

SAMPLE

EMERGING MARKETS OPPORTUNITIES FOR PRIVATE EQUITY: EXPLOITING NEW FRONTIERS

By Dr Nick Skrekas

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Nick Skrekas writes extensively on private equity, distress and alternative investments. He was Athens Bureau Chief for Thomson Financial News until recently. Nick has lectured for Euromoney Legal Seminars on cutting edge financial and legal topics and has also acted as an EU expert on corporate advice and legal policy programmes. The author has worked as a corporate banker and analyst at bulge-bracket investment banks in emerging markets, as well as a legal practitioner in top-tier law firms in financial capitals. Nick also has superior postgraduate qualifications in law, applied finance, investments and economics and is also the successful author of a Thomson Reuters report on distressed investments, among other topics.

Acknowledgements

This report could not have been accomplished without the understanding and love of my wife, the unwavering support of my parents, and the assistance of my friends and relatives. I also thank the more than 60 professionals who agreed to be interviewed and added their insights and wisdom to this worthy effort.

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First published 2010 by Thomson Reuters, Aldgate House, 33 Aldgate High Street, London EC3N 1DL, UK

Typeset by: Nita Webb, Nicola O'Hara, Angela Allwright and Bina Brown

Printed and bound by: Ikon Office Solutions, Coulsdon, Surrey, UK

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Executive summary

The following is a point form compilation of the major findings in each chapter of the report.

Positioning for the recovery

- ▶ Emerging market (EM) PE portfolios are suffering and GP investors are seeking additional liquidity or readjusting portfolios.
- ▶ EM had the advantage that they never really relied on leverage, but the mature market PE model was heavily reliant on debt, but even so financing has stalled.
- ▶ EM PE will increasingly be confined to the well screened and the most selective companies, for superior quality assets and by adding value.
- ▶ Across Asia and Latin America where there has been no systematic banking crisis, many PE funds have been able to refinance companies more easily.
- ▶ But some countries such as Russia did experience a degree of credit crunch and there has been distress as well.
- ▶ Distress funds and emerging markets funds will be the winners in due course for institutional investors that will need to invest their capital for returns.
- ▶ Brazil and China are rebounding and India is working out well, but Russia is moving in the wrong direction for political and economic reasons.
- ▶ The 'V'-shape recovery in emerging markets will boost demand for consumer durables, commodities and resources.
- ▶ These emerging market durable companies tend to attract more PE growth capital even if those in distress may offer bargain basement entry points.
- ▶ In sourcing deals some PE funds have built on 20 years of company relations, so they have an advantage and are not usually bidding for assets.
- ▶ EM PE funds will face more competition for deals from US and Europe PE firms reinventing themselves.
- ▶ PE investors have been affected by inconsistent portfolio companies, but over the course of the last 18 months defensive sectors have fared better than others.
- ▶ In Russia, due to the driving influence of oil and related services, industrial production fell during the crisis and the country took a hit.
- ▶ Brazil has been resilient but commodity exports have been affected.

“No one should expect that things will get back to normal any time soon even in emerging markets PE”

markets will be the winners in due course for institutional investors that will need to put money to work.

But no one should expect that things will get back to normal any time soon even in emerging markets PE. It will take a few years to get back to the good old days of 2007 and 2008. We may have lost about three years of growth in businesses that may only return to those levels in 2011. Visibility is low and the crisis will continue for varying periods in different regions and countries, even if emerging economies show positive green shoots.

The relative position of emerging market countries

The first wave of investing in emerging markets in the 1990s turned out to be less than a sparkling vintage of portfolios and returns. They turned out to be underperforming compared to developed markets. The second wave of emerging market PE investments occurred in 2004 and 2005 and it is premature to say how well these investments have done, even if they appear more promising. In terms of fundraising and investments the emerging markets that are most successful are the ones that have good institutional and legal frameworks and can attract PE. Cornelius of Alpinvest said: “Of course, size also matters and there are more opportunities in China and India compared to smaller emerging regions like the Middle East, South America or Africa.”

Broadly speaking, the credit crunch has had little impact other than a short sharp shock for emerging markets. But they aren't facing another five years of sub-prime growth, which is the case for developed markets.

The most notable emerging markets that have come through the crisis are China and Brazil. Collier Capital's Roex underlines that: “Brazil had some small GDP contraction but that wasn't much and is already out of recession. And China never really went into recession and it seems that they certainly are firing on all cylinders again.”

India appears to be a special case because PE relies heavily on the stock market and IPOs to get returns, which is more problematic at the moment. “It could improve in 2010,” adds Roex.

The market that most agree has fared worse, and has raised questions about its merit as a destination for PE is Russia. That is for both political and economic reasons.

