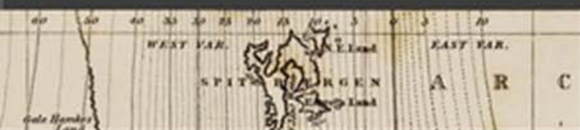

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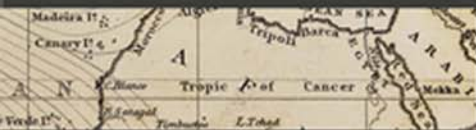

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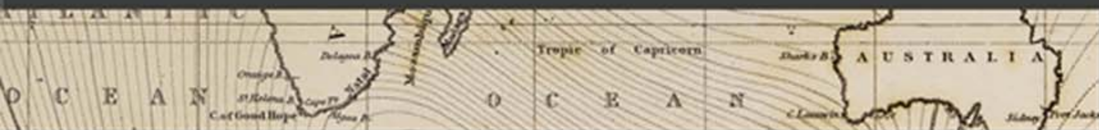

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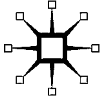

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For Ellen, my role model in life.

Contents

List of Exhibits ix

Acknowledgments xiii

Quick Reference Guide xvii

Introduction 1

1 A Private Equity Primer 19

2 Private Equity Ecosystems: A Stark Contrast between Developed and Developing Countries 49

3 The Private Equity Advantage: Operational Value Creation 81

4 Private Equity Performance before the Global Financial Crisis 115

5 A Post-crisis Assessment: New Challenges and Opportunities 139

6 China: Private Equity with Chinese Characteristics 157

7 Brazil: The Country of the Future 189

8 Kenya: Challenges and Opportunities in a Frontier Market 221

9 Looking through a Hazy Crystal Ball 245

Notes 259

Bibliography 275

Index 281

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Exhibits

1.1 Growth Constraints Reported by SMEs 21
1.2 The Private Equity Timeline 23
1.3 Basic Organization of the Private Equity LLP Fund Structure 24
1.4 The Private Equity Spectrum 29
1.5 General Characteristics of Growth Capital vs. Buyout Firms 29
1.6 The Private Equity Cycle 31
1.7 Key Considerations for Sourcing Successful Deals 32
1.8 Sample Simplified Due Diligence Checklist 34
1.9 Private Equity Falls between Two Extremes 45
2.1 New Commitments to Private Equity Partnerships, 1980–1994 51
2.2 Global Buyout Deal Value, 1995–2013 54
2.3 Emerging Market Country Ranking on Key Doing Business Indicators 63
2.4 Domestic Credit Provided by Financial Sector (% of GDP, 2012) 66
2.5 Market Cap and Turnover Value of Top 10 Companies (% of Total) 68
2.6 Standard & Poor's Country Credit Ratings (March 2014) 72
3.1 Sample LP Due Diligence Checklist 86
3.2 Sample 100-Day Plan 91
3.3 Framework for Identifying Potential Operational Improvements 93
3.4 KVP Portfolio Companies' Sales and EBITDA, 2009–2012 96
3.5 KPR Mill Sales, 2009–2012 100
3.6 Features of Sound Corporate Governance 102
3.7 Overview of KKR's Green Portfolio Approach 109
3.8 Impacts of Environmental and Sustainability Value Creation at Cogitel 113

4.1 Foreign Direct Investment in Developing Countries, 1995–2000 (US$ Billions) 116
4.2 Emerging Markets Private Equity Fundraising and Investment, 2003–2008 (US$ Billions) 128
4.3 Emerging Market vs. US and Europe Average Returns (as of end-September 2008) 130
4.4 GDP Growth Rates, 1997–2000 and 2005–2008 131
4.5 CDC Historical Fund of Funds Returns 136
5.1 Especially Post–Global Financial Crisis, Emerging Market Economic Recovery Was Projected to Be More Rapid than OECD Countries 140
5.2 Expected Change in Emerging Market Commitments as a Percentage of Private Equity Portfolio over the Following Three to Five Years 142
5.3 Emerging Market vs. US and Europe Average Returns (as of end-December 2008) 144
5.4 Developed Market Share of World Output, 1992–2015 147
5.5 Emerging Markets Private Equity Fundraising as a % of Global Total, 2009–2012 148
5.6 Emerging Markets Private Equity Fundraising and Investment, 2009–2013 149
5.7 BRIC- vs. Non-BRIC-dedicated Funds as a % of Fundraising 150
5.8 Market Attractiveness Rankings, Greatest Shifts 151
5.9 Average Final Emerging Market Private Equity Fund Sizes, 2009–2013 154
6.1 China's Economic Performance vis-à-vis India (as of year-end 2012) 159
6.2 Top 10 Countries for Fundraising, 2008–2013 (US$ millions) 160
6.3 SOEs Dominate the Hang Seng China Enterprise Index 162
6.4 Composition of Chinese Bond Market, Annual Issuance by Type 163
6.5 Growth in Private Equity Fundraising and Investment Eclipsed GDP Growth Rate 172

6.6 Private Equity Investments by Sector, 2008 (US$ millions) 173
6.7 The Rise of RMB Funds 181
6.8 PE/VC-backed IPOs in China 183
7.1 Brazil Macroeconomic Indicators, 2003–2008 196
7.2 Brazil Private Equity Fundraising, 2002–2008 (US$ Billions) 196
7.3 Latin America Private Equity Fundraising, 2004–2008 (US$ Billions) 197
7.4 Latin America Private Equity Investment, 2004–2008 (US$ Billions) 198
7.5 IPO Activity in Brazil, 2004–2007 198
7.6 Brazil's Deteriorating Macroeconomic Conditions (2010–2013) 200
7.7 Private Equity Fundraising and Investment in Brazil, 2009–2013 201
7.8 Composition of Private Equity Fund Managers in Brazil 202
7.9 Brazil Private Equity Investments by Sector, 2013 203
7.10 Senior Solution's Growth 205
7.11 The Underserved Middle Market in Brazil 206
7.12 Private Equity Investments by Stage in Brazil, 2009–2013 207
7.13 BNDES Disbursements, 2004–2013 214
7.14 Private Equity Penetration in Brazil vs. Other Countries, 2013 217
7.15 Brazil Investments by Stage, 2013 (No. of Deals) 217
8.1 Kenya Macroeconomic Indicators, 2008–2013 223
8.2 Sampling of Funds Investing in Kenya, 2008–2013 230
9.1 Global Private Equity Penetration 248

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central importance of private equity as a driver of private sector development in emerging markets.

