Private Equity In Emerging Markets Is Being Rebalanced

Part II of this Knowledge@Wharton podcast on private equity (PE) looks at the falling market share for PE in emerging markets along with the rising investments in developing countries outside of the BRICS, and the increasing importance of operational improvement. Stephen M. Sammut, a senior fellow and lecturer at Wharton, and Michael Rogers, EY's global deputy private equity leader, discuss these ideas.

An edited transcript of the podcast follows:

Knowledge@Wharton: Fundraising in emerging markets hasn't kept pace — the emerging market share of total global private equity (PE) funds raised dropped from about 20% of the total in 2012 to 12% in 2013. Many analysts say this likely reflects a bit of slowing in economic growth in those markets overall, despite some countries that are bucking that trend individually. What's your view of private equity and emerging markets over the next year or two?

Stephen M. Sammut: It's a very important question. I wouldn't go so far as to say that 2013 was an aberration, but it is reflective of a number of things. We're talking about very sensitive numbers here because the numbers are rough, generally, and pretty small. So, for the emerging market fundraise to keep pace, especially after coming off a series of very strong years, naturally, there is going to be some percent of the whole decline when there's an upsurge in capital raising in the developed markets, and I think that's what we've seen here.

Yes, most of these countries did raise less in 2013 than 2012, but that did not represent a sea change in attitude — maybe some moderation and a rebalancing of portfolios from emerging markets to developed markets. I don't know that it's going to have that much of a negative operational effect or strategic effect for the funds involved. At least, that's my take on it.

Michael Rogers: Steve, I agree with you completely on that. There was a slight decline on fundraising figures for emerging markets that does follow a decade's worth of essentially, up markets in funding for emerging markets. Steve hit on an important point, we seek a rebalance; we have been looking at that as a theme in terms of some of the recent research pieces we've written, including our Global PE Watch that we've just released. We really see it as a rebalance and a pausing, as opposed to a directional change.

I think everybody still believes that there's a growing demographic and a middle class in some of these emerging markets that are going to be there a long time. For example, the average age in the U.S., I believe, is around 36; in Africa, it's about 18. So, you have to envision that as those folks come into their consuming years, there'll be a greater GDP in those markets and private equity will more than likely be around to try and take advantage and work with those folks in those communities to do transactions.

I think it's interesting to note that in 1995 about 5% of all private equity was invested in emerging markets. Today it's about 13%. There's a long tail trend here, as more and more GDP comes out of emerging markets, I think we'll see more capital flow in. But, there was a little bit of a course correction in 2013, and I think that it should go back to a rising market over time.

Sammut: I have another point to make, which is not necessarily scientific, but I think it's an interesting observation, and that is, I personally give MBA students at schools like Wharton and its peer institutions, a lot of credit for seeing what's coming down the pike. They have come to school after being out in the workforce for a while; they are very international, very cosmopolitan.

And if you measure the attitude of what is likely to come based on the interest of students here at Wharton and elsewhere in anything to do with emerging markets, particularly private equity, that tells me that there's an energy here that is going to be overwhelming. This is not a fad, this is something the students really see as characterizing the economies during their careers. So, you shouldn't lose sight of that.

Rogers: I was at a conference recently in Africa and the energy there is very exciting. And I think if a young professional who wants to go into private equity was not considering spending some time on the African continent, I think they'd be short-changing themselves. The industry has evolved to a point where it's going to be very exciting over there for a lot of people.

Knowledge@Wharton: When we talk about averages, it tends to smooth things out — but, within that is the nuance of some countries that are bucking the trends. So, within emerging markets, would you care to pick out a couple that will buck the trend? Some are bringing up the average and some are bringing it down.

Rogers: If you go back a year or so, a lot of people spoke about the BRICS, of course, and I think you still see anecdotally, a lot of interest in China, in Brazil, somewhat in India. But, we travel around the globe and we've been into China, we've been into Latin America, we've been to Africa recently, and there are a couple of places we hear about more often than we used to.

