On the inescapable relation of risk and return

Investors expect a risk premium when making commitments to emerging markets private equity. So far, Asia's returns haven't disappointed them, says Michael Prahl

After a prolonged bull market in almost all asset classes during which investors were chasing ever higher returns, the events of recent years have shifted their attention firmly back to the kind of large disruptive risks that can wipe out several years of gains almost overnight.

It started with a crisis in obscure mortgage products that, via the ensuing deleveraging of the financial system and the accompanying liquidity crunch, developed into a full blown financial crisis. Following a short delay, it has been morphed, via the printing press, into the sovereign debt crisis that we are now witnessing.

Emerging markets risk

While increased volatility has been in capital markets worldwide, it remains an interesting characteristic of this period that Western markets and financial systems have generally been much more affected than emerging economies. Certain strains are now beginning to be exposed – witness the negative effects of China's stimulus program as excess liquidity creates bad debts in both the formal and informal economies and leads to misallocated investments on a grand scale – but until recently a re-rating of emerging market risk seemed to have been underway.

Economic theory consensus typically postulates that in order to compensate investors for their risk in emerging markets (from macro shocks, foreign exchange fluctuations, less developed socio-economic framework, and so on), assets have to deliver additional return. While there is no single static number, market participants gravitate toward a risk premium of around 2% for public equities.

The specific number aside, it appears that for public equities emerging Asia has well earned its risk premium over the last decade. Broad public market indices have returned over 10% annually for the last 10 years while US and Western Europe delivered very low single digit returns. As of October 26, the MSCI AC Asia ex Japan IMI was up 10.14% in local currency terms and 11.31% in US dollar terms; the broad Russell 3000 was up 1.8% and the MSCI Europe AC was -1.1% in euro and 3.34% in US dollars.

PE returns in emerging Asia

In private equity the risk premium between developed market buy-outs and emerging market Asia needs to account not only for country risk but also additional risks for doing PE in emerging markets. These risk factors include a lack of manager track records, team composition and skill set, less transparency on portfolio and manager level, and unpredictable growth and minority deals.

A study carried out last year by INSEAD and AXA Private Equity showed large institutional LPs in the region want a significant risk premium of an average 0.65x gross money multiple from their emerging Asia portfolio (the answers range from 0.5x and up to 1.0x). This leads to gross multiple return expectations among the majority of respondents of 2.6x.

As for actual returns, data from Cambridge Associates for the first quarter of 2011 indicates that PE returns from emerging markets – mostly emerging Asia – lead the asset class ahead of both the US and developed markets excluding the US over the one-, three- and five-year horizons yet lag behind on horizons of 10 years or more.

The data tie in broadly with the results from the INSEAD and Axa Private Equity study, which indicated expected returns for the leading LPs' portfolios of China and India focused funds of about 2.3-2.4x gross money multiple.

A follow-up study by INSEAD and LGT Capital Partners looking at exits in China and India showed in a sample of 200 fully- or substantially-exited PE investments, dollar-weighted returns of 4.9x (and 3.1x cash on cash realized) for China and 3.9x (at 3.8x almost all of it realized) for India. While the sample is heavily biased towards best performing brand name GPs and does not include any fully unrealized investments among which the bulk of the underperformers will be hiding, it is nevertheless an impressive testimony as to how far the industry has come in producing real returns for its investors.

These results have naturally sparked investor interest, prompting capital to flow into Asian equities and private equity. Last year alone almost $100 billion entered the region, $63.5 billion into Asian equities

PRIVATE EQUITY FUND RETURNS

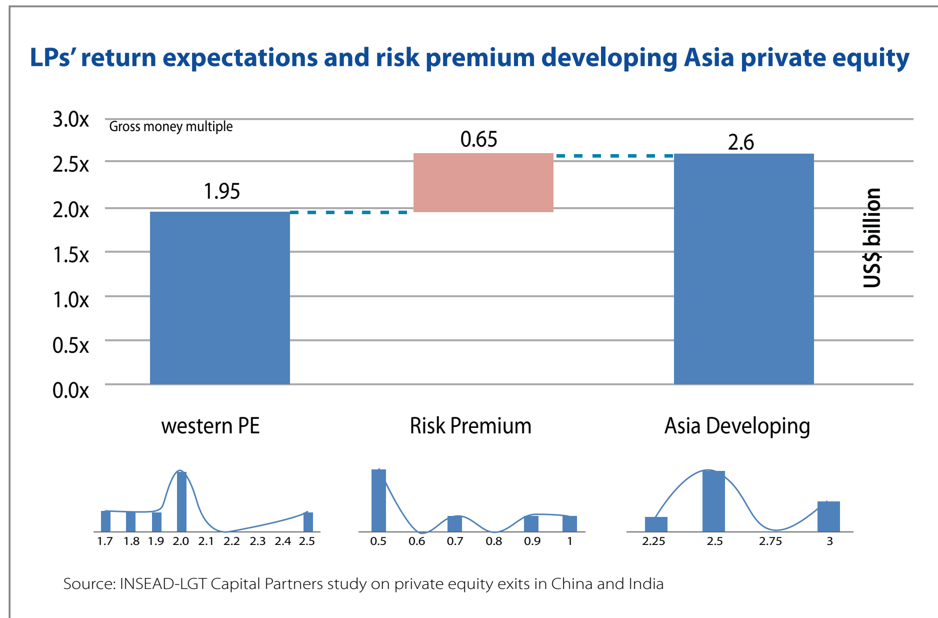
For the periods ending 31-Mar-11	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years
US PE	21.5	5.2	9.8	10.8	12.4	13.3
Developed markets (ex-US) PE and VC	25.2	-1.0	11.0	14.4	15.0	14.7
Emerging markets PE and VC	25.9	10.1	15.8	11.7	9.5	9.3

