

Watch for Private Equity Inflows into Pioneer Markets to Grow Further in 2013

Emerging and pioneer markets are beginning to shine in the world of private equity. Among the BRIC countries (Brazil, Russia, India and China), Brazil had a very strong year in 2012, while India and China fell back. However, other areas — from Africa to Latin America and so-called “pioneer markets” — recorded good performances last year. Knowledge@Wharton takes a closer look at how private equity will perform in 2013 with Philip Bass, global private equity markets leader at Ernst & Young, and Stephen Sammut, a lecturer at Wharton Entrepreneurial Programs and senior fellow at Wharton’s health care management department.

Below is an edited version of the interview.

Knowledge@Wharton: A recent report of the Emerging Markets Private Equity Association showed that emerging market funds received 20% of new capital committed in 2012, the highest percentage yet. Does this portend a sea change in global equity and is it especially impressive, since last year was not great for India and China?

Philip Bass: Last year, the highest percentage [of private equity was] invested in emerging markets. When we take a look at not only today but [also] the future, what we’re seeing is a continuation of higher GDP growth in the emerging markets, the frontier markets, the pioneer markets. They’re really mature markets and that’s a trend we don’t see changing. We see private equity continuing to take advantage of the opportunities in these markets where there’s higher GDP growth, a rising middle class [and] increased consumerism, and we don’t see that trend changing. If anything, we see continued investment in those markets going forward.

Stephen Sammut: I agree on the macro trends. Despite the big numbers making it look as if the economies are slowing down, [they do not] seem to have [had] that much of an effect. The Emerging Markets Private Equity Association data was revealing. The new capital that found its way into funds in emerging markets [represents] a fifth of all private equity last year. That overall number as

it related to Brazil, China and India was actually down [over that of 2011]. But that is because 2011, in terms of capital into the industry, was an explosive year in and of itself, at least since 2008. That created an overhang of capital to be invested during 2012. So in 2012, those same countries, particularly Brazil, saw a veritable explosion of new investment. But what is interesting is that despite the fact that, for at least the BRICs, the amount of new capital flowing in was down, overall [in emerging markets] it was up. In order to answer the question as to why [that occurred], you have to start looking at markets that in prior years were not seeing much capitalization. Those include countries like Colombia, Peru, Turkey, Indonesia and Vietnam — places that were on no one’s radar as recently as five to seven years ago. So that begins to indicate a sea change in the way people are thinking.

Knowledge@Wharton: Stephen, were there any other surprises in the EMPEA data?

Sammut: Yes, I believe there were. A particular note was the fact that things did slip in China and India and I’m still trying to sort out why. Part of it may have to do with perturbations in the Chinese capital markets during that time period and that might have put a little bit of a chill on the prospects. The other thing is Chinese private equity is undergoing a transformation from dollar-

denominated funds to where more and more of the capital — and it may well be a majority of the capital — now are in funds denominated in RMB (renminbi). This is not a trivial change because it means that there are different types of professional managers managing the capital and building the whole private equity process, or rebuilding it.

Knowledge@Wharton: Philip, what would your comments on that be?

Bass: When you look at the data, the thing that jumps out is the \$8.3 billion that was invested in the non-BRIC emerging markets. That really picks up on what Steve was talking about. Historically, when we talked about private equity, we talked about investing in the BRICs. What we're seeing now is an expansion throughout Latin America, for example, and Peru, Chile, Colombia and Mexico picking up as well. We're looking at Africa all of a sudden on the radar, [and] we're looking at the greater Asia Pacific [region].

So it's not just China now, it's not just Brazil. We're seeing increased focus and opportunity for private equity in the pioneer or the frontier markets, in developing countries. [They will] have a lot of similarities to the BRICs in that you end up with a higher GDP growth, a rising middle class [and] increased consumerism. We're seeing them roll out to many other countries in different regions and providing opportunity for private equity.

The other market that did jump out is Eastern Europe. [In 2012] it raised \$4.9 billion, more than the last three years combined. So that's a region [where] we're going to see some increased interest [from private equity] going forward.

Sammut: With respect to emerging Russia and Europe, we are seeing somewhat of a resurgence. Russia has gone hot and cold since the fall of the Soviet Union, but it now seems to be back on the radar screen of private equity funds. Funds that set up shop and operate out of Russia [and] funds that have operated outside of Russia and attempted to invest in Russia, [had] gotten cold

feet, which, given the current Russian winter, is probably not a very apt image. But [now], capital wants to flow to these places.

An EMPEA chart on private equity penetration ranked private equity investment against GDP. The predictable big three were Israel, the U.K. and the U.S., who dwarfed everyone else. But that's actually good news or interesting news, because with the growth of other economies, the room for the amount of capital as a percentage of GDP that goes into private equity transactions [reveals] enormous capacity for growth.

Knowledge@Wharton: It strikes me that these pioneer, frontier countries did well in a world economy where the U.S. was lackluster. Europe was going down GDP-wise, and the prediction for 2013 is it will further decline. Japan didn't have a great year either. Are the pioneer markets decoupling? Are they more self-sustaining? How is that that they're looking so good and aren't dependent on other regions so much for their growth?

Sammut: That's a macroeconomic question that I'm not the best person to answer. I can give you my views on the function of private equity. Private equity activity oftentimes is and has been decoupled from the overall macroeconomics in a particular country. Private equity is largely about industrial reallocation and industrial restructuring. And in many instances, although the capital markets might not be cooperative, those are very fallow times for actually making the investments. Values might be better [and] existing owners are more eager, perhaps, to restructure their businesses. Control and buyout transactions, not typical of most emerging market private equity, do happen. The opportunities there are very strong.