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(In order to maximize the likelihood of candor, every interview was conducted on the condition of strict confidentiality, and therefore these individuals are not identified by name in the text without their express permission.)

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Quick Reference Guide

100-day plan: An action plan mapped out by a private equity fund in collaboration with the senior management of a portfolio company to be implemented during approximately the first 100 days post-investment. The plan is designed to outline which value-enhancement initiatives should be implemented during the initial months of a private equity partnership, when management is believed to be most receptive to making important changes.

Angel investor: A high net worth individual, often with extensive industry expertise, who invests her own capital in entrepreneurial start-up companies.

Asset class: A classification of financial assets based on assumptions about the similarities of their risk, return, and liquidity characteristics. Private equity is considered its own asset class, and this book contends that emerging markets private equity, which has a unique set of characteristics, should also be considered a separate asset class.

Asymmetric information: A term that refers to a reality in nearly all transactions: one party (e.g., a company owner) possesses more information that is relevant to the transaction than the other (e.g., the investor). In private equity, the company management knows more about the underlying operations of the business than the investor, which may result in the investor making decisions regarding the investment that are based on incomplete or inaccurate information.

Carried interest (carry): The share of profits from a private equity fund's investments that are allocated to the general partner, typically after the limited partners receive their original investment and agreed-upon preferred return (or hurdle rate). The standard practice in private equity is a 20 percent carry (also known as a performance fee) allocated to the GP.

Committed capital (commitments): The total amount of capital from limited partners and general partners that is allocated to

a particular fund. The term also refers to the specific amount of capital a limited partner contractually commits to a private equity fund.

Comparables (comps) analysis: A valuation methodology that involves comparing a company's historical performance with similar companies in the same industry, usually by using financial ratios.

Convertible securities: A debt or equity security that under certain specified conditions related to company performance may be converted into another security (usually common stock). There are various types of convertible securities, each with its own well-defined rights and conversion conditions.

Deal flow: A term used by asset managers (e.g., venture capital funds and private equity funds) to refer to the availability of new investment opportunities. In private equity, it refers to companies that are likely to meet the fund manager's investment criteria.

Development finance institutions (DFIs): Institutions that are backed by governments to provide financing and technical assistance for projects in developing countries for the purpose of spurring economic growth and development. Examples of well-known multilateral DFIs that focus on the private sector include the World Bank's International Finance Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD).

Discounted cash flow (DCF) analysis: A valuation methodology that measures the profitability of a prospective investment by projecting a company's potential cash flows over a period of years and then discounting these financial flows back to the time of the initial investment to establish a present value. According to this methodology, a potential investment is generally considered attractive if the present value of the discounted cash flows is higher than the anticipated initial investment.

Distribution waterfall: The method of establishing the order of financial distributions as a private equity fund realizes its investments. For example, usually a distribution waterfall specifies that general partners only receive profits from an exited investment

after the limited partners receive their original investment and a specified preferred return.

Due diligence: The evaluation of a potential investment. With private equity, due diligence refers to the process undertaken by the fund manager to assess the operational, financial, and managerial strengths and weaknesses of a prospective portfolio company in order to determine whether the company satisfies its investment criteria.

EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization): A common measure of a company's net income (profitability) before making adjustments for interest expense and/or tax obligations.

ERISA: The United States Employee Retirement Income Security Act of 1974, which established minimum rules for pension plan investing activity, as well as the tax effects of such investments. ERISA is relevant to private equity in particular because it included the so-called Prudent Man Rule, which forbade pension fund managers from investing in alternative assets such as private equity because of their risk profile. Once the rule was repealed in 1979, pension funds quickly became a major source of funding for private equity and the industry began to experience explosive growth.

Exit: Refers to a private equity fund's sale of all or a portion of its stake in a portfolio company, usually via an initial public offering (IPO), trade sale, or sale to another financial investor.

Fund of funds: An investment fund that raises capital from institutional investors, and then functions as a limited partner, making investments in a number of individual private equity funds. Fund of funds offer their investors greater diversification by holding a portfolio comprising a number of GPs, typically with differentiated strategies, which in turn invest directly in companies.

General partner (GP or fund manager): One or more individuals who are responsible for the day-to-day operations of a pool of capital (the fund), usually structured as a limited liability partnership. In private equity, the GP is responsible for raising capital from a group of institutional investors (the LPs), identifying

potential companies in which to invest, and actively overseeing the companies within its investment portfolio until the exit.

Growth capital: A term that generally describes significant minority private equity investments in companies that are relatively well established and seek to increase their growth and profitability by improving and maximizing efficiency within their operations, and expanding into new products, industries, or markets.

Hedge fund: A pooled investment fund that differs from private equity in that it targets investments in liquid assets, such as securities, instead of illiquid assets, such as private companies.

Hurdle rate (preferred return): The minimal acceptable return a limited partner must receive from a private equity fund investment before a general partner may begin to share in the profits generated.

Initial public offering (IPO): The first-time sale of shares to public investors by a company that previously was not listed on a public stock exchange. An IPO is often the preferred method of exit for a private equity fund investment, as it provides liquidity for any remaining shares in the company and generally, but not always, generates the highest financial returns.

Internal rate of return (IRR): The discount rate that makes the net present value of all future cash flows from an investment equal to zero. Generally speaking, the higher the investment's internal rate of return, the more desirable it is. As such, IRR is often used by private equity investors to rank prospective investments they are considering. IRR is also used as a means of measuring the real financial returns on an investment at the time of exit.

Institutional Limited Partners Association (ILPA): A global member-driven not-for-profit organization that represents the interests of limited partner investors in the global private equity industry by conducting research, engaging in advocacy and education campaigns, and fostering networking and collaboration opportunities for LPs engaged in private equity investing.

Institutional Limited Partners Association (ILPA) Private Equity Principles: A detailed list of suggested guidelines and best practices published by ILPA (see above) to clarify the terms and conditions governing the relationships between general partners and limited partners in a private equity fund. The Principles focus on such key

issues as the alignment of interests between LPs and GPs, governance of the private equity funds, and disclosure and transparency.