The Andean region of Latin America, which is really Columbia and Mexico, primarily, even Peru, to some degree, often gets brought up as a location that, because of the Pacific Alliance, and the fact that they are reducing trade barriers and trying to make that an attractive place to do business, it seems to pop up on more and more radar screens these days. It's interesting how fickle it is. Last year, Brazil would have been very hot; this year, I was just down in Brazil last week, and they're struggling from an investment perspective. Turkey was on everyone's radar screen, and of course, with a little bit of civil unrest, suddenly it's taking a little bit of a back seat. We hear from folks about Indonesia and the Andean region of Latin America.

Sammut: And those are all very good examples. There's something I'd like to raise that maybe is an offset factor here, and I don't know what the EY research shows. In your report, you do point out that the size of the equity check is actually declining fairly consistently, if not rapidly, and at the same time, there is significant growth in the amount of leverage.

What's very interesting is that that leverage is no longer restricted to the U.S. and European markets; we're starting to see more and more leverage work its way into the emerging markets. I wonder if the availability of that leverage offsets maybe the decline in the investment, in the funds themselves, because there will be sufficient capital to do the same number of transactions, maybe even at higher valuations. So, there's things to look at during 2014 that in the 2015 studies are going to be very interesting, in my view. So, I don't know if you've reflected on this issue of leverage?

Rogers: Well, of course we look at it because that's a major component of what people are willing to pay or capable of paying. We talked earlier about the strength of the capital markets and in the U.S. and in Europe, the banks are getting a little bit stronger. Certainly, in the U.S., we've seen debt multiples rise — almost, in some cases, back to where they were at pre-crisis of 2008, which should give us a little historical reflection.

But, you'll see it — as you mentioned, around the world, the development of some of the capital markets in some of these countries is allowing for more leverage go into these transactions. Although, it's still, in some markets, there's not really a debt capital market to speak of, not very many banks available.

Certainly Africa and some places in Latin America — when a private equity goes in there, they're bringing most of the capital with them, and maybe they put it in different tranches or there's mezzanine or something else, but there's really not a traditional bank market, as we would anticipate. But, it is growing. There are certain markets, as you point out, where there is going to be better bank support in the marketplace.

Sammut: I think it's worth reflecting that, in the developed markets, we are still looking generally at controlled positions being transacted. In many of the emerging markets, partially because family businesses and the discomfort of the promoters or entrepreneurs is still gaining with the way private equity operates, these are still largely growth equity investments, non-controlling positions, in many cases.

This creates a very different atmosphere and in many instances, if the promoters had the opportunity to bring in leverage, that's probably their preference. But, again, this remains to be seen. This is real time development.

Knowledge@Wharton: M&A activity has come back strong, with many saying the return of corporate interest in this area means both more opportunities and more competition: Many corporations will be offloading companies, but, others will be in the hunt for buying. Corporations are sitting on a lot of cash, so the competition piece could be an important factor affecting PE firms. How it will play out?

Rogers: Some big deals have hit the headlines. We have just issued our tenth annual corporate capital confidence barometer and it [polls] 1600 executives around the world in 54 countries, and we try and get a sense of where they're headed M&A-wise. It was interesting, the respondents this time were talking about doing larger transactions, so maybe stepping out a little bit more on the curb, using the credit conditions that we were chatting about earlier that are very favorable, maybe increasing leverage a little bit. That is going to allow more companies to do some measured, but bolder transactions in this year.

But, despite the fundamentals being great and in place, the capital markets being low volatility right now, you'd think corporations would be out doing transactions. But on the corporate side, what we're seeing is that there's just no real impetus to go spend that cash. You touched on the cash values that are sitting on the books of a lot of these companies, I think a lot of corporate treasurers have long memories and they think back to the point where we had some very large public entities here in the U.S. who had difficulty floating their commercial paper overnight.

I think people go into this — they're building their balance sheets and just gaining more and more strength. You can call it "hoarding cash", but at the same time, they're being very cautious about the future.... I don't think you're going to see people going out and doing things that are not affiliated or adjacencies that don't make sense for their businesses — the boards won't tolerate it.

On the other side, you've got a little bit of the push and pull. You have the activists out there that are looking at this and to your point, saying, "Oh, you're just building cash, you're not really doing anything with this, you're not paying dividends to the extent that you're generating cash, you know, you need to return some of these shareholdings," or, "you need to get more aggressive on the M&A front." But, my sense is, we've been holding our breath waiting for some of this cash to come back in the market for such a long time, I just wouldn't count on it all flooding back in at once. I think there will be a trickle out; people will see some strategic deals they want to do and they'll take advantage of that.

