Asian Emerging Markets Private Equity – Challenging Multifold Risks

A thesis submitted to the Bucerius/WHU Master of Law and Business Program in partial fulfillment of the requirements for the award of the Master of Law and Business (“MLB”) Degree

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<th>Full Form</th>
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<tr>
<td>PE</td>
<td>Private Equity</td>
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<td>EMPE</td>
<td>Emerging Markets Private Equity</td>
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<td>EM</td>
<td>Emerging Markets</td>
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<td>VC</td>
<td>Venture Capital</td>
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<td>LP</td>
<td>Limited Partner</td>
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<td>GP</td>
<td>General Partner</td>
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<td>DFI</td>
<td>Development Finance Institution</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>EMPEA</td>
<td>Emerging Markets Private Equity Association</td>
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<td>WB</td>
<td>World Bank</td>
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<td>ADB</td>
<td>Asian Development Bank</td>
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<td>IFC</td>
<td>International Finance Corporation</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>EBRD</td>
<td>European Bank of Reconstruction and Development</td>
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<td>ACGA</td>
<td>Asian Corporate Governance Association</td>
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<td>EVCA</td>
<td>European Venture Capital Association</td>
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<tr>
<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
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<td>MBO</td>
<td>Management Buyout</td>
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<td>LBO</td>
<td>Leveraged Buyout</td>
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<td>IPO</td>
<td>Initial Public Offering</td>
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Abstract

This paper is about Private Equity Investment in Asian Emerging Markets. A short description of the characteristics of Private Equity and its history is provided. Hence, it reflects the current situation and special requirements of Emerging Markets Private Equity. The implication of all those special conditions leads to a challenging investment environment which requires distinctive investment approach in Emerging Markets Private Equity regarding initial investment placement decision making, monitoring, corporate governance issues as well as viable exit strategies. The paper illustrates value drivers of emerging markets private equity, presents appropriate strategies and their analysis from the investor’s point of view.
Introduction

The paper deals with Private Equity Investments in Emerging Asian Markets. This alternative investment asset class is associated with attractive opportunities and abnormal risk-adjusted returns. After a period of disappointment and unmet expectations in late 1990s and early 2000s, the private equity industry in Emerging Markets showed strong growth over the last few years. Even after the recent global financing crisis, emerging markets kept on receiving increased interest of investors. Among all regions, Asian emerging markets attracted almost 70% of the total capital commitments of investors to emerging economies. Private Equity is the source that fills in financing gap in the economy and considered as a primary source of equity for small and medium sized companies. It is associated with higher default risk than conventional loans provided by banks, but in exchange for higher risks it offers the opportunity to receive higher returns. What is fascinating about private equity financing, as well known as “smart money”, is that its benefits to economy are multifold – fills in financing gap in private sector, promotes hi-tech innovations, best corporate governance practices, positive impact on the GDP of nation. It is the integration of investment banking and management consultancy. Although the environment of Emerging Markets is challenging, it is coupled with outstanding growth opportunities and attractive deal flows. Only Asia itself comprises more than a dozen countries that have opened up their doors of economy to global players. But they have their own home-born weaknesses - these markets are characterized by weak legal institutions, political, regulatory and economic risk, dysfunctional capital markets and a low standard of corporate governance. The combination of the long term high risk asset class Private Equity with the high risk environment of Emerging Markets results in challenging high risk investments. But the superior return opportunities attract more and more investors. Fundraising numbers from 2003 to 2007 shows dramatically increasing results and now, after a short term shock period during global financing crisis, investors are again showing strong confidence in those markets and planning to increase their commitments.

The main value drivers of investments in those emerging markets are strong management team, post-investment monitoring and value addition, local presence and knowledge of local networks and markets. Integrity and honesty among players of emerging markets private equity is as important as any of the above mentioned value drivers. The introduction of good corporate governance is essential for the provision of a hospitable investment climate. If the legal
framework is weak, efficient governance structures can serve as a substitute. Intensive due diligence, monitoring, involvement, networks and exiting are the keys to success of Private Equity funds investing in Emerging Markets. With an appropriate adjustment of the strategy, risk can be mitigated and the investment is likely to be successful. Emerging Markets Private Equity can be beneficial for both the investors and receiving nations. Especially small and medium sized enterprises and family-owned companies in Emerging Markets benefit from this source of equity while investors receive potential extraordinary returns and diversify their portfolio.

The studies are based on Private Equity implications in emerging Asian markets. The choice of Asian emerging markets as a candidate for studying the PE industry and investment strategies used in developing economies is justified for a number of reasons. First, for the past years the region has showed fantastic results in terms of economic growth and more favorable regulatory changes. Second, the amount of capital commitments in the region made by investors is expected to increase and investors are showing strong confidence in the future returns of the Asian markets PE investments. Finally, the investment atmosphere and conditions in the region makes PE investments in Asia distinctive and requires special approach.

The rest of the paper is structured as follows. Section I briefly describes the history of PE industry in emerging markets coupled with Section II explaining why emerging markets private equity investments under-performed and did not met expectations of early investors. Section III discusses some of the macroeconomic factors that are increasingly important for the development of PE industry in the region. Sections IV and V analyze the investment approach in Asian emerging markets and gives practical implications in order to establish successful private equity practice.
Section I: Early stages of emerging markets private equity investment

Just like in any other developed country, in developing countries there are companies with a risk profile that enable them to raise capital through conventional ways, such as taking up bank loans or even issuing securities. There is also other group of companies that are too new to have an encouraging track record, or over leveraged, and even some of them have opaque financial reporting standards that discourages any investor. However, reaching the certain level of development those disadvantaged companies that are unable to finance themselves from within, need more financing in order to keep on competing effectively and this is where private equity comes into play. The main purpose of private equity is to fill this gap between self-financing and conventional capital market activity.¹ In general, private equity can be divided into buyouts and venture capital. Buyout deals are characterized by the purchase of established companies with stable cash-flows, whereas venture capital investments target start-ups and companies in the initial phases of their development.²

In comparison with investments in traditional investment vehicles, investing in Private Equity³ entails high risk and high illiquidity in a largely unregulated market.⁴ Due to those unusually high risks associated with PE, private equity investors expect financial returns that are much higher than returns from conventional investment instruments. Indeed, one of the main divers of equity flows are the interesting risk-return characteristic of PE firms compared to other investment assets.⁵ However, unlike the average public stock portfolio, in private equity investments, there is a substantial volatility regarding performance of top and bottom private equity funds. While top performing fund managers can achieve over 30 % returns per annum, lower ranked managers may not even return the invested capital.⁶ This is due to fact that private

³ Hereinafter referred to as “PE”
⁶ Supra note 2, pp 2
equity is skill based activity and performance gaps among funds are the result of wide differences in private equity fund manager experience, breadth of networks to source the best investment opportunities, operational and financial value creation during the holding period, and successful execution of a selective sales process in an inefficient market.

Private equity funds vary from one to another. In terms of their investments, for instance, so-called mezzanine capital funds provide growth capital to mid-sized portfolio firms for their expansion. Private equity is an investment vehicle that provides structure whereby limited partners can invest equity in a managed fund. While having limited liability in their investments, limited partners have no power on management authority. The idea behind limited partners is that they seek large long-term investments as a means of attaining high returns and diversifying their holdings. They are prepared to take on risky private equity fund investments that do not pay back a penny until the portfolio firms are exited. Because of these long term investments, high risks and sometimes government regulation requirements, limited partners tend to be university endowments, pension funds and high net-worth individuals. Annex I gives a brief outlook at the breakdown of capital commitments in private equity by the investors of different classes.

As it has been mentioned above, private equity covers both buyouts and venture capital financing. Further down the stream, there are two types of buyouts in private equity – management buyouts and leveraged buyouts. MBOs are initiated by the management of the target company and typically involve management buying out shareholders’ equity and taking the public company private, whereas LBO is the acquisition of a target company through a high debt-to-equity ratio transaction. Whenever, managers of companies turn to PE fund for financing, such private equity general partners will sponsor the buyout transaction by raising debt and providing equity in exchange for controlling equity rights as well as strategic control of the target company.

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8 Hereinafter referred to as “MBO”
9 Hereinafter referred to as “LBO”
10 Supra note 7, pp 22
11 Ibid, pp 23
Several widely used methods available for private equity funds to exit their portfolio firms – initial public offering, a trade sale, selling to another private equity firm, or a company buy-back. Since the profit of private equity firm is realized when it exits its portfolio company, exit strategies are extremely important to general partners.\textsuperscript{12}

Private equity, together with hedge funds, venture capital, credit derivatives and real estate, so called alternative asset class investments, is a form of business investment which can be Foreign Direct Investment.\textsuperscript{13} On the other hand, FDI is the crucial accelerator of economic development of the country. Today, most alternative asset class investments in developing nations are FDI made by foreign investors seeking high returns in risky but high-yield emerging markets. FDI significantly drives the economic growth of emerging markets. There is a high correlation between private equity and economic growth of emerging markets. Because of this, many emerging economies started unfolding and gained more receptive attitude towards the private sector generally and foreign investors particular.

