, and builds for long term independence. Emerging markets, where so many people are increasingly willing and able to create "real" value to their economies, represent the most recognizable and realistic opportunity to combine financial returns while making a positive difference to communities and the environment. A private equity strategy seems to be best suited to achieve the outcomes wished for by so many.

July 2012

FOOTNOTES

1 Environmental, Social, Governance

2 The Institute of International Finance, Capital Flows to Emerging Market Economies, 2012

3 For a thorough discussion on the effects of Aid in Africa please see *"Dead Aid", by Dambisa Moyo. March 2009*

4 Please see Dilma Rousseff in *The Economist: The World in 2012; December 2011*

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