



Is Emerging Markets Private Equity Dying?

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Introduction

Periodically over the last few years, one nagging question would burrow its way into my mind: is the emerging markets private equity industry (“EM PE”) dying?

Some of the data told a straightforward story: stagnant volumes of capital being raised by fewer and larger managers; a smaller number of funds achieving a final close. In other instances, a news story would cross my screen and leave me befuddled. IFC committed to CDH Fund V? The African Development Bank committed to Carlyle? I don’t know the rationale for these decisions, and I’m certainly not passing judgment on them. They did, however, spark a curiosity to examine EM PE’s vital signs.

The prognosis that follows suggests that existential challenges are besetting the industry, despite its continued viability as an attractive asset class that can create value for investors and investee companies alike. I worry that fewer entrepreneurs will access the human and financial capital they need to grow, fewer people in emerging markets will find jobs, and we all will continue into the morass of secular stagnation.

I hope that you enjoy this piece, and that it kindles a search for solutions to the industry’s challenges. Do please drop us a line and let us know what you think—we’d love to hear from you.

Best wishes,



P.S. As Roger Leeds, founding Chairman of EMPEA and Professor at Johns Hopkins SAIS, notes in [his book on the asset class](#), a health warning is warranted on EM PE data. *Caveat lector*.

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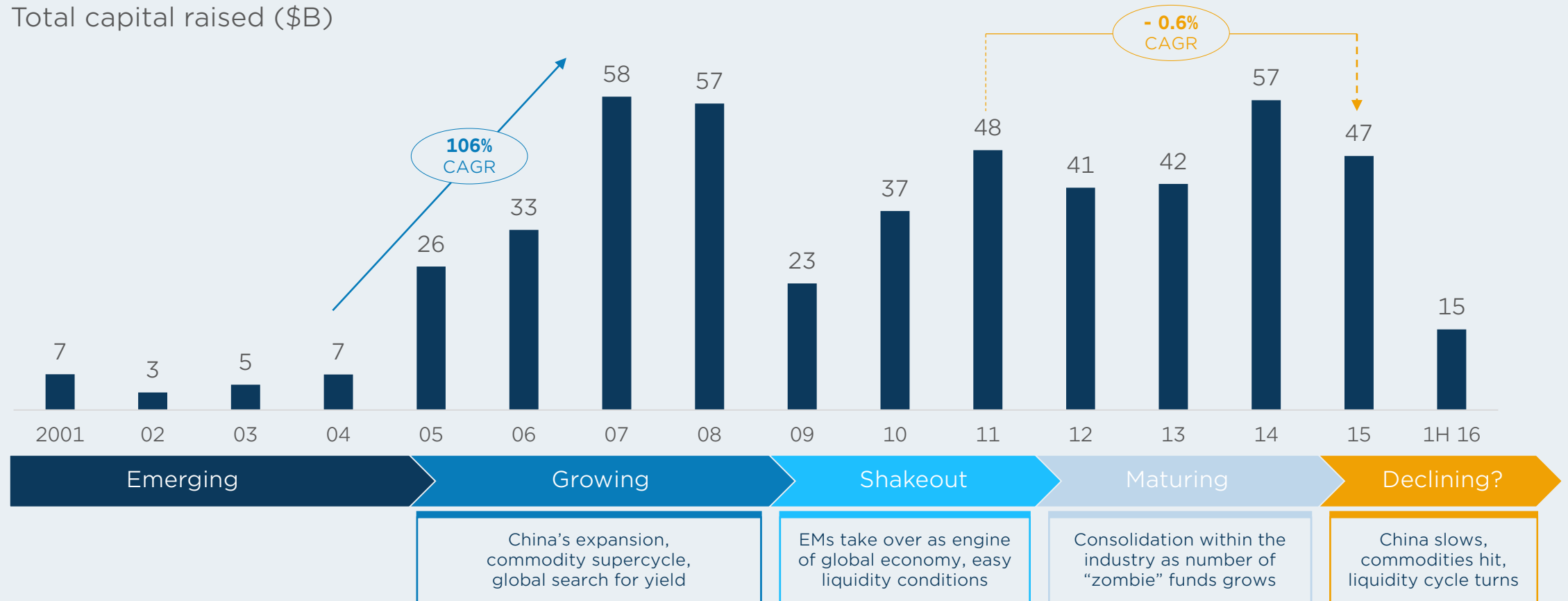


Where are we in
the industry life-cycle?

The EM PE industry is not growing

Following rapid growth at the end of the last decade—and a swift recovery on the heels of the global financial crisis—the volume of capital raised annually has been stagnant since 2011

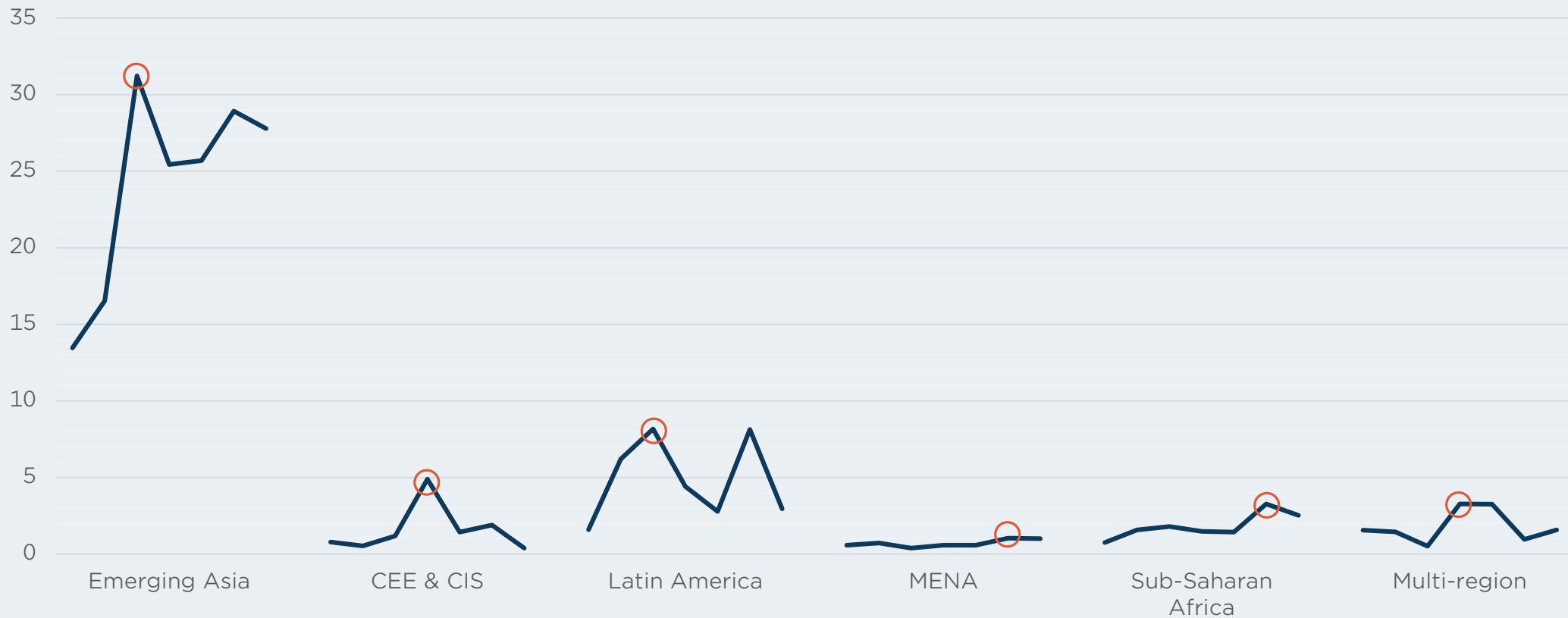
Total capital raised (\$B)



A fundraising slowdown is visible across regions

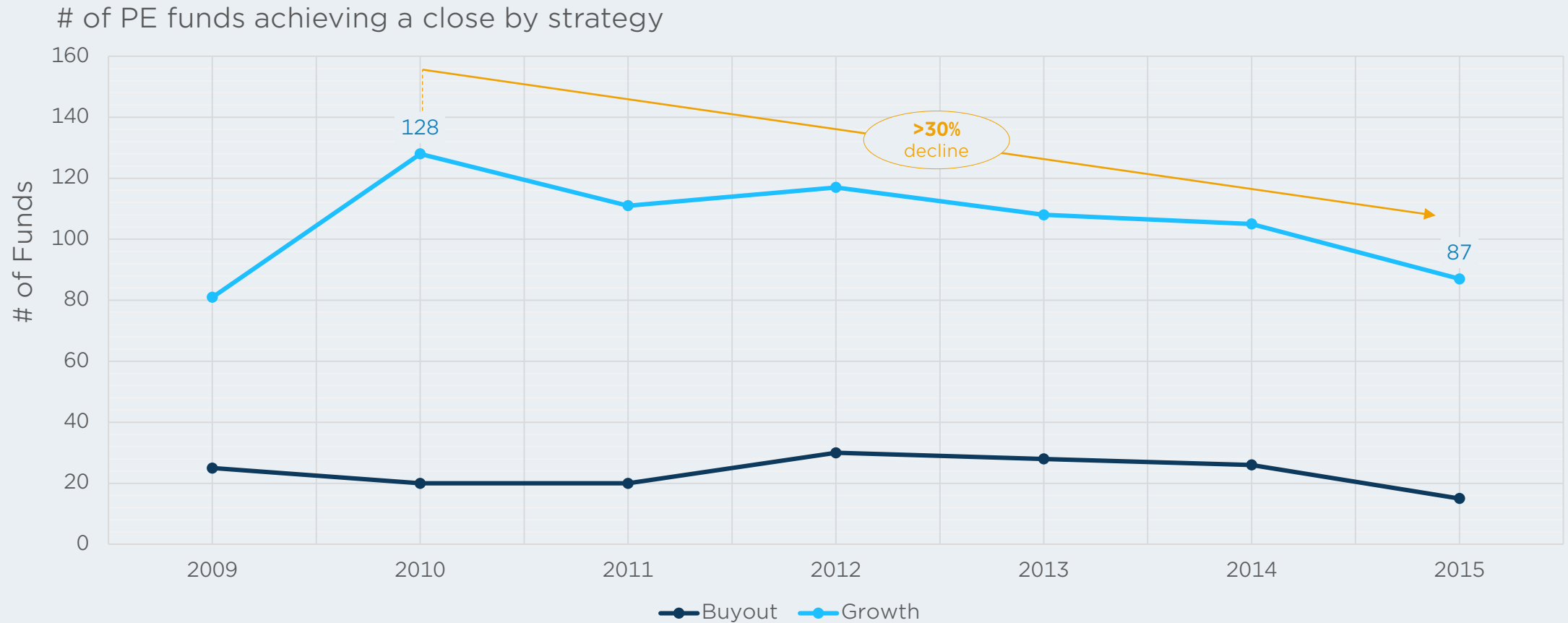
Outside of Sub-Saharan Africa and the MENA region, PE fundraising hauls peaked in 2011 / 2012