Going back to the history of emerging markets in the early 1990s, large portion of emerging markets’ private sector were filled with family-owned companies with limited access to capital markets and small lines of credit through traditional bank financing.\textsuperscript{14} Most of the national economies had small saving pools, current accounts in deficit and largely shallow capital markets. Considering all these constraints on capital and equity supply, companies in emerging markets tended to look for private equity funds for additional source of growth capital. Foreign fund investors, who were looking for new opportunities, were also attracted by the emerging markets private sector conditions. Potential portfolio firms were often undervalued in an atmosphere of fierce competition for undersupplied capital, implying higher rates of return on investments in favorable global economic conditions. By mid 1990s the world economy was in a period of grow and macroeconomic indicators were relatively stable.\textsuperscript{15} During this period, inflation and interest rates were relatively down and policy makers worldwide followed the

\textsuperscript{12} Han Smit, Ward van den Berg, Private Equity Waves, Erasmus University Rotterdam and Tinbergen Institute, Department of Business Economics, TI 2006-053/2, pp 12

\textsuperscript{13} Supra note 7, pp 17

\textsuperscript{14} Magogodi Makhene, Alternative Growth: The Impact of Emerging Market Private Equity on Economic Development, pp 26

concept of open markets without barriers to competition, which in its own turn secured investor’s confidence in emerging market’s manageable risks.\textsuperscript{16}

1.1. Investors’ appetite and expectations

“A decade ago these countries [emerging economies] were loaded with debt and low foreign reserves that were vulnerable to interest rate swings. How they’ve got low inflation and strong economic growth… From the standpoint of fundamentals, some of these markets are safe havens”

- Gunter Heiland\textsuperscript{17}

Historical trend of interest of many PE investors was to stay away from Emerging Markets PE because the returns have been low in comparison to those available in industrialized economies. However, this trend is changing rapidly and emerging markets PE funds are starting to pay out higher returns. Moreover, investors, who received unprecedented returns in the US venture capital tech boom in the mid 1990s and on private equity investments made in industrialized financial markets, happened to have a robust appetite for risk. The author of Private Equity in Emerging Markets, Leeds, also states that investors began to worry that the enormous increase of capital flows into US private equity would outpace the supply of high return investments. The Figure I shows how the US private equity fundraising has increased over from 1969 to 2007 by reaching more than 250 billion US dollars.

\textbf{Figure I:} US Private Equity Fundraising, 1969-2007

\textit{Source:} Josh Lerner, Emerging markets and private equity: The past, present, and future, Harvard Business School, Boston


\textsuperscript{17} Managing Director and Co-Head of JPMorgan Investment Management’s emerging markets debt team
Increasing competition among private equity funds in the US and Europe and narrowing return expectations of investors, improvement in legal and regulatory framework in some emerging markets and improvement in exit environment and returns were another reason for the accelerated shift to emerging markets.\(^\text{18}\) For instance, only in Asia since 1999, 11 countries have issued regulations requiring independent directors and 8 countries have required audit committees.\(^\text{19}\) These two requirements are driving forces for private equity funds in order to be able to maintain their positions in a post-investment period. The following Figure II gives the overall picture of counties that made changes to their legislation.

**Figure II:** Regulatory changes made in Asian emerging markets


\(^\text{19}\) Ibid, slide 14
While so many factors pointing in the right direction, emerging market funds boomed in the mid-nineties. As Leeds and Sunderland pointed out in their Private Equity in Emerging Markets, the number of private equity funds in emerging markets has dramatically increased. “By the end of 1999, there were more than 100 Latin American funds, where virtually none had existed earlier in the decade. Between 1992 and 1997, the peak years for fund-raising in Latin America, the value of new private capital grew by 114% annually, from just over $100 million to over $5 billion. In the emerging markets of Asia, the numbers were even larger, with about 500 funds raised more than $50 billion in new capital between 1992 and 1999.”20 However, by the end of 1990s, those previously made private equity commitments were seriously underperforming. Some of the clear indicators of this result were time-consuming long exits, as well as low returns on investments, which were not parallel to higher risks associated with emerging markets. The promise of private equity in emerging markets has failed to meet investors’ expectations.

20 Supra note 16, pp 4
1.2. Transferring existing Model to emerging markets

Starting from the late 1990s and early 2000s, the almost all of the private equity funds used American-style private equity financing model as a tool in funding in emerging markets began delivering disappointing results in comparison to expectations and similar funds in industrialized countries. Academics explain this failure by addressing emerging markets’ low standards of corporate governance, limited legal recourse and dysfunctional capital markets. However, it is important to underline here that private equity funds’ returns in the US and Continental Europe back in late 1990s were unbelievably high due to high tech IPO bubble, and investors’ comparison of emerging market funds’ performance with those in developed countries provided unrealistic measurement standards. According to the EMPEA industry survey of 26 investors with an aggregate $108 billion managed funds, majority of investors reported overall dissatisfaction with emerging market return on investment rates. Reasons cited centered on macroeconomic issues such as local currency, liquidity, volatility and crises, legal and institutional challenges, as well as political risks.

The disappointing outcomes of investors’ investments in emerging markets back in late 1990s and early 2000s at least made them start questioning processes and venture capital model they have used in those markets. Some of the investors while investing into emerging markets private equity did not even bother about country specifics. The model that worked so well in the US and then in Europe did not showed expected results in emerging markets. The same Leeds and Sunderland that have been referenced above state that “in almost every respect, the new breed of private equity funds were clones of their US predecessors in terms of fund raising strategy, organization structure, investment processing, staffing, and exit strategy”. The US venture capital industry has been often held up as the model other nations should attempt to replicate.

One of the distinct differences of emerging markets private equity from that of American is that governments in developing countries influence the private equity activities greatly. Governments

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21 Magogodi Makhene, Leeds and Sunderland
22 Emerging Markets Private Equity Association
23 EMPEA, Institutional Investor Views on Emerging Markets Private Equity, Initial Survey Results for IFC Global Private Equity Conference, May 6, 2004
24 Idib, slide 7
are much in favor of direct regulatory intervention in business development than are America’s federal, state and local governments.\textsuperscript{25} Another major significance of emerging markets was the absence of a large, liquid market for the stocks of portfolio growth firms, whereas in America it was NASDAQ that provided exit to private equity funds through IPO.\textsuperscript{26}

Private Equity industry in the US that has gradually developed over many years has been accompanied by the strong demand from cooperative entrepreneurs, sympathetic public policy environment, a reliable legal system, political and economic stability, as well as developed financing markets.\textsuperscript{27} However, foreign investors in emerging markets private equity funds has clearly missed the crucial fact that all the above success factors were absent in emerging markets. These fundamental factors underline three major discrepancies in the used private equity model in late 1990s until early 2000s and explain why the industry underperformed – low standards of corporate governance, limited legal recourse, and dysfunctional capital markets. These three shortcomings are highlighted more in details in later sections.

1.3. Role of DFIs in building up investor confidence in emerging markets

The early stages of private equity development were strongly supported by the development financial institutions.\textsuperscript{28} At this point, it is worth to note some of the DFIs such as Overseas Private Investment Corporation (OPIC), the US Agency for International Development (USAID), International Finance Corporation (IFC), and International Monetary Fund (IMF), the European Bank for Reconstruction and Development (EBRD), as well as Emerging Markets Private Equity Association (EMPEA), organized by IFC. The commitment of DFIs in emerging markets back in mid 1990s was crucial since private investors were hesitant to commit capital to countries with unfamiliar local conditions and highly uncertain risk-return tradeoffs.\textsuperscript{29}

\textsuperscript{26} Ibid, pp 26
\textsuperscript{28} DFIs
\textsuperscript{29} Supra note 27, pp 4
IFC is the member of the World Bank Group, which also includes the World Bank, Multilateral Investment Guarantee Agency, and the International Center for the Settlement of Investment Disputes. It is highly multinational and multilateral organization with over 179 shareholder countries and its main focus is improvement of sustainability in developing countries. IFC supports private sector development both by investing and by providing advisory services that build businesses. For instance, only in 2007, the organization has invested approximately $8.2 billion for its own account in 69 countries, mobilized an additional $3.9 billion through loan participations, structured finance, and parallel loans, and provided services in 125 countries. As of fiscal year 2007, IFC had committed more than $64 billion of its own funds, and had arranged $27 billion in syndications from some 3,760 companies in 140 developing economies since its founding in 1956.

IFC, being as a global partner and promoting excellence in governance which increased investors’ confidence at the same time, has three roles that are milestones of its activities in emerging markets. First, events known as knowledge-sharing are directed to share IFC’s expertise with others on topics such as environmental, social, and governance issues, industry and country knowledge and others. Secondly, IFC also promotes trade with emerging markets, providing guarantees that cover participating banks’ payment risk for trade-related transactions in emerging markets. Finally, IFC can support its clients’ expansion by adding value as a long-term investor.

Nonetheless, almost all of those above mentioned DFIs, being strong promoters of private sector development in emerging markets, encouraged investors to use identical fund structures and investment models even though regulatory and legal frameworks did not provide adequate investor protection. Following those strategic counterparts, investors willingly started heavily investing in emerging markets using the same investment tools and at the end faced with disappointing early results.

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30 IFC brochure, Creating Opportunities in Emerging Markets, Financial Institutions, pp 3
31 Ibid, pp 4
33 Supra note 27, pp 2
Section II: Reasoning behind under-performance of Asian emerging markets private equity

As mentioned in earlier section and described by Leeds and Sunderland, the early stages of cross-border private equity investing in emerging markets followed the same “modus operandi”\textsuperscript{34} that had worked so well in the US and Europe, causing mostly disappointing results because of significant contrasts in corporate governance, accounting standards, as well as exit strategies. At this point it is important to underline that because of huge differences among emerging markets, model that work in some markets, such as Latin America and Africa, may not work in other markets, such as in Asia. Therefore, it is important to distinguish and investigate the specific characteristics of emerging market investments in each region separately. Because of it, this paper takes Asian emerging markets only and tries to point out its differences from developed economies. Even Asian emerging markets are not homogeneous but share similarities in a broader context.

There are many differences between developed economies and Asian emerging markets but three of these distinctions are especially relevant to the private equity investors. First, institutions tend to be less mature, and corporate governance practices tend to be weaker in Asian markets than in developed economies. Second, legal systems in those markets tend to be ineffective or less effective to enforce contracts and equally protect all classes of investors. Finally, macroeconomic volatility in emerging markets is much higher than in developed countries, thus strengthening weaknesses of already dysfunctional capital markets.

