2012

SME private equity 2.0

GDPs, account deficits, proprietary sourcing and operations

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Executive Summary

Private equity (PE) commentary has increased to a furor in the past five years amidst the ending of easy credit for LBOs, the rise of the Chinese Dragon and the Indian Elephant, consequent reallocation by LPs and, of late, increased focus on small and medium enterprises (SMEs).

Today, no discussion on private equity is considered comprehensive without touching upon PE in emerging markets. Justifiably, positive macro-indicators such as demographics and higher growth rates versus those seen in the West drove LPs to accept multifold risks and strongly consider, if not deploy capital in these markets. Amidst a constantly adapting and dynamic landscape, most GPs, even successful ones are relegated to learning along the way or to practice a trial-and-error approach.

As the industry evolved in these geographies, SMEs have now became the flavor of the month given smaller deal sizes available, a robust deal pipeline of family-owned businesses and the lack of leverage for large LBOs. However, 2011 saw currencies spiraling downward, country deficits climbing and even the likes of India and China lowering their GDP outlook. While concerns of investing in the "East" had been well documented, this was the first time that investor bullishness saw a reevaluation (not even 2008 really shook the emerging markets story as much). Against this backdrop, we aspire to provide practitioners, both GPs and LPs, with analyses, guidance and frameworks to adapt their PE model.

In this four-part project, we focus on Asia and particularly tailor our analyses to SMEs, identifying (a) capital deployment trends in Asia and (b) drawing attention to macroeconomics of developing geographies beyond routine macro-indicators such as demographics. We believe that after 2011, it has is critical for investors to look at some KPIs from an economist's lens.

Leveraging deal-based insights from senior advisors such as the IFC, Aureos Capital, Everstone Capital, Sino Century, Bain & Company as well as operators such as the ex-CEO of a manufacturing SME, the project develops a commentary and develop a framework for two of the most critical areas on SME EM deals: proprietary deal sourcing and operational value-addition.

Profiles of Authors:

Saumil Annegiri *is currently an investment banker in New York. Earlier he was a cross-border dealmaker between the U.S. and India with a focus on manufacturing and technology companies and a supply chain specialist with the U.S. Defense department. Annegiri is an alumnus of the Wharton School of the University of Pennsylvania.*

Suhas Kulkarni*, currently a dealmaker in natural resources, energy and technology products, is a former chief executive officer of the Hydrolines Group in India and an executive director with UBS, London and New York. He has been advising corporate, funds and governments across the globe since 1999. Kulkarni is an alumnus of London Business School.*

Stephen Sammut*, a partner with Burrill & Co., has been an investor for more than a decade across Western, Eastern and African markets. He has advised and helped set up some sovereign wealth funds and is on the boards of others. Sammut is also a senior fellow and lecturer at the Wharton School of the University of Pennsylvania.*

Fund raising and deployment

Teetering currencies or flailing growth rates notwithstanding, Asia continues to be the mystical attraction for investors. Of the total capital raised in 2011, Asia took the 2nd highest share of the monies allocated after the United States. Topmost reason cited across surveys by a majority of LPs for this attraction? Potential to make higher returns, rather than diversification benefits or, the desire to match long term assets to liabilities.

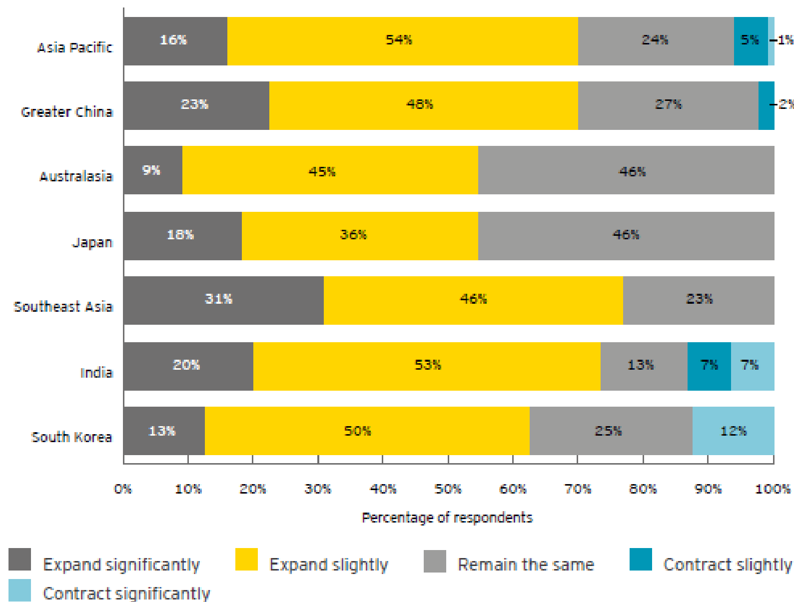


Figure 1.1: Survey of expected private equity activity by geography
Source: Asia Pacific private equity outlook, Ernst & Young, November, 2011

A majority of respondents in the Ernst & Young survey expected private equity activity to expand in Asia, and even more so in South East Asia. According to EMPEA, the median LP allocation as part of their PE portfolios will increase by 33% toward EMs. The 64% y-o-y growth from $23bn in 2010 to $39bn in 2011, of funds raised for EMs conveys that the Asia bullishness will sustain in the medium term.

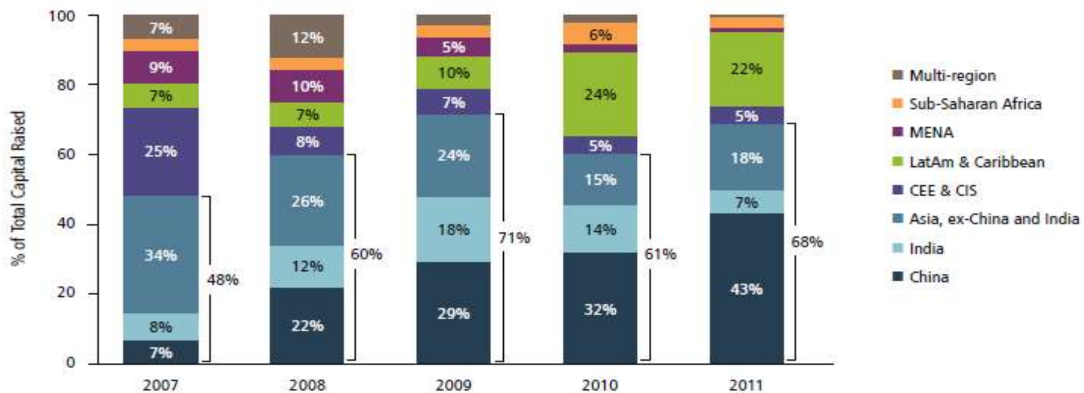


Figure 1.1: % capital raised by geography
Source: EMPEA Annual Fundraising and Investment Review, 2011

Expectedly, China and India grabbed a lion's share of this capital allocation amongst Asian geographies. However, surprisingly fundraising for India continued its downward spiral, maybe an indication of investor confidence after the political and financial instability in the country.