Private equity fundraising by region and strategy (\$B), 2009-15



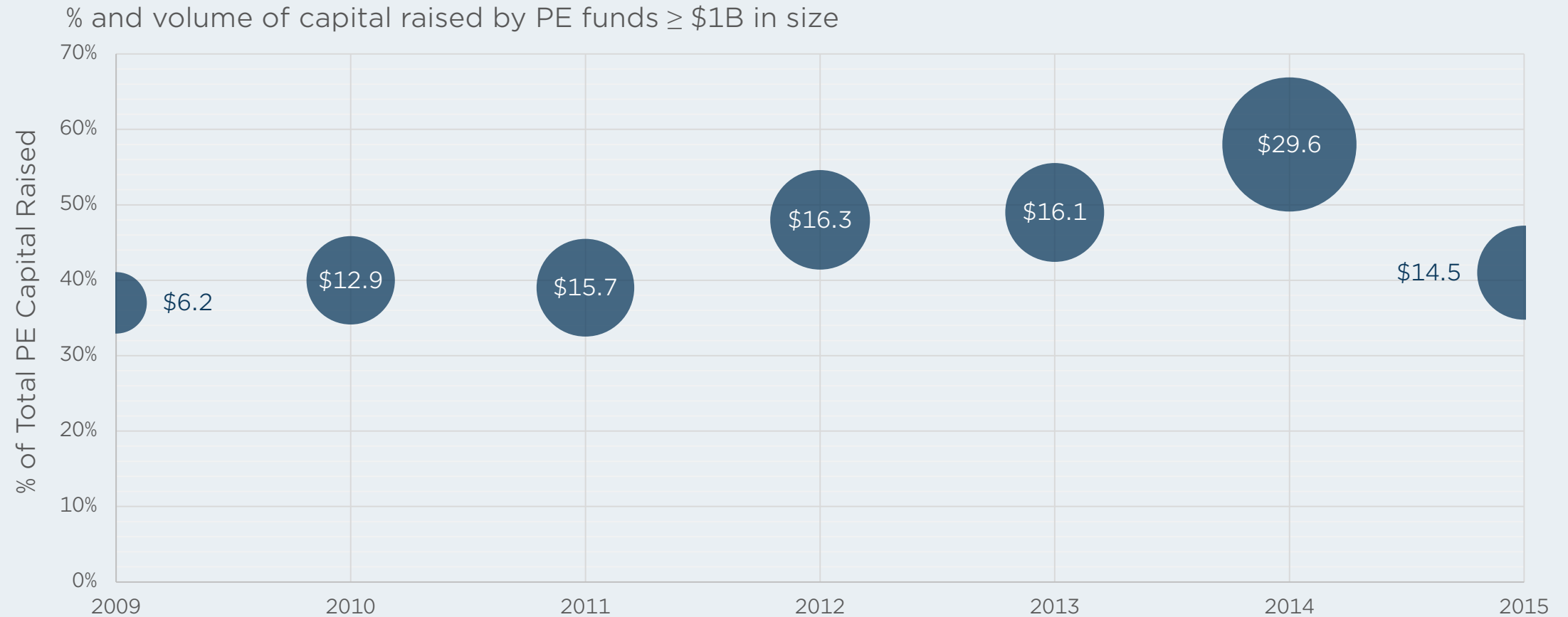
Fewer private equity funds are achieving a close

While an average of ~ 25 buyout funds achieve a close each year, there has been a 30% decline for growth equity funds since 2010



Capital is concentrating in fewer funds ...

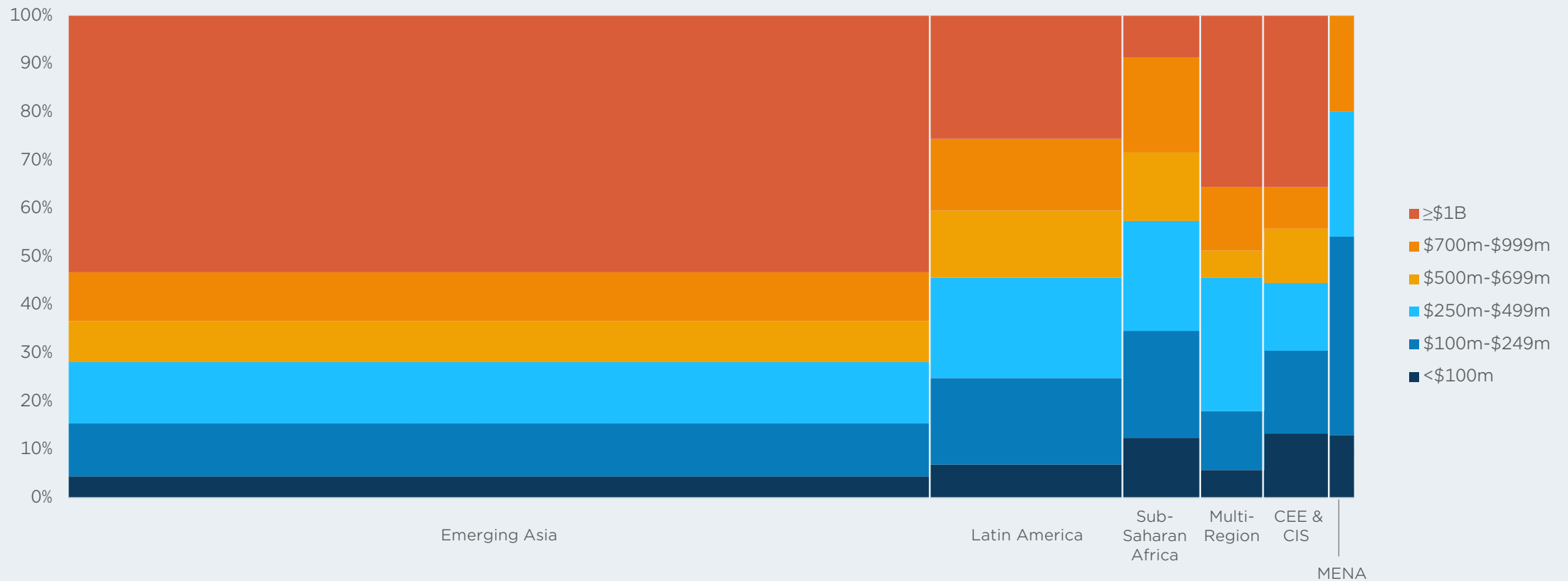
Fund vehicles \geq \$1 Billion in size are capturing a larger share of EM PE fundraising, while constituting only 7% of the total number of funds achieving a close in a given year (on average)



... and in larger segments

Leading to questions regarding a potential mismatch between capital flows and the landscape of investable companies in certain markets

Volume of capital raised by region and fund size, for vintage years 2012-16



A preemptive dispelling of criticism

I received some gentle pushback on this issue of capital concentration when I wrote [an article](#) about Sub-Saharan Africa's private equity landscape two years ago. To be clear:

- The problem is the thinning out of small-cap and mid-market funds, not the fundraising successes of larger funds. Many of the larger funds are managed by excellent firms, and their ability to scale offers a potent demonstration effect.
- The diminished number of small-cap and mid-market funds is a shame because there are companies in need of expansion capital and business expertise, and they're not able to secure it. Moreover, it reduces future deal flow for larger funds.
- The available data do suggest that the pools of investable companies at larger segments look relatively shallow, but that could be because there are, indeed, too few companies in the formal sector; or simply because obtaining quality data remains an onerous task.
- The focus on investable companies misses the broader evolution underway, in which fund managers are deploying capital into platforms and companies that do not yet exist (more on this point later). In addition, it underplays the volume and tranches of capital that some EM companies require to achieve scale.
- Objectively, there *is* a non-zero risk that the concentration of capital in larger segments could lead to poor performance. But investors generally know the peer groups of larger managers that are coming to market (often at the same time), and they have placed their trust in these managers' ability to execute their investment strategies with discipline.