We get the sense from the PE clients that we visit with, that they'd like 2014 to be a better M&A year, they'd like to do more deals, they would like to put more capital out. But, now you've got the confluence of rising valuations in the public markets, a little bit more competition from the corporates, and so, it'll be a fight it out kind of year to make your numbers and to get deals done, so I know they're concerned about that.

Sammut: That assessment is spot on, and I would size it up much the same way. The necessity to deleverage hit everyone very hard, and the deleveraging psychology, it's appearing to have a very long tail.

Those habits are not going to reverse themselves too quickly. Having said that, I think many corporations realize now that they cannot neglect or delay entry into these markets, especially those countries that have rapidly growing middle classes, otherwise, they're going to miss the boat. And many of them recognize that they are, indeed, in competition, especially on the African continent, with Chinese concerns and will have to find ways of entering the markets.

The good news for them is the available properties almost certainly have been much better managed and are more professionally organized than the properties were even five years ago.

As the private equity firms have had to hold their properties and focus attention on operations and governance, they're producing more viable candidates that could actually be bought in an acquisition and not represent a hit on earnings, at least on a very selective basis. So, companies that start to look and network themselves with what private equity firms are doing will find some manageable opportunities.

Rogers: Steve, just to add to that we're in an environment of low growth. I think the Fed and everybody's watching just to make sure — can we hit some growth projection in the U.S.? I think Europe's afraid of deflation, so you've got a situation where there's not a lot of consumer-driven growth.

And so, for private equity or others to go spend a lot of money on a company that's only growing 1% or 2%, that's a hard sell to the board. You've got to have a very strong investment thesis going into it….You have to have a very strong case, that makes strategic sense, that have synergies to be gained, et cetera, because it's just not as easy as it used to be.

Knowledge@Wharton: So, on the one hand, it's a little bit of remembering when the hammer came down and wanting to have something ready for an emergency. But, maybe they'd be able to forget that more easily if they had some sense that there was going to be some strong growth in the economy. Growth in the U.S. is not even strong enough to bring unemployment down to where it was before the crisis — not even close — and it's been going on five or six years already.

Rogers: It also speaks to the fact that we see a lot of M&A activity in tech and in health care, which are two of the higher growing industries out there. That tends to support the thesis of borrowing money and going out and going through the hassles of actually doing a deal, if you have some upside on it, it makes it all the better.

Knowledge@Wharton: Activity in 2013 and early 2014 indicated that leverage is once again available and foundational in deal structuring. In recent years, the emphasis in the development of portfolio companies shifted from achieving alpha through financial engineering, to improving revenues, margins and global reach. Do you think that in 2014, we'll see a return to emphasis on financial engineering or are the operational disciplines here to stay?

Sammut: Well, I'll take that, but I have a question for Michael first, and it's — do you agree with the premise of the question, regarding the availability of leverage?

Rogers: Yes.

Sammut: Okay.

Rogers: There is more debt capital available.

Sammut: Okay. Yes, your report suggested that. The answer to the end of the question – is operational discipline here to stay — I think absolutely yes. And the hiring patterns in many of the private equity firms, large and small, reflect that there's an increasing emphasis on putting together teams that can manage and add value to the portfolio companies.

I think the reliance on basically, structuring debt in different ways, paying off debt, breaking up companies in order to reduce debt obligations, while that still maybe part of the investment hypothesis of a lot of buyout funds, in particular, I think the emphasis is going to be on growth. Because although things are looking nice right now with the IPO market, that could change very abruptly and firms may end up having to hold their positions over the long-term again.

So, performance acceleration has been a very important theme for many of the funds, and I see that as more and more likely to continue. Many students in MBA programs at conferences and the like are always asking questions like, "Do I need to have a banking background or an M&A background to break into private equity?" And increasingly, I'm hearing from panelists, when asked that question from the private equity firms that, "Well, no — strong operational skills and learning how to run things are of equal value," and that's not something I heard five or 10 years ago.

