IFC International Finance Corporation
World Bank Group

# The Case For Emerging Markets Private Equity

V.9 February 2011

# Introduction

IFC has a long-standing commitment to developing the private equity asset class in Emerging Markets (EMs).

We are now approaching ten years of experience with a dedicated approach to investing in Funds and we think other investors may benefit from sharing this experience.

Based on our experience and analysis of data from over 90 funds holding over 800 companies, we make the following observations:

1) Significant growth-oriented PE opportunities are available beyond the small number of countries in which most EMPE investments are currently concentrated.

2) Economic forecasts suggest that the EMs will continue to grow for the foreseeable future, supporting growth-based PE.

3) The returns on Emerging Market Private Equity (EMPE) are driven by growth and efficiency rather than leverage or multiple expansion.

4) There appear to be diversification benefits in EMPE related to its focus on domestic growth, low leverage and different industry coverage relative to listed markets.

5) Many of the risks of EMPE are over-stated and we provide data which places these risks in perspective.

# Presentation

We intend that this becomes a living document.

We have based the content of this presentation on conversations with investors about the issues they have when they think about investing in EMPE.

There will be other issues of interest beyond the ones presently covered, so we have used PowerPoint to make the information available as it is easy to up-date and add new information in response to requests.

We encourage you to ask us questions and, if we have the information with which to answer or provide some insight, we will add it to the presentation posted on our website:
http://www.ifc.org/funds

If you find the information useful and use it in your own presentations, we would appreciate an acknowledgement of IFC.

# Acknowledgements

It is possible to present this information due to the cooperation and hard work of a large number of people. We would particularly like to thank:

- The Managers of IFC invested funds who have been very generous in responding to our requests for information.
- The Emerging Markets Private Equity Association (EMPEA) for providing market data and insights.
- Cambridge Associates for providing benchmark data.
- Markus Taussig, a doctoral student at Harvard, for gathering and analyzing the data.

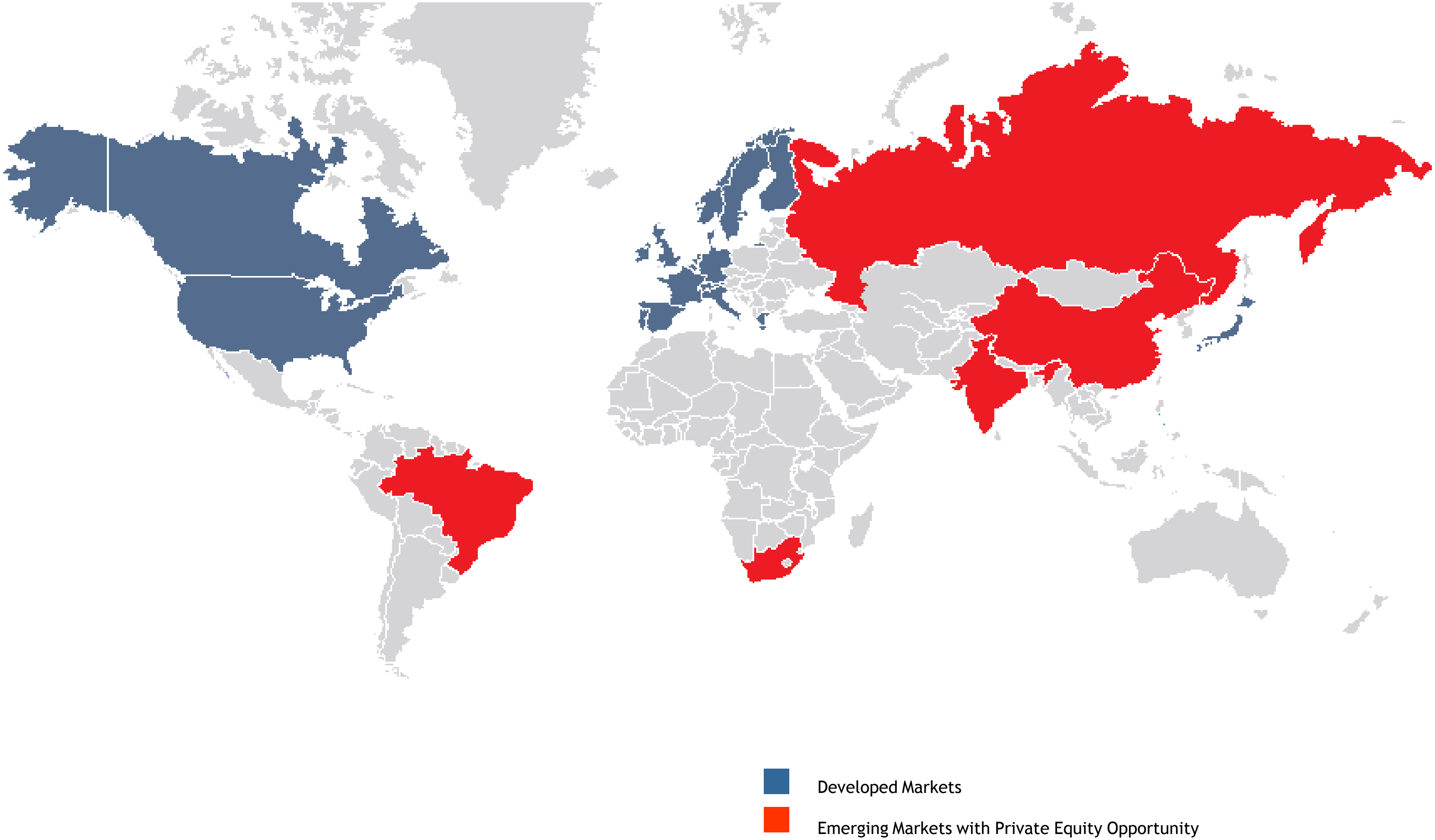
# The Opportunity is Larger Than You Think