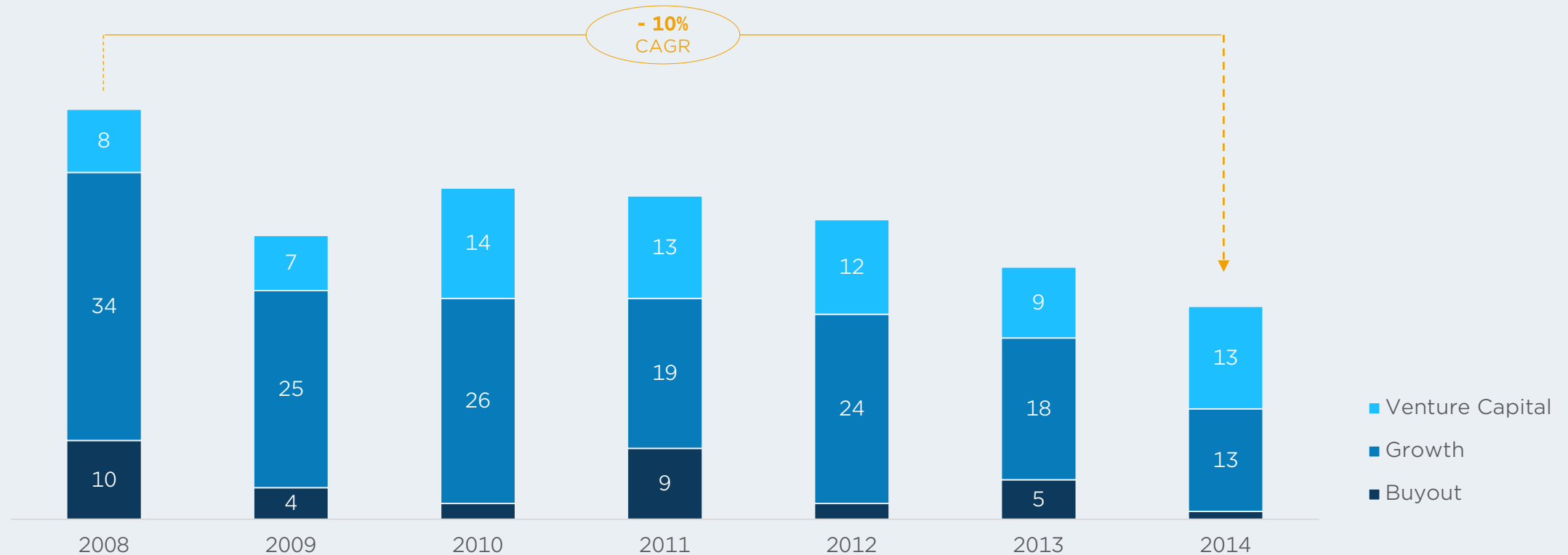


Are new firms entering?

Fewer first-time funds are achieving a final close

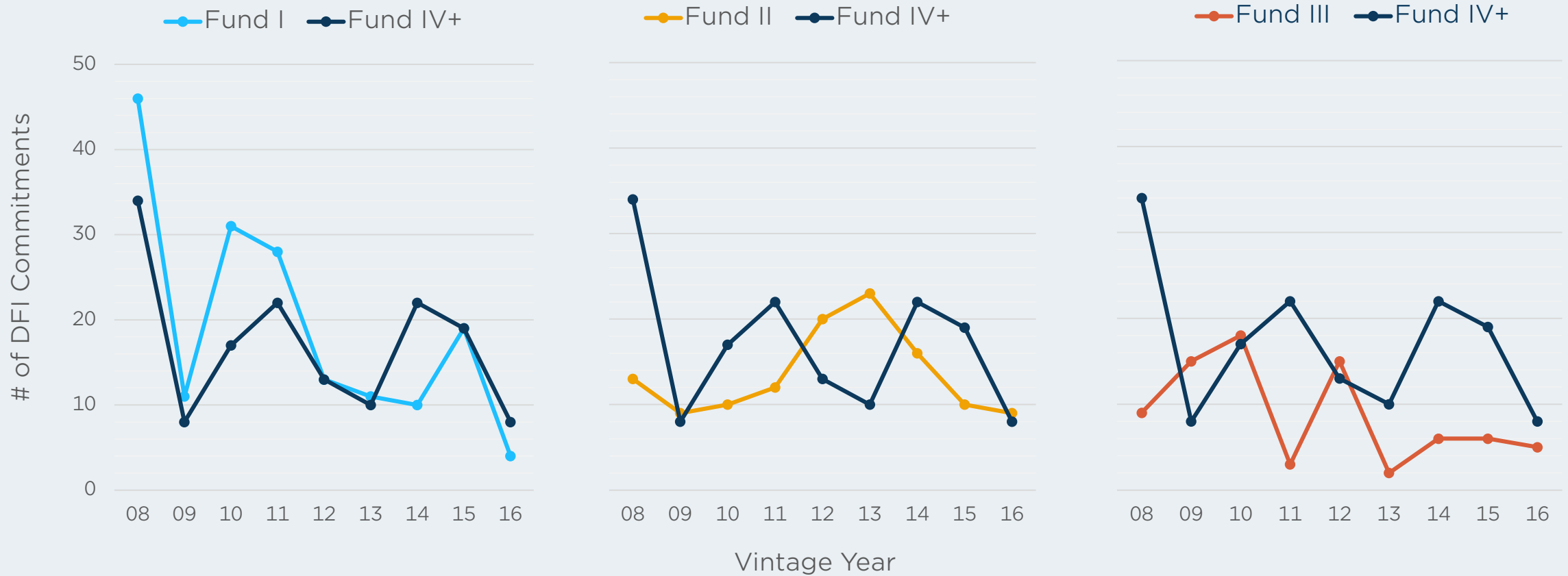
Growth equity funds, in particular, are being pummeled as the private capital ecosystem is beginning to take the shape of a barbell—more VC and large-cap funds, leaving a thinned-out middle market

of first-time funds holding a final close by strategy



And they're not getting help from DFIs

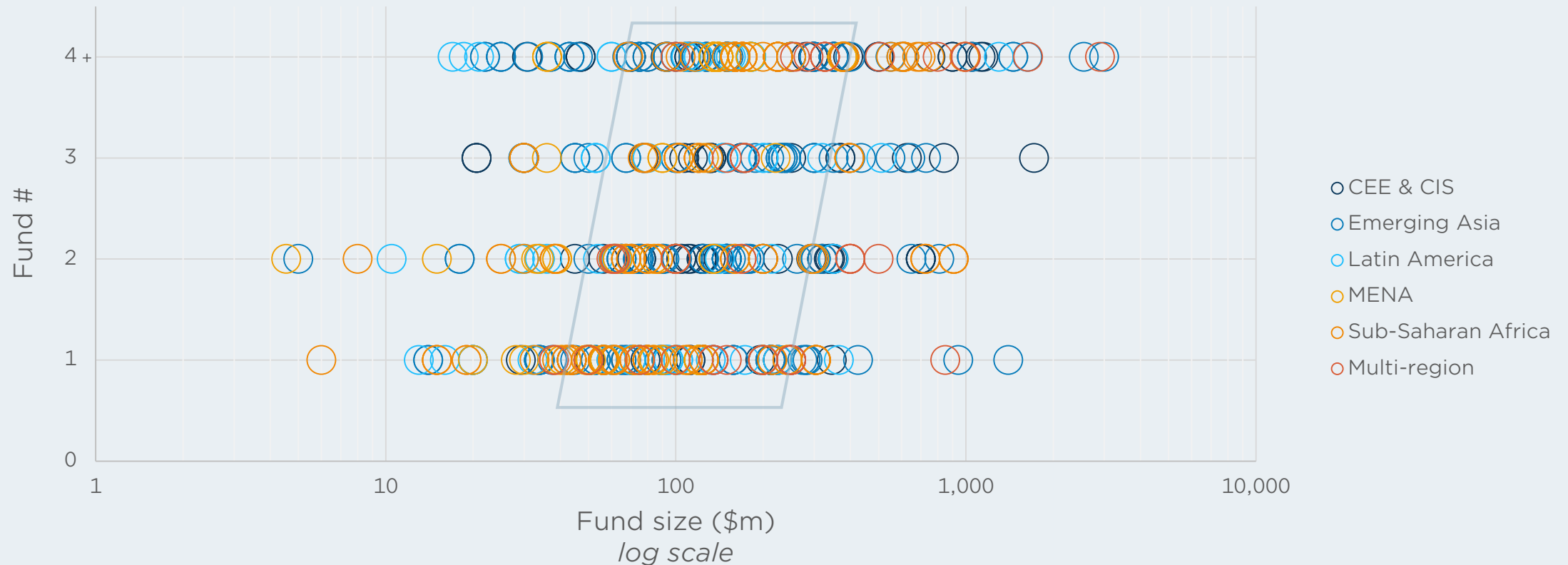
DFIs are committing to more Funds IV+ than to Funds I, II or III, raising questions about GP viability, a DFI “flight to quality,” and the amounts of commercial capital that DFIs are catalyzing



Though DFIs remain critical in the mid-market

The majority of DFI commitments are to funds between \$30m-\$350m, which offers a modicum of encouragement for the fate of the asset class over the long term

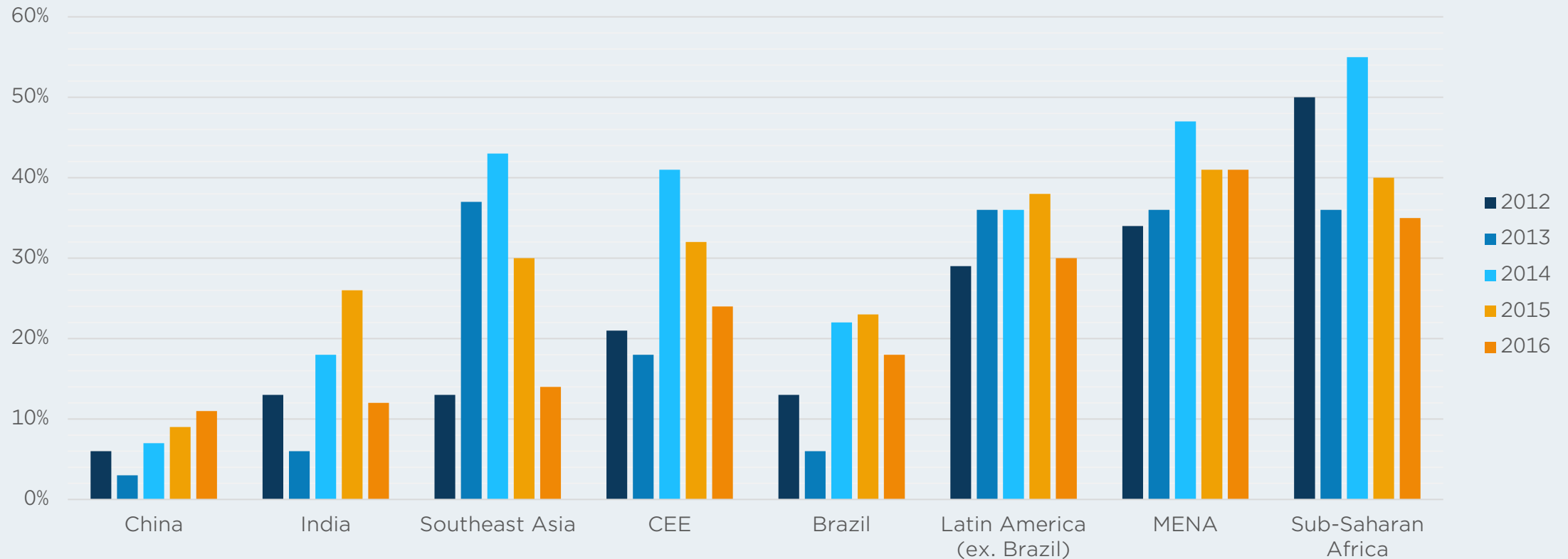
DFI Commitments by fund #, size, and region, for vintage years 2006-16