Rogers: I think the complexity of private equity has enhanced over the last couple of decades. When the industry first started in the 1980s and 1990s, a lot of those deals were financially oriented. You could afford to buy something a little bit less expensive than where it should have been trading. You could put a lot of leverage on it, and you could ride the wave up, and oftentimes, sell out and make nice returns for yourself and your investors. I think many of those opportunities have been sought out and taken advantage of, and I think that those simple situations are gone. It's a little too hard to find those any longer.

Now people generally are having to pay a more full price and the sellers have gotten smarter, so they want a full price — and they prep their businesses for sale, so the private equity or the corporates, buy these. But, if a private equity firm buys it, it has to have an outstanding investment thesis on the front end, it has to execute flawlessly through the diligence phase and get the deal structured correctly. Then, equally as important as the buying and selling is the value creation phase.

We definitely agree that there's more leverage available. But, I think where we're at now in the cycle of PE as an industry, is if you're not a good operator and you can't add value to the business that you purchased, you're probably not going to do very well on the exit side of it.

We now see businesses, as Steve touched on … the MBAs at the private equity funds work on the front end, they identify the opportunities, they work with the bankers, they work with folks like ourselves doing deal origination, they execute the deal, and then they begin this process of the holding period where they're working on value creation. But, oftentimes there are now value-creation or operating partners onboard at these funds who work in conjunction with [those] who sought and acquired the deal, and they'll live with that for several years until getting it prepared for exit.

I saw David Rubenstein … from Carlyle [in Brazil] — he mentioned that at this phase of the game in private equity, you have to be a good operator, you have to add strategic value to the entities you purchase or you will come up short when it comes to returns at the end of the day. I think that we would agree with that completely. And, in fact, if you look at the hiring the funds are making, it parallels the way many of the firms, like ourselves, are hiring.

We're hiring more and more professionals in that field so that we can match up and be of assistance to our clients as they own and operate these businesses for a longer period of time. The buy-and-flip days are over. Oftentimes, it's not uncommon to have five, seven, nine-year holds, and if you're not adding any value to it, then you're not helping your investors earn the returns they should. We believe wholeheartedly in the value creation phase.

Knowledge@Wharton: Would this trend, which seems to have been forced by the financial crisis, have happened naturally over a longer period?

Is private equity in danger of being a victim of its own success? If you're always finding the firms that aren't getting the most value out, then eventually, all of those firms are going to be found out, and the ones that haven't been found out will learn that they had better straighten themselves out or something maybe not good is going to happen to them.... You're culling the herd to the point where all of the sick ones have been taken out of the herd, and therefore, it gets to where it's buy and hold, and improve operations over a longer term.

Sammut: We could probably do a podcast on just this, but I'll give one reflection on it — in my view, and one of the reasons I've been so interested from an academic and research point of view in private equity is, I concluded a long time ago that the hostile takeovers, that characterized a lot of buy-out activity in the 1980s, actually went a long way to improving the quality of American businesses for exactly the reasons you cited.

Management realized if they weren't putting full attention and driving growth in their own companies, they were going to be out of a job. There was a lot of self-policing and self-cleansing of some very bad corporate practices. That was one of the unintended but positive consequences of the whole LBO movement back in that period of time. And I think that still continues today. It's certainly a factor in the developed markets; the emerging markets are probably less vulnerable in that regard for now. But, as those economies become more sophisticated and businesses become more transparent, management is going to see the same threat.

Rogers: The other discipline that's there that may not have been there as prevalently in the past was the LPs really digging in and monitoring these assets — I think they were more passive in the past. The returns were flowing in without many adjustments being made in terms of operating the businesses. But now, from what I understand, I've obviously not been part of these meetings, when the LPs come calling and you're talking about fundraising from a GP perspective, the LPs will definitely ask you, "What's your value-creation plan? How do you go about extracting value? Show me where you did it. How did your returns get enhanced as a result of that?"

If you can't demonstrate that or don't have a good thesis or a good plan, then you will fall to the bottom of the list, as you were describing. There will be a fall-out over time — that's where the fall-out will be, because if you can't demonstrate that you've been able to add value and enhance your returns, then as an LP, I can choose to go where I want, and I'll go somewhere that somebody does have a robust package and program to extract value from these entities. So, I think it will self-fulfill over time.