Leveraged buyout (LBO): A controlling private equity investment financed predominately with debt (often as much as 80–90 percent). The debt is then repaid from the cash flow generated by the acquired company. This form of acquisition is common in developed markets private equity, particularly in the United States, but rare in developing countries due to limited access to this form of debt financing.

Limited liability partnership (LLP): A business partnership in which some partners (the LPs) have limited liability, meaning they can only lose as much capital as they have invested, rather than being liable for losses in excess of their capital investment. Most private equity funds are structured as LLPs, with the fund manager (GP) assuming unlimited liability.

Limited partner (LP): A partner in a LLP (see above). In private equity funds, limited partners are passive investors, while the general partners are responsible for the day-to-day management of the fund. Limited partners in private equity funds tend to be major institutional investors, such as pension funds, university endowments, family offices, development finance institutions, and insurance companies.

Limited partnership agreement (LPA): A legal document that sets forth the terms and conditions governing the relationship and responsibilities of the LPs and GP in a private equity fund, including, for example, the fee structure, hurdle rates, carried interest, methods used to value portfolio companies prior to exit, and disclosure requirements.

Management fee: The annual fee that limited partners in a private equity fund pay to the general partner to compensate the latter for actively managing the fund. The management fee is usually calculated as a percentage of the committed capital to the fund, with each LP paying in proportion to its investment.

Placement agent: A firm that specializes in assisting GPs (fund managers) in raising capital from institutional investors (LPs) during the fundraising stage.

Portfolio company: A company in which a private equity firm invests.

Prudent man rule: A section of the United States Employee Retirement Income Security Act of 1974, which forbade pension fund managers from investing in alternative and riskier assets such as private equity. In 1979, the Department of Labor clarified the Act in such a way as to permit pension funds to invest a portion of their capital in private equity and other relatively high-risk asset classes. This government action is largely credited with the explosive increase in the volume of private equity fundraising beginning in the early 1980s.

Secondaries market: The market for limited partner commitments to private equity funds; secondaries funds purchase unwanted LP commitments, usually at a discount, and then sell them to other investors.

Strategic buyer: The acquirer of a private equity fund's stake in a portfolio company that is in the same or similar business and has a long-term strategic interest in the company.

Supermajority voting rights (protective provisions or affirmative conditions): Provisions in a term sheet that provide a private equity fund with specified rights to approve major decisions made by the management of a portfolio company even though the private equity fund is a minority investor.

Term sheet: A preliminary, non-legally binding document that outlines the terms and conditions of a proposed investment by a private equity fund in a company. Term sheets also serve the same purpose in defining the structure of the relationship between the GP and LPs in a proposed new private equity fund.

Trade sale: A private equity exit in which the fund's stake in a portfolio company is sold to a strategic buyer, as opposed to an initial public offering or a sale back to the company's management (i.e., management buyout).

Venture capital: A subset of private equity that involves equity investments by a fund in early-stage companies with the potential for exceptionally rapid growth, profitability, and high financial returns. Traditionally venture capital was associated with promising new companies in such high-growth sectors as technology and biotechnology, but in emerging market countries these investments occur in a broad range of sectors.

Introduction

Discovering private equity—a personal odyssey

I have been thinking about this book, perhaps subconsciously, ever since I disembarked in Brazil about 40 years ago as a wide-eyed, naïve Peace Corps volunteer. Fresh out of college, I was assigned to work as a rural agricultural extension agent in one of the country's poorest and most remote regions. This initial grass-roots immersion in the problems of underdevelopment was then followed by a career path that zigged and zagged after graduate school from a Wall Street investment bank to the International Finance Corporation at the World Bank, back to the private financial sector, including a stint at a private equity firm, and finally academia, where I have been privileged to teach graduate students what I had practiced for decades.

* Throughout this book, the term "developing countries" will be used interchangeably with "emerging markets," a label first coined in the early 1980s by Antoine van Agtmael, then with the International Finance Corporation (IFC), to define a small subset of relatively prosperous developing countries that attracted the interest of international investors because of the size of their public equity markets. Mr. van Agtmael later acknowledged that his intention was to attach a certain prestige factor to this special category of countries. "I . . . came up with a term that sounded more positive and invigorating. 'Third World' suggested stagnation; 'emerging markets' suggested progress, uplift and dynamism." From this modest beginning, the term gradually gained broader acceptance with international investors and the media, becoming a convenient shorthand to describe virtually all developing countries rather than the few that have relatively well-developed domestic equity markets. For the purpose of this book, developing countries or emerging markets refer to all markets outside of Western Europe, the United States, Canada, Israel, Japan, Australia, and New Zealand.

Although at first glance this career path may seem disjointed, a common thread runs through my decades of experience in the public and private sectors, as well as academia: a primary focus on business practices, financing tools, and public policies designed to strengthen the private sector's role as a constructive contributor to economic growth and poverty alleviation in developing countries. As my career advanced, my interests narrowed. Why, I asked myself, had the private sector underperformed by every measure in virtually all of the more than 100 emerging markets where I traveled, worked, and observed in comparison to developed countries? For example, World Bank studies have estimated that the contribution to gross domestic product (GDP) of small- and medium-size companies in developed economies average 51.5 percent compared to only 15.6 percent in low-income countries. Other commonly used metrics of private sector contributions to economic growth, such as new job creation, export generation, and commercialization of research and development (R&D) initiatives, revealed a similar pattern of marked underperformance. Although explanations for the performance gap were numerous, in the course of my professional odyssey I became convinced that limited access to capital and relevant business expertise topped the list of reasons why the growth and competitiveness of so many emerging market companies was stunted. This belief led me to private equity, the subject of this book.

Private equity, I learned, had a proven track record as a significant contributor to business performance in developed countries, but was largely nonexistent in those countries where I had spent a professional lifetime. Although by no means a silver bullet that would solve all the problems of worthy firms, this particular type of financing, I came to recognize, was endowed with a unique set of attributes that makes it especially appropriate for a wide range of companies in developing countries. In fact, my experiences as both a practitioner and an academic have convinced me that the case for private equity is even more compelling in developing countries, where alternative sources of capital and business expertise are relatively scarce. To be sure, as this book will argue, the investment risks in these countries are higher, but so are the opportunities, both for investors and local businesses. And yet, many of the

stakeholders who should be its most forceful advocates don't know what private equity is, how it works, or why it is exceptionally well suited for many of the company owners with limited or no access to the capital they need to grow their businesses.