A lack of established GPs inhibits new commitments

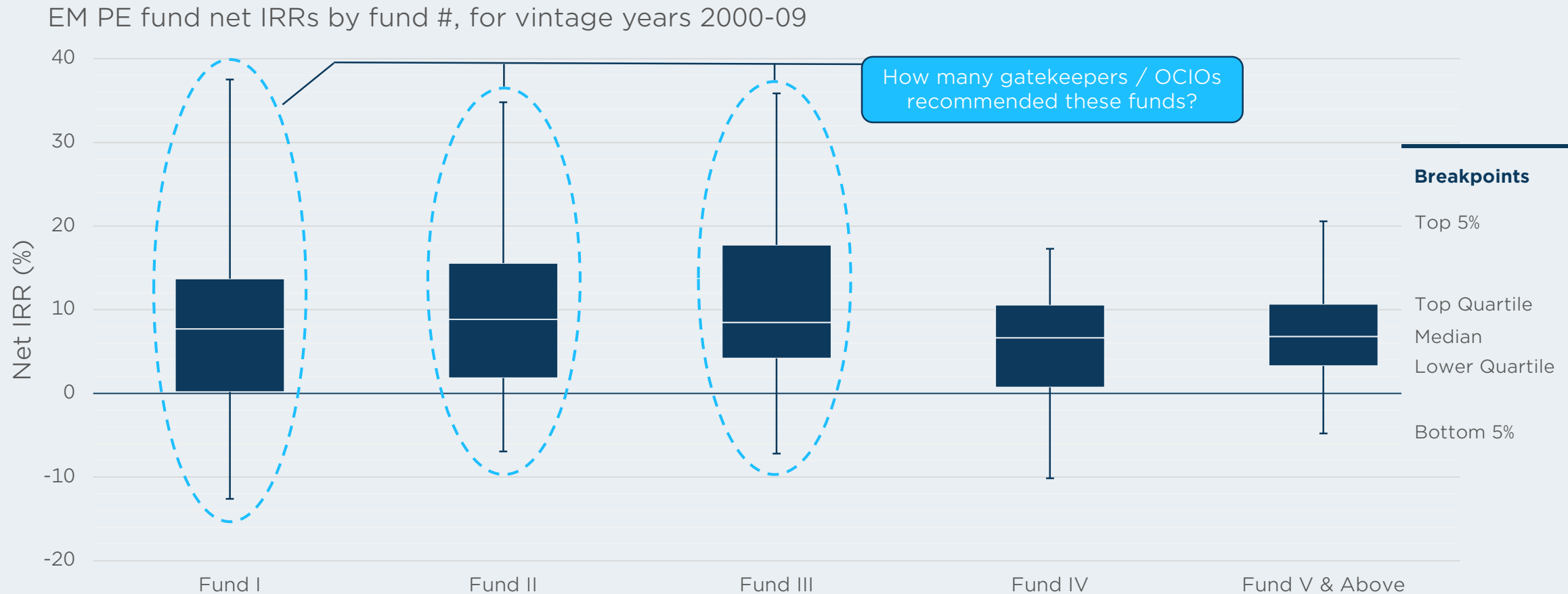
According to EMPEA's "Global LP Surveys," a shallow pool of established fund managers remains one the primary deterrents for greater LP involvement in the asset class

% of LPs noting that a limited # of established GPs deters commitments to said market



Despite clear opportunities for alpha in early funds

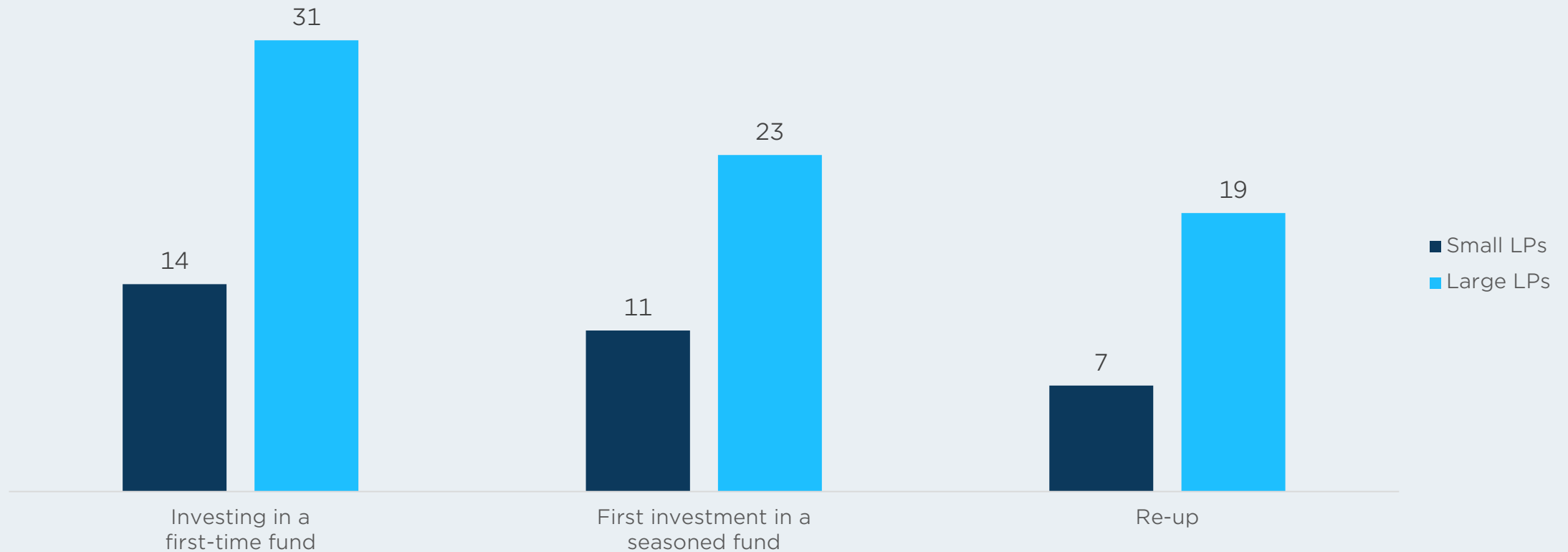
The dispersion of returns historically exhibited by earlier funds illustrates the precise opportunity for LPs to be in EM PE—inefficiently priced assets, with clear benefits to astute manager selection



But smaller LPs don't have time for due diligence

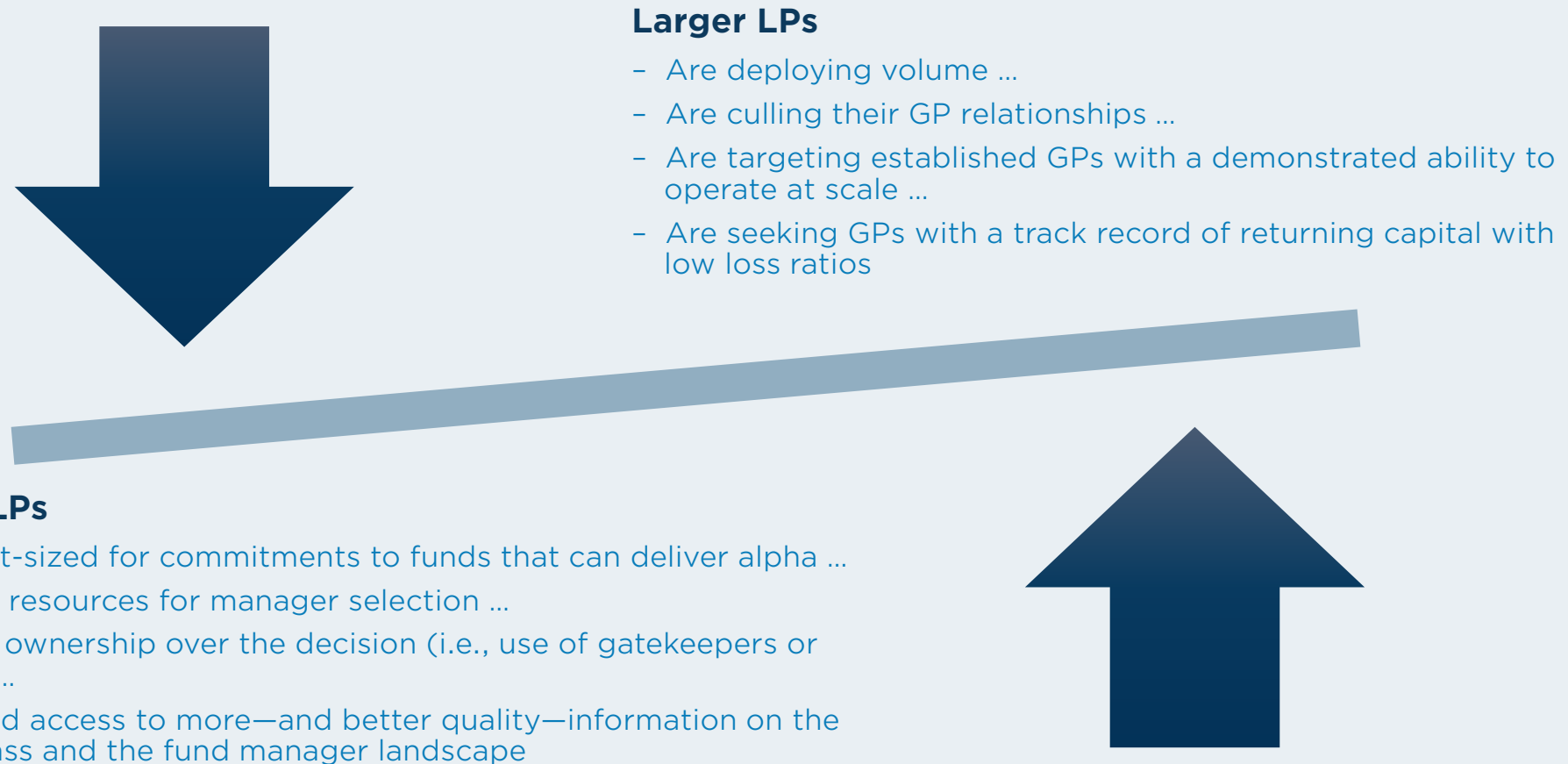
A recent survey shows that smaller LPs can allocate a fraction of the time for GP due diligence compared to their peers at larger institutions—this is a critical growth constraint for the EM PE industry