	2007	2008	2009	2010	2011
Emerging Asia	**28,668**	**39,669**	**15,938**	**14,206**	**26,251**
China	**3,890**	**14,461**	**6,617**	**7,509**	**16,616**
India	**4,569**	**7,710**	**3,999**	**3,268**	**2,737**
CEE & CIS	14,629	5,559	1,586	1,192	1,752
Russia	1,790	880	455	75	135
LatAm & Caribbean	4,419	4,461	2,248	5,608	8,441
Brazil	2,510	3,589	401	1,078	7,079
MENA	5,333	6,875	1,070	448	423
Sub-Saharan Africa	2,034	2,241	964	1,499	1,332
Multi-region	4,077	7,721	801	524	350
Emerging Markets	**59,160**	**66,517**	**66,517**	**23,478**	**38,549**

Figure 1.3: Funds raised in EMs
Source: EMPEA Review, March 2012

* Note that Emerging Asia covers both South East and South Asia.
More recently, we are also starting to see a bigger participation from Asian LPs as well as local denominated funds. Hony Capital, a premier Chinese firm even allocates part of its pool in local currency. Combined with local investor appetite and as LPs the world over, sought to put additional capital to use, fund sizes have also climbed with smaller sizes falling out of favor.

New evidence, this time on the deal side has emerged that drives home the point (yet again) against bucketing all EMs together and analyzing each country separately. While average check sizes across (declared) transactions increased in China, they held constant or even dropped slightly (by ~10%) in India.

Figure 1.4: Deal value and volume in EMs
Source: EMPEA Annual Fundraising and Investment Review, 2011

An economist's view

Although currency risks amongst others were always part of LPs analysis prior to releasing capital in developing markets, perhaps this is the 1st time when the role of the Economist has become important in private equity. Take India as an example. Just in the last 8 months the currency has almost depreciated by ~20%. Interest rates are on a persistent high, inflation is still holding on to the ceiling and GDP growth rates have been tempered. If risk free rates offer strong returns, what incentives (or penalties) do businesses have to take managed risks to keep growing? A combination of these factors have confluenced into two consequences: those that have invested are seeking to withdraw their investments and, those that were on the fence are continuing the wait before pulling the trigger and investing in India. Prior to even incorporating issues related to political stability and regulatory environments for investing, from a macro-economic perspective, the country is raising questions in eyes of financiers.

Similarly, in the case of China, Europe happened to be the largest destination for exports. With the turmoil across Europe from Ireland, to Greece to Portugal to Spain, this has dampened Chinese outlook, albeit admittedly much lesser so than some of its competitor countries such as India.

In this section we take a snapshot of the key indicators for select countries in Asia and see the pressing need of doing so for LPs and GPs alike.

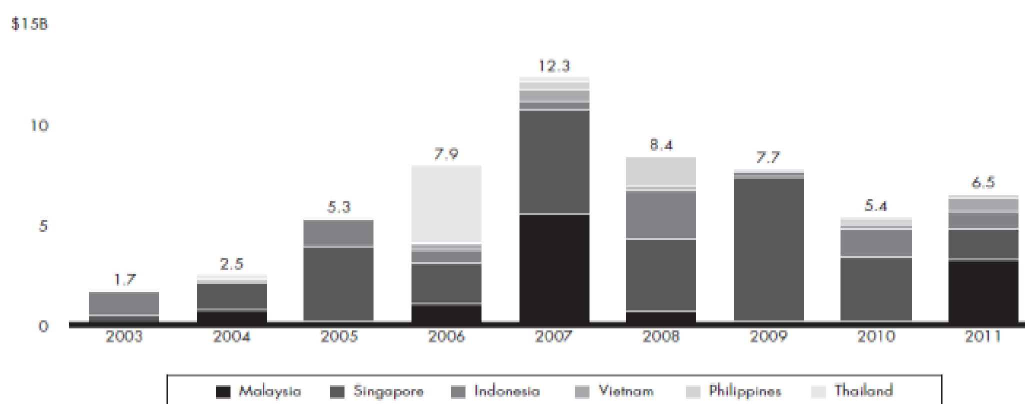
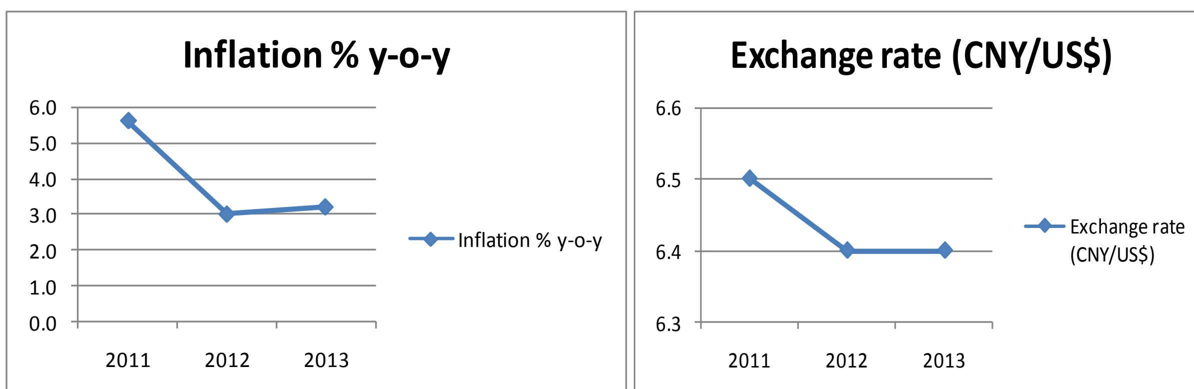


Figure 1.5: Comparative data on deal value by select South East Asian geographies
Source: Global Private Equity Report 2012, Bain & Company

Given the importance by deal value and fund-raising we will focus on China, India, Indonesia, Singapore, Malaysia and Vietnam.