My views on the untapped potential of private equity in developing countries stem from years of interactions with a broad spectrum of those who have a direct stake in building a stronger, more competitive private sector. For starters, I have talked and worked with hundreds of entrepreneurs, managers, and owners of a broad range of small, medium, and even large businesses: shrimp farmers in Ecuador, sausage makers in Bulgaria, marble cutters in Uzbekistan, snack food entrepreneurs in China, packaging materials manufacturers in Brazil, fitness center chain operators in Colombia, and telecom operators in Nigeria. Regardless of the country, the sector, the business size, or the track record, our conversations invariably got around to the subject of money, and I kept hearing more or less the same story: "I cannot take my business to the next level because I am unable to get capital on affordable terms." As the conversations drilled down on the details, again the story was *always* the same: "The banks won't lend beyond six months, the domestic stock market is off limits because my business is too young, too small or growing too slowly, and attracting foreign capital is a nonstarter for the same reasons."

Private equity in emerging markets—underutilized and underappreciated

Part of the problem, I learned, was of the entrepreneurs' own making. The vast majority of business owners in developing countries were unfamiliar with even the most rudimentary ABCs of raising capital. Moreover, they often compound their financing problems by being mistrustful, even fearful, of "outsiders" who routinely demanded company information that they either did not have or were unwilling to share. As the owner of a capital-starved Bolivian wood processing company explained to me following an initial meeting with a prospective private equity investor, "I had no reason to trust these people. Why should I believe they would be any different from the last so-called investors who walked through my door, raised my hopes, and then disappeared, wasting my time?"

No matter the country or the company, I repeatedly witnessed one or another version of this defeatist, suspicious attitude about the prospects of attracting third-party capital.

The investment professionals on the other side of the table who were just beginning to explore private equity opportunities in developing countries were facing their own set of challenges. In the mid-1990s, as an embryonic private equity industry was beginning to take off, some of these pioneering investors shared with me their personal stories of success as well as miserable failure. For the most part, they recounted tales of bitter disappointment and frustration as they learned from painful experience that private equity investing in developing countries is fundamentally different from what they had experienced in the United States and Europe. From conducting due diligence before making an investment to monitoring the performance of portfolio companies after the capital was committed, they begrudgingly acknowledged how ill-prepared they were to deal with the pitfalls. "The legally binding shareholders agreement we signed with the company owner was not worth the paper it was written on," explained one disappointed investor who learned about the futility of seeking legal recourse in Nigeria when he was unable to resolve a serious dispute with the majority shareholder. And another who had a long track record of private equity success in the United States conceded that he was out of his league when he launched a fund in Latin America. "Finding the right skill set in emerging markets is tricky," he recounted. "We learned the hard way that to build company value we had to be able to say to the founder, 'Your brother has to go, or you must sell this subsidiary.'"

By the start of the new millennium, the initial results from this first generation of private equity investors began to trickle in, and the results were not pretty! Although at this early stage there was virtually no data on the nascent asset class, anecdotal evidence revealed that the vast majority of these early pioneers were producing miserable results. Predictably, many first-mover investors concluded that private equity had no future in these high-risk environments, and they retreated to the sidelines. Although I continued to believe that private equity's unique characteristics were tailor-made to bridge the financing gap for many companies in

underserved developing markets, it became increasingly evident that this early performance would have to be explained and corrected if the asset class was to have a future.

My work also brought me in regular contact with a third set of stakeholders alongside business owners and private equity investors—government policymakers and development finance experts with responsibilities for strengthening the role of the private sector in developing countries. I was struck that with a few notable exceptions, such as the International Finance Corporation (IFC), a member of the World Bank Group, the term "private equity" was not even on their radar screen. My questions to these experts about this financing mechanism that had made a significant difference in the performance of countless businesses in developed countries were usually met with blank stares or, even worse, glaring misperceptions based on headlines in the press about job-destroying, asset-stripping Western leveraged buyout firms. Surprisingly, I learned firsthand that most experts in the development financial institutions (DFIs) displayed little interest in private equity, even as they advocated and advised on the most appropriate policies and programs to stimulate private sector development. As one critic observed about economists more generally, "There is so much inbredness in this profession. They all read the same sources. They all use the same data sets. They all talk to the same people. There is endless extrapolation on extrapolation on extrapolation, and for years that has been what has been rewarded."[1]

This "inbredness" came to mind when I asked a senior World Bank official a few years ago why his institution had not published a single report on private equity, despite voluminous research conducted by Bank staff on private sector development. The disingenuous response was simply, "We don't have anyone who knows enough about the subject." He might just as well have said, "We have enough to do without exploring beyond our traditional comfort zone." But perhaps I should not have been so taken aback. Judging from the academic literature, private equity in developing countries has also been largely ignored by economists and others in academia specializing in international development. Even in the most prestigious Master of Business Administration (MBA) programs, as I have learned firsthand, the curricula reveal a disturbing

lack of attention to why private companies in these markets underperform relative to their counterparts in more developed countries—although student bodies are increasingly demanding more courses that address emerging markets subjects.

This inattention to addressing the financing problems of companies across the developing world was all the more vexing in view of the seismic shift occurring in development strategies. By the early 1990s, a global consensus had taken hold among government policymakers, economists, and development finance specialists that the private sector, not the state, should serve as the primary engine of growth and development. But if these experts and stakeholders truly believed in the superiority of market economies and private enterprise over central planning and state-dominated development models, why did private sector underperformance persist unabated? Despite the supportive rhetoric and seemingly endless stream of DFI technical assistance and financing to promote private sector growth, the pattern remained the same.