# Both the Breadth and the Quality of the EMPE Opportunity Have Improved Since 2000

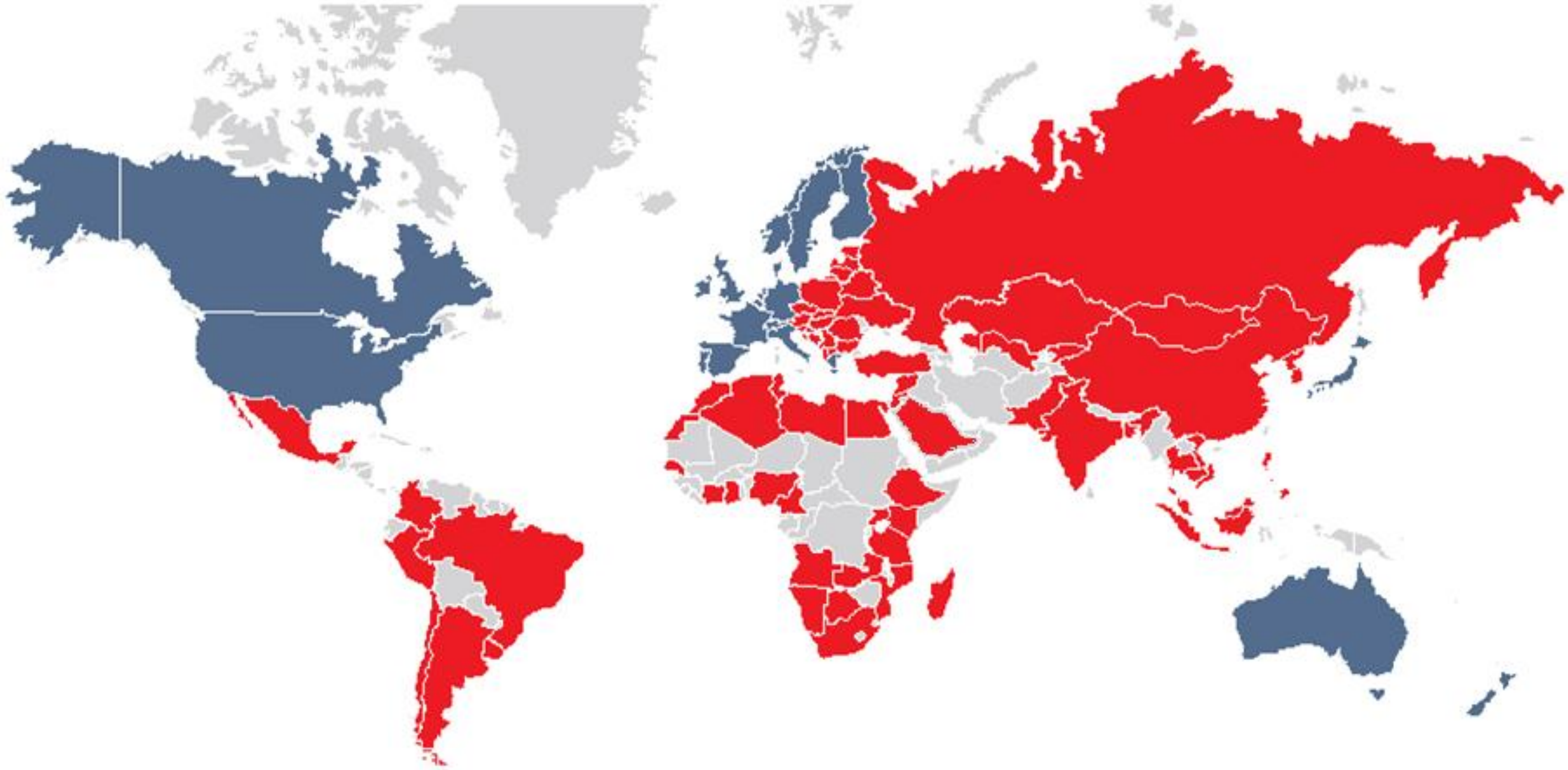
- Since 2000 the number of countries in which there is a meaningful volume of deal flow suited to PE (equity with real influence or control) has increased considerably.

- Having adequate deal flow to support local country-based teams improves the quality of the opportunity as deal origination, structuring and providing advice to the companies, can be done in close proximity and in real time by people embedded in the local market.

# 2000 - the Start of a Rapidly Growing Opportunity



# 2009 – The Opportunity is Very Broad



Developed Markets

Emerging Markets with Private Equity Opportunity, mostly single country, some regional

# What Has Driven the Growth of the PE Opportunity?

**PE requires (i) interesting businesses in which to invest, and (ii) access to equity stakes with *influence* over the business.**

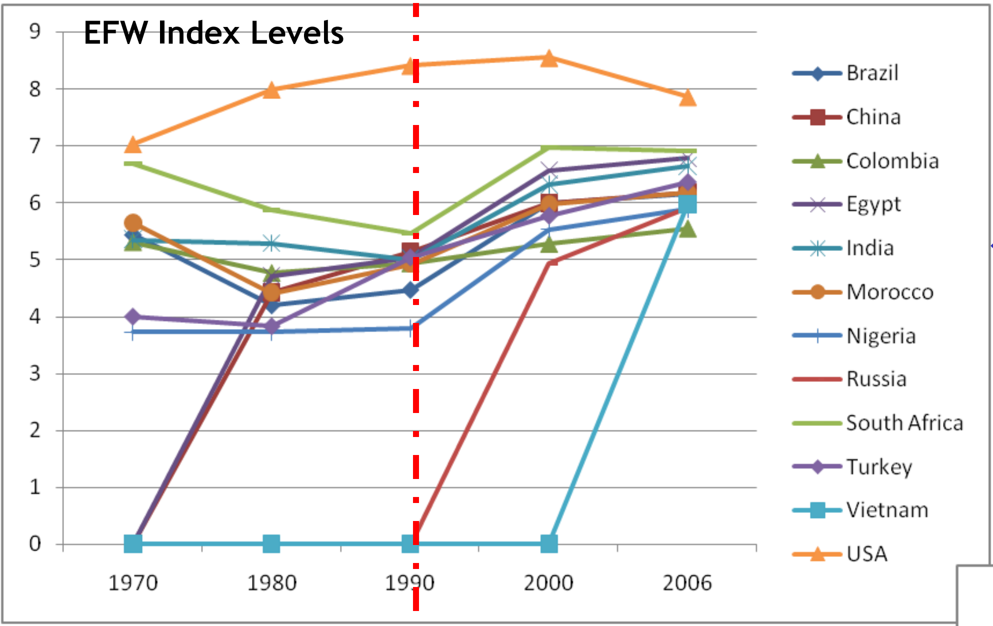
**Three trends have increased both the number of businesses and the ability to acquire influence.**

- **The move to market-based economies since the 1990s is increasing entrepreneurial activity and the number of businesses of interest to PE** **(see slide 16).**

- **The opening of trade and capital flows since 2000 increases both opportunities to expand and competitive pressure, leading to more business owners seeing third party capital as a solution** **(see slide17).**

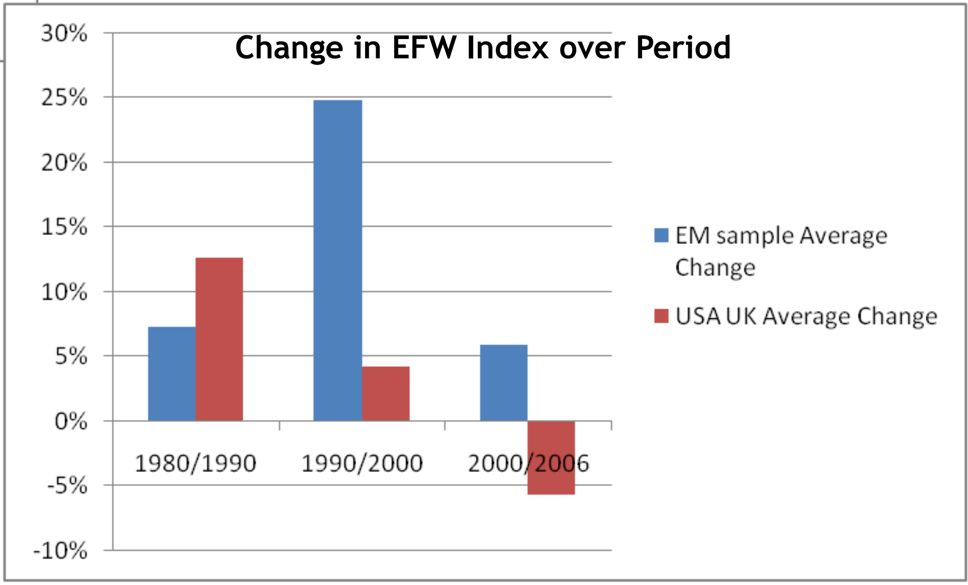
- **The close identification of family status and wealth with direct ownership of a company reduces as portfolio wealth becomes an option and is seen to work, reducing reluctance to allow in third party equity.**

# Improved Local Conditions Create Businesses




Measures of conditions for private business have improved across a wide range of emerging markets since the 1990s, leading to an increase in the number of companies of interest to PE.

