# Private Equity in Emerging Markets

# Chances and Pitfalls for Private Equity Firms

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**This essay was prepared by Raphael Schmid Vantroost (GEMBA 2016), Managing Director, Head of Buy-Side of Noor Advisors (Switzerland) SA (www.nooradvisors.com) under the supervision of Claudia Zeisberger, Academic Director of the Global Private Equity Initiative (GPEI) and Professor of Decision Sciences and Entrepreneurship and Family Enterprises at INSEAD.**

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## 1) Executive Summary

Private equity buy-outs are very established in the developed world. Their business model is proven and follows clear patterns. The landscape can be described as homogenous, which is an advantage for both, general and limited partners alike. Due to their success, it is nothing but logical for private equity firms to expand into new territories such as emerging markets with untapped opportunities waiting, as centres of economic growth are shifting from the mature to the developing regions. However, when it comes to buy-outs in emerging markets, additional challenges emerge, the traditional business model often fails, applying classic investment criteria is significantly harder and limited partners don't seem to be willing to take on the additional risk.

The author of this implementation essay is currently working on a private equity buy-out in Tehran, Iran for Noor Advisors (www.nooradvisors.com), a Swiss based boutique investment advisor that has recently entered the Iranian market. The objective of this essay is to analyse differences between developed and emerging markets for private equity buy-outs and examine how general partners can improve their chances to succeed based on a mix of research and personal experiences gained.

## 2) Context setting

Population trends and GDP growth rates of emerging markets have been growing for years. Emerging market countries are expected to add 1.4 billion people to their middle classes in the next decade and account for more than 60 percent of global GDP growth between 2010 and 2016.[1] Emerging markets are expected to grow 4.3% in 2016 and 4.7% in 2017, compared to just 0.2% in 2016 and 2.1% in 2017 for mature markets.[2]

Despite this promising outlook and positive forecast, emerging markets only accounted for 12% in 2015 in terms of global private equity fundraising[3], a low number considering that more than 80% of the world's population live in emerging markets.[4]

When looking for reasons, many explanations come to mind; the volatility of emerging markets, regulatory risks, political instability, inadequate investor protection, the lack of decently sized buy-out targets, as well as less certain exit scenarios.

Although valid, those concerns lie in contrast to the promising market outlook of emerging markets and it seems unreasonable to just ignore the high upside potential these markets can offer. The question is, if and how these obstacles can be mitigated by adapting the traditional private equity model to the market environment of emerging economies.

In order to find solutions and make recommendations, we will break down the private equity process and analyse each step from fundraising to exit.

## 3) Analysis of key challenges for private equity firms when entering emerging markets

### a. Fundraising

Typical private equity investors (limited partners) are looking for low risk investments with above average potential. From a limited partners' perspective, risk can be reduced by building trust with teams of general partners as well as looking at the consistency of the general partners' track record. Traditionally, private equity firms frequently raise capital with blind-pool structures, meaning limited partners contribute capital without knowing which assets will be acquired. A private placement memorandum will shed some light on the investment strategy, but in the end limited partners have no control where their capital will be deployed.

In developed markets, private equity firms can run consecutive funds with a very similar structure, investment strategy and ultimately outcome, reducing the risk for investors. The homogenous market environment of developed countries enables them to specialise in certain types of deals or industries.

By contrast, emerging markets are fast moving and very diverse, making it difficult for general partners to establish a pattern and thus ultimately building up trust with limited partners. New markets like Iran have no history of buy-outs whatsoever. Fundraising therefore also entails a good amount of educating limited partners about the country itself, before even getting the opportunity to talk about the investment strategy.

### b. Deal Sourcing

Most buy-out funds look to invest in operating companies with significant amounts of borrowed funds to create value by realising opportunities and eliminating inefficiencies. For example, by using debt as financial leverage. This implies a certain maturity and size of target companies, making it difficult to find enough suitable investments.

The emerging market landscape is primarily dominated by smaller and midsized family owned companies, often only run by the second or third generation. Approximately 60% of private-sector companies with revenues of USD 1 billion or more were owned by founders or families in 2010.[5] By contrast, less than one-third of the companies in the S&P 500 remain family owned businesses.[6]

Deal sourcing of family owned businesses often add an additional layer of challenges. These types of deals are often more emotional and require intrapersonal skills and a good amount of patience. Larger and more mature companies are therefore scarce and thus often require a premium to be paid, making deal sourcing in emerging markets even more challenging.

In the Middle East, it is common that the official management roles don’t indicate who the actual decision makers are. CEOs and CFOs are a good source of information, but might not be in charge for taking key management decisions. In Iran companies are frequently controlled by large pension funds or even social foundations. The right connections and approach are required to even just get a foot into the door.

### c. Due Diligence

When entering emerging markets, thorough due diligence is crucial. Local expertise is key, as a simple checklist exercise and standard procedures are not enough to mitigate the risks adequately.