2.1. Corporate governance issues

“The practice of good corporate governance will help to improve the confidence of investors, may reduce the cost of capital and may induce more stable sources of capital”\textsuperscript{35}

- OECD report on Corporate Governance

\textsuperscript{34} Joao Neiva de Figueiredo, Unique characteristics of cross-border emerging market private equity: implications for investors and managers, Journal of International Finance and Economics, 15 June, 2010, pp 8

\textsuperscript{35} Organization for Economic Co-operation and Development (OECD), Ad-hoc task force on corporate governance, 1999, SG/CG995, http://www.oecd.org/document/7/0,2340,en_2649_37439_1854919_1_1_1_37439,00.html
According to Frank and Thomas\textsuperscript{36}, effective corporate governance relies on reliable and timely reporting of corporate performance measures for good internal board monitoring and outside investor evaluation. They further elaborating on this definition state that “without accurate and timely information on firm performance and risk taking, it is nearly impossible to evaluate how well a firm is performing and whether investors are getting an appropriate market return for the risk that they are bearing”\textsuperscript{37}. Paul Fletcher, Senior Partner in the London office of Actis, talking about risks of investing in the emerging markets, highlights issues of management and governance as risks of re- eminent importance. If investors do not have sound management, decently functioning board and governance environment, there is a little chance that they are going to get a high performing portfolio firm.\textsuperscript{38}

Private equity funds usually demand active participation in the company’s governance, since they gain their returns on investments only at the exit and if there is the upside position. The process leading to investment from initial contact to closing can be long and laborious because, there is substantial information asymmetry between the investor on the one hand and the portfolio firms’ managers on the other. However, due to many structural and cultural factors, corporate governance practices in emerging markets are often not up to desired private equity standards and Asian emerging markets are not the exception.\textsuperscript{39} Private equity funds, while chasing after profitable projects, didn’t give much of an attention to the quality of the business practices of many firms. Leeds and Sunderland claim in their Private Equity in Emerging Markets that the missing factors in early stages of private equity in emerging markets were - the accuracy, timeliness and transparency of financial and operating information provided to investors, and the willingness of managers to subject themselves to some degree of accountability by outsiders. In most of the cases, investors often find their voice is all but unheard, and the tradition of autonomy and secrecy is very challenging to break in family-owned emerging market companies. Most of these concerns are rarely challenged until the need for outside capital becomes imperative. For instance, few have undergone an independent audit or


\textsuperscript{37} Ibid, pp 8

\textsuperscript{38} Paul Fletcher, \textit{Another Practitioner Viewpoint}, Research Newsletter Private Equity, ECGI, Volume 6, 2008, pp 13

\textsuperscript{39} Supra note 34, pp 4
adhered to international accounting standards that are prerequisites for virtually every professional investor. Therefore, it is not surprising that most all fund managers address difficulty of assessing the competence and integrity of the entrepreneur as their most difficult task during the due diligence phase.

The issue of corporate governance stays essential for investors starting from early in the investment cycle and becomes even more important when the deal is consummated. If in early stages the access to information is necessary in order to make critical judgment about company performance and value, then once the deal is consummated, the investor needs a regular flow of accurate financial and operating information in order to monitor company performance. The reality in many emerging markets, however, is discouraging and much different from that in developed countries. Very often this deception brings tension to both the deal and relationship between investor and managers of portfolio firms, impacting negatively on investor’s capacity to orchestrate certain planned exit plan.

**2.2. Effectiveness of legal systems**

It is observed that the weaknesses in the governance structure of the private sector are often attributed to weaknesses in the law.\(^{40}\) However, this observation disregards the role of private legal rules, ex ante and ex post. Private legal rules are established by contracts, ex ante, and implemented and enforced, ex post, by means of various contractual dispute resolution mechanisms, such as courts, arbitration and even mediation. Private legal rules, in other words contracts, are powerful tool and they are in the heart of capital markets.\(^ {41}\) Carefully drafted and enforced legal contracts serve as the foundation for conducting all financial transactions, regardless of the country. Financial contracts are written to assign cash flow and control rights between contracting parties such as private equity fund and manager of a firm.\(^ {42}\) Equity investors normally have little direct control over the firms in which they invest and depend heavily on the

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\(^{40}\) Katharina Pistor, *Patterns of Legal Change*, pp 46

\(^{41}\) Cally Jordan, Mike Lubrano, *Corporate Governance and Emerging Markets: Lessons from the Field*, University of Melbourne Law School, 2006, pp 6

\(^{42}\) Josh Lerner, Antoinette Schoar, *Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity*, pp 4
legal system to protect their rights. Generally, the legal structure protecting investors in emerging markets is weak and they lose most of the control rights after they the deal is consummated.\textsuperscript{43}

Within the context of private equity investments shareholder agreements play the central role. Shareholder agreements usually stipulate terms and conditions of the relationship between investors and the company such as the timing and content of reporting requirements, board, representation, voting rights, and the terms and conditions for exiting the investment. However, the findings of Leeds and Sunderland after interviewing private equity fund managers indicate that early private equity experience in emerging markets demonstrates too frequently that regardless of how sound the signed agreements, there is minimal legal recourse in the event of serious differences with management of portfolio firms. In addition to this, many complex instruments such as preferred stocks and ratchets available in developed countries are not available to provide priority to investors in emerging markets. Therefore, in majority of cases regular common stocks are used to invest.\textsuperscript{44}

With the regard to legal systems and recourses under those systems, Grossman and Hart highlight that if courts are unable to enforce or even verify complicated, state-dependent contracts, the allocation of control rights can allow the parties to reach a second best agreement, which is securities.\textsuperscript{45} Speaking in general terms, securities can allocate control to the firm when things are going well, but allow investors to retain control if the firm is doing poorly. In the private equity context, Kaplan and Hellman identify several benefits to both investors and entrepreneurs from using convertible preferred stocks. Investors who can maintain control rights without majority cash flow rights are in favorable position, since they can invest relatively small amounts of capital early on without fearing expropriation, whereas from the perspective of entrepreneurs, they do not have to give away cash flow right early on when valuations are still very low.\textsuperscript{46} However, if the securities do not work in certain nations, then private equity funds

\textsuperscript{43} Mihir Desai, \textit{Overcoming challenges of new ventures in emerging markets – The Ebay-baasee.com transaction: What are the Challenges and how did they overcome them}, Final paper– International Financial Management, pp 6

\textsuperscript{44} Ibid, pp 7


can employ the use of controlling blocks of common stock or straight debt. This instrument of investing is most prevalent in emerging markets where the legal system is less well developed. Obviously, the worst situation can be that courts are so inefficient or corrupt that they cannot enforce any contract at all. In those cases, presumably, even majority ownership would not protect investors.

2.3. Capacity of domestic equity markets

Because private equity funds make their profit in the sale of their share in the target company, exit strategies are tremendously important to general partners of private equity funds. Of all exit mechanisms, presumably, the most profitable with highest returns on investment and often used are Initial Public Offerings (IPOs). An IPO is a procedure by which a private company raises capital by selling company shares to the public. As Black and Gilson claim, the potential for an IPO to provide a higher-valued exit than sale of the company must be considered reasonable.

The same source states that the potential for exit through IPO, even if exit often occurs through the sale of portfolio firm, is critical to an active venture capital markets. One has to admit that even the most advanced emerging market economies lack equity markets that can be used as an option for exit from companies in private equity portfolios. The primary market of emerging market economies can hardly perform function of raising capital, except in very few cases involving largest players of the market, whereas majority of private equity fund backed firms are small and medium sized companies. Therefore, without developed and reliable equity market, exit options are limited to management buyouts, sale of portfolio firm to other big players of the market, or to another private equity fund. Most of the private equity funds that had invested in emerging markets back in late 1990s and early 2000s presumed that they have IPO exit from portfolio firms as an option and therefore did not even ponder to reconsider their exit strategies in the early stages of deals. Coming from developed nations such as US and UK, where capital markets are highly advanced and the primary exit option is through IPO in

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majority of deals, investors’ expectations were misleading when the same private equity investment model transferred to emerging markets.

It is commonly believed by many players of the financial markets that the pressures of the capital markets will improve the governance of corporations and the improvement in corporate governance will promote the development of capital markets. However, Cally Jordan and Mike Lubrano challenge this misperception and try to prove that the relationship of capital markets to the governance of corporations is neither simple nor linear.\(^{49}\) Going further into details, scholars stated that how effective capital markets are in exerting governance on corporations in, in part, a function of how effective the legal rules are through the market operates. As one can see from this analysis, scholars tend to interlink all these three factors, corporate governance, legal system and capacity of capital markets.

2.4. Liquidity issues

One of the brilliant minds and widely considered as emerging markets investment guru, Mark Mobius of the Franklin-Templeton Group, while pointing out risks involved in emerging market investment lists out remittance/exchange control, convertibility and currency devaluation issues.\(^{50}\) Since most of the developing and emerging market countries still have high level of restrictions on capital account transactions, capital account openness is a matter of degree.\(^{51}\) As it has been already mentioned earlier, the Chinese and Indian markets vastly differ from each other, however when it comes to matter of foreign exchange, they share one important feature – government controls the flow of money in and out of the country.\(^{52}\) Whereas, if compared to developed countries, the interest rate and foreign exchange are deregulated and determined by the market forces.

\(^{49}\) Supra note 41, pp 4


Another important aspect of risks involved in emerging markets is volatility. Volatility always has been a problem of emerging markets, which in its own hand brings additional mistrust of the people. Nonetheless, one cannot claim that volatility is a typical risk factor of emerging markets only, because in 1999 and in early 2000s volatility has been also the of the developed economies. Volatility in emerging markets comes together with illiquidity that makes them highly risky.\(^{53}\)

Many of first generation funds claim that they have been also hit badly in their investments in emerging markets by the sharp appreciation of dollar against most currencies in Asia and Latin America since the mid-nineties.\(^{54}\) In the cases when portfolio firm performed exceptionally well in local currency terms, if the currency has depreciated significantly against the dollar, real returns to foreign investors just vanished.