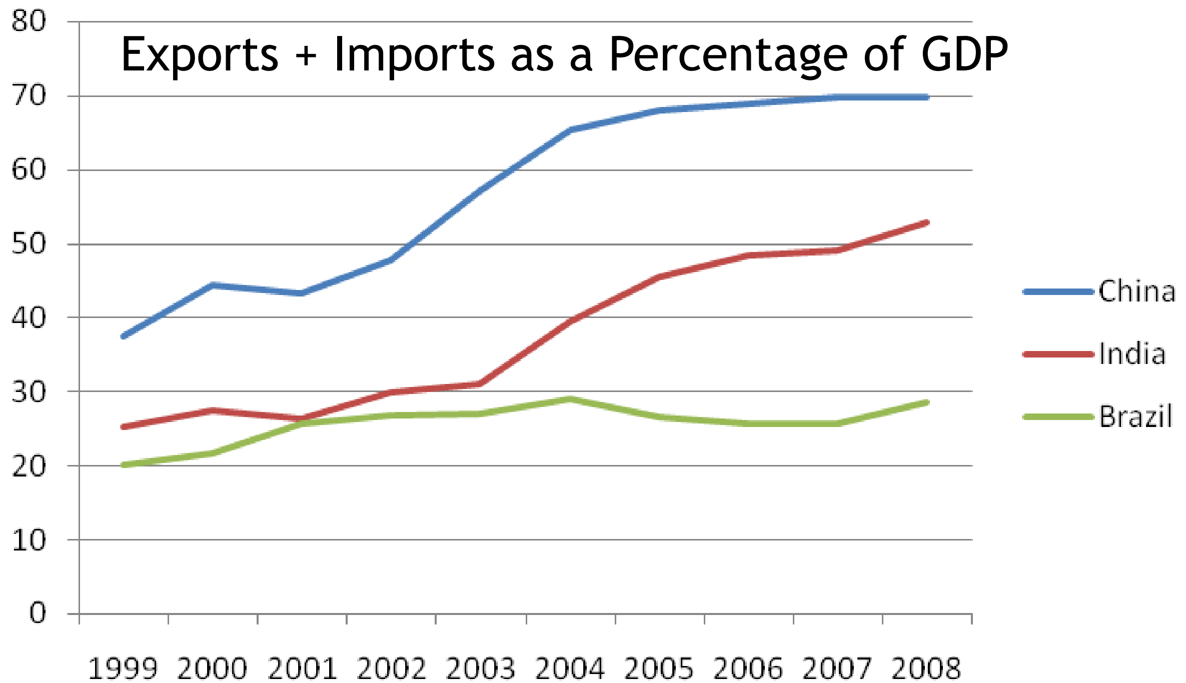
The scale of the improvement in conditions for private business in Ems since 1990 is significant.




Source: Fraser Institute, Economic Freedom of the World (EFW) Index

# Increased Openness Creates PE Deal Flow

**Emerging markets have opened their trade and capital accounts since 2000, increasing both opportunities to expand and competition in domestic markets. This creates more situations where sale of equity with influence over the business is seen as desirable by owners in order to attract the capital or the skills needed to expand, to compete, or to increase focus on core business by sale of non-core business.**

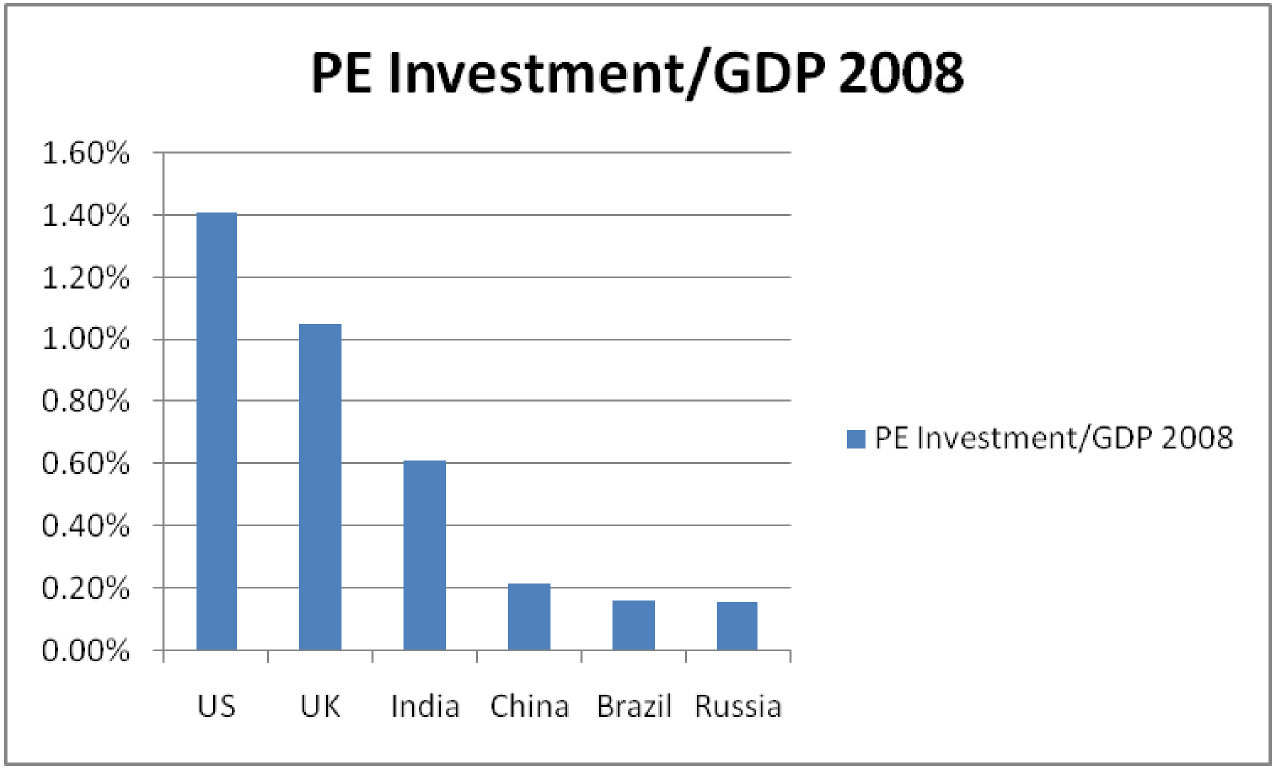



Increase Over Period

**86% China**
**110% India**
**41% Brazil**

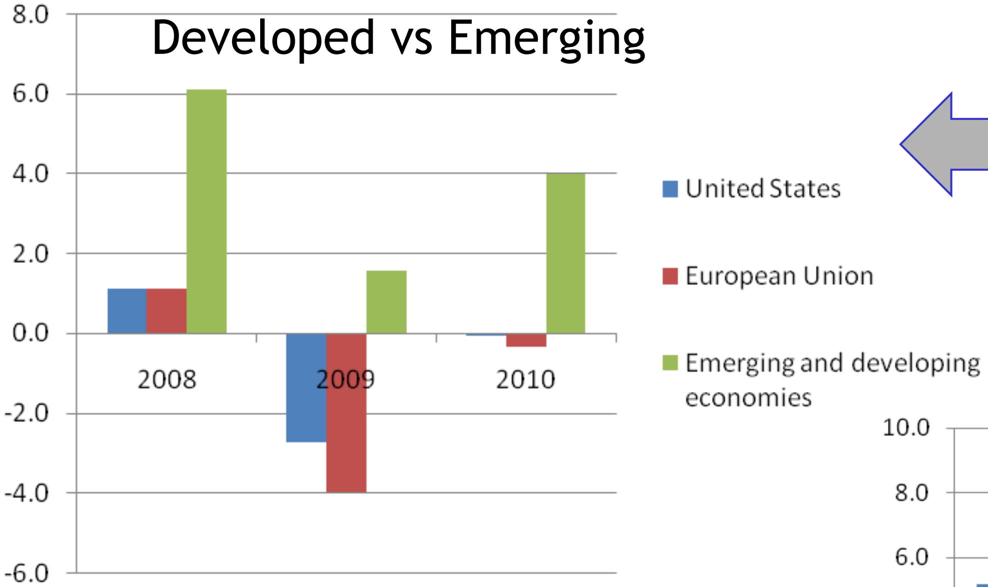
# Low Penetration – Room to Grow Further