“The dynamics of the market is that there is a limited supply and demand growth is gradually rising”

Impact on the secondaries market

In 2008, the secondaries market reached an estimated US\$90bn of cumulative funds raised, which is still a tiny fraction of the overall PE market. The principal role of secondaries in the market is to provide short-term liquidity, improving the attractiveness of PE as an investable asset class. Peter Wilson, Managing Director at HarbourVest Partners says: “Secondaries typically comprise three transaction types.” Traditional deals involve the transfer of LP interests in a given PE fund from an existing LP to a new investor who, for an agreed price, assumes ownership of the selling LP’s capital account value and assumes the remaining unfunded obligations from the seller LP. “Secondly, synthetic secondaries, or secondary directs, involve creating a new partnership to purchase a portfolio of direct investments, using an incumbent or new general partner (GP, manager) contracted to oversee and ultimately sell the assets in the partnership.” Thirdly and finally, “structured transactions involve the formation of special purpose vehicle(s) to establish a unique legal framework/structure that helps accomplish the goals of a particular seller in closing a transaction.” In this type of deal, assets may include LP interests or a portfolio of companies, or both. But today there is a wide spread between bid and ask prices that is slowing the market down. In light of the uncertainty, fewer parties are pursuing transactions.¹

Emerging market PE portfolio secondaries trading seems to be limited compared with transactions concluded in the Western world, according to most experts. But interest seems on the upturn. Ernest Lambers notes: “There will eventually be a good secondaries emerging market trading, but to date it is still a small market.”

A key issue is sometimes the lack of interest of buyers in the secondaries market. Guen of MVision also cautions that the primary market can be cannibalised by making portfolios available in the secondary market at a discount: “Why should anyone give you fresh money if they can get a fund for a 30% discount. So why contribute fresh funds if I can get a relevant portfolio more cheaply on the secondaries market?”

One of the factors that is boosting secondaries activity is the fact that new firms are offering a semi-secondaries market in order to make their proposition more attractive. Ernest Lambers explains the way it works: “The new fund that they are raising acquires a part of their previous portfolio at an attractive valuation.” So investors see more value when committing capital to this team. “They offer something new to LPs. It’s a new feature that is becoming popular for existing management teams,” Lambers adds.

market in China is that valuations have come down significantly from their 2007 heights. And while they are still often expensive, things are more realistic now. Carlyle’s Poon says: “While valuations are more attractive than last year, we haven’t seen as significant a lasting drop as we would have expected.” Paul Choo, Beijing-based chief representative for Investor Growth Capital in Beijing, agreed with that thesis.

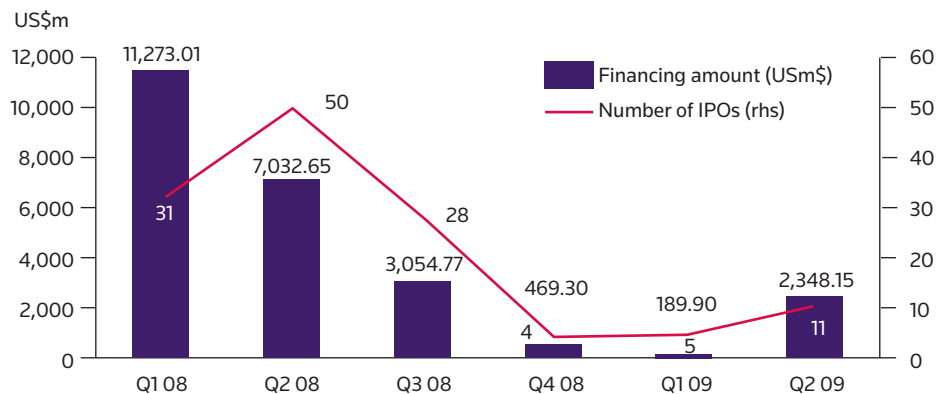
PE exits

Since the start of the recession, the Asian capital markets have essentially been closed, and it is only in the last quarter of 2009 that companies have slowly started to go public again. These first IPOs have had encouraging results. “However, we are still a very long way away from pre-recession numbers,” says Nick Cham of Deloitte.

Numbers from Zero2IPO show that the second quarter in 2008 saw no fewer than 50 Chinese companies do an IPO, either domestically or internationally (see Figure 4.3). That is compared to the second quarter of 2009 which saw only 11 companies go public, mainly in traditional and clean technology industries.