Average # of days LPs spend on due diligence, by experience with fund and LP size



An imbalance in supply and demand for capital

The industry confronts a market failure: larger LPs are deploying sizable volumes of capital to EMs, but smaller LPs are constrained due to a lack of resources, independence, and quality information

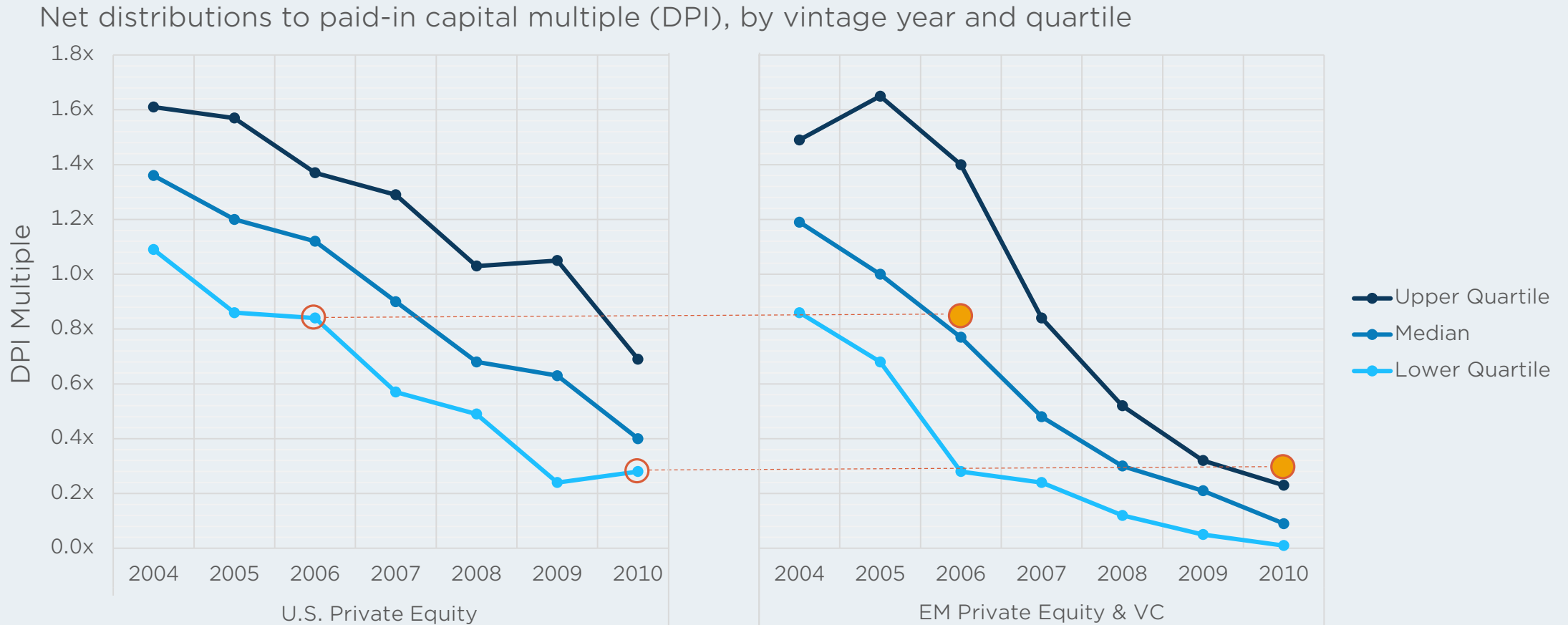




Are stragglers leaving?

Distributions are slow, impeding new allocations

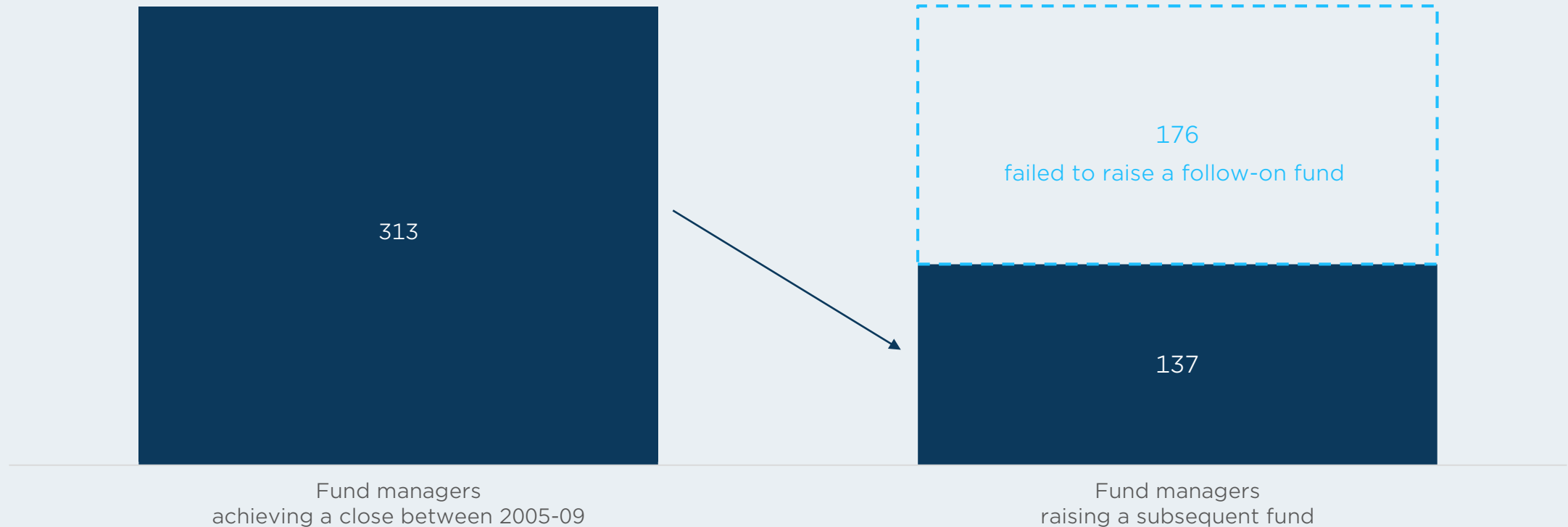
Emerging market distributions have lagged behind those for U.S. PE funds, with a pronounced sluggishness beginning with 2006-vintage funds



There appear to be more “zombies” than viable GPs

56% of the GPs that raised a fund between 2005-09 have failed to raise a follow-on fund, suggesting a significant volume of GP restructurings and secondaries may be required to clear the market

EM PE fund managers achieving a close between 2005-09 that raised a subsequent fund



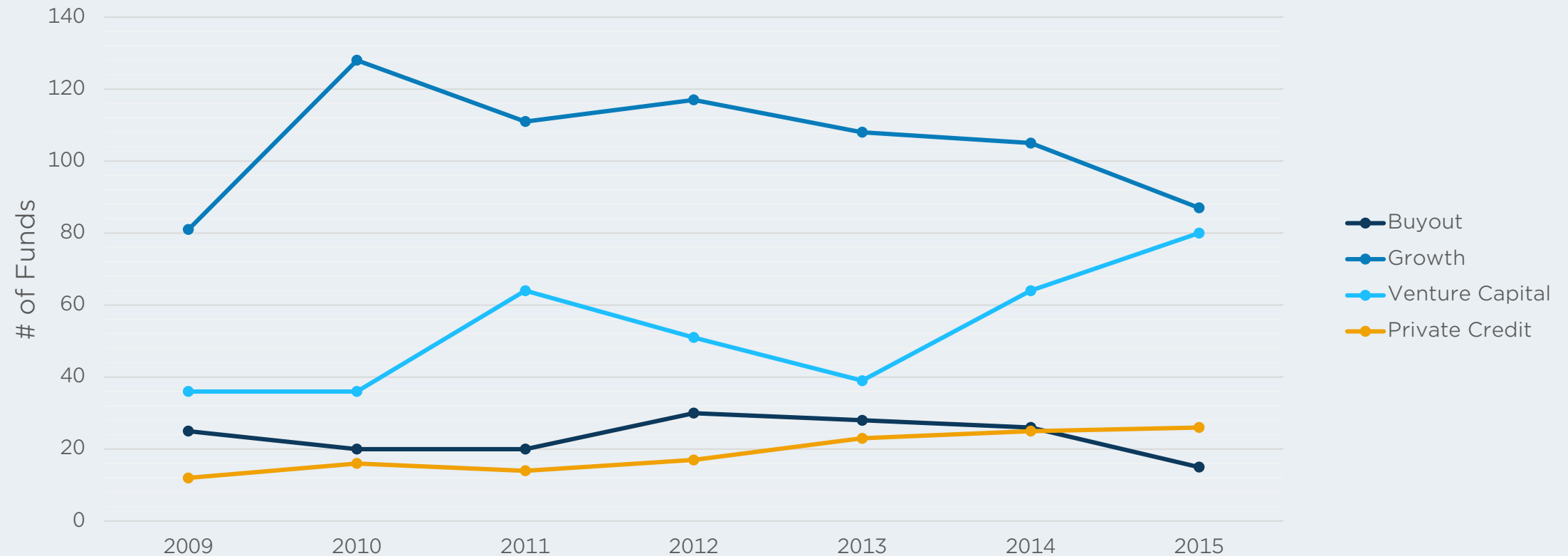


Are there substitutes?