**Even in the BRICs, fundraising as a percentage of GDP is low in EMs compared to the US, indicating much more room to grow.**



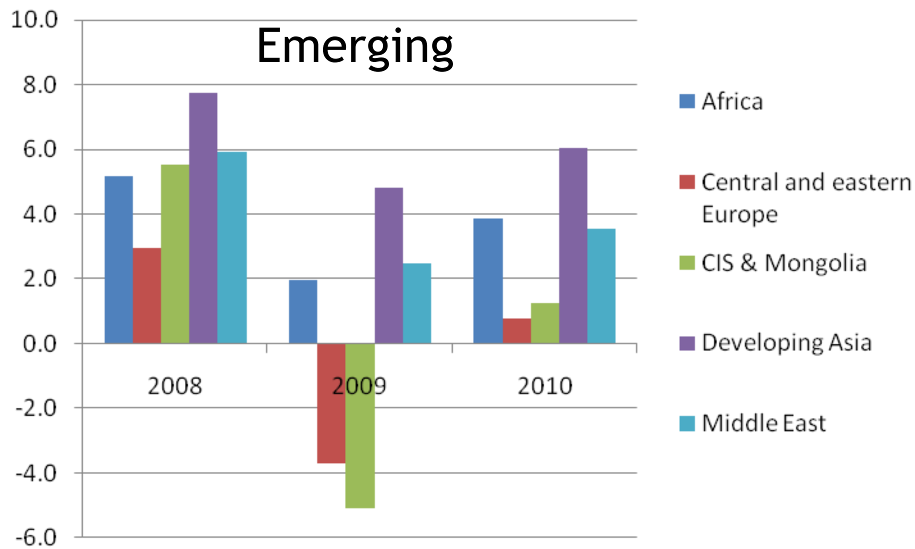

Source: EMPEA

# Continued Growth in Emerging Markets Supports Private Equity



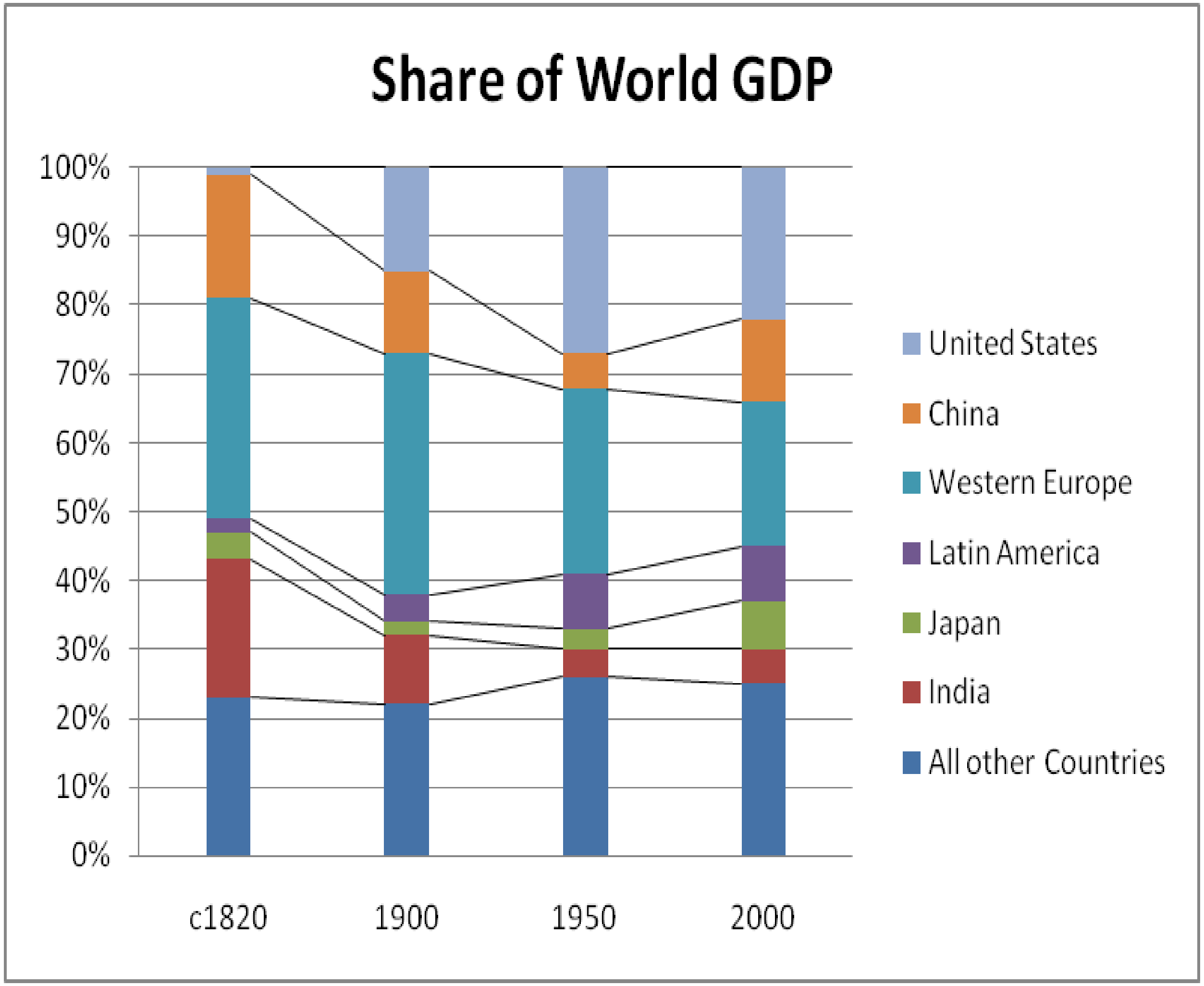

**GDP Growth predicted to continue in EMs in 2009 & 2010**

**GDP growth predicted to remain positive in most EMs**




Source: International Monetary Fund, World Economic Outlook Database, April 2009

# Share of World GDP is Dynamic




**Differential rates of growth, over time, have a significant effect on the distribution of investment opportunities**

Source: Angus Maddison, University of Groningen

# Diversification Benefits Exist: Focus on Domestic Growth Low Leverage Industry Exposure

| | All Funds Net to LP | Top Quartile Net to LP |
|---|---|---|
| Correlation US and EM Private Equity 2000-2009 * | 0.7643 | 0.4907 |

Source: Cambridge Associates, quarterly data March 2000 – Sept 2009

# There are Four Basic Ways to Create IRR

A PE fund can achieve the same IRR through any of four basic strategies: leverage, multiple expansion, growth and efficiency.

Most funds use a blend of the four.