Section III: Macroeconomic conditions and policy issues

Clearly, improving macroeconomic conditions in emerging markets and the new receptivity of governments to foreign investors are some of the main driving forces that encourage private equity investors to make higher risk investments in those developing economies. At the same time, as it is described in first two chapters, underestimated differences in those conditions were the result of disappointing early returns. EMPEA cites reasons centered on weak macroeconomic variables such as currency volatility and market liquidity, conflicting cultural perceptions on entrepreneurial cooperation and market access and some of the managerial issues. Most of the fund managers anticipated that fundraising for emerging market investment will be very difficult since investors got discouraged with lousy returns. In addition, investors did not have any high profile models of successful fund to demonstrate that this type of investing works well. It was obvious that as long as this negative attitude prevails, emerging markets private equity investing will see its downside. However, the further changes in emerging markets in the next three-four years showed dramatic shift in investor confidence and optimistic expectations. The following Figure III illustrates increase in capital raised for emerging market private equity funds in years from 2003 to 2005.

Figure III: Emerging Market Private Equity Fundraising in years 2003-2005.


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As it is seen from the Figure III, Asian Emerging Markets Private Equity constituted almost 80% of the total emerging markets private equity fundraising in 2005. This indicates that majority of investors were satisfied with their Asian investments and willing to commit more new money in those markets.

Looking at the development of private equity financing and macroeconomic conditions of Asian emerging markets the correlation between these two becomes obvious. For instance, the constant deregulation of domestic markets and reduction in barriers to trade and capital flows in both China and India back in 2000s caused trade flows grow from 38% of China’s GDP in 1999 to 70% by 2008, and from 25% of India’s GDP to well over 50% over the same period.\(^5\) The same increasing trend can be observed in private equity fundraising in Asia, particularly in India and China, during the same period. Figure IV presents the increasing trend and the breakdown of fundraising activity according to Asian countries.

**Figure IV:** Fundraising in Asia

*Source: Asian Venture Capital Journal*

After years of rapid economic expansion, emerging economies today account for the largest block in the global economy, contributing 35% to world nominal GDP at current exchange rates in 2010.\(^{57}\) Strong growth rates and a good exit environment offering superior return opportunities have attracted many foreign private equity investors to emerging Asia. [Annex V]

However, apart from all those economically favorable conditions, it is also important that governments of emerging countries will seriously address systemic issues such as corruption and a lack of transparency. For example, it is a common practice in most of the emerging markets’ companies to maintain two or even three sets of accounting records in order to avoid the tax collections, that in its turn frustrates the due diligence process to gain an accurate picture of performance. These systematic pitfalls also play crucial role when private equity funds exit their portfolio firms. Nowadays, potential buyers are placing a much greater reliance on detailed due diligence to uncover potential liabilities in targets and to verify valuation models.\(^ {58}\) In particular, emerging markets due diligence with respect to corruption, money laundering and bribery issues are increasingly becoming hot topics.

\(^{57}\) Maria Laura, *New World: Emerging Markets after the crisis*, Deutsche Bank Research, April, 2010

\(^{58}\) Mark E. Thompson, Benjamin R. Newland, *Emerging Market Private Equity: How To Find Light at the End of the Tunnel*, The Metropolitan Corporate Counsel, King & Spalding LLP, February 2010
3.1. Corruption and money laundering

Corruption and money-laundering are often addressed in relation to emerging markets. Paul Fletcher of Actis says that “the fact that corruption is systemic in some of the markets in which we invest, does not mean that it is all-pervasive and that there are not businesses that operate very ethically”.\textsuperscript{59} Another fund manager while commenting on this issue stated that “one big problem in emerging markets is skeletons in the closet and many of those great companies have hidden subsidiaries, offshore sales and other tax avoidance schemes”.\textsuperscript{60} There is a common perception that a country plagued by corruption is likely to attract less investment than a relatively uncorrupt country, and to lose economic growth as a result.\textsuperscript{61} Asian Development Bank, which play crucial role in fostering anti-corruption policies in Asia and Pacific, stipulates that “corruption deprives countries of precious recourses, hampers efforts to alleviate poverty, undermines political stability and economic growth and diminishes a country’s attractiveness for investment”.\textsuperscript{62}

According to the report of Federal Reserve Bank of San Francisco from July 2007, while money laundering and corruption are worldwide problem, Asia is a primary center for those activities. One of the reasons for this is the political and economical instability in the region. Political and economical instability persist in a number of countries in the region, which at the same time can foster a culture of public corruption and contribute to increased money laundering activity.\textsuperscript{63} Especially, economic instability can promote the evasion of laws by encouraging entrepreneurs to conduct their business in the underground or informal sector of the economy.\textsuperscript{64} Rigid government policies are another factor that influences corruption activities. For instance currency

\textsuperscript{60} Roger Leeds, Julie Sunderland, \textit{Private Equity in Emerging Markets: Rethinking the Approach}, Journal of Applied Corporate Finance, January 2003, pp 7
\textsuperscript{61} \textit{The United Nations Today}, Department of Public Information, New York, 2008, Chapter 3, pp 209
\textsuperscript{62} \textit{Controlling Corruption in Asia and the Pacific}, presented at the 4\textsuperscript{th} Regional Anti-Corruption Conference of the ADB/OECD Anti-Corruption Initiative, Kuala Lumpur, Malaysia, December 2003, Organization for Economic Co-operation and Development and Asian Development Bank, pp 5
\textsuperscript{63} \textit{Anti-money laundering reforms and trends in Asia}, Country Analysis Unit, Federal Reserve Bank of San Francisco, July 2007, Asia Focus, pp 1
\textsuperscript{64} Ibid, pp 2
control policies and trade restrictions can encourage individuals to circumvent official rules in order to conduct business.

Although corruption is certainly widely spread in many Asian countries, it is not necessary that it be tolerated in cross-border private equity investments. In fact, funds that have failed to take a stand and who have tolerated unchecked corruption with regards their portfolio firms have endured higher price than those with better developed corporate ethics practice and zero-tolerance policies. Of course, there can be events that are outside of their control such as unforeseen regulatory and political risks. For instance, political events might not be immediately apparent but yet they can have severe material impact on funds’ investments. These factors are more enlightened in the further subsections.

Corruption in a country may be characterized in terms of the degree to which the highest officials of the state are corrupt, in other words state capture, and the degree to which low-level bureaucrats are involved in corrupt acts, also known as administrative corruption. For instance, the Figure V illustrates the correlation between state capture and administrative corruption and to what extent these two types of corruption are spread in southeastern Asian countries. One can conclude from this information how much corruption and money-laundering can create serious barriers for businesses in Asian emerging markets where corruption penetrates deep into economic, cultural and political environments.

**Figure V**: State Capture and Administrative Corruption in Southeast Asia


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65 Steve Vickers, *Top Corporate Risk Factors in Asia*, South China Morning Post, pp 2

3.2. Receptivity of governments to foreign investors

Foreign direct investment continues to be a driving force in the world economy. As foreign direct investment has continued to expand by all means, developing countries have increasingly opened up their economies to such investment and benefit from it through GDP and economic growth. Annex II shows the growing importance of FDI in emerging market economies. As it has been already mentioned in the Chapter 1, private equity financing in emerging markets, which mainly comes from foreign sources, takes the form of foreign direct investment (FDI). Therefore, a developing country that desires to attract more FDI will most likely have to reduce the requirements and restrictions it imposes on such investments. The perfect environment would be where a country abolished all restrictions and relied on market forces and competition to shape investment and prevent abuses, but of course this scenario is far from the real life conditions. However, developing country government can reduce the number of regulations and administrative burdens it imposes on foreign investments, which in its own turn will be perceived by investors as the costs, delays, and risks investing in those economies are decreased.⁶⁸

⁶⁷ For instance, take Chinese and Indian private equity funds

Because of the heavy role of private sector in the development process of emerging economies there is a presumption that local governments are cooperative with private equity financing. Within the context of this cooperative commitment of developing countries’ governments, Annex III lists some of the steps governments can take to reduce the burdens, restrictions, costs and risks of investing in their country. Nonetheless, if carried out by governments, these actions have double-edge effect and can lead to trade-offs such as reduction in government’s ability to control the domestic economy and guide the country’s development trends.69 Usually when there is a resistance to more perceptive and cooperative policy that liberalize FDI entry, policy makers may believe that their countries have not achieved an adequate degree of economic stability, or their markets do not function well enough to allow competitive forces control foreign business operations.70 Meanwhile, it is important to underline some of the factors that will effectively impact on farther development of private equity in emerging markets – protecting shareholder rights, promoting sound corporate governance standards, liberalizing investment restrictions for both local and foreign institutional investors, as well as improving access to public equity markets. If local governments truly understand benefits of private sector development and importance of private equity as a means of filling financing gap, then they must realize their key role in promoting private equity industry, and actively take steps to strengthen the enabling environment. Perhaps the most important signal of making reforms and abolishing restrictions should be demonstration that emerging economies’ governments are capable of effectively enforce new laws. Hence, this will be perceived by investors as positive trend and incentive to lifted investor confidence. At the same time, investor confidence concentrates around a credible legal and regulatory framework, which includes a capacity of oversight of market behavior and effective enforcement when laws a breached.

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3.3. Cry for policy reforms

As the competition in both global and domestic arena intensifies, the policies, regulations and business practices that promote rather than discourage investors to risk their capital becomes increasingly important. Increasing attractiveness of a country to foreign investments, investor confidence and the level of corruption are directly linked with to what extent governments willing to cooperate and face new reforms. Further commenting on this point, several eastern Asian countries such as Thailand, the Philippines and the Indonesia have embraced more market-oriented economic policies in order to attract foreign investment and inspire domestic confidence. Hence, this has reduced the size of the state and lessened opportunities for corruption.⁷¹

During the last several decades, privatization policies of many Asian emerging markets have doubled positive effect of market-oriented policy reforms. President to the Board of Directors of the Asian Development Bank stated the following about the private equity market of Pakistan, the country in the south of the Asian – “benefiting from ongoing reforms, financial sector has recorded significant changes in its size and ownership structure, increasingly dominated by the private sector in response to the government’s privatization policies”.⁷² Privatization is also seen as a vehicle for foreign direct investment and therefore it is not surprising that it is still among the top priorities in the policy agenda of almost all developing and transitional countries.⁷³ Quoting the World Bank, the privatization in 62 developing countries continued to pick up in 2004 and 2005, with 400 transactions worth about 90 billion USD.⁷⁴ Indeed, privatization is the irreversible fact for developing economies and at the same time large pool of potential deals for private equity funds with an exposure to emerging markets.