CHINA

	2011 A	2012 E	2013 E
Population (mn)	1,348	1,354	1,358
GDP growth (%)	9.1	7.5	7.1
Income / capita (US $)	5,260	5,855	6,441
Current account (US $bn)	235.5	250.7	241
Lending rate (%)	2.8	3.2	3.0

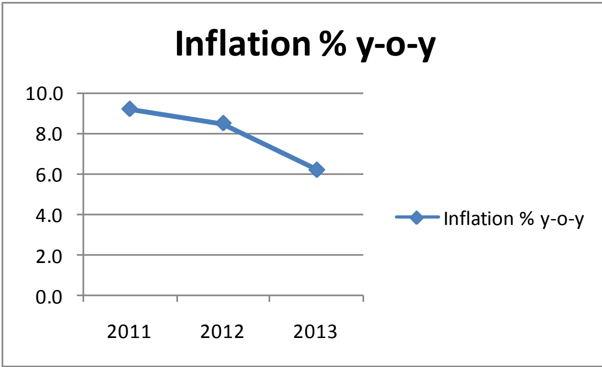


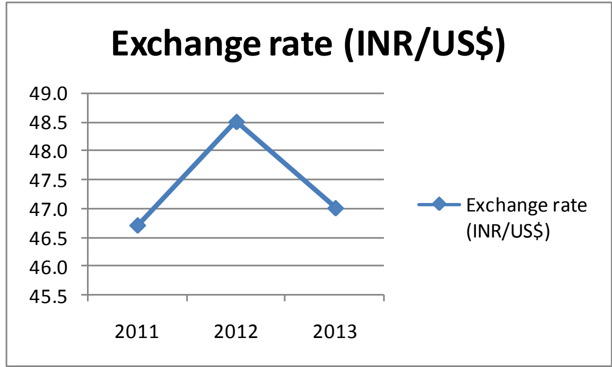
Business Monitor International marks Chinese growth as "end of the 8%+ growth", preferring instead a lower 7.5% in 2012 and even there, leaving room for a "further possibility of lowering of outlook pending severe slowdown". While demographics and urban migration still sustain as strong, domestic consumption is still only 40% of GDP and export shocks did have an impact in 2011 on the country's outlook especially with Europe's ongoing problems. Moreover, beyond concerns over a questionable growth model with more money going in (investment) than coming out (consumption), a weakening currency, manufacturing and services output, stressed banking sector all are serving to be a drag on the overall economy. If this wasn't sufficient, possibly the first time since China started its March toward double digit growth, the country is starting to feel rumblings of dissatisfaction politically.

Albeit this morbid start to our representation of China, she still has a treasure chest of foreign reserves to protect against external shocks and, is still the fastest growing economy with a massive trade surplus. Moreover, we have still not seen global brands emerge consistently from China and this may just keep the aspiration of the next big wave alive. Despite the concerns, possibly dangerously, investors have not backed down in part because the country still offers them one of the best risk-adjusted returns relative to any part of the world. The continuing story of state owned enterprises privatizing and private firms looking for expansion capital is seeing a strong demand for PE investors. The government has also realized the role of PE in developing the economy and admittedly is creating a supportive regulatory environment. With over $10bn deployed just in 2011 and local LPs starting to emerge, this is bound to keep growing.

INDIA

	2011 A	2012 E	2013 E
Population (mn)	1,242	1,258	1,275
GDP growth (%)	6.8	7.3	7.8
Income / capita (US $)	1,504	1,682	1,875
Current account (US $bn)	-64.8	-66.0	-76.6
Lending rate (%)	6.1	6.0	6.0



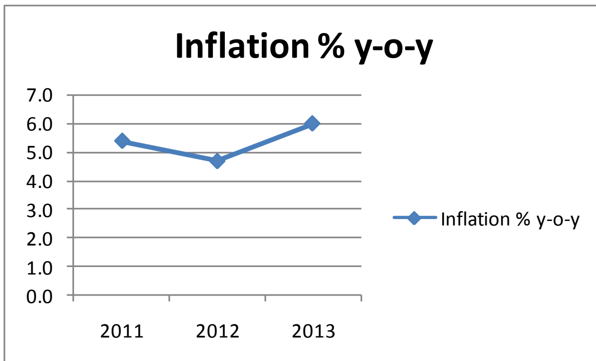


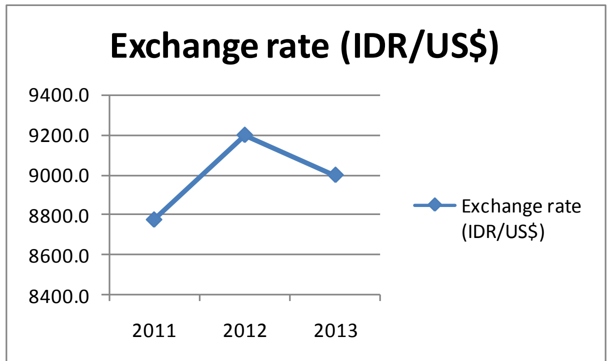
The benchmark Bombay Stock Exchange India Sensitive Index (SENSEX) has fallen over 25% since November, 2010 and the rupee has depreciated ~20% since July, 2011. The current and fiscal deficits are burgeoning and dependency on oil exports continues to hold strong. Inflation rates and interest rates have held at a steady high, agricultural efficiencies are low and, although domestic consumption was supposed to be the big story behind growth, it is not near the level of exports-based growth with per capita income oscillating around a dismal ~$1500. To worsen matters, not dissimilar to China, political instability / competence is a prominent investor concerns. The lure of a deregulated retail sector vanished when political factions blocked the way.

Although PE investments have started to come back relative to 2009 ($4.01bn) in 2011 ($6.17bn), they still came out to be lower than 2010 ($6.22bn). However, this macro-view is not deterring investors entirely: while total funds raised for India in 2011 came in lower at $2.73bn than 2010 at $3.28bn, over 250 firms have opened shop in the last 5 years, a testament to the fact that the geography will continue to stay in favor with LPs, just cautiously so.

