Country, regional or global funds?

Is there a right or wrong approach to gaining exposure to private equity's emerging markets? Lisa Bushrod reports

Commitments to funds investing in emerging private equity markets have grown dramatically in absolute and percentage terms over the past four years and the indications are that 2007 will see this trend continue. (Just US$3.5bn was recorded as heading into emerging private equity markets in 2003 and by 2006 this figure had jumped to US$33bn.) On top of these commitments, a survey in May this year conducted by the Emerging Markets Private Equity Association (see data section this issue) found that around half of limited partners surveyed not currently invested in private equity funds in emerging markets were actively watching even the earliest stage markets of Africa and the Middle East.

But given the relative immaturity of the private equity asset class outside the long established markets of North America, Continental Europe and Australia, New Zealand, Korea and Japan, many in the private equity advisory community are themselves on a steep learning curve. This may explain why there is something of a debate going on within the industry as to whether country funds, regional funds or global funds are the way to build an emerging markets focus in the private equity asset class.

James Seymour, who is a managing director of EMP Global's fund-of-funds practice in Washington, says: "We would prefer a country fund over a regional or global fund, but it is also determined by the size of the market opportunity. For example, I would prefer that the Philippines be handled from a regional fund given the limited investment opportunities, but it makes sense to have a Greater China only fund given the much greater size and complexity of the opportunities."

Since private equity is just beginning to come into being in the emerging markets, the scale of the opportunity, relative to most developed markets, is small. Hence, big is beautiful in terms of the private equity opportunity for emerging markets: the bigger the country, the greater the private equity opportunity is likely to be, from potential deal flow to number of PE firms active there. Mounir Guen, CEO placement firm MVision, says: "BRIC countries will be the first area of focus and from that [LPs are] looking at larger emerging market economies."

Even though fast economic growth countries with large populations, like Brazil, Russia, India and China, are an obvious starting point, as evidenced by the EMPEA survey, many investors are spending considerable time monitoring the potential of markets new to them before moving in. Bruce Chapman, a partner at placement firm CP Eaton's London office, says: "I think a lot of investors are at an inflexion point where they have been actively reviewing the [emerging] markets for some time and are starting to commit, often to country funds in places like China and India and develop that into a full scale investment programme. They will cherry pick brand names in those countries before going on to less well established managers, as that is still an area that many investors are cautious on."

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But the country funds route is not going to suit everyone. "Very large investors simply cannot invest into country specific funds simply because they are too small. So they have tended to use regional funds and fund-of-funds as an access point and then cherry pick the large funds," says Chapman.

And for those funds that can commit in smaller amounts it's probably harder to make a batch of country fund commitments purely from a resources point of view. To do the analysis in-house is time consuming, tying up often limited resources and to outsource it carries an additional cost burden. And, as Guen points out, the country fund approach carries an inherent risk. He says: "On the strategy of investing on [an emerging market] country fund basis in some countries the jury is still out. To claim you can identify which market will be in the right cycle can be a fairly tall order."

And, as always when building a portfolio of investments, there are diversification issues to take into account, which in a private equity sense will be driven by investors' individual circumstances, such as enough capital to diversify sufficiently across country funds and geographic regions. So an

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obvious solution here is the fund-of-funds route. But the traditional North American and European fund-of-funds managers, in the most part keen fans of a combination of US venture and European buyouts where historically the best returns have been found, have been slow to embrace the new private equity world. But that has left the door open for others to step in.

Chapman at CP Eaton, which recently raised the Asia Alternative fund-of-funds vehicle, says: "Some of the newer fund-of-funds managers from the region are of very high quality. Often they have teams that are not just fund-of-funds but also have direct investment experience, which is rare to find in a fund-of-funds manager. You build networks and relationships in Asia by being a direct investor that makes you better able to reference people in Asia. Making reference calls on anyone in Asia; it's extremely difficult to get a clear and full picture. Culturally I think there is a far higher degree of reservation about giving an opinion on someone. You need a strong relationship in order to persuade someone to give an opinion."