⁷¹ Supra note 65
⁷² Report and Recommendation of the President to the Board, Proposed Equity Investment in JS Private Equity Fund I LLC, Asian Development Bank, June 2007, pp 5
⁷³ Efa Yonnedi, Does Privatization Affect Organizational Change: A case of Indonesia, 10th Public Management Research Conference, Ohio State University, October 2009, pp 2
⁷⁴ World Bank Group’s Privatization Database 2007, Privatization Trends, Washington DC
Giving right incentives for further development of financial sector, filling financing gap in the economy, hence improve wellbeing of the whole nation should be some of the core objectives of developing countries’ governments behind deregulating, privatizing state owned enterprises and establishing new policy reforms. At this point it is important to mention that almost all of the Asian emerging markets have bank-based financial systems and banks are the major, if not the only, players in the market that provide financing both to public and private sector projects. This phenomenon leads to huge financing gap considering how most of the private sector enterprises either have very few past records or no collateral for the conventional bank loan to expand their businesses. However, in most of the Asian emerging markets it is the case that, given the magnitude of the financing gap that needs to be filled, most governments have done surprisingly little to undertake reforms that would improve the enabling environment for private equity.

3.4. Leadership of DFIs

During the last century the world has witnessed tremendous political change in the form of the collapse of communism and astonishing leap in privatization. As those reshaping countries opened up their economies to new players by privatizing state-owned enterprises, this has allowed private participation in infrastructure. At this historical turnaround point, the focus of Development Finance Institutions (DFIs) was to make the transition as effective as possible.

While some of the major players involved in private sector projects in developing countries are private sector firms, private financial institutions, international development financial institutions, local governments and nongovernmental organizations, DFIs play the most important and catalytic role in the development of private equity in emerging markets. Those are the only institutions that possess all the experience and capability that one can only wish to have in order to shift emerging markets private equity to another level. First, they have financial resources that can be invested into emerging markets private equity funds. Second, they have long standing and credible relations with local governments that can be used to initiate much needed policy and regulatory reforms that have been mentioned in earlier subsection. The last but not the least, they have power to influence with limited partners in order to encourage more active participation in emerging market private equity. International Finance Corporation (IFC)
is the oldest and the most experienced among these specialized institutions.\textsuperscript{75} It is type of organization that has attempted to learn from projects where it made mistakes because of a lack of precedence, an absence of clear understanding of the issues, or otherwise honest but unintended actions. IFC is the early bird that has investigated the issues, responded with changed or new processes and procedures, and put system in place so that these mistakes will not be repeated.\textsuperscript{76}

It is interesting that the participation and commitments made by DFIs attract additional private investment on the basis of their participation. Indeed, if those institutions, such as IFC, IMF, EBRD and others are unwilling to commit their own resources at risk in emerging market private equity, it is hard to imagine other investors to stay in the game. With the knowledge base and lessons learned in early stages, DFIs need to increase their efforts to screen and select right fund managers with right skills set for the right market (since emerging markets are not homogeneous and each and every of them need special skills and local presence) and then define conditions that promote strict accountability and achieve results.

The broader picture of objectives behind active involvement of international finance organizations in investing developing countries is that developing country performance is increasingly important to the global economy. Supporting developing countries is not only about building investor confidence and instigating investor-friendly policy reforms, but also investing in sustainable global growth in a longer term. Those emerging markets in developing countries are full of opportunities for high-return investments, which in its own turn creates new sources of growth in global demand. Just to imagine the magnitude, according to paper prepared by World Bank Group for the G20 Summit in Toronto, Canada, June 26-27, 2010 developing countries now contribute about half of global growth. And every dollar spent on investment goods in developing countries can yield 35 cents worth of demand for capital goods produced in high-income countries, precisely the kind of high-value goods that generate well-paying jobs.\textsuperscript{77} Therefore, World Bank Group is increasing its commitment to emerging markets year by year.


\textsuperscript{77} \textit{Recovery at the Crossroads: Role and Implications for Developing Countries}, paper prepared by staff of the World Bank Group for the G20 Summit in Toronto, Canada, June 26-27, 2010, pp 1
The following Figure VI illustrates how much World Bank Group invested in developing economies in 2008-2010 years.

**Figure VI: WBG Commitments, billion US dollars**

*Source: Recovery at the Crossroads: Role and Implications for Developing Countries, World Bank Group, G20 Summit in Toronto, Canada, June 26-27, 2010*

<table>
<thead>
<tr>
<th></th>
<th>FY08</th>
<th>FY09</th>
<th>FY10 estimate</th>
<th>Cumulative FY09-10e</th>
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<td><strong>IBRD</strong></td>
<td>13.5</td>
<td>32.9</td>
<td>44.2</td>
<td>77.1</td>
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<td><strong>IDA</strong></td>
<td>11.2</td>
<td>14.0</td>
<td>14.8</td>
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<td><strong>IFC</strong></td>
<td>11.4</td>
<td>10.5</td>
<td>12.0</td>
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<td><strong>MIGA</strong></td>
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<td>1.4</td>
<td>1.5</td>
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<tr>
<td><strong>World Bank Group</strong></td>
<td>38.2</td>
<td>58.8</td>
<td>72.5</td>
<td>131.3</td>
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*IFC own account

Apparently, the capacity, experience and objectives of DFIs put them in the center of development of developing countries’ private sector. Private sector-oriented DFIs should capitalize on their reservoir of knowledge and practice to energize the industry. Development Finance Institutions need to keep their credibility in the eyes of investors and their client governments by leading the way.
Section IV: Increasing experience of emerging markets private equity funds and creative solutions

“What has changed in emerging markets and why should investors pay attention? People! People! People! The consensus of our speakers today is that we now see a much more seasoned class of managers.”

- Josh Lerner, Harvard Business School

Understanding the potential for private equity investments in Asian emerging markets requires not only skills and methods commonly used in developed countries but also many country specific challenges. It is not the secret that private equity industry in Asia is driven by the growth and strong macroeconomic indicators. Therefore, understanding the nature of growth in the different markets of Asia is a key factor in successful private equity investment in the region. For instance, most of the Asian markets’ growth is driven by domestic demand and thus, it is wise to invest in domestic demand-led businesses. The following Figure VII shows the class of portfolio firms that create deal flows. As a result of the trend in deregulation and openness, most of the EMPE opportunities are companies targeting growth in domestic or intra-emerging-market markets.

Figure VII: Target Markets of portfolio firms

Source: IFC, The Case for Emerging Markets Private Equity, v.6, January 2010

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78 Nitin Deshmukh, CEO, Kotak Private Equity
79 Survey covers 833 companies that clearly indicated their market focus
Emerging markets are the kind of markets that are increasing in both size and quality of conditions in astronomic pace. However, the central change that should warrant increased attention to emerging markets private equity is the quality of management. In majority of investments it is the case that finding good quality private equity General Partners (GPs) is not an easy task. Most of the times it is very difficult to find right people with right skill set who can understand both country specifics of doing business and standards and methods developed in industrialized economies. EMPEA in its survey lists management issues as one of the main reasons why emerging markets private equity has underperformed in late 1990s and early 2000s. Too many funds didn’t try or were not able to really influence portfolio companies. It was common among senior staff of funds to do the deals but then do not stay involved to work with the companies.

Compared with private equity industry of developed nations, private equity investment is still relatively recent phenomenon in the region, so not all private equity funds are with experience of weathering the ups and downs of business cycles. But over the past 5-6 years, the experience of Asian emerging market private equity funds has increased and they have become more attentive. Survey conducted in 2007 shows that LPs noted growing evidence of maturity in many of emerging markets, including dramatic progress in the quality of governance and communications

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81 Ibid, slide 9
among their fund managers. In 2007, only 15% of LPs surveyed thought governance at the fund manager level was inferior to the rest of their portfolio, versus 40% in 2006. Jen Choi, EMPEA’s Director of Research comments that “this improvement indicated that GPs in those markets are becoming more attentive to the needs of the institutional investor community”.

Presently, the skill set of fund managers is better than ever before. Due to the increased interest of LPs in emerging markets private equity investments and better investment conditions in those markets, the industry sees emergence of a top tier emerging markets managerial class, trained in the best business schools, apprenticed at blue chip corporations, consultancies and investment banks and now building businesses in emerging markets to global best practice standards. Jean Eric Salata, one of the fund managers in Baring Private Equity Asia illustrates this change by stating the following – “The number one change is improving in the management gene pool. Entrepreneurial activity in the US that is heavily dominated by non-US citizens, particularly Indians, Chinese and Russians are now taking up leadership positions in private equity firms in the home countries.”

This improvement in management of funds and returns on investments did not come without tradeoffs and lessons learned. Based on the early experience of private equity funds and DFIs in emerging markets certain success factors were discovered – establishment of local team, repackaging professional skill-set, hunting down and creating successful deals, consideration of exit plans before making investment placement decisions. These are some of the success factors that will be explained in detail and analyzed in farther subsections.

4.1. Less foreign and more local

According to Chris Meads, Head of the Asian Operations of Pantheon Ventures, private equity funds with highest returns are those that built up strong local teams. For investors, a strong multicultural local presence, in-depth knowledge of the region and active relationships with GPs help to overcome barriers of entry, hence, making complex due diligence more easy to conduct.