INDONESIA

	2011 A	2012 E	2013 E
Population (mn)	242	245	247
GDP growth (%)	6.5	5.8	6.2
Income / capita (US $)	3,492	3,656	4,165
Current account (US $bn)	2.1	1.1	-1.1
Lending rate (%)	14.8	14.4	14.9

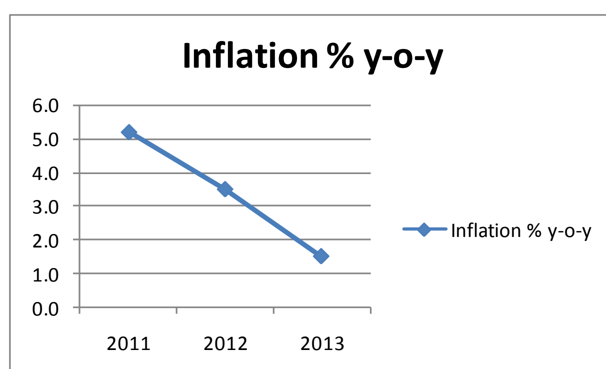


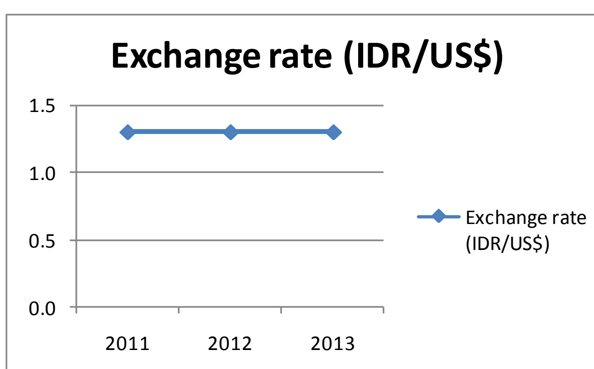


One of the better geographies to weather the storm during the financial crises, Indonesia along with Singapore and Malaysia is increasingly catching investors' fancy. Although issues with physical infrastructure, high unemployment and slower growth rate bog the country, investors are finding appeal in the strategic location between the Indian and Pacific Ocean and its' resource-richness primarily. Given that after India and China, this remains the highest populated state fueling hopes of rising domestic consumption. The rise of Islamic financing, the fact that Indonesian equity markets showed a solid performance during the financial crisis and the country posted a positive growth during the same time will drive PE investors toward the geography not to mention its' stable manufacturing and commodity exports.

SINGAPORE

	2011 A	2012 E	2013 E
Population (mn)	5	5	5
GDP growth (%)	4.8	2.6	3.5
Income / capita (US $)	51,339	52,061	56,878
Current account (US $bn)	49.5	43.8	46.8
Lending rate (%)	5.4	5.4	5.4

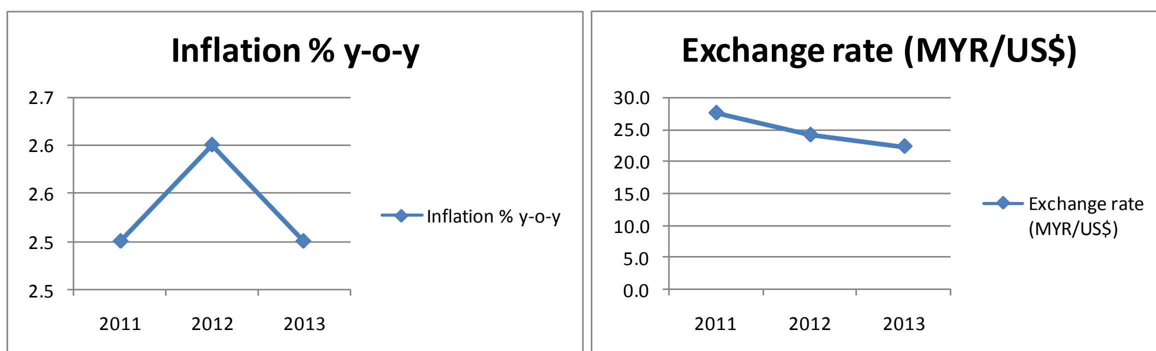




A hard landing in China has affected the export-driven country the most, posting a negative 4.9% quarter-on-quarter growth. Steady inflation near the 5% mark and a loss of exports still is not expected to dampen the current account surplus much but has still led to a lowering of growth rate outlook by as much as a ~1% (3.5% to 2.6%). However, the strong account surplus (20% of GDP), government's ability to manage the currency and potential of added development of sectors in an otherwise under-diversified economy is still helping the country gain favor from global rating agencies.

MALAYSIA

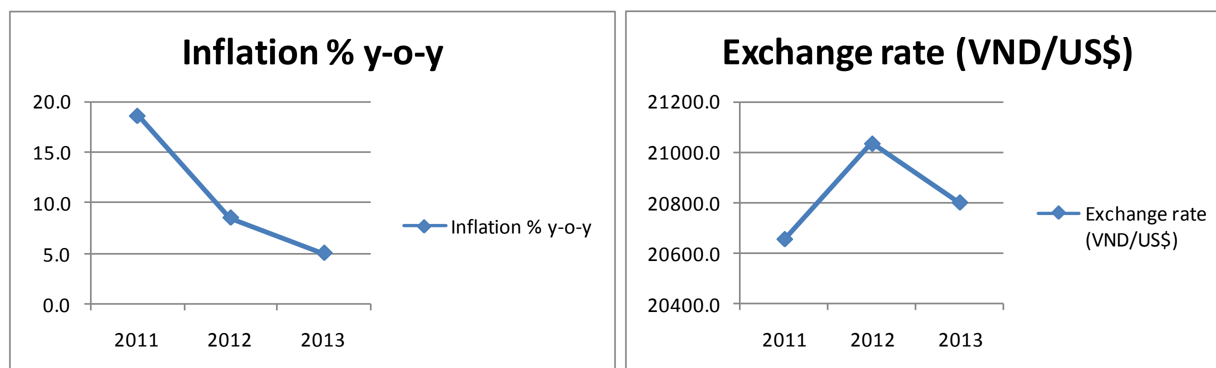
	2011 A	2012 E	2013 E
Population (mn)	29	29	30
GDP growth (%)	4.5	3.2	4.6
Income / capita (US $)	9,136	9,356	10,398
Current account (US $bn)	27.5	24.1	22.3
Lending rate (%)	5.3	5.4	5.5



Foreign direct investors remain resilient about the geography. Despite a downward trend of growth rate, a high level of foreign reserves, a strong account surplus, proactive policies by the government to handle inflation and moderate and stable politics are driving positive sentiment. Moreover, what is impressive is the Malaysian transformation from a commodities industry to a computer and electronics producer. It happens to be the one geography in South East Asia to be a net exporter of crude oil, further bolstering investors.

