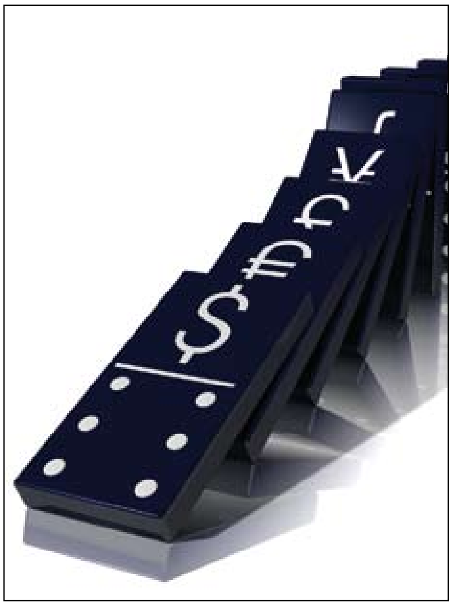

Global viewpoint: the year that shook the world

Even if it started well for emerging markets in particular, 2008 will go down in history as a year that many would prefer to forget. Several months on, the question remains, 'how much of an impact will private equity in emerging markets feel in 2009?'

As we went into 2008, the prospects for emerging markets were looking rosy. Spiralling oil and commodities prices were boosting the reserves of many of the governments badly in need of capital for infrastructure spend, such as those in Russia, Central Asia, Latin America, the Middle East and Africa. Large-scale development projects were being completed or announced that were boosting growth rates and also creating opportunities for investment by nascent local private equity managers as well as the global buyout titans.

More developed markets were looking shaky as the credit crisis was starting to impact Western firms' ability to do deals, but there was plenty of scope to expand into emerging markets, they reasoned. Faced with moribund markets at home and lured by the prospect of ever-growing pools of capital abroad, investment bankers and private equity houses set up shop in some of the key emerging market cities, with the phrase "Mumbai, Dubai, Shanghai or bye-bye" becoming a common refrain among financial services workers.

For their part, LPs across the world had really started to warm to the idea of investing in emerging markets. The previous year had seen a record US$59bn committed to private equity funds destined for emerging markets, according to the Emerging Markets Private Equity Association; nearly double the US$33bn for 2006 and up substantially from the US$3.5bn recorded in 2003.

Then the unthinkable happened. Wall Street came crashing down as Lehman Brothers folded, bringing with it a crisis of confidence in the financial sector that is still working its way through the global system. Credit evaporated, leaving businesses exposed and developed economies dived headlong into recession.

If the scale and speed of the collapse of the West's economies came as a surprise, its effects on emerging markets will have shocked many, not least those with capital invested there. As problems escalated at home, many foreign investors in emerging markets stock markets withdrew capital, with dramatic effects. "Foreign capital was the driver of growth in some emerging markets, such as CEE," says Marc Bennett-Coles, managing director, development, at AON. "These regions have now seen a flight of capital, foreign money is no longer there and stock markets have crashed by over 50%. In the MENA region, stock markets crashed by nearly 60% in just November and December last year."

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"The first three-quarters of the year was the busiest period we've ever had in emerging markets," says Tihir Sarkar, partner at Cleary Gottlieb. "But activity slowed dramatically at the end of the year. In some ways, the emerging markets fell quicker than more developed ones as the withdrawal of foreign capital gathered speed and the drop in demand for exports made itself felt."

The decline in demand for oil and commodities has also had an impact on many economies. Russia is a case in point. "In Russia, the macro-economic deterioration was particularly marked," says Leon Hadass, principal at Pantheon Ventures. "The first half of 2008 was still very positive as commodity prices were at record highs and oil revenues were filling the state's coffers. Following the Georgia conflict in August and the collapse of Lehman Brothers in September, however, the country saw sharp declines in the stock exchanges with foreign capital fleeing the Russian market. The Russian Central Bank then saw its reserves depleted as commodity prices plummeted while the state tried to avoid a substantial rouble devaluation."

Meanwhile, the nascent debt markets in emerging markets were cut off barely before they developed; extinguishing the hopes of many of the larger global PE firms of rapid expansion outside Western economies. "To the extent that there was any debt available for private equity deals in emerging markets, that disappeared by the end of Q3 2008," says Peter O'Driscoll, partner at Orrick. "Lion Capital's acquisition of Russian Alcohol in July 2008 was the last large transaction in a short-lived trend."

In short, the idea that had grown up over previous years that emerging economies were operating on a different cycle from the West has proven to be a fallacy. "Last year was one of two halves for emerging markets," says Peter Schmid, partner at Actis. "There was a view at the beginning of 2008 that emerging markets were in some way decoupled from the rest of the world; that myth has now been debunked. We still expect there to be growth at a time when more traditional markets are sliding into reverse, but it will be half what had been expected." Indeed, the International Monetary Fund has recently downgraded GDP forecasts for 2009 for countries such as India, which has reduced from 8% to 5.6%, South Korea has gone down from 4.7% to 0.6% and China from 9.3% to 7.4%.