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and promising to secure high returns.\textsuperscript{83} EMPEA Survey conducted in 2006 showed the presence of locally-based private equity fund management teams as one of the many factors that would affect interests of LPs in investing in emerging markets private equity and venture capital.\textsuperscript{84} When the deal involves new environment and utterly different local conditions than those of in developed markets, the local base of operation is even more necessary. Due to this reason many private equity funds when making cross-border investments often partner with local investment firms to obtain inside information and greater savvy in navigating local conditions.\textsuperscript{85} This partnership is called international syndication. The presence of local investors with whom to partner in a syndicate may play an important role in taking on certain responsibilities that may be easier to manage from a domestic position.\textsuperscript{86} Those local partners are attractive to foreign investors because they have information about the operation of the local market, including access to deal flow as well as dense networks of contacts and familiarity with local laws.\textsuperscript{87} However, syndication is not always an answer to solving problems faced in EMPE deals. It depends on the development of the target region, including the maturity of the PE industry\textsuperscript{88} and a supportive institutional environment\textsuperscript{89}. Specifically speaking, if a PE industry is underdeveloped, there is very small use of local partners because often they are inexperienced. In addition, less supportive institutional environment makes it more difficult to invest in this or that country due to increasing information asymmetry, the need to align their behavior with this environment and the need to adjust their style of working. Thus, the need of large international PE funds for syndicating with local investors can be substituted or substantially reduced by the knowledge of their local offices.

\textsuperscript{83} Benita von Lindeiner, Philipp Gysler, \textit{Private Equity in Asia and the decoupling debate}, Partners Group Research Flash, May 2008, pp 8
\textsuperscript{84} EMPEA Survey of \textit{LP Interest in Emerging Markets Private Equity}, Conducted with Liberty Global Partners LLC, March 2006, slide 25
\textsuperscript{85} Survey conducted by Deloitte, 2006
\textsuperscript{86} Makela M, Maula M, \textit{Inter-organizational commitment in syndicated cross-border venture capital investments}, Entrepreneurship Theory and Practice, 2005, pp 14
\textsuperscript{87} Mike Wright, Sarika Pruthi, Andy Lockett, \textit{International Venture Capital Research: From Cross-Country Comparisons to Crossing Borders}, Center for Management Buy-out Research, Nottingham University Business School, pp 14
\textsuperscript{88} Tykvova Tereza, Andrea Schertler, \textit{Rivals or Partners? Evidence from Europe’s International Private Equity Deals}, ZEW Center for European Economic Research, 2006
\textsuperscript{89} Meuleman Miguel, Mike Wright, \textit{Cross-Border Private Equity Syndication: Institutions and Learning}, Working Paper, Nottingham University Business School
Generating market intelligence and new investment opportunities with very high returns is very complicated and definitely becomes much less effective when fund managers must fly half of the world in order to do extensive due diligence on prospective deals and initiate deals. Sometimes complex process of due diligence may last many months which makes everything incredibly expensive and inefficient when the appraisal team commutes back and forth between the home office and portfolio firm’s office. The necessity of ongoing direct involvement with company management during the post investment phase is compromised by long distances that tend to reduce the frequency and quality of interaction.\textsuperscript{90}

Investments made without being present locally so-called cross-border investments, pose multifold challenges for identifying deals. Different types of deals require different approaches to deal generation and screening. In order to be successful, EMPE funds should take more local approach. Information asymmetry, regulatory differences, different cultures of doing business requires local connections and in most cases an office presence very close to the portfolio companies.\textsuperscript{91} Once local office managers gradually gain experience and deepen their understanding how to handle those institutional differences, those differences will stop having constraining effect on success of investments. Making a better use of local institutions and networks can accelerate EMPE fund’s chances to take an advantage of the opportunities within the market. Especially, social networks are very crucial in Asian emerging markets. At the end of the day, being less foreign and more local decreases EMPE funds’ investment risk substantially if they can make sure that the fund has links with local officials and other reputable companies and managers.

\textbf{4.2. Professional skill set for value enhancement}

Over the last years, private equity funds, especially those with investments in emerging markets, have transformed their roles from being mere providers of capital to active participants of value creation process of the portfolio firms. Nowadays, the main objective of a private equity fund is

\textsuperscript{90} Leeds, Sunderland, \textit{Private Equity in Emerging Markets: Rethinking the Approach}, Journal of Applied Corporate Finance, pp 11

\textsuperscript{91} Bruton Garry D, Vance H. Fried, Sophie Manigart, \textit{Institutional Influences on the Worldwide Expansion of Venture Capital}, Entrepreneurship Theory and Practice 29 (6), 2005
to increase the value of a portfolio company, with the ultimate aim of realizing this increased value monetarily through a direct sale or listing. Value enhancement role in post-investment stage of the private equity investor in emerging markets is even more important that in industrialized nations, given the extraordinary challenges of creating viable exit opportunities. However, the best strategy to achieve desired outcomes can differ significantly from market to market, and depends on a company’s stage of development.\textsuperscript{92} Emerging markets in the Asian region are not homogenous and they vary from country to country. Nonetheless, when it comes to private sector development stage, most of those developing markets share the same factors such as corporate governance issues, underdeveloped capital markets and regulatory issues. Managers of private equity funds are needed to take on the difficult tasks such as strengthening corporate governance practices, restructuring management and positioning the portfolio firm for a profitable exit starting from the day one. Cleaning up mess and completing turnarounds can take a lot longer time than leading a promising firm in the right direction and accelerating its growth trajectory.\textsuperscript{93} In one of the interviews with EMPE fund managers conducted by Leeds and Sunderland fund manager stated that “When you sign the deal is when the real work starts, not ends. Finding right skill set in emerging markets is tricky. We need to know how to build company value”.\textsuperscript{94} Fund managers are key players in the PE industry and in the best position to contribute to value creation by selecting the right target companies and undertaking appropriate changes.\textsuperscript{95} It is no longer era when everything depended on investment bankers who were trained to analytically evaluate potential deals and negotiate in order to make an investment. Now managers need to reconsider their skill set required to enhance corporate value during the post-investment phase. Understanding the businesses very well and bringing significant management and operations experience to the table is very crucial.

\textsuperscript{92}Private Equity: Best Post-acquisition Practices for Growth Capital, Wharton Business School, Amwal AlKhaleej
\textsuperscript{93}Ibid, pp 2
\textsuperscript{94}Leeds, Sunderland, Private Equity in Emerging Markets: Rethinking the Approach, Journal of Applied Corporate Finance, January 2003, pp 9
\textsuperscript{95}Who’s next, The Deal, July 2008
4.3. Creating successful deals

Private equity is still relatively new in emerging markets and in most of the developing countries it is often not perceived by the entrepreneurs as an option of financing or their businesses. Most of the businesses in emerging Asia tend to be family owned and majority of owners are entrepreneurs who has built a successful business with virtually no capital or shareholders beyond their immediate family and close friends. Therefore, it is often the case that interests of company and owner are indistinguishable from each other causing the absence of the necessary accountability and mixed company financial accounts with personal accounts. This autonomy, secrecy and independence have been practices in most of the developing Asia, hence become tradition running deep within the corporate culture.\textsuperscript{96} It is exactly the same reason why some of the fund managers became more discriminative regarding deal selection. “It is simply is not worth the aggravation and tension, so we are concentrating only the deals where both the firms and the managers are younger, more flexible and less likely to have acquired many of the bad habits that hinder good relations with traditional family businesses”.\textsuperscript{97}

However, it is not always portfolio companies that need increased attention and investigation, but also relevant experience of fund managers. Good deals are those that fit the skill set and industry knowledge of the fund manager and offer identifiable opportunities for enhancing values. Possessing specialized knowledge and expertise in the sector invested is the vital momentum of private equity investing be it in developed country or emerging economies. Specialization lowers risk and increases returns by enhancing ability to better manage “controllable risk”.\textsuperscript{98} Thus, in order to reflect strategies adopted by PE funds, strength of fund managers and realities of the market place, sometimes it might be better to chase down deals once PE fund decides to enter specific sector. One prominent Asian fund manager noted that “the best deals are ones we create where we proactively approach potential portfolio firms”.\textsuperscript{99}

\textsuperscript{96} Supra note 74, pp 6
\textsuperscript{97} Ibid, pp 10
\textsuperscript{98} Debora A. Guthrie, \textit{What are the implications of the Increasing Specialization Among Private Equity Managers and To What extent is this an irreversible trend?}, Presentation to Super Investor Conference, November 2004, Paris, slide 9
\textsuperscript{99} Supra note 74, pp 10
4.4. Exit planning before entering into the deal

“One of the keys to success in emerging markets private equity is planning for exits from day one; opportunity doesn’t knock every often or at the right time in thin capital markets, so GPs need to manage duration more explicitly than in developed markets”

- Andreas Beroutous, McKinsey’s Private Equity Practice

What kind of returns I am looking for from investments in emerging markets private equity? What are the available exit plans from EMPE investments and how much clear, realistic and reliable they are? What are the barriers to exit plans from investments? Is it possible to predict exit format in the initial investment placement decision? These are some of the questions that any investor has to ask himself before making initial investment placement decision.

Typically, risks in emerging markets are higher than in developed countries due to inherent political and economic risks, information asymmetry, financial markets volatility, serious corporate governance transparency concerns, and government corruption. On the other hand, all these risk factors coupled with overall solid structural fundamentals such as rapid economic development\textsuperscript{100}, reduced reliance on foreign debt, and massive improvements in the monetary and fiscal management of emerging Asian economies since late 1990s creates an environment ripe for skilled EMPE fund managers and investors to generate above average, in other words “abnormal” returns from their investors. International investors’ community is also aware of these returns and their appetite for emerging markets private equity investments is increasing. Around 60-70\% of capital raised for emerging markets private equity in the last four years has been raised for Asia. And yet, the opportunities are considerably broader.\textsuperscript{101} Because of these above average returns investors are ready to take large and risky long-term private equity investments that curtail access to invested capital until the fund’s underlying assets are exited. The only and the most desired return on an investment is realized at the time of exit, thus, it is very important to strategically plan the exiting. Fund managers and direct investors have to demonstrate their ability to put incredible rigor into the exercise of mapping out a viable exit at the outset of their investment in a portfolio company.