VIETNAM

	2011 A	2012 E	2013 E
Population (mn)	89	90	91
GDP growth (%)	5.9	5.8	6.5
Income / capita (US $)	1,357	1,512	1,694
Current account (US $bn)	-5.7	-6.6	-6.3
Lending rate (%)	19.5	13.0	11.0



In the last 20 years, Vietnam's poverty rate has fallen from 58% to 10% and it has earned its place as one of the top 5 fastest growing economies in Asia. Account and trade deficits and an overall weak currency inhibit some of the country's potential. However, political stability, membership to WTO and thereby foreign capital and markets and positive macro-economic measures such as urbanization, demographics, and privatization is masking the negatives to continue attracting investors.

Why do we feel these are important to LPs and GPs? Typically such detailed indicators maybe more relevant to hedge fund analyses. Issues such as rising inflation and high interest rates have a double impact: on one hand it dampens local consumption making these geographies even more reliant on

exports and on the other, it can create a sentiment of "parking money" in risk free bonds versus taking risks and borrowing for business growth. Consequently this can affect overall growth in an economy, impacting issues such as account and trade deficits which can continue its negative downward spiral by pushing investors who have positions to withdraw capital and those that are sitting on the fence, to wait longer. As seen with India, this can start to impact the currency feeding into dismal returns on invested capital especially for foreign denominated funds.

By appreciating these factors, PE firms can really feel the need of driving growth in portfolio companies independent of riding the market curve. For instance, increasing productivity in portfolio companies can ensure that costs are contained and wages don't rise faster than the output of a firm, thereby staving off overall inflation.

This is particularly significant when the portfolio companies are SMEs since an SME is in much more danger of revising forecasts if it was depending mostly on riding the overall market growth (For e.g. such firms will have lower cash on hand and working capital and has a much lower tolerance for canceled orders/revenue).

In the next section, we will discuss approaches to mitigating such risks for SME-focused investors either prior to a deal by adopting a differentiated sourcing strategy or by adding hands-on value post-deal.

Proprietary sourcing & operational involvement

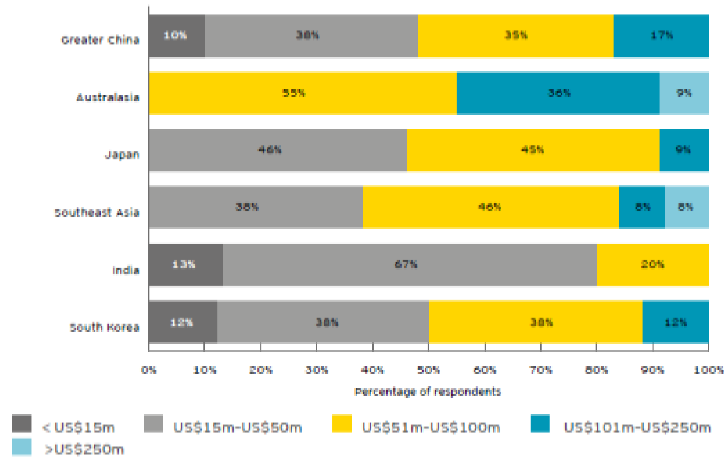


Figure 3.1: Expected deal size ranges going forward by geography

When Ernst & Young asked respondents of the expected deal ranges in Asia, most cited the small and medium sector. In the 13th Annual Global Private Equity conference, 2011, attendees cited that investing in SMEs will be a crucial engine of economic growth in the emerging markets, and conference participants commented that investors able to comprehend SMEs will see satisfactory returns.

Beyond the sheer volume of SMEs in EMs providing a healthy deal pipeline and their contribution to GDP etc., SME investing offers GPs an interesting play. The lure of SMEs for PE firms started once they came to terms with the reality that neither large targets nor significant leverage was available for deals and that SMEs offered high growth, quickly. In theory, one could take an acceptable equity position, provide much needed working capital, make expert contribution to establish a formal organization structure, make a few calls for business development and mostly, ride the growth curve to post healthy IRRs to LPs. Easier said than done.

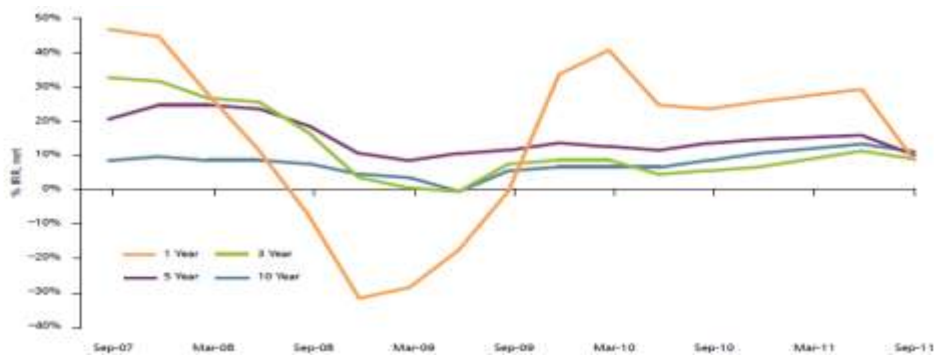


Figure 3.2: EM PE & VC performance, September 2011 (values shown net of fees, expenses and carried interest)
Source: Cambridge Associates Proprietary Index

According to the Emerging Markets Private Equity & Venture Capital index, one year net IRRs in emerging markets spiraled from 29.9% to 9.5% over the prior quarter, with Emerging Asia returns declining from 30.9% to 10.9%. An unnamed service provider to the PE industry recently commented that

spending additional time with a portfolio will increase returns on the edges but a PE firm's true value add comes in finding the next great deal. Further, their survey (possibly accurately) cited that only 30% of those surveyed expected to focus operationally to improve performance. Amidst this backdrop, already existing challenges in investing in SMEs and, mellowed macroeconomic KPIs in most EMs, how do you keep posting healthy returns?