If an emerging private equity market fund-of-funds is one answer, another might be a regional fund manager or even a global one. By and large there's an acknowledgement that regional funds only make sense where there is a grouping of countries that have some common linkages, such as language, currency or trade. Global funds, on the other hand are all the more complex.

Global funds dedicated to emerging private equity markets tend to fit into one of two categories. They either have preferred countries for investing in and people on the ground that serve those countries (or small regional groupings of countries), or they like sectors and go into countries on the basis of the attractiveness of the operators within a particular country. The other category is the global mega funds that predominantly invest in North America and Europe but seeing the high growth rates and investment opportunities, they are increasingly being attracted into the emerging private equity markets space.

Seymour at EMP says: "There are increased difficulties in managing a global team whether it be a team of suitcase professionals or a collection of teams on the ground in various countries around the world. The difficulty in managing multiple cultures across distances and time zones and keeping everyone happy and appropriately compensated is magnified as you move along from country fund, to regional fund, to a global fund."

A mix of cultures and boundaries definitely bring challenges for investors and their advisors when undertaking due diligence on private equity fund managers in these markets. And to get a complete picture often involves more footwork than some may have come to expect in developed markets. Chapman says: "In Western markets you have generally always looked for an independent highly motivated, high skilled team. While you want all those components from an emerging markets manager sometimes you have to view them slightly differently to see them."

While the top level view on country versus regional versus global funds have to be taken into serious consideration, as always it's the deals that get done and what sort of impact they have on a fund's performance that matter.

Seymour at EMP says: "We make an initial assessment of the appropriateness of a fund for our portfolio on three levels: transaction size; management of the firm; and the breadth and depth of local connections and resources for deal sourcing and execution. Transaction size is a major driver in our assessment because we believe investors should be more interested in cash on cash return rather than just IRR. You cannot spend IRR and from a simple mathematical standpoint the larger the transaction the harder it is to achieve a 2.5x return. I say this cautiously because some of the larger transactions, particularly in the developed markets have delivered very good cash multiples and IRR's over the last few years, but have been dependent on the heavy use of leverage and with the credit squeeze we will see less of that in the future."

It's not just size that matters, as Guen of MVision points out. He says: "There is an underlying difficulty in the emerging economies; they are initially more infrastructure and growth expansion focused. Whereas, historically in the industry, the best performance comes from influence and control and the ability to drive your investments."

But for one global emerging private equity markets manager, Actis, the view is that influence and control, in the form of the buyout mechanism, are going to be part of the equation going forward.

"We believe strongly that control deals and buyouts are a significant part of [the emerging private equity] stage. In India and South Asia we have done five buyouts (there have been 13 in all), in South East Asia we have done three buyouts, and six in South Africa and one in Egypt and one in Zimbabwe. The emergence of control deals is a growing trend," says Jonathon Bond, who heads Actis' investor relations function.

A defining characteristic of an emerging market is probably one that is fast moving and therefore the goal posts are likely to keep moving. If buyouts do become an integral part of the scene in the emerging private equity markets, as many LPs and GPs moving into these territories hope, this will amount to a new tool for these markets to get to grips with and there will inevitably be teething problems along the way. And some of the managers that have been in these markets for a long time may also find the transition from an emerging to a developing market hard. "As emerging markets develop, the challenge for local groups is to be able to evolve. Local groups either have a really dominant position in their [size] market and they can adapt and move onto larger transactions so they have the ability to do any size deal in their country but will also do some of the more mid sized deals," says Guen.

Part of the lure of emerging markets, namely their impressive economic growth rates, is serving to further complicate the picture for investors. In short, there's more than the suspicion that some managers are riding the economic growth, able to turn in impressive performance figures on their funds while themselves adding little value to their portfolio companies; something they would not get away with if they were operating in a low or slow growth environment.