Figure 4.3

Chinese enterprises’ domestic and overseas IPOs, Q1 2008–Q2 2009 (US\$m)



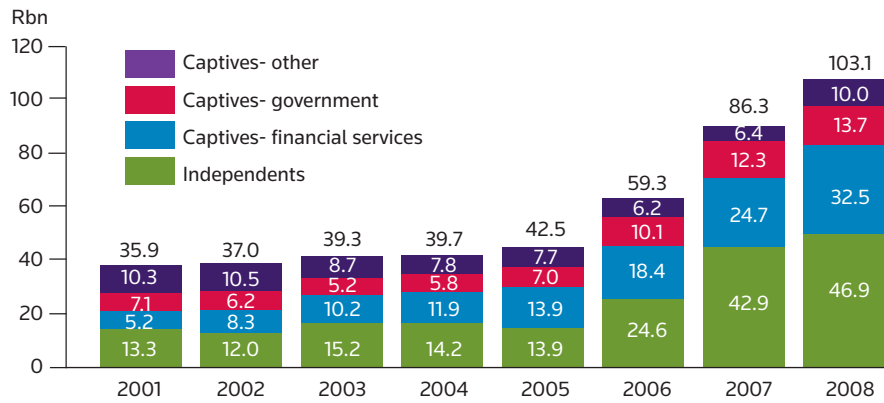
Source: Zero2IPO Research Center

At this stage, China has stock exchanges in Shanghai, Shenzhen and Hong Kong and it is in the process of developing a second board in Shenzhen with the Growth Enterprise Market (GEM) Board.

The listing requirements for the GEM are annual profits of US\$1.5m for the past two years, or US\$750,000 for one year based on turnover of at least US\$7m; compared to net profits of and sales of US\$4.5m and US\$44m respectively. “One of the GEM board’s aims is to allow smaller companies to more easily

Figure 8.1

Total funds under management, 2001–08 (Rbn)



Source: KPMG/SAVCA

In terms of a breakdown of funds, 39% of all funds raised during 2008 were from South African sources, while the UK contributed 27%, and the US contributed 13%. The KPMG-SAVCA survey suggests that we are likely to soon see the ‘spin-out’ of private equity teams of some of South Africa’s financial institutions into semi-captive fund managers. But independent funds currently account for 45% of total funds under management.

In terms of total funds under management relative to GDP, South Africa’s private equity industry at 3.2% is higher than the global average of 2.7%. That is higher than the European average of 2.6% and 2.1% for Asia-Pacific. It is still some way off that of North America at 4.7% and the UK at 5.9%. Nevertheless it is still a very vibrant PE industry for an emerging – or growth – market.

Reported South African PE investments decreased by 18.4% year on year to R21.3bn in 2008 and the total number of investments decreased to 719 from 834 in 2007.

Jumbo deals in South Africa have shrunk given current capital market conditions and restricted credit markets. The overall average investment deal size has remained largely flat at about R30m in 2008. In terms of sectors, mining, natural resources, the retail sector and infrastructure investments dominate PE in South Africa.

Later-stage finance deals also dominate in South Africa, and buyouts ranked second, while new seed, start-up and early-stage investments came a very poor third in 2008. The country seems to be following international trends, according to the KPMG-SAVCA survey.

“The SEE region has suffered from a lack of transparency for many years”

Levis cited several examples of deals that 7L and its principals have taken part in:

- ▶ Credit card processing in Romania – In 2000 the 7L principals took part in a joint venture credit card processing company. At that time the business only serviced half a million customers who had credit or debit cards. “It was a no-brainer that in a country of 22m people this would be a significant growth area as retail banking would develop to meet consumer demand.” When it exited the company was servicing 10m cards, which is still below the European average given its population;
- ▶ Air cargo in Romania and Bulgaria – After EU accession local air cargo companies had to be grounded because they didn’t comply with European regulations and standards. 7L saw an opportunity to fill the gap;
- ▶ Broadband communications in Serbia – Serbia only has a broadband penetration of 1.5% of the population. In Europe the average stands at about 25% of the population. 7L considers that there is tremendous potential for a leap in broadband access;
- ▶ Software for banking applications in Bulgaria – Because is it easy to find very sophisticated and cost-effective IT expertise in Bulgaria compared with the rest of Europe, 7L invested in a company that develops software for banking applications in Bulgaria that can be marketed to the whole world.

Transparency problems

The SEE region has suffered from a lack of transparency for many years. This has hurt the development of PE and made fundraising for focused players more difficult. And a related problem investors come across is poor and indiscriminate decisions by regulators. Levis says to be able to succeed at PE investment in the Balkans as a strategic investor you have to be accustomed to dealing with market irregularities and so the issues have caused them less concern. They have such experience in the region it has given them a competitive advantage over other firms.

Expansion funding

As in many other regions, acquisition funding has disappeared and buyouts in the region have been limited. Start-ups also have never been significant in the Balkans because investors want to avoid their considerable risk.

Bancroft likes expansion funding deals and Hiliarhopoulos explains that to buy out a company in 2006 and 2007 you had to pay very high premiums because valuations were too high. Now they are more reasonable but usually sellers are not willing to reduce their valuation expectations. Hiliarhopoulos says that