

Catalysts in the Development of Emerging Markets Private Equity

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A robust private equity industry is critical to the development not only of a dynamic, growing and increasingly formal economy but also to attracting additional foreign capital which fuels further growth. This article will examine three elements key to the development of emerging markets private equity: 1) Foreign investment from developed market limited partners, 2) local investment from government agencies and pension funds, and 3) an active secondary private equity market.

The relatively resilient performance of some emerging markets during the current crisis has led institutional investors to view the emerging market asset class in a more positive light. Emerging markets, or at least the more 'orthodox' ones, are indeed looking quite good compared to developed markets in terms of private and public sector leverage, current account deficits, a banking system free of toxic assets and a growing middle class with an increasing rate of consumption. This dynamic is inviting to developed market limited partners (DMLPs) who are looking for ways to participate in this growing slice of global GDP. Due to their conservative investment policies, the large amounts of money they manage and relatively lean investment teams, DMLPs usually allocate their capital based on criteria such as country GDP, population, growth rate and maturity of capital markets among other factors. Based on these criteria, a DMLP looking to acquire exposure to emerging markets would begin with the largest single country markets or with regional funds and focus on the best known, and therefore usually largest, GPs who are on their third or fourth funds. Although this is a sensible and conservative approach, the combination of largest countries and largest managers leads to a relatively narrow field of investment opportunities.

A parallel although somewhat riskier growth opportunity exists with emerging managers who, for the reasons stated above, rarely have the early support of DMLPs. 'Emerging market emerging managers' generally put themselves on the map by gaining the support of institutions that are either local, and can therefore better understand the investment thesis as well as the risks, or have a developmental mandate. This group of institutions has effectively served as one of the catalysts helping to develop emerging GPs of various vintages into a class of experienced fund managers with proven track records. Multilateral development finance institutions (DFIs) and local government institutions [e.g. International Finance Corporation (IFC), Inter-American Development Bank (IDB), Multilateral Investment Fund (MIF), Andean Development Corporation (CAF), Asian Development Bank (ADB) and others] were among the earliest sponsors of private equity in emerging markets and have been supporting the industry for more than a decade. The IFC has been supporting emerging market private equity funds since the 1990s and continues to be the most active and high profile DFI in the emerging market private equity funds industry. The IDB, through its IDB and MIF arms, has also contributed to the success of the asset class – the IDB on the private equity side and MIF with its seed and venture capital – by investing in more than 59 funds throughout Latin America since 1996 and it continues to invest US\$ 25-35 million per year with emerging managers, with an average of around five commitments each year.

Local government agencies have also been active investors in private equity, in some cases for more than 15 years, and continue to increase their commitment to the asset class. BNDES, Brazil's development bank, has been investing in private equity funds since the mid 1990's and currently participates in 28 funds (13 venture capital and 15 private equity) with a total of R\$ 620 million dedicated to the program and it expects to make commitments to seven additional funds by the end of 2010. Future fund commitments will include sector focused funds in such areas as oil and gas, agriculture, clean tech and others. The bank runs manager selection programs and usually invests up to 20% of a given fund. FINEP, a development agency subordinated to the Brazilian Ministry of Science, has been running the Inovar program since 2000 with R\$ 300 million committed and currently participates in 23 funds including seed, venture capital and private equity. Its manager selection process has attracted the participation of regional Brazilian Development banks and smaller pension funds. In Chile, CROFU has invested in 27 innovation-focused venture capital funds. Mexico's development bank, NAFINSA, has recently absorbed various government entity sponsored fund programs into a fund of funds and has committed an additional US\$ 250 million to invest in new local and regional private equity funds. Similarly, Colombia's Bancoldex has recently provided US\$ 50 million to invest in a local funds program. Although the motivation is clearly developmental, DFI investment programs are expected to be profitable and managers who do not do well are not able raise subsequent funds.

Local pension funds also increasingly look to take part in local private equity markets in order to diversify their assets and participate in the base of the corporate pyramid that represents the bulk of an emerging economy's GDP. While Brazil's larger pension funds have been exposed to private equity for more than 10 years, recent regulations that created the FIP (a local fund structure regulated by the Brazilian securities authority which facilitated pension fund investments in private equity) have incentivized them and others to increase commitments and lend important support to fund programs sponsored by BNDES, FINEP and others. Banco do Brasil has recently announced its intention to form a fund of funds program aimed at offering diversified access to private equity to the 200 plus second tier pension funds who would be interested in making smaller commitments but do not have the management infrastructure necessary to administer their own private equity programs. Colombia and Peru recently approved regulated investment vehicles similar to Brazilian FIPs and have similarly attracted investments from their local pension fund industries. The Mexican pension funds, which are highly regulated and restricted with regard to private equity investments, are also developing innovative structures to enable AFORES to participate in private equity.

Local pension funds are motivated by several drivers as well. High interest rates that have historically been in place in many countries as anti-inflation strategies allowed fund managers to meet their actuarial requirements by investing in low risk fixed income government bonds and top tier corporate instruments. The recent precipitous decline in interest rates across the region forced managers to increase their exposure to equity strategies. Another dynamic which nudges pension funds towards private equity is that in most countries the local markets are still small relative to pension funds' assets under management, resulting in situations where institutional investors end up owning a disproportionately large percentage of the float of certain issues. Pension funds understand that they

must play an important role in developing local capital markets, creating a pipeline of IPOs so that the number of issuers grows at a pace similar to their AUM.

Finally, a third catalyst in the development of emerging markets private equity is the secondary private equity market. The secondary market can play an important role in bringing DMLPs and emerging GPs together. It can also leverage the DFI's mandate to further the development of capital markets and attract foreign institutional investors. Secondary transactions around the existing portfolios held by DFIs, government agencies and local LPs can offer foreign LPs (the LPs of the secondary fund) an acceptable risk profile through diversification and accurate underwriting, while providing visibility to local GPs who would not have been investment candidates on a primary basis. Local GPs benefit by broadening their investor base and improving fundraising prospects for their subsequent funds. Local LPs and DFIs benefit from secondary transactions through any or all of the following: cleaning up portfolios of legacy investments that may have become small relative to the overall portfolio, obtaining balance sheet relief from unfunded obligations, or monetizing mature positions to enable them to continue developing new managers without increasing overall exposure levels. It is also important to note that secondary transactions around mature portfolios do not tend to materially "move the needle" in terms of returns to the sellers, but they do sometimes provide new time frames for GPs and new capital for existing portfolios. There is little doubt that as the existing inventory of emerging market private equity funds grows, the secondary market will increasingly be used as a portfolio management tool much as it has been in developed markets for some time and that an important midterm collateral benefit resulting from these transactions will be a larger universe of primary investors willing to invest in the region.

When considering investments in emerging markets DMLPs should keep in mind that the universe is much broader than the handful of household names represented by the largest funds. The local private equity industry has evolved and benefited from continued and increasing support from a diversified investor base and today represents a robust investment chronicle spanning several generation of funds and managers.