In EMs IRR is driven by growth & efficiency (see Slide 7)

| | IRR | Equity | Cash out by Dividend , Stock Purchase etc | P/E at Entry | P/E at Exit | Revenue Growth p.a | Margin Improves from 5% to x% | Holding Period Years |
|---|---|---|---|---|---|---|---|---|
| Leverage | 25% | 30% | 55% | 6 | 6 | 0% | 5% | 5 |
| Multiple Expansion | 25% | 75% | 10% | 6 | 14 | 0% | 5% | 5 |
| Growth | 25% | 75% | 10% | 6 | 6 | 20% | 5% | 5 |
| Efficiency | 25% | 75% | 85% | 6 | 6 | 0% | 30% | 5 |

Source: IFC model

# Returns on Private Equity in Emerging Markets are Driven More by Growth than Leverage

**Higher growth and lower leverage makes the source of risk in EMPE less cyclical and more operational**

## Companies in IFC-invested Funds:

| | Emerging Markets | |
|---|---|---|
| | Median | Average |
| Annual revenue growth * | 19.5% | 37.8% |
| Debt-to-equity ratio ** | 0.33 | 0.74 |

Sample: * 527 companies in IFC-invested funds with holding time of at least one year ** 604 companies in IFC-invested funds, not including financial services

# The Growth Focus in Emerging Market Private Equity is Also Apparent in the High Rate of Job Creation and Support for Smaller Companies

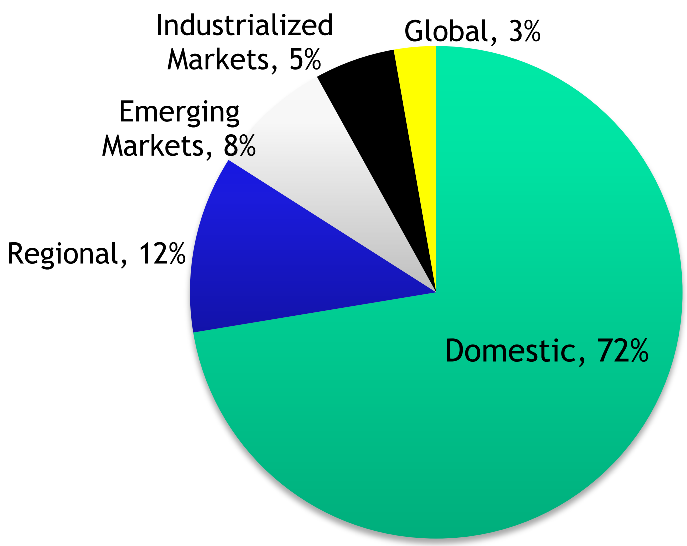
| | | |
|---|---|---|
| Companies in IFC-invested funds since 2000 | | 706 |
| Jobs created * | | 299,066 |
| Annual rate of job growth ** | Median | 11.9% |
| | Mean | 22.3% |
| Comparable regional average job growth**** | | 2-3% |
| SMEs supported (250 or fewer employees) *** | | 64% |

Sample: * 552 firms for which data on employment at entry and at exit/present is available. ** Further subset of 412 firms with holding period of at least one year. *** 579 firms for which employment at entry or exit/present is available. **** International Labour Organization

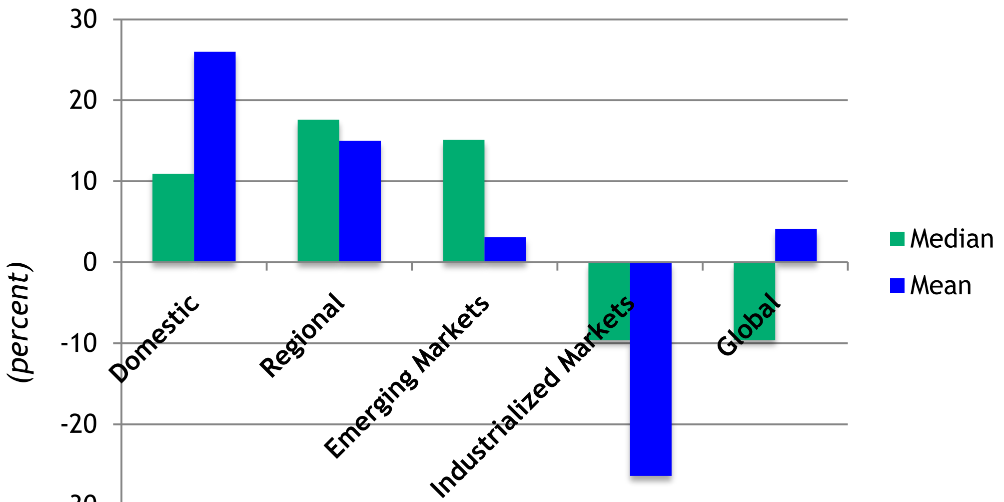
# Growing Domestic or Regional Companies Provide the Deal Flow

**As a result of the trends in deregulation and openness, most of the EMPE opportunities are companies targeting growth in Domestic markets or Intra-emerging-market growth.**

### Target Market - Focus *




### Target Market - Return **




Sample: * 833 companies with clearly indicated market focus ** 300 companies that were fully exited

# More Exposure to Consumer Growth than Listed Markets

| Market Sector | MSCI EM + Frontier index weight | IFC -backed Funds |
|---|---|---|
| Consumer Discretionary | 5.6% | 26.4% |
| Telecommunication Services | 9.1% | 18.3% |
| Financials | 25.8% | 11.8% |
| Industrials | 6.7% | 10.1% |
| Information Technology | 12.8% | 9.3% |
| Materials | 14.3% | 7.9% |
| Consumer Staples | 5.5% | 5.3% |
| Health Care | 2.2% | 4.9% |
| Utilities | 3.5% | 3.2% |
| Energy | 14.4% | 2.9% |
| Total | 100.00% | 100% |

**Source: Investee companies within IFC-backed funds 2000 and later**

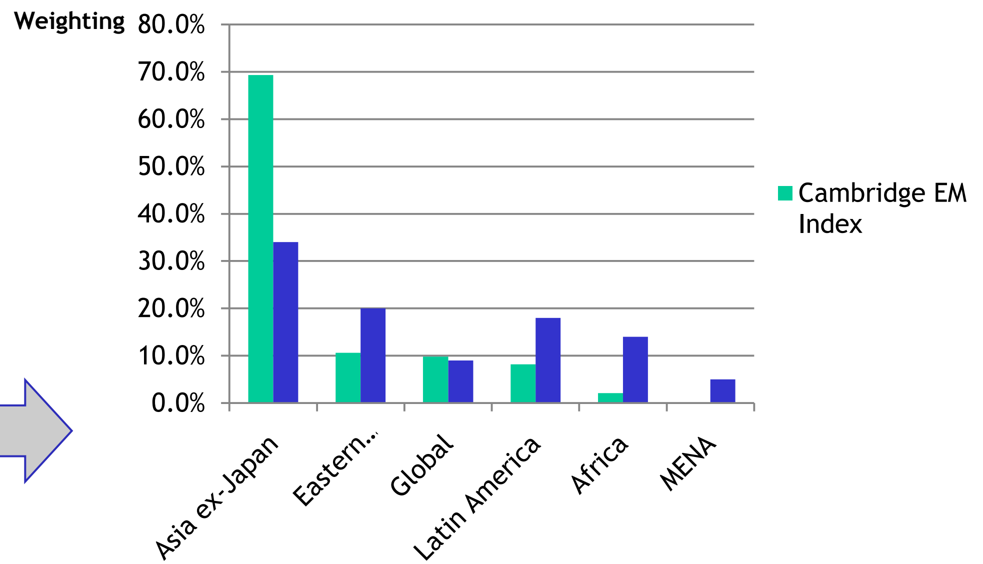
# Taking Advantage of the Broader Opportunity Improves Returns