In virtually every developing country I visited, the private sector was sharply bifurcated, with a tiny handful of the largest firms dominating access to financial resources, especially the medium- and long-term capital that *all* companies need sooner or later in order to grow and compete. For example, the privatization programs that gained momentum in country after country in the 1990s as a way to boost the private sector's contribution to growth were characterized predominantly by large multinational corporations and banks purchasing huge state-owned enterprises (SOEs), sometimes through joint ventures with equally large local companies. Similarly, the surge in foreign direct investment that was flowing into developing countries revealed a comparable pattern of large on large. Reinforcing this trend, notoriously weak domestic financial markets in most developing countries were dominated by the capital raising activities of a few of the largest local companies and the insatiable appetites for credit of deficit-plagued governments. As a practitioner working in many of these countries, I believed that private equity was one way to bridge this private sector financing gap, especially for small and midsize firms, if only more of these thought leaders, policymakers, and financiers would take notice of its potential and support its wider use.

Just as private equity activity in developing countries was beginning to gain some momentum, I was leaving the world of practice for academia. I used my new perch at the Johns Hopkins School of Advanced International Studies (SAIS) to organize a study group comprising about a dozen seasoned private equity investors and development finance specialists. As I wrote in my invitation letter to these leading figures in the industry, "The purpose of the seminar series is to provide an independent forum that allows you to share experiences with a group of your professional peers, learn from one another, and generate useful lessons about private equity investing in emerging markets."

In 2001, we began to meet monthly for dinner at SAIS, with structured discussions led by one of the participants, focusing on one or another of the specific obstacles that was impeding private equity success in developing countries. What, we persistently asked, must be done to nurture private equity investing for deserving firms in these countries? And why had the first generation of emerging markets funds failed to deliver the financial returns investors were expecting? As word spread about the SAIS dinner-seminar series, my phone began to ring with requests to attend the monthly sessions from others in the private equity community, and the group quickly expanded. What began as a one-year experiment, continued into a second year, and then a third.

The surprising interest in the private equity seminars revealed something important that in hindsight should have been obvious. Prior to this initiative, no independent forum existed where members of the fledgling developing country private equity community could gather, exchange views, and learn from one another. We also discovered that there was virtually no data, analysis, or commentary of emerging markets private equity, an unfortunate reality that explained why there was such widespread misunderstanding about its potential benefits to bridge the financing gap. We came to recognize that this impediment to expanding the use of private equity in developing countries could be overcome by producing more thoughtful, credible information about the asset class.

This led us to the idea of creating an independent, member-driven industry association, and in 2004 the Emerging Markets Private Equity Association (EMPEA) was launched (I served as Founding

Chairman until 2011).[2] In addition, numerous regional- and country-specific private equity and venture capital associations across the emerging markets began to spring up, complementing EMPEA's efforts to collect, analyze, and disseminate information about the asset class in their respective spheres.

However, despite these encouraging initiatives, private equity investments in developing countries still remain a fraction of what takes place in developed markets, and far too many businesses with exceptional growth potential continue to be starved of capital and business expertise. In sub-Saharan Africa, for example, although private equity investments have grown in recent years, they represented a miniscule 0.12 percent of the region's GDP in 2013—and this metric was even lower in Latin America, the Middle East, and parts of Asia.[3] If the asset class is to be used more widely, as I believe it should, someone must make a persuasive case. With 40 years of experience as both a practitioner and academic, I immodestly believe that I am well placed to take up the challenge. This book is the result.

The Absence of Data: No Excuse!

Ever since developing countries became a subject of serious intellectual inquiry, researchers have been plagued by the absence of reliable, robust data. More than half a century ago, for example, the highly respected authors of one of the first books on the subject of development economics cautioned readers that due to their lack of confidence in the available data, "we use statistics only sparingly." Nonetheless, they went on to explain, this frustrating reality was insufficient cause to abandon their work: "The difficulty or impossibility of submitting certain economic phenomena to quantitative treatment or the insufficiency of statistical information, does not mean the phenomena cannot be understood or analyzed."[4] More recently, another prominent development economist provided a realistic and sympathetic perspective on the persistence of the problem by observing that when a country is poor and governments are underfunded at so many levels, "it is hard to keep statistical offices running."[5]

If reliable developing country data is generally hard to come by, the problem is immeasurably worse when dealing with this book's two core subjects: private firms that are not publicly listed on a stock exchange

and private equity. For example, virtually every published analysis of the severe financing problems encountered by small- and medium-size companies includes the caveat that credible data to substantiate the claim is either inconsistent or unreliable.[6] There is not even a consensus among the leading DFIs, such as the World Bank and International Monetary Fund (IMF), or within individual country governments, about what constitutes a "small" or "medium" or "large" company. Moreover, despite the voluminous information published annually on financial flows to developing countries by DFIs, the data is not disaggregated to reveal how much is directed to very large companies compared to small- and medium-size ones. As for private equity, it merits hardly a mention from any of these authoritative sources reporting on developing country financial flows.

And it gets worse. Private equity is far more difficult to track and analyze than other financial assets for the simple reason that it is "private." Unlike publicly listed companies and financial institutions that are subject to relatively intense regulatory oversight and stringent disclosure requirements, most private equity funds are not legally required to disclose information that would shed light on their performance, or even the companies that are recipients of their investments. This information deficit exists in all countries, but it is significantly compounded by the very short history of private equity in emerging markets. Prior to the early 2000s, for example, virtually no quantitative data trail exists that would illuminate the amounts of private equity capital raised and invested in emerging markets, much less how individual funds performed. And even today it is difficult to benchmark the financial returns generated by private equity investors in emerging markets against the same asset class in developed countries; the data is simply too sparse and unreliable.[7] Although a number of private equity and venture capital industry associations and other private research firms[8] have begun to compile useful information on the asset class, there are significant methodological differences among them that result in major disparities in what is reported and how.[9]

This statistical conundrum, however, no matter how uncomfortable and frustrating, is hardly a justification for shying away from a serious analysis of the subject. On the contrary, these formidable data gaps provide additional motivation for writing this book, which hopefully illuminates the potential of private equity to overcome some of the most formidable obstacles encountered by most firms in developing countries. In doing so, I hope that this book serves as a catalyst for better data collection and encourages others to pursue similar research.

Three premises at the core of this book

This book's purpose is to narrow the knowledge gap by illuminating the distinctive attributes, as well as the risks, of private equity investing as compared to other types of financing available to worthy companies in developing countries. Although others have written books about private equity, no one has explored the proposition that private equity investing in developing country environments comprises an asset class with unique risk/return characteristics compared to developed countries. Ultimately, the intent of this book is to illuminate these key distinctions and present a persuasive case for why this particular financing mechanism, with a long history of success in more advanced countries, merits wider attention and application in developing nations. With this in mind, the content of subsequent chapters is driven by three themes.