In the West, private equity firms were hit with a double whammy. Many portfolio companies started feeling the pinch and valuations took a nosedive. Meanwhile, LPs were causing concern: many fund investors found themselves facing liquidity issues as their private equity allocations were kicked out of kilter as the lack of exits meant distributions were all but absent. Not to mention the impact public equity falls have had on asset allocations.

The global fall in fundraising had already started before the events of September. "Fundraising collapsed in the spring of 2008," says Oliver Tant, global head of private equity at KPMG. "There were no specific private equity market circumstances to prompt this, although it may have been a realisation that numbers were down in the December 2007 reporting rounds from firms. LPs were also seeing the effects of the slowdown of realisations and were faced with the question of where to invest the limited liquidity they had."

Mounir Guen, CEO of MVision, agrees. "LPs stopped investing in about May last year," he says. "They had used their 2008 allocations in the boom year of 2007 and so had asked GPs to wait until September, when they could start committing their 2009 allocations. Then Lehmans happened."

With the prospect of leaner times stemming from lower returns or outright losses from their portfolios and a distressed investor base, many started reducing headcount. The last quarter of 2008 and early 2009 saw the likes of Cerberus Capital Management, Sun Capital, Blackstone, American Capital, 3i, Carlyle and Cognetas cut staff by between 5% and 20%. It was a move mirrored in some emerging markets, although to a lesser degree. Dubai International Capital and Istithmar World have both axed staff.

With portfolio companies closer to home keeping them busy, the doubt arose as to whether some firms' expansion into emerging markets would last. Carlyle has closed its Central and Eastern European operations. Some think it may be the start of a trend. "The skill set required for success in emerging markets is very different from

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that required for large deals in the US or the UK," says O'Driscoll. "The question of whether large buyout funds will be successful in some of these markets has been on the table for some time. Those that are exclusively focused on emerging markets, especially those with a diversified international flavour, are likely to be best placed to take advantage of the opportunities we will see."

Others believe any cut-backs may be only temporary in nature. TPG, for example, has recently reshuffled its emerging market operations, following some disappointing investments in Asia in particular. "Global private equity firms will be taking a hard look at their emerging markets operations," says Stefan Hepp, CEO and founder of SCM. "They have been making double the returns of developed markets, but with the distressed opportunities in more traditional markets, their need to invest elsewhere will decline. They won't stop investing there, but they may trim costs. Over the longer term, however, they know they need to be there for when we see the next upswing."

Yet even that scenario only holds true as long as these firms remain in favour with LPs. "We will see a shift in the players perceived to be good investors," says Tant. "Some have damaged their investment records by having an overexposure to investments at the top of the market. We will see institutions that were champions of the

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sector dwindle and maybe even disappear." Whether those that wish to capitalise on distressed opportunities in more developed PE markets will be supported by their LPs remains to be seen: making money out of such opportunities against a background of slow growth and general economic uncertainty is a whole different skill set to growing sound companies in a bull market, which is all these managers have known for the past seven or eight years.

For local managers, the prospects appear mixed. Fundraising numbers for 2008 still look very positive; the latest EMPEA figures show emerging markets funds raised another record total, US$66.5bn. Those such as Actis' US$2.9bn emerging markets fund, closed at the end of last year, will have boosted the figures. There are still 371 emerging markets managers seeking US$144bn, but EMPEA predicts 2009's figures will be significantly down on 2008, suggesting that many of these firms will be disappointed. "There will be a big clean out of funds, particularly in emerging markets, where many don't have a long track record and therefore won't be able to raise successor funds," says Hepp. "We will also see a rearrangement, where funds that used to be considered the best are no longer in the top league. Some of the industry's gold-plated names have lost their shine, although it's too early to tell if that is a blip or a permanent blot on their copybook."

Yet for those with capital, 2009 and beyond could be a period of opportunity, even if they are forced to take a more sober approach to their investments. "At the beginning of 2008, there was a lot of enthusiasm for emerging markets and risk wasn't being priced appropriately, especially in India, China and Russia," says O'Driscoll. "Now, investors will be much more risk averse and will structure deals and investments with a view to mitigating risk. They can do this now, because there is far less competition. Hedge funds, which had become big players in emerging market private equity investments, are no longer there."

He adds: "In early 2008, the competition for deals meant entrepreneurs were able to successfully play off one fund against another. There was a race to the bottom; funds gave up a lot of rights and minority protections in exchange for the chance to invest in businesses and the balance of power was clearly with the target companies rather than the funds. It reminded me of the US venture capital market in 1998-1999."

With sources of capital, from bank finance to public markets, private investors and many competitor private equity funds now increasingly rare, those with local knowledge, networks and funding will have the pick of the best companies to invest in. If latter part of 2008 was a year to forget for many, the second half of 2009 could be a highly memorable one; for all the right reasons. Cause for optimism includes not only the fact that many PE opportunities are linked to the ongoing medium to long term infrastructure spend required among many of these economies but also the fact that the increasingly important emerging middle class, and its domestic spending power, is not expected to dwindle but grow in the short to medium term.

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