Source: Cambridge Associates
Note: Returns are on LP fund level performance and are net of fees, expenses and carried interest

ex Japan and $30 billion into Asian private equity ex Japan, Australia and New Zealand, according to EPFR and AVCJ, respectively. However this year's global increase in risk has at least temporarily stopped or reversed the trend for public markets, with about $17.4 billion leaving the region since the beginning of the year through early October.

As for private equity fundraising, the first six months of 2011 saw a continuation of the strong growth of last year. However, we have to wait for third quarter numbers to see whether the fundraising climate has been significantly impacted by recent market turmoil.

While private equity overall has been performing well in emerging Asia, especially in the two big markets of China and India, there exists a much wider performance variance in the region compared to the West. Put another way, top quartile managers outperform their peers in the West – although the larger number of funds per quartile in the US and Europe suggests a certain reversion to the mean – while the worst performers loose substantial portions of investors' money. The larger the performance spread, the more important manager selection. This isn't helped by the paucity of industry data and track records.



Source: INSEAD-LGT Capital Partners study on private equity exits in China and India

Performance drivers

So why have returns for emerging Asian private equity been so strong? Is private equity just riding on the performance of public markets as is often alleged to be the case in Europe and the US?

The INSEAD and LGT Capital Partners study on exits in China and India found that while there is a positive correlation between market returns and investment returns, market conditions can only explain about 15% of the variance of returns. This shields private equity returns in Asia to a certain extent from market volatility. It explains why even in the middle of the financial crisis funds were able to exit some non-venture investments with returns above 20x invested capital.

Although the performance of private equity in these markets is less correlated with public equities than in Western markets, functioning stock markets still play an important role. Private equity benefits from a liquid and well performing stock market, either as an exit route, a source of capital or, increasingly, as a source for deals. Funds have become highly adept at using capital markets as an exit route in particular. Their relatively long investment horizons and experience in the financial industry means they are skilled at timing periods of liquidity and upwards momentum in order to pick the optimum time to make their move.

Aside from market timing, it is company-specific and investment-specific factors that drive the exceptional returns mentioned above.

Company-specific factors relate to the type of companies typically financed by private equity in emerging markets. Investees often evolve in a fast-growth environment where the fit between products and changing consumer needs, the ability to generate a cost or positioning advantage, and effectiveness in managing fast-growing organizations, play a larger role than in mature markets. If private equity firms succeed in identifying well positioned companies and build successful relationships then comparatively little active support can result in attractive returns.

Likewise these relationships will often help with entry valuations given the opacity of the market. At the other end of the investment lifecycle there exists substantial arbitrage potential on exit by either exploiting the wide valuation gap between pre-IPO investments and IPO pricing, especially in China, or collecting the premium that strategic buyers are willing to pay for good quality acquisition targets in coveted markets.

A sustainable dynamic?

The above factors are more often than not the result of inefficiencies in a still young industry, resulting from a lack of transparency, low competition, low intermediation, imperfect transmission mechanisms for capital, and so on. Yet it is hard to predict how long this opportunity set can persist, given how much capital is flowing into these markets, rapidly increasing competition from both established and new GPs.

Every apparently outsized return will over time either be arbitraged away or turn out to be not so outsized after all when the risks materialize for which the return "prepaid." Fat tail risks in emerging markets are numerous.

The AIG division that underwrote insurance for mortgage portfolios was for more than 15 years the company's most profitable division. It seemed to have stumbled upon an effectively risk-free way of making money as common wisdom had it that a diversified portfolio of mortgages backed by property in a market which for generation has only been going up could not default.

In fact it was so profitable that it a lot of institutions rushed in to copy the model. Then came 2008 and the rest, as they say, is history.

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