First, while private equity has historically been an important financing tool for companies in developed markets, even when the heightened risks are taken into consideration, the case for private equity in emerging markets is more compelling than in developed countries for a number of specific reasons. Most importantly,

- alternative sources of long-term financing and value-creating business skills are scarce or nonexistent for countless growth-oriented companies. This reality is a defining feature of virtually every developing country.
- as a consequence of this pervasive gap in financing and business skills, the universe of companies able to satisfy the investment criteria of private equity practitioners is large. The bulk of these potential targets resides in what is loosely defined as the middle market—an extraordinarily diverse range of growth-oriented companies that operate in an endless array of industries, such as basic manufacturing, technology and communications, financial services, tourism, energy, environmental services, infrastructure, health care, education, and even real estate. They also comprise the core of the productive private sector, serving as the primary source of job creation, income generation, tax revenues, and other indicators of economic development and poverty alleviation.[10] And unlike advanced countries where highly devel-

oped financial sectors provide these middle market firms with access to a diverse range of affordable financing options to spur their growth and profitability, this is rarely the case in developing countries.

- the very weaknesses and inefficiencies that characterize many developing countries, industries, and individual companies are sources of opportunity for discerning private equity investors who are equipped with both the financial resources and skill sets required to bridge the gaps and bolster performance.

Second, private equity is unique compared to any other financing mechanism available to private companies. In addition to serving as a source of long-term capital, private equity investors are highly incentivized to be active, hands-on participants with company owners and management to enhance enterprise value—the prerequisite for a profitable exit. Moreover, this ongoing, sharply focused involvement mitigates many of the risks typically associated with investing in developing countries.

And third, private equity investing in developing countries is embryonic relative to its potential to benefit a broad range of stakeholders—private and public investors from both developed and developing countries seeking new opportunities to generate high financial returns and achieve diversification of their portfolios; countless private companies in developing countries seeking scarce long-term capital on affordable terms and operating expertise designed to strengthen their competitiveness and profitability; and governments across the globe that are committed to enhancing the capacity of the private sector to fulfill its role as the primary engine of economic growth and poverty alleviation.

The SME Misnomer

In this volume, the middle market is loosely defined because there is no widely accepted consensus on the appropriate demarcation separating "small" from "medium-"size firms. The literature and policy-related discussions about the severity and consequences of the financing gap in developing countries, for example, invariably utilize the term "small and

medium enterprises" (SMEs). But this term is disturbingly broad, imprecise, and unhelpful from an investor's perspective for a number of reasons. First, despite the enormous attention devoted to SMEs by scholars, policymakers, and the development finance community, there is no agreement on how to define or classify this universe of firms that comprise the bulk of every country's private sector. Even different entities within the World Bank Group do not agree on a common set of definitions, and individual countries use a confusing array of different metrics that often do not coincide with the metrics used by the World Bank or other DFIs. Second, from a private equity investor's perspective, the convention of classifying firms on the basis of the number of employees or annual revenues has limited usefulness as a metric for decision-making. Although company size may enter into their calculus, they are more likely to focus on employee productivity or revenue growth (e.g., revenue generated per employee) compared to other businesses in the same sector, rather than absolute numbers. Finally, notwithstanding these disparities regarding what constitutes a "small" versus a "medium-size" firm, there is general agreement that the outer boundary for SME analysis is 250 employees. But what about larger firms? Are firms with more than 250 employees as likely to be victims of the financing gap as those with 50, 150, 200, or 249?

Unfortunately, it is literally impossible to address this question with even minimal precision because neither governments nor DFIs collect data on firms that break through the SME 250-employee barrier. They may be unimportant to analysts and policymakers, but anyone who has spent time observing private sector activities in developing countries can empirically attest that they are (i) numerous and (ii) often victims of the very same financing constraints as firms with fewer than 250 employees. And finally, it is worth noting that, although rarely acknowledged, the term "SME" is a misnomer.

Who should read this book?

This book is intended for a broad audience of specialists and non-specialists alike. They need only share an interest in learning how and why private equity is a particularly compelling tool to provide long-term capital and business expertise to a broad range of growth-oriented firms in developing countries. More specifically, the book is designed to reach four reader categories:

- Entrepreneurs and company managers in developing countries who are struggling to gain access to the type of investment capital and expertise they need to grow their businesses and compete. Many are either unaware of private equity, misunderstand its benefits, or have serious reservations about the prospect of allowing "outsiders" into their company. And those who are potentially interested in a private equity partner may not know how best to market themselves to investors.
- Professional private equity practitioners, including fund managers, institutional investors, and those who provide direct support services to investors, such as attorneys, consultants, and accountants. All have a direct stake in raising the profile of private equity in emerging market countries, dispelling the misperceptions, and expanding its use.
- Government officials and professional staff in international financial institutions, like the World Bank, who are engaged in stimulating additional private investment as a means of catalyzing economic growth and development and who undervalue or misunderstand the role that private equity can play in this process.
- Finally, an increasingly large universe of students around the world, including my own, who are seeking stimulating career opportunities that allow them not only to make a good living financially but also be engaged professionally in an activity that will better the lives of the underserved in developing countries.

Except for the practitioners themselves, it is no small irony that many of these prospective readers are strong advocates of an expanded private sector role in developing countries, but are largely unaware of private equity. I hope, therefore, that this book will remedy both the inattention to and misunderstanding of the asset class.