Venture and credit funds are gaining traction

LPs are manifesting an appetite for alternative strategies for accessing private EM companies—on opposite ends of the risk-return spectrum

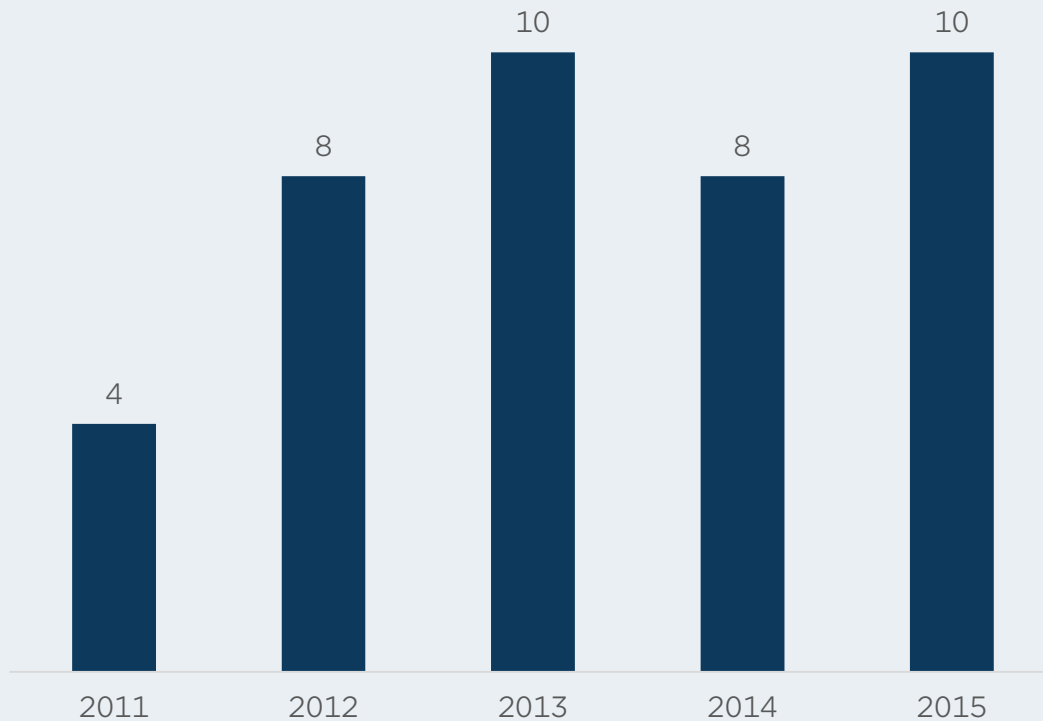
of PE funds achieving a close by strategy



As are “impact investing” funds

While “impact” funds are a tiny fraction of funds raised, the definition is as slippery as a greased pig, and a number of fund managers seem keen to pollute the distinction from value-creating PE investments

of “impact investing” EM PE funds closed



Who is an “impact investor”?

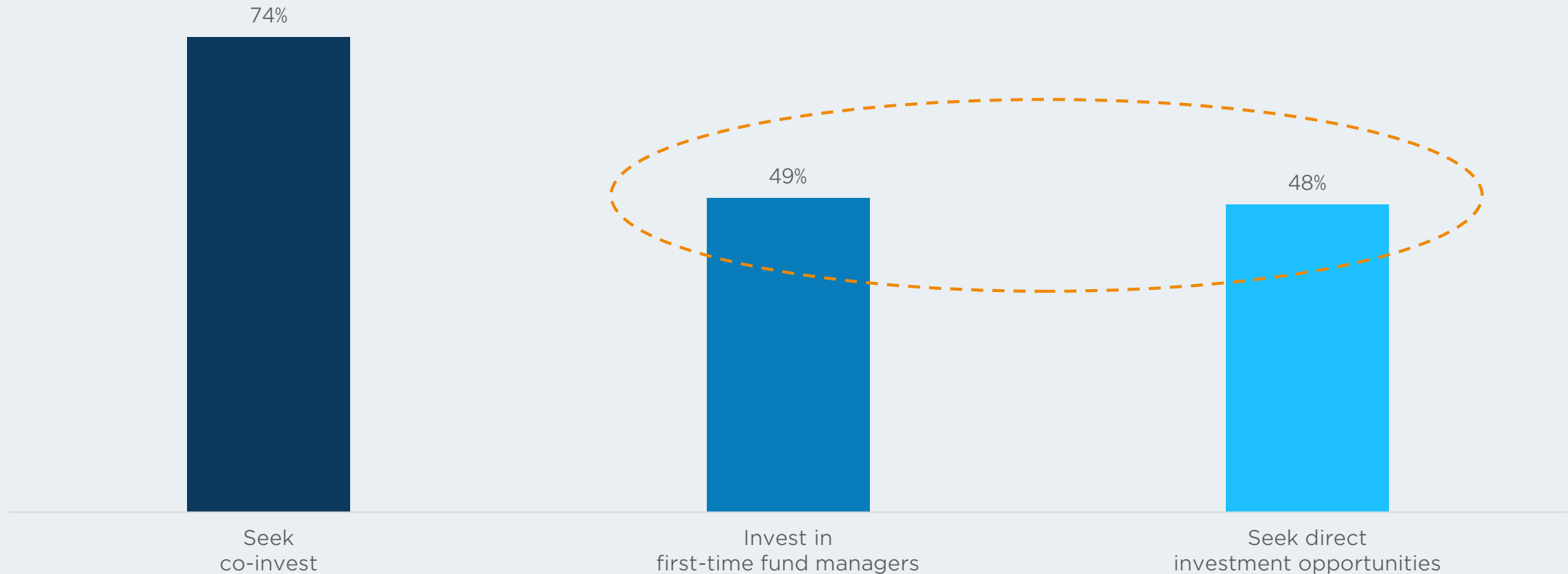
- Global growth markets PE firm The Abraaj Group is positioning itself as one
- KKR’s investment in Modern Dairy helped bring a safe supply of milk to *millions* of consumers
- Pan-EM PE firm Actis helped its portfolio company Umeme connect more than 120,000 Ugandans to the country’s electrical grid
- “Impact” firm LeapFrog invested alongside PE firm India Value Fund Advisors* in Magma Fincorp, a KKR portfolio company
- Helios Investment Partners led a consortium of investors to build out Africa’s telecom infrastructure with Helios Towers Africa
- (there are *countless* others)

* The investment was made by Indium V, an investment vehicle advised by India Value Fund

LPs are looking to reduce fee drag

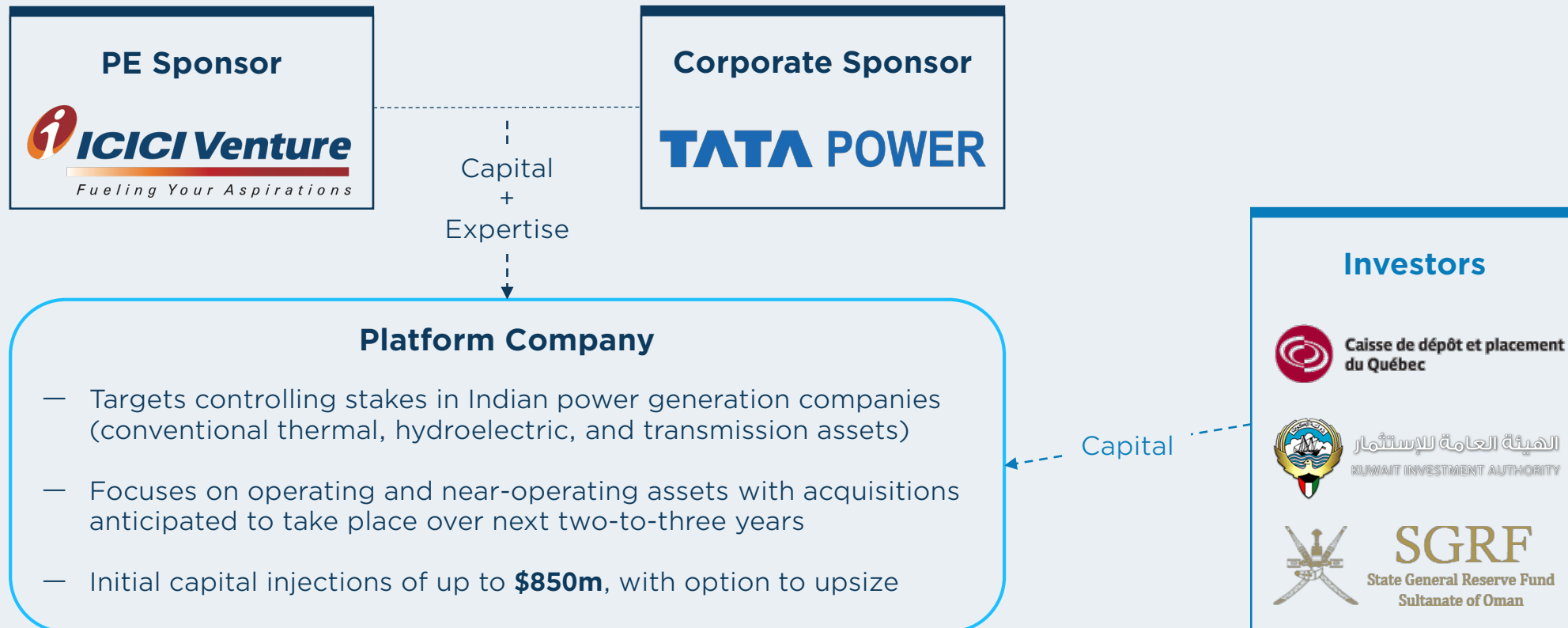
Respondents to EMPEA's "LP Survey" are as likely to go direct as to commit to a first-time fund manager, while MVision's "The New Paradigm" reveals that one-third of GPs have bumped up against LPs in auctions

% of LPs indicating preferred means for accessing EM PE opportunities



Large investors are bypassing funds for platforms

PE fund managers are sourcing attractive deal flow directly for LPs, in some instances partnering with corporate co-sponsors, and mobilizing large volumes of institutional capital





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Are legal
and regulatory
policies supportive
of industry growth?