PROPRIETARY SOURCING

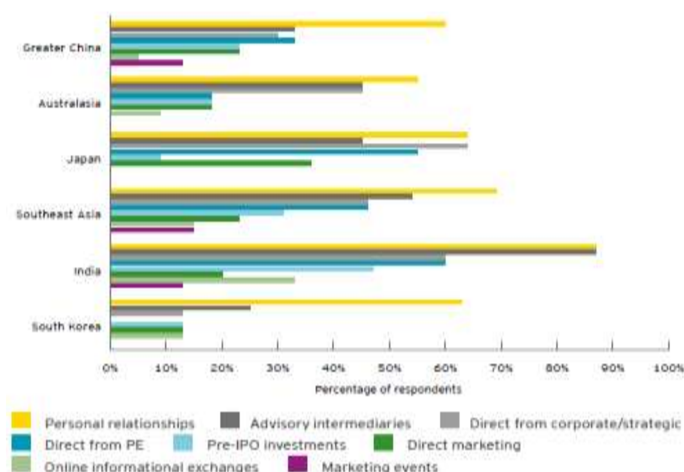


Figure 3.3: Methods of deal sourcing in EMs
Source: Asia Pacific Private Equity Outlook, 2011, Ernst & Young

In speaking with Raj Morjaria, CIO at Aureos Capital (recently acquired by Abraaj Capital), one of the highly reputed authorities on SME investing across the US, Europe, Asia, Africa and Latin America, 86% of last year's deal flow was generated through proprietary channels and is one of the themes behind their success.

As seen above, a majority of respondents expressed personal relationships as the major deal sourcing avenue. However, as David Wilton, Chief Investment Officer, International Finance Corporation explains, "Claiming proprietary sourcing leads is easy and, to an extent, routine. What matters is if you have the resources as a GP to go beyond saturated primary geographies, possibly secondary, even tertiary cities to find that deal."

We define proprietary sourcing, not as one wherein there aren't intermediaries or payments made. Realistically, most relationships will justifiably require, some payment in kind, whether they are formally registered brokers or not. Instead, such a sourcing strategy may be classified as proprietary if it is not auction-based; does not encounter a bidding war / competition at the table and in the case that it does, has an insider network to getting better terms on the deal. In Chinese societies, such a network is named, *"guanxi",* a trusted ecosystem of relationships. We term it "*network leverage."* Further, as Raj enlightens, "It is not the deal that is proprietary. What is important is if you have access to relationships that show you the deal before they show anyone else. It is such relationships that are proprietary."

As deal hunting moves from primary to secondary regions in some of the more "mature" emerging markets such as China and India, and from primary to secondary markets in the likes of Singapore and

Malaysia, the channels of seeing proprietary deals are also undergoing a change. PE firms interested in accelerating relationships with firm founders should consider talking to the likes of:

- The firms' accountants, lawyers and assigned credit rating officers if any
- Less pursued but equally valuable agents are tax inspectors, executive coaches (yes, they exist even in EMs!), behind-the-scenes personal wealth managers of HNIs, media conduits who regularly interact with CEOs of certain SMEs
- Referrals from existing portfolio companies

Gaining the trust of these agents not only allows to influence the founder positively and appreciate their aspirations and fears but also increases the likelihood of getting access to better quality information. Creativity, empathy and, an inherent interest in people, is necessary to build such relationships. To invest in an SME, an investor must first appreciate the personal needs of the founder and those that are in his circle of trust. Is it succession planning that worries him? Does he wish his children were more involved in the business? Can you push forward aspirations of those in his circle of trust somehow? Additionally, as deal sourcing starts to move to lesser explored regions of a country, we believe the role of the public sector leader will start to escalate again as these geographies maybe less mature / closely controlled. Appreciating this can allow PE firms to staff advisors differently or strategize entry into these geographies proactively.

Moreover, as Aureos Capital found to be true, paying careful attention to deal generation using some of the strategies highlighted here, can "help seek better alignment with a portfolio which helps with legal and price negotiations and importantly, in executing action plans going forward."

OPERATIONAL INVOLVEMENT

From finding creative deal sources, to building relationships with not just the founder but those who have the founder's ear, to struggling with resistance in retooling the organization structure, to dealing with canceled orders in the wake of economic uncertainties, GPs have to sidestep landmines if they aspire to make satisfactory returns from SMEs. Looking beyond generating such deal flow, operational involvement has caught much press in recent times.

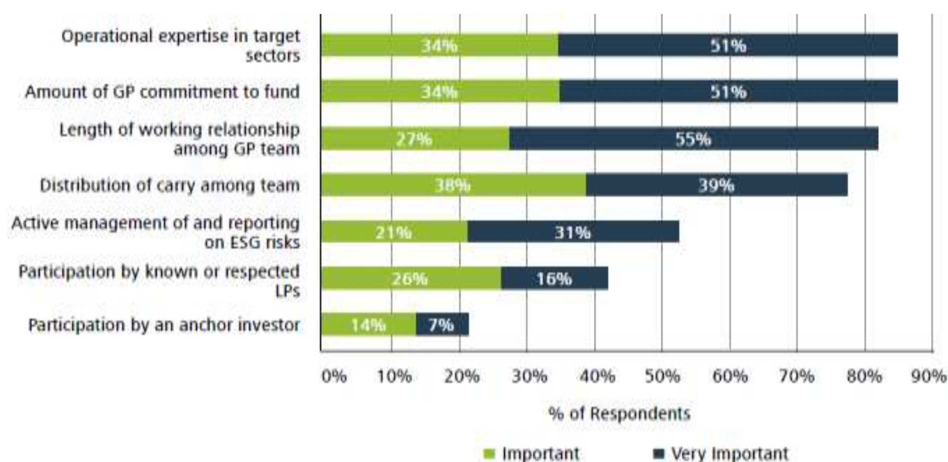


Figure 3.4: LP preferences in EM GPs
Source: EMPEA Global Limited Partners Survey, 2012

As indicated, EMPEA found operational expertise in a GP team is one of the top three criteria that LPs are seeking in GPs. As David said, "Since it may be challenging for an LP to ratify a GP's deal generation ability, it also comes down to what you can bring to the table if there's competition for a deal and in most emerging markets operational value addition is critical to success of the deal."

Rightfully, Sri Rajan, Managing Director, Bain & Company, India is more cautious, "There's a lot of talk about this amongst funds as a way to differentiate themselves for not just fund-raising but also in convincing entrepreneurs to take their capital. But this may not always materialize into action."

