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The New Emerging (Fundraising) Market

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After several heady years of growth in fundraising – which peaked in 2008 with 210 emerging market funds raising over $66.5 billion – the wave of private equity fundraising came to a halt in the face of the perfect storm. The sector had seemed to offer a silver lining following the start of the credit crunch in 2007, with funds in China, India and other global markets promising high sustained growth with neither the risk of nor reliance on hard-to-obtain leverage. The breadth and depth of the ensuing global economic crisis, however, soon dispelled any notion of a decoupled market.

For many limited partners in the West, the emerging markets are currently inconsequential in a world in which private equity closer to home is taking a big hit, causing pain in their portfolio but also providing value investing opportunities in more familiar markets in North America and Europe. The relative weighting of the BRIC economies and other frontier markets in their portfolios is not going to move the needle. Although many LPs recognize that longer term this is where global growth will come from, in the shorter term, emerging market funds are going to have a tough road fundraising.

In the first quarter of this year, overall private equity fundraising reached its lowest levels since 2003. That year, emerging market funds accounted for a mere $3.5 billion, or under 3.5% of the total funds raised, while last year it accounted for over 11.6% . While that percentage has come down a little in 2009, investor surveys and our own research have shown that at least half of the active LP community will be increasing commitments to the space. Nevertheless, in a climate of economic uncertainty, compounded by the denominator effect as total assets under management have shrunk, investors realize there is no first mover advantage for them. If the grief doesn't come from the market, it may still come from boards and investment committees questioning their timing.

Over the last two years, the average time it has taken for a fund to get closed has gone up from 12 months to somewhere between 18 and 24 months. Even then, there is a survivorship bias, as these figures are for the funds that actually managed to have successful closings and ignore the large number of funds still out in the market – officially over sixteen hundred as of September '09 (with half of these having wishfully expected a final close last year) with countless other in seemingly perpetual "pre-marketing mode" waiting for the tide to turn. With a focus on secondary investments (some of which are trading at no cost in exchange for taking over unfunded capital commitments) and distressed investments (which arguably comprises the entire asset class at present), LPs have much less of an already reduced cache of dry powder to put to work on other primary investments – maybe 25% of what they had last year. And of course re-ups will continue to be their first priority although there will be some rebalancing and triaging on that front.

Emerging market managers will have an additional challenge. Many of the success stories of the last several years were built on passive minority deals that enjoyed the benefit of a bull market. Today, the back-to-basics approach of most LPs will require GPs to prove that they have real private equity skill sets. They will have to demonstrate an ability to create value at every step of the investment process and apply an owner-operator mindset to their portfolio companies. At a time when liquidity is at a premium, they will need to demonstrate the potential to deliver returns that on a risk-adjusted basis outperforms the public markets.

However, even first-time emerging funds –well-prepared and of the right quality – can, with the right help, get funded.

The slowdown coupled with a combination of increased regulations, bank restructurings and a political fallout from a US pension scandal have hit the placement industry hard. Some venerable names have disappeared while others are keeping their heads down and focused on their bread-and-butter business, but a handful of established full-service agents recognize the potential of emerging markets. They understand that the less efficient, often underinvested, demographically favorable markets of Asia, Latin America, the Middle East and Africa with their rising middle classes, can provide the growth that the more developed economies simply cannot at present.

A placement agent with experience in the relevant markets over different parts of the cycle can help a GP communicate with and manage the complexity of existing investor programs. They can provide insight into prospective investor programs that seemingly have minimal interest in new GP relations. Importantly they can often help craft the narrative needed to navigate LPs' initial screening process to enable them to prioritize the opportunity. Agents who have gained LPs' respect by having in the past identified highly differentiated managers that would be additive to an investor's private equity portfolio should be able to demonstrate that you are suitable for that particular program.

In many ways, even for experienced managers, fundraising today will take them into uncharted waters. The world has changed and while the destination remains the same, the journey will always be different. One thing is certain. This will take a little longer and will require more endurance and more patience – and a good guide.

[1] EMPEA Emerging Markets Private Equity Fundraising and Investment Review 2008
[2] EMPEA Emerging Markets Private Equity Fundraising and Investment Review 2008
[3] Preqin Private Equity - Funds in Market