# Private Equity Performance Benefits from Diversification

| IRR from 2000 to... | Sep-08 | Dec-08 | Mar-09 | Jun-09 | Sep-09 | Dec-09 | Mar-10 | Jun-10 | Sep-10 |
|---|---|---|---|---|---|---|---|---|---|
| IFC: Private Equity Funds* | 22.9% | 15.6% | 14.4% | 15.3% | 17.0% | 18.1% | 20.1% | 19.5% | 18.8% |
| IFC: All Funds (includes debt, real estate, etc) | 19.8% | 12.3% | 11.4% | 13.0% | 14.1% | 15.0% | 15.7% | 15.3% | 14.9% |
| Cambridge EM Top Quartile | 16.9% | 10.7% | 9.4% | 10.3% | 12.7% | 16.2% | 16.8% | 14.1% | 17.0% |
| Cambridge Asia ex-Japan Top Quartile | 14.9% | 10.6% | 6.6% | 8.5% | 9.0% | 14.5% | 15.5% | 13.7% | 17.0% |
| Cambridge US PE Top Quartile | 19.5% | 14.2% | 12.0% | 12.2% | 16.0% | 14.1% | 13.9% | 14.1% | 15.5% |
| MSCI (IFC PE Fund cash flows) ** | 8.8% | 1.8% | -1.1% | 7.7% | 12.1% | 13.4% | 13.1% | 9.6% | 13.3% |

**The Emerging Market Index has outperformed the Asia-only Index, although close to 70% of the Emerging Market Index is Asia.**

**IFC has out-performed the Emerging Market Index with a much more geographically diversified exposure.**




Source: * All *Private Equity* funds invested by IFC since 2000, calendar year. Excludes debt, infrastructure & real estate funds. Numbers differ from early presentation due to mistaken Inclusion of two non-PE funds and omission of closed fund, now corrected. ** Matching cash flows to IFC Private Equity Funds invested/divested from MSCI. Cambridge Numbers from Cambridge Associates.

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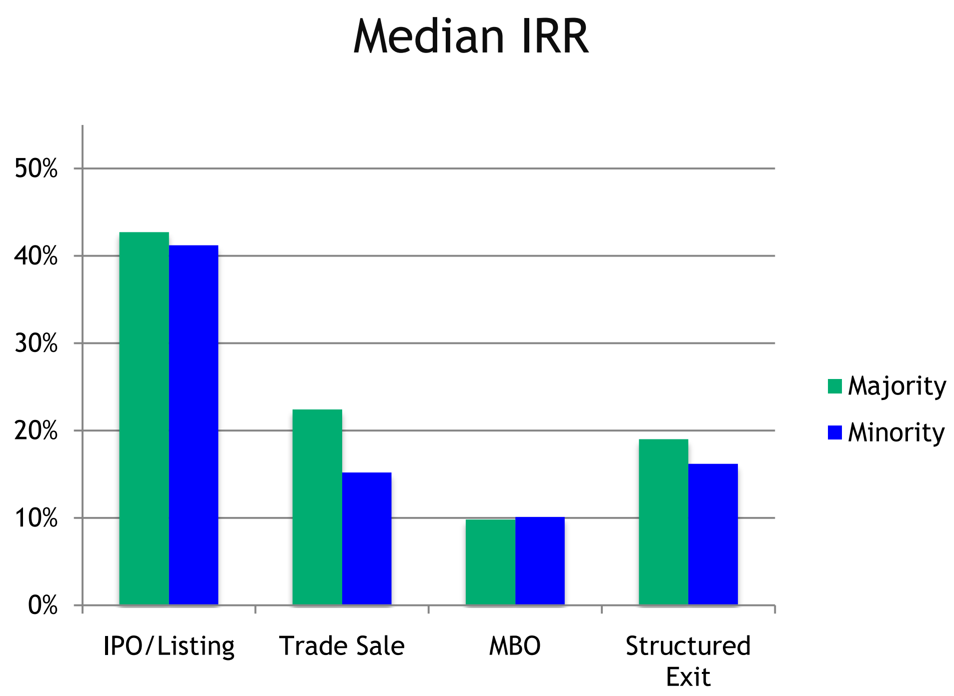
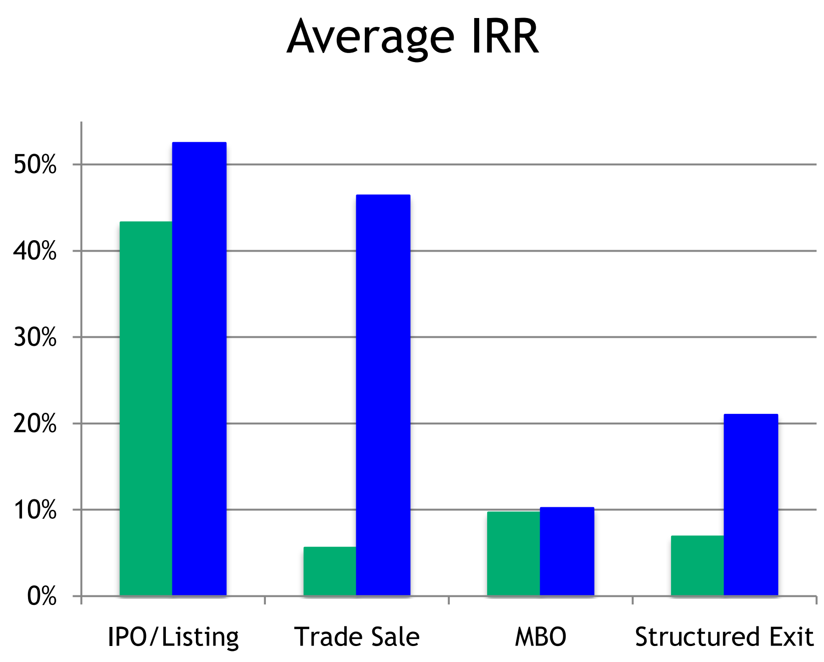
# Myth Busters: Frequently Cited Risks with Private Equity in Emerging Markets

# Minority Positions Are NOT Too Risky

**Minority positions (blue) have performed well in all forms of exit, indicating that the risks associated with minority positions can be managed effectively.**