It's harder to raise capital from today's asset owners

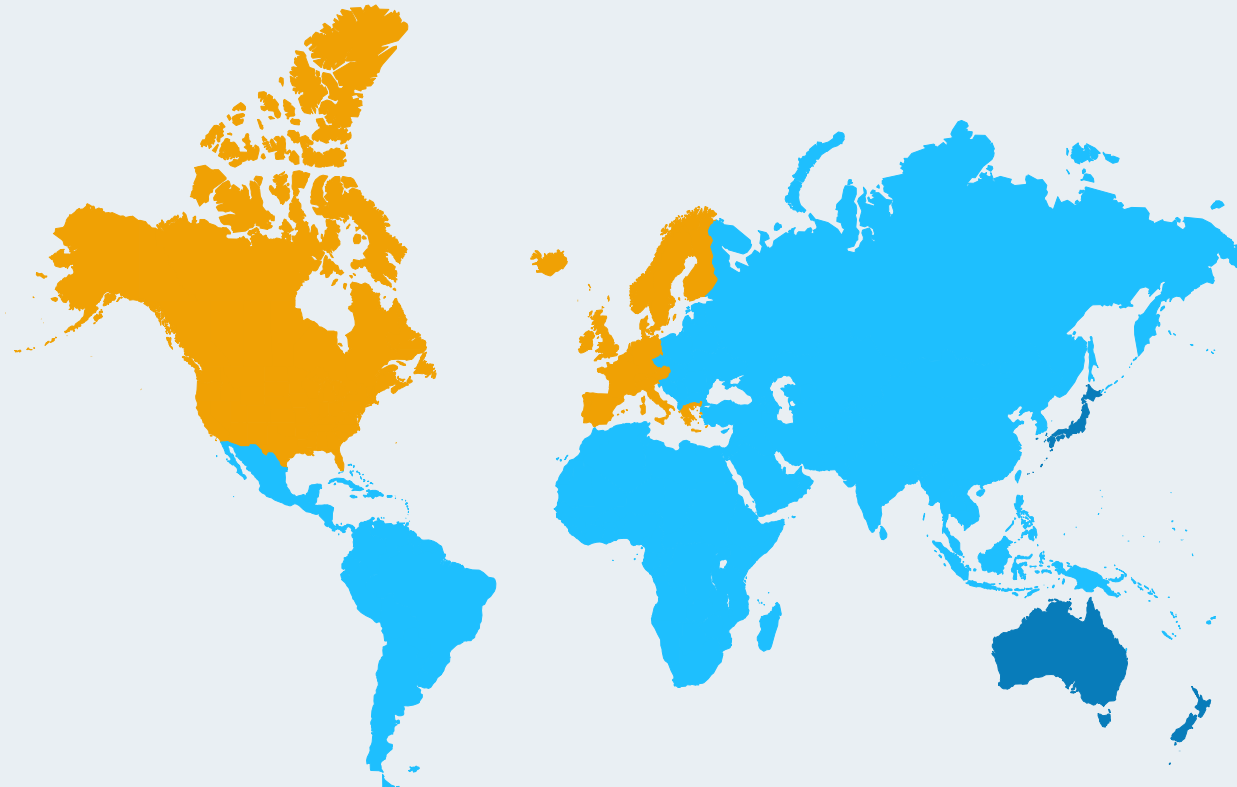
Regulatory complexity is making it more difficult for fund managers to raise capital—depriving some LPs access to a broader investment opportunity set—while many EMs are fostering PE development

North America &
Western Europe

> **\$21T**

in pension assets, with
regulatory complexity
being layered on

- AIFMD
- FACTA
- SEC
- Solvency II
- Volcker Rule
- ESG
- Brexit



Emerging Markets

> **\$2T**

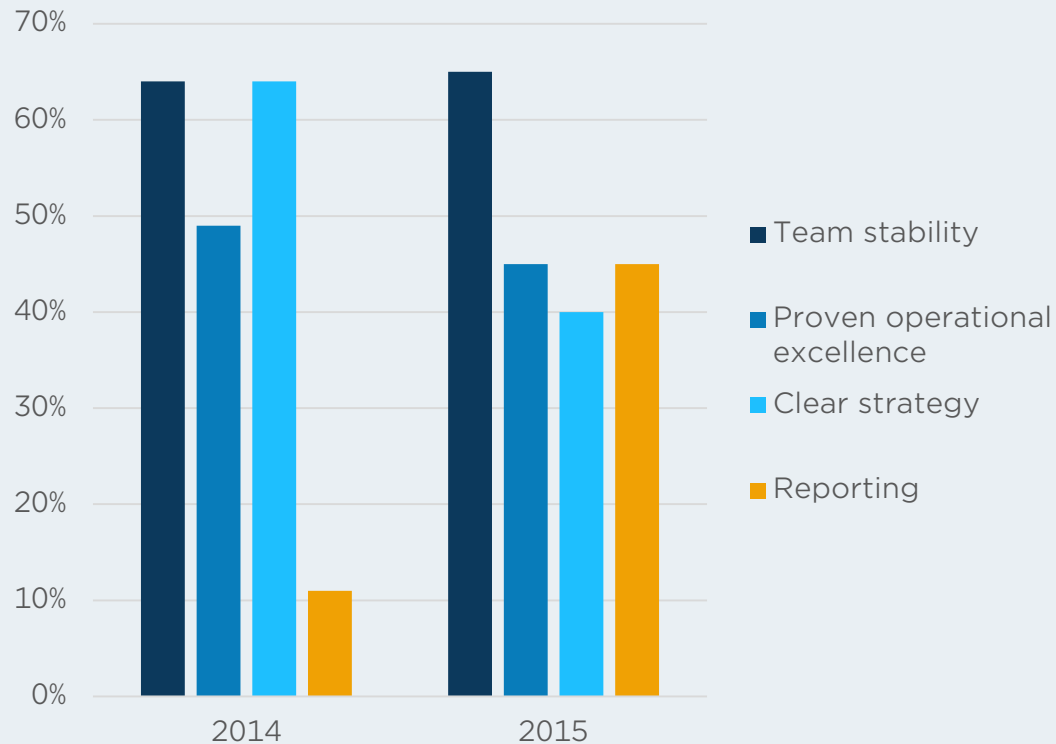
in pension assets, with
regulators generally keen
to facilitate investment

- Enabling pension funds & insurance co's to invest in PE
- Innovative structures for DC plans to pursue long-term investments
- State-supported PE & VC ecosystems (i.e., China, Brazil)

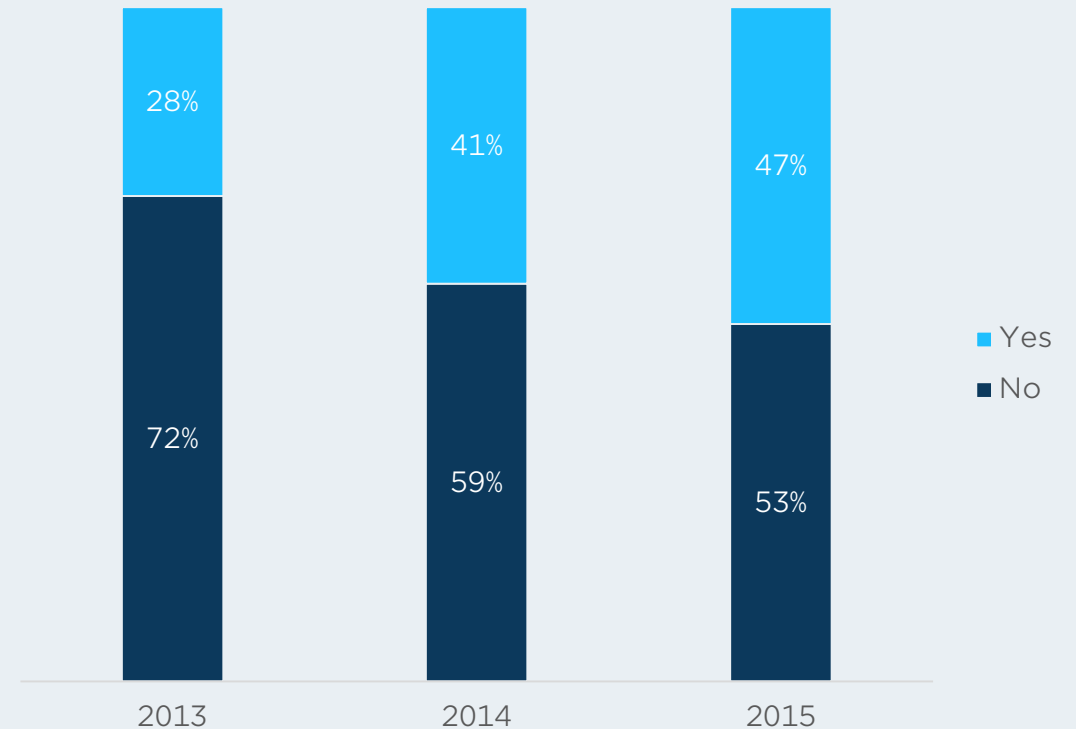
Compliance costs, reporting requirements increasing

Quality and frequency of reporting are becoming more important, and surveys of practitioners suggest that audits are increasing in frequency as well, taxing the bandwidth of smaller fund managers

Beyond track record, what are you most concerned with?



Were you subject to a regulatory audit or examination in the past two years?



Where are we going?

The tyranny of choice

Investors will increasingly grapple with the big question: is private equity the right model for investing in EM private companies?