How this book is organized

As briefly described below, the book is structured in two parts. The first section, comprising chapters 1–5, provides readers with a detailed examination of the book's principal themes. These include

explaining step-by-step the private equity investment process and why the skills required for success differ from other types of financing options; exploring the evolution of the asset class in developed markets; identifying the building blocks that serve as the foundation for a thriving private equity industry, taken for granted in developed countries but largely absent in emerging markets; highlighting the nonfinancial value-creation attributes that make private equity an especially compelling financing tool in developing countries where business expertise is often as scarce as capital; and tracing the history and performance of emerging markets private equity from its origins in the 1990s to the present day, highlighting the lessons learned along the way. The second part of the book illustrates the challenges and opportunities described in the first five chapters by profiling in greater detail the private equity industry in three distinct developing countries—China, Brazil, and Kenya. More specifically, the book is organized as follows:

Chapter 1: A Private Equity Primer: The reader is introduced to the distinctive characteristics of private equity that separate it from all other financing mechanisms available to private companies. The specifics of the private equity investment cycle are traced, highlighting how the skills required of successful private equity practitioners and the tasks they perform differ markedly from those of other, more conventional finance professionals such as investment and commercial bankers. The narrative then proceeds to build the case for why private equity is an especially relevant financing tool in higher-risk developing country environments by highlighting three interconnected features that set it apart: active ownership, illiquidity, and financial incentives to create long-term value. The chapter concludes by arguing that these unique features that define private equity are particularly relevant to a vast universe of growth-oriented firms in developing countries, but stakeholders must recognize that *both* the risks and opportunities are fundamentally different from its application in advanced economies. Readers who are already familiar with the distinctive features and investment mechanics of private equity may wish to proceed directly to chapter 2.

Chapter 2: Private Equity Ecosystems: A Stark Contrast between Developed and Developing Countries: To reinforce the

premise that private equity in developing countries bears little resemblance to its counterpart in more advanced economies, this chapter briefly traces its gradual evolution over more than half a century in developed countries, where it benefited from an ecosystem that facilitated and encouraged its growth. The building blocks that serve as the foundation for a thriving private equity industry include, for example, supportive government policies; confidence-inducing legal frameworks that enforce contracts and protect investors; efficient financial markets that offer firms affordable access to diverse sources of capital; a range of viable exit options; relatively stable macroeconomic and political conditions; business adherence to internationally accepted best practices, such as standards of accounting, financial reporting, and corporate governance; and deep pools of entrepreneurial, operational, and managerial talent. These critically important private equity success factors are markedly less robust and dependable in virtually every developing country, heightening the challenges and risks at every stage of the investment cycle described in the previous chapter. Paradoxically, however, it is precisely these shortcomings that are the source of private equity investment opportunities that have largely disappeared in most developed countries.

Chapter 3: The Private Equity Advantage: Operational Value Creation: This chapter expands on the premise that the deep reservoir of expertise focused on nonfinancial value creation provided by private equity professionals is as important or more so for company owners in developing countries as the injections of scarce long-term capital. These investors have accumulated this highly specialized value-creating expertise from working with countless firms that have experienced similar problems. It may take the form of improving products and marketing strategies, strengthening corporate governance practices, expanding access to new markets, implementing a financial reporting system to increase the company's access to additional sources of finance, or introducing training programs to boost worker productivity. It may also include other performance-enhancing measures that at first glance may have a more tenuous correlation with the bottom line, such as compliance with internationally accepted environmental standards. Regardless of the carefully tailored value-creation strategy that is agreed upon

between the private equity firm and management, the overriding objective is to strengthen long-term company performance—the prerequisite for a profitable exit.

Chapter 4: Private Equity Performance before the Global Financial Crisis: This chapter traces the dramatic ups and downs of the relatively nascent industry in emerging markets through two distinct phases leading up to the 2008–2009 global financial crisis. The first generation of emerging market private equity funds was created in the mid-1990s, and investment rapidly accelerated for a few years. But by the early part of the new millennium, these pioneering funds were registering disappointing results in both absolute terms and relative to their counterparts in developed countries. As a result, many early investors retreated to the sidelines, concluding that private equity was simply too risky in these environments, and some even predicted the asset class was too discredited to survive. The naysayers were proven wrong, however, and in 2004 the industry began a surprisingly robust recovery. Institutional investors began to take a second look, new emerging market funds proliferated, more developing countries were targeted by investors, and results began to markedly improve. An examination of this history illuminates for practitioners and policymakers alike the specific reasons why the first generation of funds performed poorly, the lessons learned by various stakeholders, and the changes that led to the resurgence in many, but by no means all, developing countries.

Chapter 5: A Post-crisis Assessment: New Challenges and Opportunities: Although not completely immune from the disruptive consequences of the 2008–2009 global financial crisis, the asset class was by then sufficiently well established and credible to carry on. Unlike previous episodes of global financial instability, developing country economies proved to be surprisingly more resilient than their developed market counterparts in the immediate aftermath of the crisis, reaffirming for many investors that emerging markets private equity should be a critical component of their portfolios. In contrast to earlier in the decade when the industry nearly disappeared due to subpar performance, a more mature emerging markets private equity industry not only survived the crisis but was also attracting an increasingly

greater percentage of global private equity fundraising compared to developed markets. Moreover, the deepening of the industry has been accompanied by several other encouraging developments, such as diversifying interest among institutional investors and an uptick in private equity activity beyond the so-called BRICs (Brazil, Russia, India, and China) into more nascent markets across sub-Saharan Africa, Latin America, and Southeast Asia. Nevertheless, as this chapter explores, the industry now faces new challenges that must be addressed if it is to sustain and build upon the pre-crisis momentum. For example, overall fundraising has declined, at least temporarily, as many Western institutional investors face cash pressures, and the exit environment continues to be problematic. And most notably, even though the asset class is more credible than ever, the financing gap persists for a majority of small- and medium-size firms in emerging markets. This shortfall represents both an enormous challenge—as well as an opportunity—for the next stage of the industry's growth and development.

Chapters 6–8: Country Case Studies—China, Brazil, and Kenya: Each chapter presents a country-specific private equity profile for the purpose of empirically illustrating through specific examples the trajectories private equity have taken in three very different emerging market countries. These differences include, for example, geography and business culture, stages of private sector development, historical evolution and performance of private equity, and the role of the government as a facilitator or impediment to development of the asset class. Each country chapter also profiles individual private equity transactions for the purpose of providing readers with realistic insights into the challenges investors encounter at every stage of the process, including screening and selecting prospective firms, conducting due diligence and agreeing on a valuation, developing and implementing customized nonfinancial value-creation strategies, and carrying out exits.