Similarly, if you're talking about growth equity [such as] making minority investments in entities controlled by other parties, those companies still need capital for growth and there may be few sources available to them. They are more interested in bringing in professionally managed

capital — despite the contested issues of governance and control — than they might be when times are booming. There is in some ways a contrarian nature to the whole private equity enterprise.

Knowledge@Wharton: So it's fundamentally a bit counter-cyclical. Philip, what's your view?

Bass: What we're seeing for the most part in the emerging markets is the taking of minority stakes in entrepreneurial family-run businesses and providing the capital that they need to get to the next level. [They get] not only the capital, but [also] the governance and a lot of the expertise that private equity can bring to take them from a \$15 million business to a \$200 million business.

If you go back to one of the points that Steve mentioned earlier [about] the PE penetration ratio, in a lot of the emerging markets, there is an absence of debt financing and venture capital is quite level. You end up with a void ... and what you see is private equity stepping in and providing that capital. In many of these markets, these are businesses that are taking advantage of the local economy and not relying upon the global economy. That's why they've been driving a lot of growth.

Knowledge@Wharton: Could you share your views on what's happening in Africa or Latin America?

Bass: Brazil had a tough year [in 2012 and] GDP growth was slow. But its GDP is expected to pick up in 2013, and it's still higher than many of the mature markets, including the U.S. and obviously Europe. Brazil has the fundamentals for continued growth. It has a huge population taking a lot of the attributes that I've mentioned before, so we'll really see Brazil continuing to grow from a private equity standpoint to an active private equity market with plenty of competition. At the same time, there's enough opportunity, even with increased prices for private equity, to drive value creation and increase the value of some of these businesses. Brazil is going to continue to be a big focus [area] for private equity.

We're seeing growth in the [Latin American] region, with Colombia being the center of that. Colombia has a lot of the same fundamentals and we look at it as a place where private equity has a lot of focus. Chile and Peru are attractive as well. Mexico has picked up over the last six months and it's a big market. When we look at Latin America as a whole, that's going to be a place where private equity invests quite a bit, and we see the market as a whole picking up with the focus going on those five countries.

Sammut: I agree with Philip's assessment across the board. I could put a finer point on Brazil. One of the investment themes appears to be infrastructure opportunities, especially related to health care and education, on the one hand, and the impending World Cup (FIFA football event in 2014) and the Olympics (in Rio de Janeiro in 2016) on the other. There's a lot of press [suggesting] that these are driving a lot of interest in PE. That may or may not be the case, but it is certainly true that what Brazil is enjoying in private equity is significant diversity in the kinds of investments, categories and sectors in which investments are being made.

So [Brazil has] the combination of the capital overhang I mentioned earlier — the excess of invested or committed capital during 2011 and how that showed up in 2012 in actual transactions that was fueled in part by the huge diversity investors could enjoy — and that diversity, to some extent, softens pricing pressure. All of the Brazilian PE funds that I've spoken with do bemoan the fact that prices have gone up, but they are investing across a wider spectrum of opportunities. Financial services, telecommunications, health care and education are all getting substantial inputs of capital.

Knowledge@Wharton: Philip, let's turn to Africa. Could you offer your views on that market, please?

Bass: Private equity firms are increasingly interested in Africa. Again, you've got a lot of the same fundamentals that we've talked about before — positive demographic trends, improved

governments and business environments. Some African countries rank ahead of other emerging markets in ease of doing business. Sub-Saharan Africa has posted remarkably resilient growth in the face of the global economic uncertainty. We think that the trends are going in the right direction for Africa. Private equity investment in Africa was around \$1.2 billion in 2012 and while down from \$2.2 billion in 2008, we do see this as a market that's going to continue to grow over time.

Sammut: I couldn't agree more. Lots of interesting surprises in Africa and many other countries you would still categorize as frontier markets and yet, they are enjoying an influx of private equity. It's worth mentioning that a lot of the credit for what's going on in Africa should go to the International Finance Corporation, which is the private sector [lender] of the World Bank. Long before any other organization was putting money at risk in this category, they were. They got behind some extraordinarily well managed funds that entered in the high risk phase.

Emerging Capital Partners, for example, Zephyr and Helios, just to name a few [private equity investment firms], paved the way, did a great job in instructing governments as to what needed to be done and the environment, almost from out of nowhere, has transformed into a fairly — I wouldn't go so far as to say congenial — effective place to do business. When you look at the emerging middle classes in countries like Tanzania, Ghana, Kenya, South Africa and Nigeria, the opportunities for investments in

financial services, telecommunications, education and even health care abound and there's a very bright future there.

Knowledge@Wharton: How quickly do you see emerging and frontier markets developing over the next five years?

Sammut: Five to seven years from now, if the current trend of capital flowing into private equity in these markets continues, [they may account for] 25-30% of all [global] private equity investments, and it could be even higher. That's up from 20% today, and there probably will be a few more countries that are the beneficiaries of this activity that are not right now. I'm fairly bullish.

Knowledge@Wharton: Philip, how would you characterize this?

Bass: I would agree with Steve. Greater Latin America, greater Asia-Pacific, Africa, and Eastern Europe are going to be the markets that are going to take it from that 20% to 30%. A lot of the market conditions in those countries are pretty stable and ripe for continued investment at the pace that they've been over the last 12 to 24 months.

Knowledge@Wharton: Thank you both for helping us learn more about this. Previous podcasts and additional insights into private equity are available at our private equity website. The address is <http://kw.wharton.upenn.edu/private-equity/>