\textsuperscript{100} Growing middle class, growth in domestic consumption, and significant investment in infrastructure

\textsuperscript{101} David Wilton, \textit{IFC’s Experience in Emerging Markets Private Equity}, Quarterly Review, vol VI, Q1 2010, pp 1
If exit strategies are so important, then what are the available exit plans from Asian EMPE investments and how much clear, realistic and reliable they are? Private equity funds have several avenues in their disposal to exit portfolio companies – IPO, a trade sale, selling to another private equity firms (secondary activity) or a company buy-back. However, the exit conditions in emerging Asia are not the same as in western developed countries where exits are supported by well developed financial infrastructures and regulations. In developing economies, selling a company and repatriating the proceeds are often extremely difficult and expensive; hence exit choices become very limited. The solution to these exit strategy challenges is all in the form and depth of the knowledge and initial due-diligence that private equity funds are willing to undertake before coming to initial investment placement decision. According to David Wilson, Chief Investment Officer for IFC’s Private Equity and Investment Funds Department, there is a relationship between the drivers of return and the mode of exit used and the background of the GP’s team. Due diligence needs to match the GP’s skills and it is important to have to a GP team with the right skills to help companies grow and deal with complexities of corporatization. Therefore, the fact how much clear, realistic and reliable exit plans in Asian emerging markets private equity investments can be is, at a general level, dependent on the extent to which exit barriers are considered in due diligence process and GP team’s matching skill set.

What are the barriers to exit plans from investments? Although emerging markets private equity forecasts show that conditions are getting better and governments are becoming more receptive to this type of financing industry, there are lots of different factors that pose limitations and barriers for structured, predictable and successful exit plans. One of the most important and hard to overcome barriers is regulatory and political barriers. For instance, the difficulty, in certain situations and in certain emerging markets where regulations are positioned not in the favor of private equity, to use stock options, to enforce liquidity preference, and to recover capital in case of bankruptcy, places the whole exit strategy of PE funds under question. The other example of regulatory barriers for exiting investments in emerging Asian countries can be the complexity of regulatory issues such as one activity might be required to be approved by several public authority institutions and sometimes the opinion of those institution can dilute from each other.

102 Don Goodwin, Challenges in International Private Equity, Cedar View, pp 3
103 Supra note 100, pp 3
With the regard to political barriers, political instability both in the country or region can cause difficulty in finding buyers of portfolio companies in liquidity event and even sharp drop down in the price of the company. Some of the Asia Pacific countries such as Taiwan and Philippines can be a perfect example of how strongly the political instability can impact on the PE industry development.

Taking into account all the barriers and skill set of GPs mentioned in the current and previous chapters, is it possible to predict best available exit format in the initial investment placement decision? The timing of the exit, although extremely important, cannot be determined in advance because of the volatility of public and strategic markets.\textsuperscript{104} However, even there is huge uncertainty about the exit event that will take place at least 3-4 years from the moment of initial placement of PE investment, it is essential to identify viable exit at the very beginning of the investment process and then to make sure that portfolio company management fully understand, and be committed to pre-fixed strategy. If the exit is not possible through initial public offering, then parties have to clear out whether management is willing and able to execute a management buyout after certain period of time. If the trade sale is an option, then it needs to be identified who are those potential buyers and what are they looking for in a company so that the management can build up on these factors over the years. Fund managers need not to be limited with already known and available exit strategies. New approaches to exit strategies in developing countries need to be in place well before a deal is structured.\textsuperscript{105} For instance, recognizing the difficulty of assuring future liquidity, private equity investors can build arrangements into their financing structure instruments, which by the terms of the instrument allow a payout in the absence of a market for the equity.\textsuperscript{106} One of such instruments can be the form of investment subordinated debt, with an interest rate and repayment schedule that provides at least minimally acceptable return. In addition to term sheet, there shall be warrant or equity conversion, which allows the investor to realize a full equity return if the investment is successful.\textsuperscript{107}

\textsuperscript{104} Joao Neiva de Figueiredo, \textit{Unique characteristics of cross-border emerging market private equity: implications for investors and managers}, International Academy of Business and Economics, 2008, pp 34

\textsuperscript{105} Supra note 101, pp 4

\textsuperscript{106} Robert D. Stillman, \textit{Alternate Exit Strategies for International Private Equity}, pp 136

\textsuperscript{107} Ibid, pp 137
Section V: Recent developments in Asian emerging markets private equity

“Right now is as good as it gets: low interest rates, commodity prices at the right spot in the cycle, good deal flow, more trusted opportunities. All of these factors are leading to much better performance for emerging markets private equity”

- Paul Fletcher, Actis

It is not a secret that looking at the emerging markets, investors tend to focus on macroeconomic and political risks and legal system and governance issues, hence establish that the risks are high. However, more closer look at the recent dynamic changes in those markets prove that the investor outlook for emerging markets private equity is increasing and in many of those markets there are huge opportunities to generate extraordinary returns. Especially emerging Asia stands out among this crowd of developing economies by attracting the interest of private equity investors with strong economic growth rates [for figures see Annex V] and a good exit environment offering superior return opportunities. Much debated concept of Asian emerging markets “decouple” from the slowdowns in US economy indeed took place, at general level, during the last credit crisis caused by housing bubble in the US. Hence, this positive affect accelerated shift of investors to Asian emerging markets and increased investor confidence. Of course the region cannot prove itself immune to the global slowdown, but the growth will remain on a healthy trajectory.\(^\text{108}\)

Continued growth in emerging markets supports private equity practice. The sustained, strong economic expansion of the region over the last years with GDP growth rates fluctuating between 6% and 10% promised high profit generation of the underlying portfolio firms.\(^\text{109}\) Strong and constantly growing domestic consumer demand coupled with stable macroeconomic and fiscal policy frameworks corroborated attractiveness of emerging Asia. As the below Figure VIII illustrated, among all emerging markets around the world Asia shows highest GDP growth and it is predicted to remain positive.


\(^{109}\) Ibid, pp 2
Another success factor of emerging Asia is an attractive valuations, a high share of growth capital deals and favorable exit environment. Together with strong economic growth, improving corporate governance issues and organic growth were some of the important value drivers of investments in emerging Asia. Due to improving exit environment, Asian emerging market private equity returns has performed significantly better than other markets.

**Figure IX: Returns from Asian private equity market**

*Source: Asian Private Equity Review*
However, the central question still stays there – what are the drive factors of these abnormal returns on investments. What are the factors that GPs have to take careful consideration in order to satisfy their investors with over the average payouts?

5.1. Value drivers

In the market environment where the level of market volatility is higher and remedy mechanisms for the various private equity problems related to information asymmetry is more complex, it is very important to clearly understand true hurdles and methods to overcome barriers. Since emerging markets private equity is utterly different from mature markets PE industry, before committing capital one has to realize value drivers of EMPE investments. In other words, what are the factors that if present, pay back exceptional returns on investments?

Based on the reflections above, these are some of the main suggestions to investors to pay attention and these can well become value drivers of any model of PE investing in Asian emerging markets.

- Management team.

In fact, when PE funds make an investment in emerging markets they are investing in management team of the portfolio firm. A strong, credible and experienced management team is critical for operating and growing a successful company.\textsuperscript{110} Two decades of emerging markets private equity investing shows that majority of those investments are not made for a quick profit. The main strategy was to squeeze out as much value out of the portfolio firm as possible. This effort takes time and good management. Don Goodwin of Cedar Consulting states that “a key to any successful PE placement is a pool of local management”. Management team should be local talent with highest quality and familiar with doing business in the region and dealing with the public authorities. However, one has to be realistic and admit that lots of businesses in Asian emerging markets are family owned and sometimes can be much disorganized. Robert Binyon, chairman of Aureos Advisers Asia, commenting on this says that it is often possible to add value by setting up new management systems and providing help at board level. “We help in areas like producing decent accounts and cash management, things those managers in small businesses

\textsuperscript{110} Jason M. Malak, \textit{Private Equity Investing: The Quest for Value}, Cogent Valuation, pp 2
have not been able to do well. Lots of small businesses go bust because they don’t know what is happening to their cash”.\textsuperscript{111} Sometime when the target company is a spin-out of a state owned enterprise, then the management team comes as a part of it and it is practically impossible to replace it. But fund managers can do is that to align incentives of management team with those of investors’ incentives. Good corporate governance standards can still shift incentives of management team and generate good returns.

- Local presence

Again quoting Paul Fletcher of Actis, - “effective risk management means having your finger on the pulse of the markets where you invest and that is the key to making attractive returns over the course of the economic cycle”. Indeed, this is the only way to gain full access to local markets, the critical intuitive sense about what is going on in the local market, what are the deals you want to uphold and people you want to work with. Nonetheless, mere going local is not enough for producing extraordinary returns. It is necessary to know the local market extremely well. This knowledge of PE fund’s team comes from substantial prior experience in emerging markets in general and in the specific geography in particular.\textsuperscript{112} Knowing local markets, companies, authorities, cultures and environment is critical. Information available in almost all of those Asian emerging markets is either too old or non-existent, which at the same time makes the information knowledge of fund managers challenging. Dearth of information makes the due diligence process difficult if not impossible. Therefore, rather than relying on non-existent government data on private sector, market reports, PE investors has to start investing and collecting primary data and analysis of target company, regulations, cultural, religious and environmental issues. Investors who have been in particular emerging market for long time have analyzed the environment and opportunities under many different macroeconomic conditions and therefore they are in a better position than new comers to generate good returns.\textsuperscript{113} Going local and knowing local markets is a milestone of a successful PE investing in Asian emerging markets.