Chapter 9: Looking through a Hazy Crystal Ball: The asset class is unrecognizable today compared to when it first took off in the mid-1990s, and in all likelihood will bear little resemblance to its present profile ten years from now. With a combination of

optimism and concern, this concluding chapter offers a perspective on some of the formidable challenges the industry is likely to face in the years ahead, and what needs to change among all of the stakeholders showcased in the preceding chapters in order for private equity to play an increasingly significant and constructive role in developing countries. Ultimately, a broader and deeper use of private equity in these underserved countries will benefit not only the owners of increasing numbers of individual companies and their investors but also the overall performance of the private sector—the primary driver of robust macroeconomic growth and poverty alleviation.

1
A Private Equity Primer*

> *Private equity offers a compelling business model with significant potential to enhance the efficiency of companies both in terms of their operations and financial structure. This has the potential to deliver substantial rewards both for the companies' owners and for the economy as a whole.*
>
> —Financial Services Authority of the United Kingdom, *Private Equity: A Discussion of Risk and Regulatory Engagement*, November 2006

On the outskirts of Rio de Janeiro, far from the pristine beaches and luxury apartments of Copacabana and Ipanema, Claudio, the owner of a midsize company that provides scaffolding equipment for large construction projects, was reflecting on the turbulent history of his 40-year-old business.[1] *"We had a fantastic reputation! The company had a steady stream of reliable clients, a great brand name, and gradually we became a leader in our market. But no matter how fast we grew our revenues, the company was always encountering financial difficulties because we took on too much short-term debt. We never made any money." This paradox*

* The objective of this chapter is to provide readers who are unfamiliar with private equity with a clear understanding of the distinctive features and investment mechanics that set the asset class apart from all other financing mechanisms available for private companies. Grasping these fundamentals is essential for readers to understand why this particular investment tool is uniquely suited to boost the growth and performance of companies across the emerging markets. Private equity practitioners and others who already have a basic understanding of private equity's fundamentals may wish to proceed directly to chapter 2.

of growth without profitability is a frustrating pattern repeated by "successful" entrepreneurs throughout the developing world. And for those who survive, the story usually gets even worse.

"By 2002–2003," he continued, "the Brazilian economy was beginning a period of explosive economic growth, creating unprecedented opportunities for the construction industry. Although we had been the market leader in our specialized niche, I realized the company would quickly lose market share unless we could rapidly expand and respond to the huge increases in demand for our products. The construction materials sector in Brazil was highly fragmented, and I knew consolidation was inevitable as the building boom picked up momentum. Only those companies with access to the capital required to make new investments, achieve scale, and grow quickly would endure. I had learned from experience that the banks were useless. Even for a well-established company with a good track record in a booming market, they only offered short-term loans with crippling collateral requirements at sky-high interest rates. We even tried the government-owned development bank, and although they claimed to be interested in SMEs like us, I quickly realized they would be too slow and bureaucratic to solve our problem.

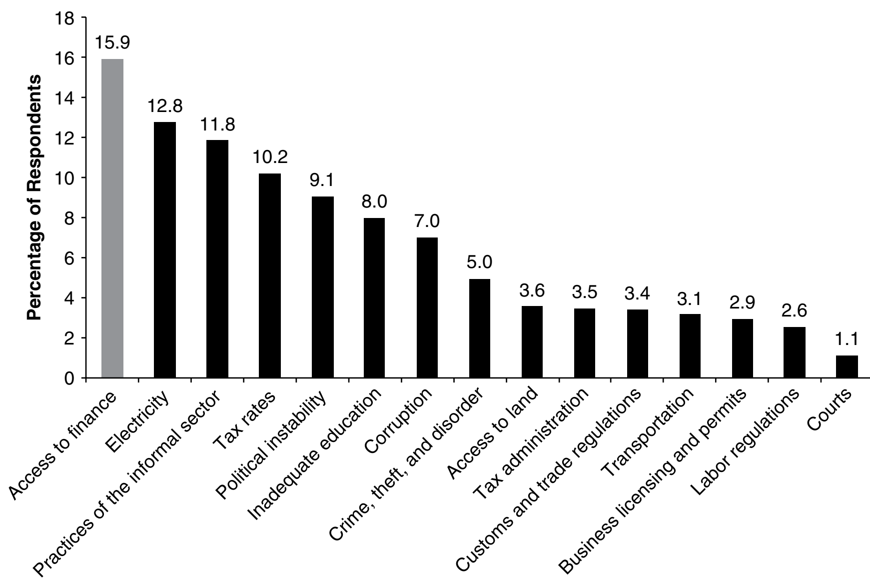
"In order to survive, we needed to attract an investor who recognized our company's potential and would be willing to make a long-term commitment. Luckily, a friend of a friend introduced me to a private equity fund manager who specialized in making investments in small Brazilian companies with rapid growth potential. During our initial meetings, the prospective investor was extremely demanding, and I became skeptical that we'd ever strike a deal. But after an extended period of time and some very tough negotiations, we reached an agreement for the firm to invest a significant amount of capital for a 15 percent equity stake in the company.

"Our entire mind-set changed once these private equity investors were on our Board. From day one, they were active, hands-on, and sharply focused on specific improvements that would strengthen our performance. For example, although we already had reasonably good corporate governance standards, they offered wisdom we simply did not have, and we were able to strengthen our accounting and financial disclosure practices in line with international best practices. They also gave us more credibility with banks, and suddenly we were getting longer-maturity loans. And with their additional capital and expertise, we were able to

execute a more aggressive acquisitions strategy, which accelerated our growth trajectory."

The financing problems experienced by this Brazilian entrepreneur are painfully familiar to owners of companies across the developing world. No matter how hardworking and successful, sooner or later they hit the same wall: limited or nonexistent access to medium- and long-term financing, which they require to grow and compete. As a result, these firms underperform relative to their potential. This linkage between access to capital and firm performance is indisputable, and is reinforced by countless surveys of business owners in a broad range of developing countries who consistently assert that the difficulty of obtaining financing ranks is one of their biggest problems (see Exhibit 1.1).[2] According to one World Bank study, in low-income countries, 43 percent of small enterprises and 38 percent of medium-sized firms report access to finance as a major obstacle to their business operations; in high-income countries, only 17 percent and 14 percent, respectively, of

Exhibit 1.1 Growth Constraints Reported by SMEs



Source: Adapted from The World Bank (2014), *Enterprise Surveys*, www.enterprisesurveys.org, The World Bank.