To appreciate how SMEs view courting by PE investors, we incorporated thoughts of Suhas Kulkarni, a senior investment banker from London turned CEO of a manufacturing firm in India. "Show me more than tell me how you can add value. Help me understand if we can get along with not the PE firm's representative on our board, but, also any advisor who can add value operationally either in reducing costs, bettering distribution or finding inorganic growth."

Suhas opines that SMEs are an interesting inflection point. Those that are attractive targets are doing well enough to not need PE money but can see the lure of growing business to the next level either with higher profile or a larger scale customer. However, to get to the next level, you don't just need capital and business development but also a retooling of the organization to ensure you don't feel like a fish out of water while meeting with such a potential customer. PE firms that appreciate such nuances are attractive to Suhas. Further, instead of showing potential BD opportunities in a "pitch deck" by an investor, it goes a long way to raise a conservative SME's comfort level in seeing that some of this growth can be captured in reality. An investor that demonstrates that such growth is indeed realistic may try to bring along letters of interest from potential customers or detail an inorganic growth opportunity. From an investor perspective, David resonates this point, "In many geographies, SMEs are starting to say, if all you offer is capital and the promise of growth, why should we share the upside with you."

To add merit this research and continual press coverage, Ernst & Young found that over 50% GPs are expecting to focus on bettering operational performance of portfolio companies in the next one year.

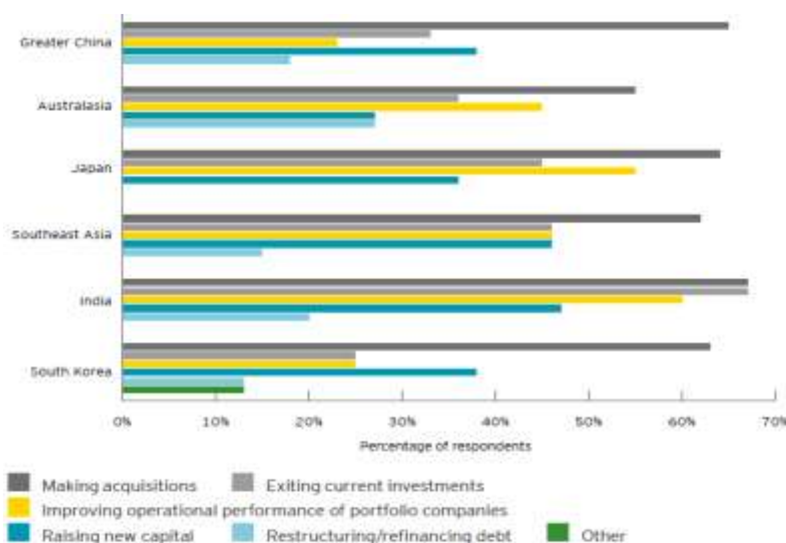


Figure 3.5: Where will PE spend its' time in next 12 months
Source: Asia Pacific private equity outlook, Ernst & Young, November, 2011

Jason Breemen, Managing Director at Everstone Capital validates this. “We need to be close to our capital even if we trust a management team.” One of the only funds in post the financial crises to be oversubscribed during fund-raising and winner of “Firm of the year in India”, by PE International, Everstone is the only firm in India with four offices and possibly, one of a select few firms which has an operations team identically structured to the deal team. However, Jason is also selective despite having an operational team on hand, “We walk away from deals where we sense our operational involvement is not sought.” The balance of power seems to be tilted in favor of the entrepreneur. Sri Rajan, shared that operational involvement in a geography like India is not just a function of the fund’s investment philosophy but also fund sizes where smaller funds may not be able to justify spending too much time with one company to their LPs.” “However”, he continues, “where funds such as TVS Capital, Actis, India Value Fund can afford the luxury and are interested in being hands-on, the gamut of activities that a fund can get involved in is not just relegated to growing the top-line but can get as deep as supply chain improvements.” A balance must be struck by firms in who they engage for such activities, in Raj’ opinion. On one hand, the investor maybe too close to the deal and a 3rd party provider may provide unbiased input and on the other, the investor may just know the business better or have a better instinct.

An inspirational case to fortify the suggestions outlined above is Sino-Century, a 500mn RMB fund focused on Chinese SMEs. Typical deal sourcing involves (a) researching an industry top-down; (b) identifying leading companies in the researched industry and, (c) investing time and effort in analyzing how Sino-Century can add value to one of these leading companies and developing detailed action plans on execution of this value-addition before even approaching a company. This helped them become the only investor beating 20 other financial and corporate suitors. Post-investment, Sino-Century spent time in using its’ *guanxi* to (a) collaborate with the Shanghai Municipal Government to grow Wind Info; (b) helped in acquisition of a trading platform in Hong Kong; (c) strategized and executed on global expansion by employing emotional intelligence in helping founder feel value of globalizing business in meetings with Bloomberg’s ex-CEO and, (d) fully participated in IPO related roadshows. As of July, 2011, this investment was valued at a 57% IRR and a 5x multiple of cost.

Parting suggestions

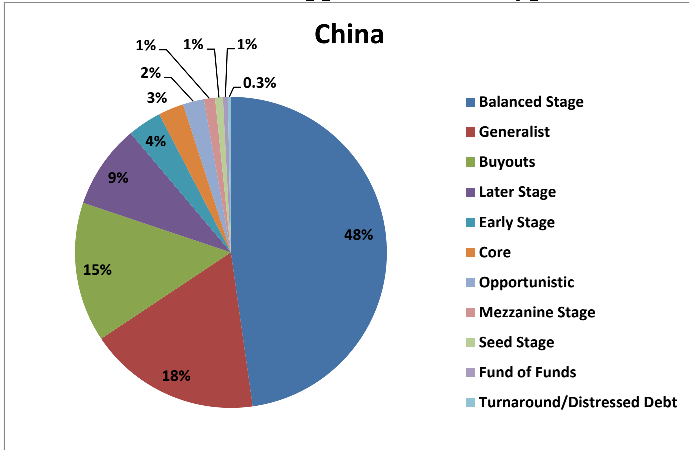
Although we aspire to provide a framework for quantifying the value of effort invested in generating proprietary channels and operational involvement, we also opine that this becomes a distracting academic exercise and moreover, hard to allocate "a portion of the IRR" to a specific activity. In lieu of this, we suspect the following metrics will become valuable to an LP to track the effectiveness of a GP's sourcing and operational strategy:

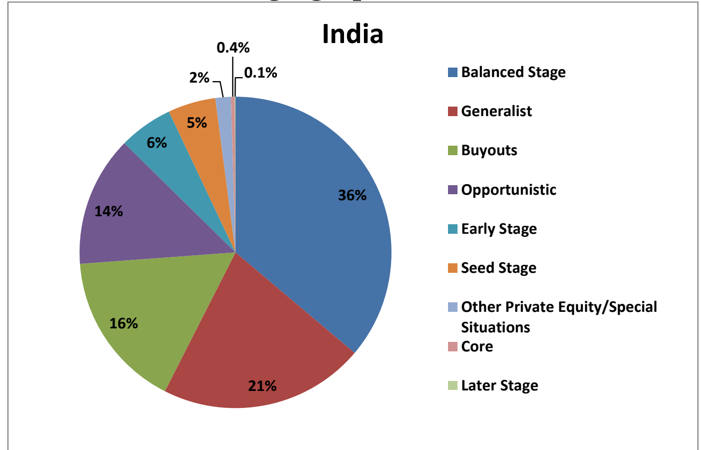
Deal generation:

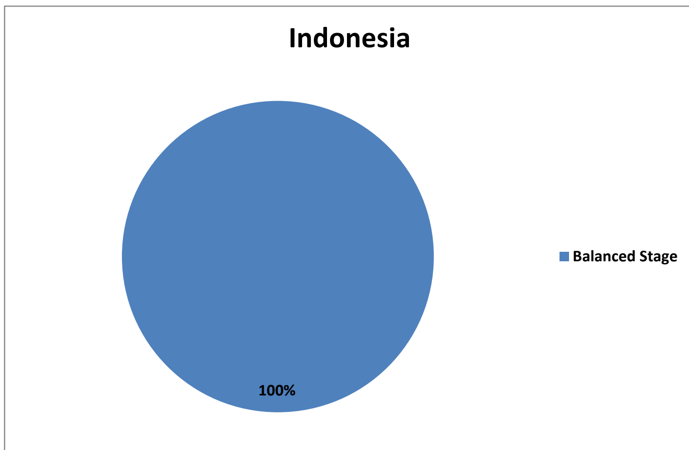
- Contrasting a proprietarily won deal vs. non-proprietary (as defined above)
  - ✓ Price paid
  - ✓ Stake sought vs. obtained
  - ✓ Time and money spent from originating to closing including intermediary payments and due diligence
  - ✓ Ratings for relationship developed with and new ideas embraces by portfolio team
- Contrasting deals / funds with an operational focus than ones with lesser involvement
  - ✓ Team composition
  - ✓ Time and money spent by internal and external operationalists
  - ✓ Metrics such as factories visited, calls handled, potential acquisitions researched
  - ✓ Consequent revenue or margin expansion accomplished

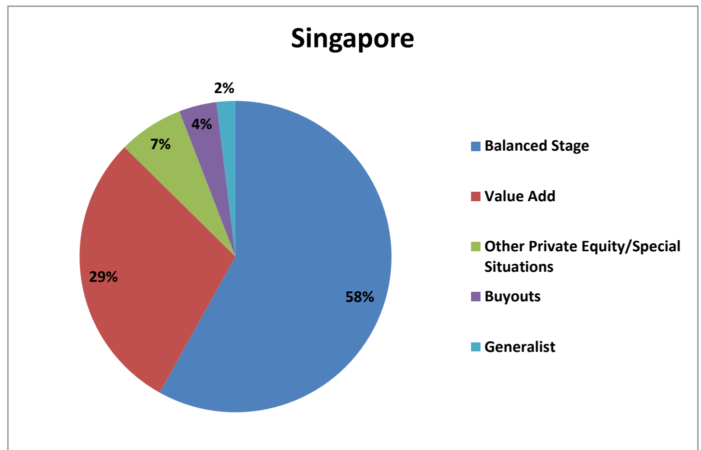
Appendix

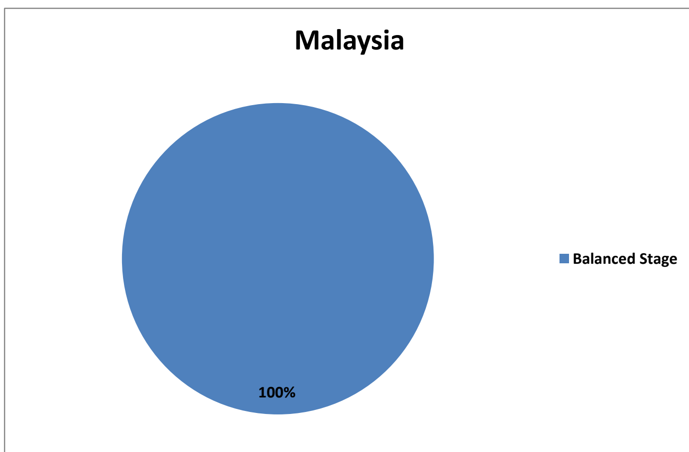
Appendix 1.1: % types of funds raised for select Asian geographies

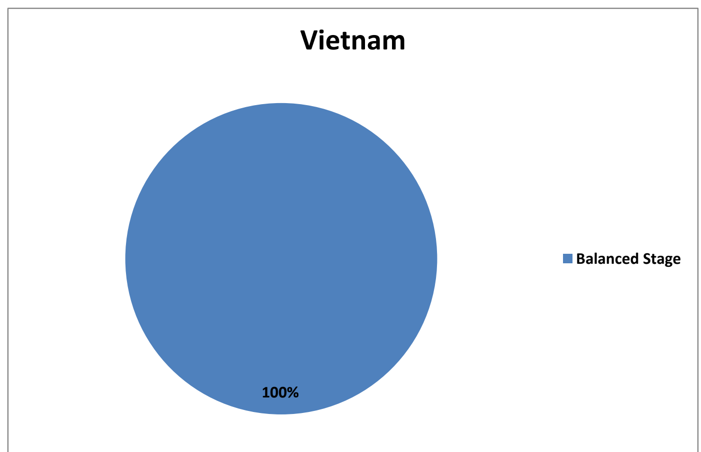












Source: Thomson Reuters