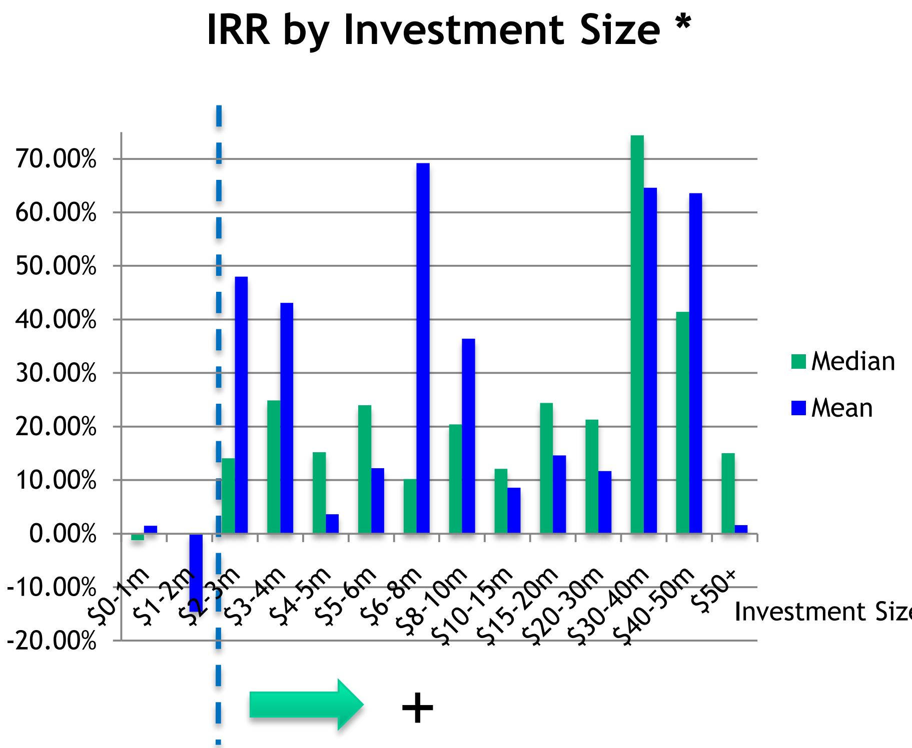


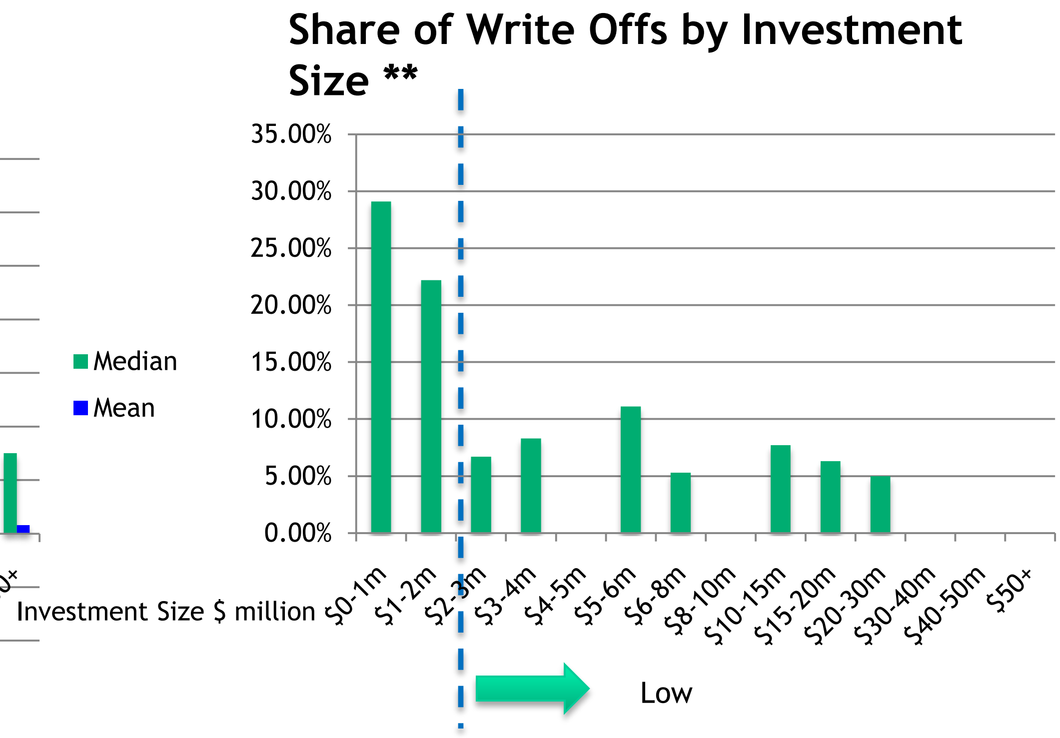




Sample: Exits of 61 majority positions and 251 minority positions from IFC invested funds

# Smaller Companies Are NOT Too Risky

**Experience in deals as small as $2 million has been positive, suggesting that smaller companies are less risky than commonly perceived.**



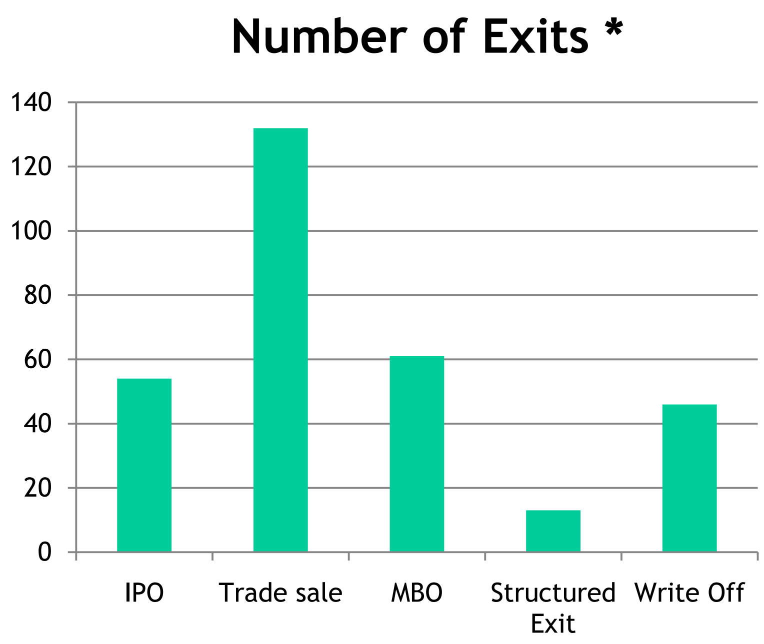



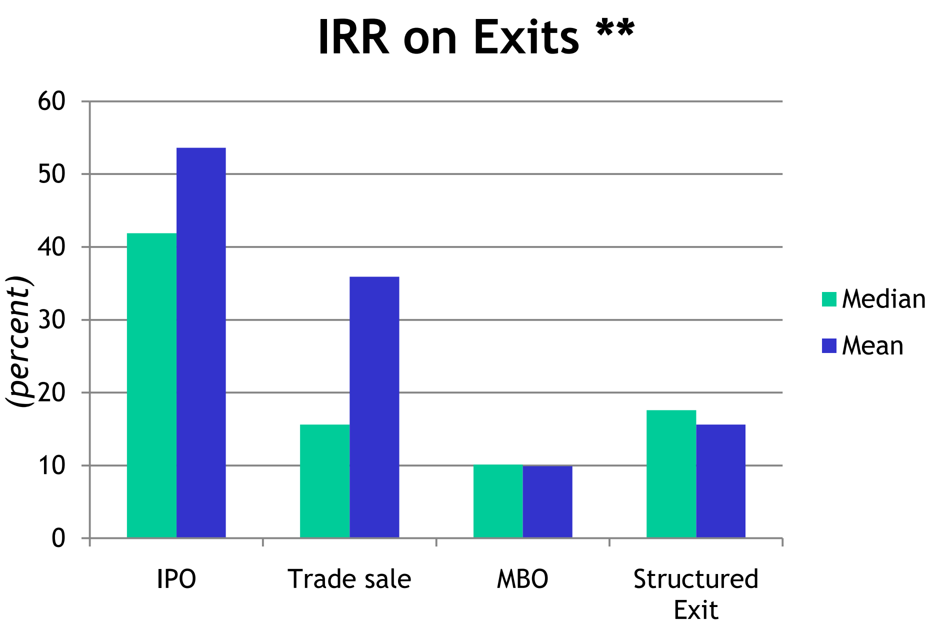

Sample: * 313 exits from IFC invested funds ** 323 exits from IFC invested funds

# Attractive Exits ARE Available

**Attractive exits are happening despite less developed capital markets, although access to an IPO improves returns.**

Average Holding Period = 4.9 years




Sample: * 325 exits from IFC invested Funds ** 266 non-write-off exits

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# A Fund Manager With the Right Skills CAN Overcome 1st Time Fund & Frontier Risks

## IFC's experience is that the differentiating factor in fund quality is the Manager's skill set, not 1st time fund risk or a frontier focus.

| | IRR as of March 2009 (simple average %) | Development Impact Score Highly Suc = 3 HighlyUn S = -1 | 1st Time Funds % | IDA % (<$1000 GDP per capita) | Average Deal Quality Score Max = 1 Min = 0 |
|---|---|---|---|---|---|
| **Top 10%** | 46.6% | 2.10 | 53% | 27% | 0.97 |
| **Bottom 10%** | -38.3% | 0.14 | 53% | 13% | 0.17 |