\textsuperscript{111} Corporatizing Asia, Banking & Finance, Financial Markets, LexisNexis, 2010, pp 2

\textsuperscript{112} Joao Neiva de Figueiredo, Unique characteristics of cross-border emerging market private equity: implications for investors and managers, International Academy of Business and Economics, 2008, pp 40

\textsuperscript{113} Don Goodwin, Challenges in International private Equity, Cedar Consulting
- Value addition

Adding value to portfolio firms is as important in Asia as it is in the developed countries. There is no doubt that the best EMPE fund managers are those who have proven their propensity for adding an exceptional amount of value to their portfolio firms including taking on the tasks of strengthening corporate governance practices, restructuring management, and positioning the company for a viable exit given the unusual challenges with creating in advance exit opportunity. The idea behind value enhancing is that building up on abilities of portfolio firms and bringing in new tools and create added value that strategic buyers will be looking for at the time of exit from investments. The added value should exceed the initially placed investments and payback over the average returns. Investors hope and expect to obtain the desired returns – which is a function of the difference between the value of his stake upon exit and that upon entry less all costs of holding the investment. Some of the factors that decrease the risk of the investment and increase the market capitalization of portfolio firms are profitability with strong margins, low earnings volatility, strong sustainable growth, higher maturity, large customer base, state-of-the-art equipment, trained and assembled workforce. As it has been mentioned above, talented management team is another factor that results in more value being attributed to businesses in emerging markets. Nowadays, even building up on patents and copyrights of portfolio firms is getting substantially valued and popular.

- Integrity, honesty and honor

It is crucial to understand that private equity investing is a personal and relationship driven business, and when it comes to emerging markets such relationships are the most important source of risk mitigation. Investors, who put integrity, honesty and honor to those relationships, are likely to do well as an investor in emerging markets. Although almost no academic paper has mentioned this factor as a value driver of emerging markets PE investments, practical knowledge of two decades EMPE investing history proves it to be of highest importance. Without the integrity, honesty and honor in relations in emerging markets, one can just pack his bags and set off to home. Just like transparency and disclosure help enhance the honesty and integrity of the financial markets, integrity and honesty in emerging markets promote the confidence of both investors and managers of portfolio firms.
5.2. Investor confidence

Investor confidence in Asian emerging markets is another parameter that identifies future path of EMPE development in the region. The amount of capital commitment in emerging markets private equity is also directly linked to how much investor feel confident about the markets. According to EMPEA Survey 2006, when wide group of investors were asked about what factors would increase their activities in emerging markets, 54% of investors have indicated investor confidence in accounting and corporate governance of EM fund managers and portfolio firms. If investors have confidence in the efficiency of a local private equity market with an established track record, they most certainly continue investing in follow-on funds.114 Asian emerging markets private equity is driven by growth of economy and attractive deal flow. Certain regions become attractive to investors only if the deal flow is large enough to support local private equity capacity and if transaction volumes and expected returns exceed expectations. Hence, there is a linear relationship between the size of an economy and PE activity.115 As it becomes obvious, Asia includes in itself all the above parameters and it certainly has a bright future that is ensured partly due to rebalancing or economic power.

Political stability is another essential ingredient for investor confidence. In the scene of unstable political conditions in either region or country, any economic or regulatory improvements fade away. As the evidence of the fact that political risks weigh heavily on investors, one can look at Philippines in the Southeast Asia. It has been difficult for the politically unstable Philippines to attract long term equity capital. Since 2009, only three investments were known to have taken place.116 This was mostly due to recent massacres and assassinations of political opponents close to the presidential elections in 2010. Annex IV illustrates the distribution of deals in the Southeast Asian region.

Ironically, the Southeast Asian region as a whole kept on attracting PE investors. The period after the global financial crisis saw investors directing their capital to new frontier markets in South and Southeast Asia. Some of the countries such as Cambodia and Sri Lanka, which has

114 Alexander Peter Groh, Private Equity in Emerging Markets, pp 5
115 Ibid, pp 6
116 Asia Private Equity Review, June 2010
been long neglected by investors, started drawing attention of investors. Annex IV shows selective funds launched for South and Southeast Asia Markets since 2009. Regardless of the fact that Southeast Asia formed relatively successful economic block, it remains “fragmented” because of various political factors.¹¹⁷

5.3. Factors accelerating shift to emerging markets

“We believe that developed markets returns will decline over time, and that makes emerging markets private equity of interest”

- Erol Uzumeri, Ontario Teachers’ Pension Plan

On the top of all the reflections in this paper, there are some other factors that accelerate the flow of capital to emerging markets – less competition against attractive deal flow in emerging markets private equity markets, increasing number of sophisticated regulations in developed countries, tax holidays and incentives granted in emerging markets private equity, returns on PE investments in developed economies are not as high as in EMPE investments. Private equity commitments as a percentage of GDP can be a good parameter to indicate how the competition for transactions in EMPE markets is relatively less than in developed markets. Despite the strong growth in capital committed to private equity in emerging markets between 2005 and 2008, PE commitments as a percentage of GDP still remains way below the levels in developed nations. However, there is another side of the story. A part of it is structural – some of the very successful businesses in emerging markets of Asia often unregistered or without a license due to complexities involved and inefficient controlling systems in those markets. These businesses are very difficult to be financed by any private equity investors, thus leaving emerging markets relatively under-penetrated.

Too many regulatory statutes and sophisticated regulatory policies in developed economies such as the US and UK are pressuring private investment funds and hence accelerating the shift of capital to emerging markets. For instance, investigations conducted in 2006 by the US Department of Justice (DOJ) regarding “clubbing”, in other words a transaction in which a

¹¹⁷ The Independents, Asia Private Equity Review, June 2010 Issue,
consortium of private investment funds collaborates to offer a joint bid for a target company in buyouts, seeded lots of debated among PE investors. DOJ was challenging the validity of the bidding techniques used by private equity funds and other club participants during the auction, which made hundreds of billions of USD worth buyout possible.¹¹⁸

Tax holidays and incentives granted to foreign direct investment investors in emerging markets is another reason why many investors are increasing their interests in EMPE. As it has been mentioned above, most of the private equity investments in emerging markets are in the form of FDI. In addition, improving exit environment and more receptive governments in emerging markets creating opportunities for PE investors to generate abnormal returns on investments, which are at the same time, higher than returns received in developed nations.

¹¹⁸ Bradley C. Vaiana, Peter Nurnberg, Club deals and DOJ investigation considerations for private equity investors, January, 2007
Conclusion

This paper seeks to understand how differences and risks in emerging markets private equity and private equity in developed nations affect investment model and approach to be used. It focuses on such systematic and cultural differences such as regulatory regime, political and economic stability, and culture of doing business as well as corporate governance practices. The result of studies is that emerging markets private equity substantially vary from those in developed countries and requires good understanding of local markets, extensive local networks both in business community and among authorities, local presence in order to be able to conduct post-investment value addition implications. In the environment with higher risks as in emerging markets, consideration of viable exit strategies before the initial investment placement decision becomes even more important. Investors, who want to be successful in those markets, have to have relevant investment background and skill set that fit to unique characteristics of the local market and their own “eyes and ears” on the ground in order to obtain reliable information.

The results of this paper indicate that investment environment in emerging markets, especially in Asia, is risky but risk-adjusted returns are high. Local presence, strong local connections and willingness to actively engage in building corporate value in portfolio firms are the strongest value drivers of EMPE investments. Private Equity in Emerging Markets is driven by growth and efficiency and there is a strong belief that Emerging Markets will continue to grow for the foreseeable future, supporting growth-based private equity.
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Annex I

Investors In Private Equity: LP Capital Commitments to Buyouts/Other Non-Venture Funds

Investors In Private Equity: LP Capital Commitments to VC Funds
Annex II

Net Foreign direct investment (FDI) inflows to developing countries, 1990-2006
Annex III

Some Elements of opening a country’s FDI regime

Reduce market distortions
- Relax currency control and increase convertibility of currency
- Reduce tariffs, quotas and other restrictions on imports
- Eliminate price controls on most goods and services
- Allow market conditions to determine interest rates
- Reduce burdensome and counterproductive labor regulations

Improve competitive conditions
- End favored treatment of state-owned enterprises, or privatize them
- Ease government buy-local policies

Improve legal framework
- Adopt laws and regulations to clarify foreign investors’ rights and obligations
- Improve fairness and efficiency of judicial system

Improve regulatory procedures
- Make screening of investment proposals more efficient and less costly and delay-prone
- Reduce number of ministries and government agencies that review proposals
- Create true “one-stop” application office
- Eliminate approval requirement: grant national treatment to foreign investors
- Base screenings on economic merits, not political concerns
- Reduce and rationalize government regulation of FDI in place

Improve substantive rules
- Fewer restrictions:
  - Increase industries open to FDI and reduce the number of industries close to FDI
  - Ease numbers on dividend remittances
  - Ease restrictions on land ownership
- Reduce requirements regarding:
  - Local majority/minority ownership
  - Level of technology
  - Diffusion of technology
  - Local research and development
  - Local procurement quotas
  - Employment creation
  - Export requirements
- Promote sound corporate governance standards
- Improve access to public equity markets

Annex IV

Distribution of Deals in Southeast Asia (2009 - 2010)

Vietnam (102; 13)
Thailand (11; 1)
Cambodia (12; 6)
Malaysia (219; 6)
Singapore (1,294; 16)
Indonesia (1,405; 6)

(USS m; number of deals)

Source: Asia Private Equity Review


- Vietnam: 27%
- Indonesia: 31%
- Malaysia: 31%
- Singapore: 31%
- Other SE Asian countries: 4%
- Thailand: 5%

Amounts surveyed: US$8,075 m

Source: Asia Private Equity Review
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All amounts in US$ m
(1) final closing date
(2) final closing size

Source: Asia Private Equity Review
Annex V

Emerging Markets’ GDP as % of world GDP (PPP)

Source: IMF

Emerging Markets’ Real GDP growth compared to developed economies

Source: IMF, Deutsche Bank Research
Public debt, % of GDP (baseline)

*GDP-weighted.

Source: Deutsche Bank Research, “Public Debt 2020”