Traditional PE Funds

- Standard fixed-life (i.e., 10-year), blind pool, closed-end fund
- Likely to remain the preferred vehicle for established GPs, large LPs, and DFIs

Platform Companies / Deal-by-Deal Funds

- Allow firms to mobilize capital for a single opportunity
- Reduces amount of time spent fundraising and can foster strong relationships with investors

Evergreen / Listed Vehicles

- Allow firms to raise permanent capital
- Likely to grow in popularity for asset managers offering multiple strategies (e.g., equity, mezzanine, credit)

Pledge Funds

- Enable firms to build a track record while giving investors the option to pass on deals

Hybrid Funds

- Provide flexibility to pursue opportunities across public and private markets (e.g., hedge funds employing side pockets for illiquid investments, PE firms executing PIPEs)

Corporate Partnerships / Joint Ventures

- Team with multinationals to de-risk acquisitions / validate entry in new markets

There will be greater participation from local capital

The involvement of EM-based pension funds, insurance companies, and high-net-worth investors is in its early stages, but it will be a core driver of the industry's development going forward

Local capital has a number of intrinsic advantages in EM PE, but it is still quite nascent

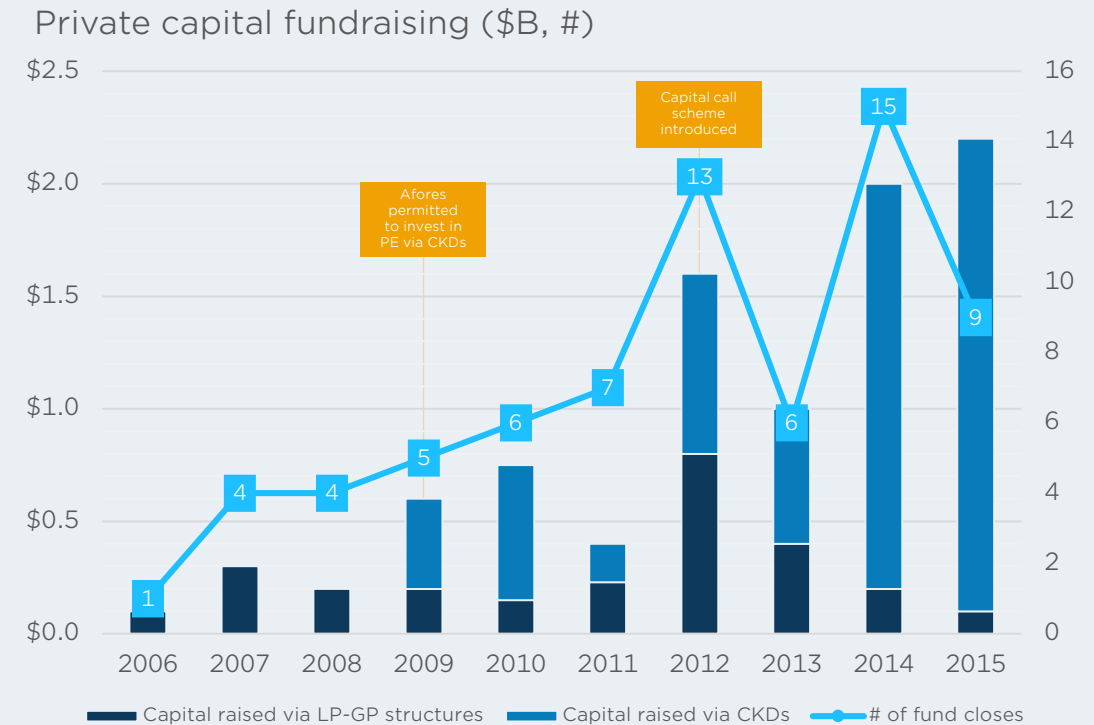
Advantages

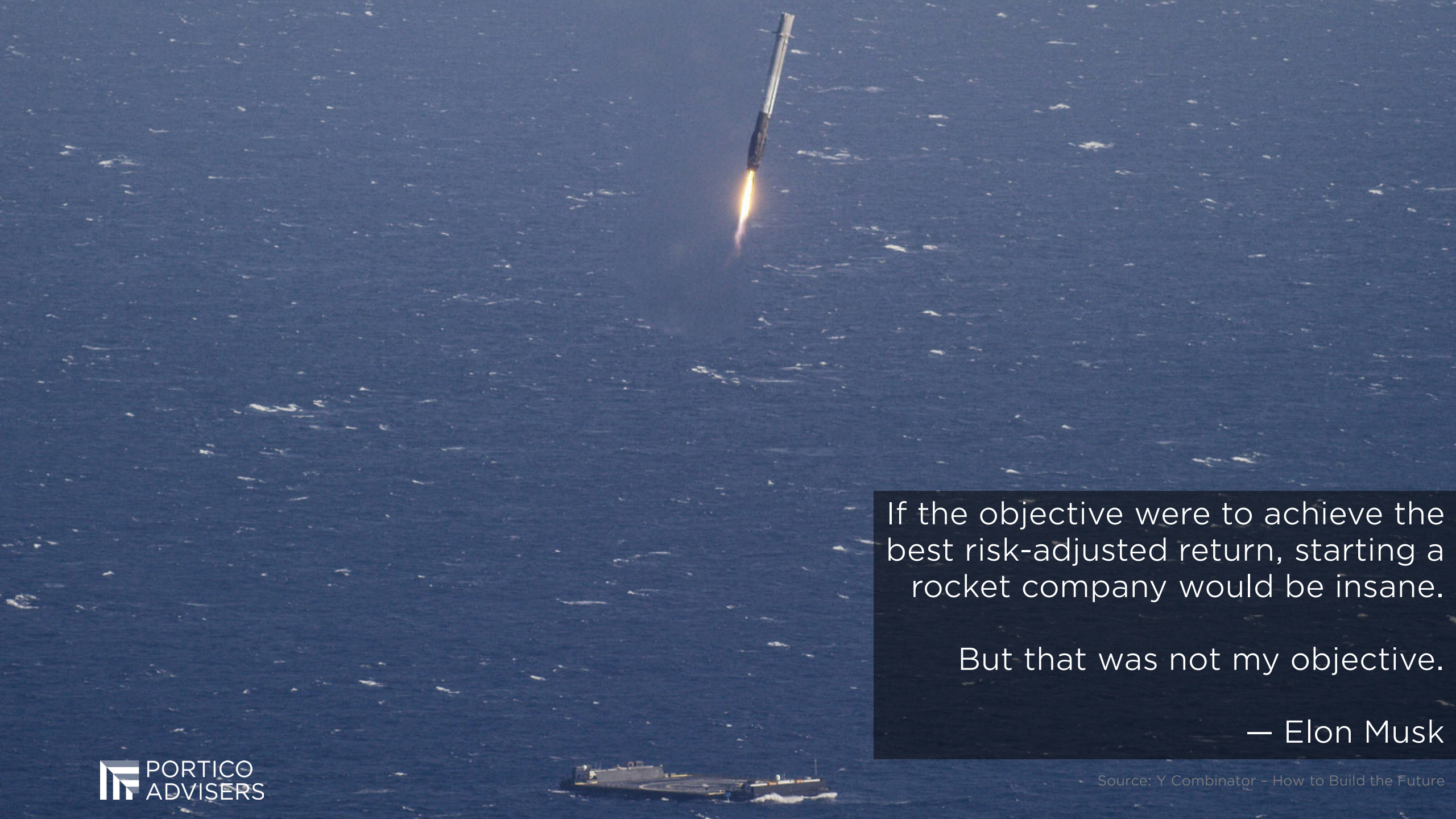
- Ticket sizes are aligned (for now) with the size of many fund managers active in emerging markets
- Local presence facilitates discovery and due diligence of fund managers
- Local currency vehicles can minimize FX risk to the LP

Constraints

- The asset class is opaque and not well understood; more efforts to educate and share knowledge are required
- Regulatory changes take time to implement
- Portfolio management experience / expertise is in short supply

Local capital's role in building a PE ecosystem: The case of pension funds ("Afores") in Mexico





If the objective were to achieve the best risk-adjusted return, starting a rocket company would be insane.

But that was not my objective.

— Elon Musk

Food for thought

When I began my research into the question animating this piece, I had a hypothesis that the industry was in ill health. Yet some of the findings were surprising. I hadn't realized the extent to which DFIs were still supporting established fund managers. I hadn't appreciated how under-resourced smaller LPs were vis-à-vis their larger brethren. I hadn't fathomed the sheer volume of "zombie" funds.

It seems clear that smaller LPs could benefit from allocations to quality GPs operating in lower market segments, but many have outsourced their decision-making processes, or simply lack the time and resources to do their homework. Local capital is a critical long-term solution, but there is a chasm between today and that idyllic future.

I doubt that the market failures on display in this piece will be solved without an open discussion of them. But concerted efforts to tackle these challenges head on should help to truncate this stage of the cycle, and build a firm foundation for the next phase of the industry's growth.

In the meantime, some more food for thought:

- Is institutionalization of the asset class killing the industry?
- Why are smaller LPs participating in the trend toward agglomeration and bureaucracy (through the use of gatekeepers and OCIOs), and surrendering their edge of agility?
- Given [recent questions over the veracity of top quartile persistence](#), and the rapidity with which emerging economies are transitioning, is track record even less relevant in EM PE?

A humble call to action

Fund Managers

- Develop a value proposition that **clearly differentiates your offering** from your competitors'
- **Map your strategy** and fund size to the investable landscape of companies in your geographies
- **Strengthen your brand** in a world of democratized discovery
- Support and **contribute data** to industry associations

Institutional Investors

- Seek out **fresh ideas on potential investment partners**
- **Pressure gatekeepers and OCIOs** to justify their fees, and identify funds that expand your institution's efficient frontier
- **Consider EM funds of funds**
- **Share knowledge and best practices** with peers at home and abroad

Stakeholders

- Create knowledge and **provide greater transparency on the asset class**, including through Internet-based platforms
- Open dialogue and build relationships with institutions that are unfamiliar with EM PE
- **Work with regulators and policymakers** to facilitate SMEs' access to financial and human capital

Everyone

- Let us know what you think about this piece and the state of the industry
- **Sign up for Portico's newsletter** to receive periodic think pieces and updates
- Follow Portico on [Twitter](#)
- **Share this piece** with friends and colleagues
- Let us know how we can be helpful

An Open Invitation to LPs Managing \leq \$1B

Portico Advisers extends an open invitation to any institution managing \leq \$1B in total AUM to reach out and participate in an introductory call with our team. During the call, we would aim to identify whether there are specific knowledge gaps that we can fill, and we would explore structuring an engagement for you on a **complimentary** basis.

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