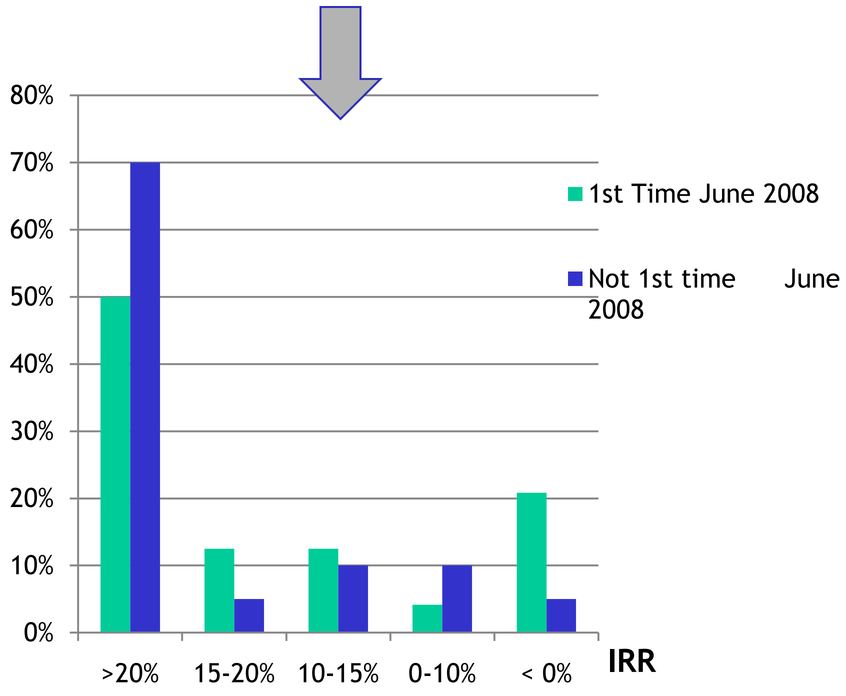
The Same

More Top 10% in the Frontier

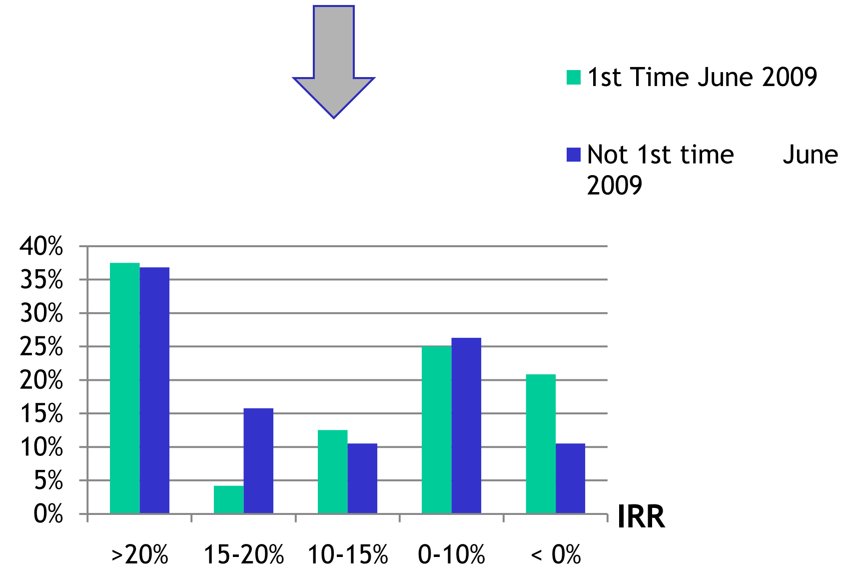
Sample: 150 Funds currently in IFC portfolio, excluding those in the J-curve

# First Time Funds are NOT as Risky as Expected

## Pre-Crisis 50% of 1st time funds backed by IFC had IRRs above 20%



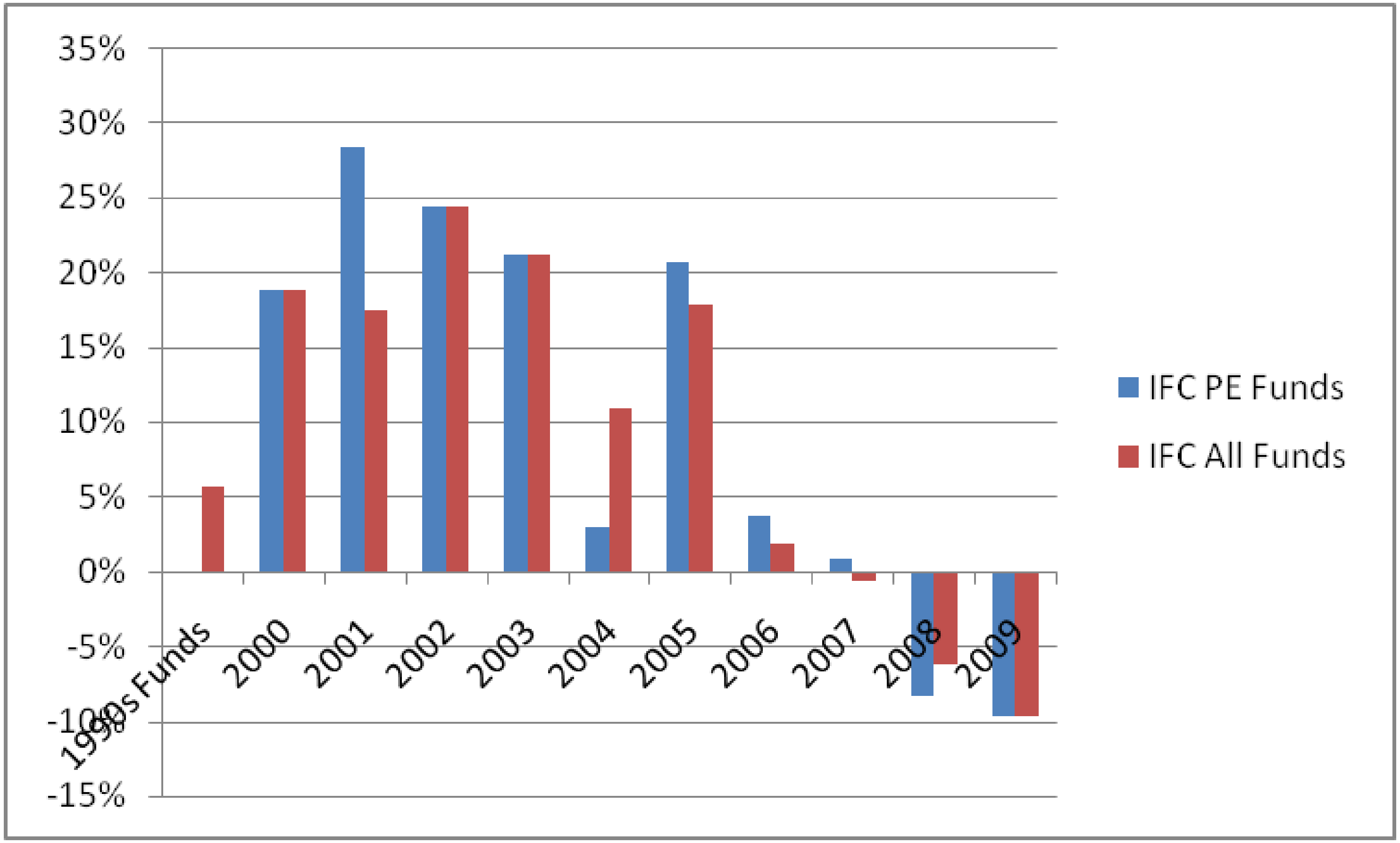

## Post-Crisis the return distributions for 1st time and non-1st time funds are similar, suggesting 1st time managers have been able to manage through the period.




Source: IFC equity fund investments since 2000 matured enough to be out of the J-curve

# It Does NOT Take Longer to Exit the J-Curve

Net IRR




Source: IFC fund investments by Vintage Year as at Dec 2009