It is very common in emerging markets to have a lower quality of information, less transparent processes, less formal approach to business transactions and agreements, as well as frequent “off-balance sheet” transactions. Group structures are often complicated by family ties or unusual company structures. Furthermore, it is important to be familiar with local customs, bribery, corruption as well as political risks or currency risks such as high inflation or severe exchange rate fluctuations. A common pitfall is to have a too narrow scope, as general partners tend to be too cost-conscious and vendors overly protective in terms of data provision.

In the case of Iran, the majority of companies have no experience with dealing in an international environment. A constant challenge of the due diligence process is to bridge the gap between satisfying international requirements and expectations, as well as potential fears from the local party.

## d. Valuation

There are various challenges when it comes to valuating businesses in emerging markets. The first question is, how to incorporate country risk, how do cash flows get impacted and what effect does it have on discount rates? Secondly, adjustments for lack of transparency and potentially poor corporate governance need to be made. Thirdly, if comparable companies are being used, differences need to be assessed in-depth and require respective adjustments. Further adjustments and considerations might need to be taken into account.

Currencies in emerging markets for example, frequently experience high volatility, both in terms of exchange rates and inflation. Pegged currencies often lead to the false assumption that currency risks are gone and that the risk of the currency it is pegged to can be used for valuation. The absence of long-term default free bonds means a risk-free rate needs to be constructed for valuation purposes.

Stock markets often used as a source for comparables can be misleading too, as financial markets are often not very liquid, with very small amounts of free-float that open the door for manipulation. Companies frequently borrow from banks rather than issuing market-traded bonds which requires additional consideration when estimating the cost of debt for valuation purposes.

To summarise, although the same valuation methods will be used when working on private equity deals in emerging markets, there are considerably more estimations and adjustments needed. Same as for the due diligence, it is important to stay alert and to really comprehend all differences that come along with an emerging market buy-out.

## e. Deal Negotiation and Transaction Execution

Cultural differences lead to different tactics, assumptions and strategies when it comes to deal negotiations. Companies in emerging markets often have a much shorter history than their counterparts in the developed world. They were built over a short time span, through hard work and good connections. However, when it comes to dealing with private equity firms, international lawyers or consultants, they tend to be very inexperienced. This experience gap is often the source for misunderstandings and can later lead to legal disputes.

Acquisitions in emerging markets usually require more time and resources. It is important for private equity firms to take their time and fully understand the different relationships around the target company.

In the case of Iran additional obstacles arise out of usually standardised processes. For example, since the country is not (yet) connected to the international banking system, the entire settlement of the deal becomes a challenge on its own.

### f. Value Creation Post-Closing

Once a deal is closed in emerging markets, the real challenge only starts. In the developed world, private equity investments tend to be in established businesses with structural deficiencies, but with experienced managers aboard they can rely on. However, in emerging markets it is mostly about unleashing growth potential and requires more of a VC-type approach. Turn-around scenarios in developed markets ask for a completely different skill-set to emerging markets. Finding the right managers can be a challenge on its own.

The traditional approach of primarily hiring former investment bankers might suffice for companies with structural deficiencies in developed markets, but in emerging markets it makes sense to have a mixed team of investment bankers and experienced entrepreneurs, familiar with growing businesses in the respective area.

In the Middle East, this would mean having a mixed management team of internationals and locals, the majority with an entrepreneurial background in building up businesses in the respective industry. In Iran it probably would make sense to also staff the management team with someone who has good relations with regulators and authorities.

### g. Exit

The holding period for private equity investments is typically between 3 to 5 years. This time frame has been proven successful in developed markets and seems also to be desired by private equity investors. A study by Bain & Company shows that the holding period has extended in recent years due to higher insecurity in the market and higher paid multiples at purchase.[7] Emerging markets have by definition higher insecurity, family businesses that are only in the 2 or 3$^{rd}$ generation bring along more variables than established businesses in the developed world. A study by Thomson One conducted in 2015 concluded that in emerging markets, value creation is less homogenous and there are more variations in terms of holding periods, for trade sales, sponsor-to-sponsor and IPOs alike.[8]

Sponsor-to-sponsor sales would therefore make sense in emerging markets. Many portfolio companies in developing markets remain too small and underdeveloped for an IPO or trade sale after 3 to 5 years.

However, despite on the rise, sponsor-to-sponsor deals only account for 10% in emerging markets, versus 25% in developed markets.[9]

The most attractive exit for limited and general partners alike is an IPO. In contrast to developed markets, exits via IPOs are much more common. The above mentioned study by Thomson One, based on 1,661 developed market exits and 1,682 emerging market exits found that IPO exits are five times more likely in emerging than developed markets (51% vs 10%).[10]

## 4) Conclusion and Recommendations

Private equity in emerging markets can be very attractive and has developed significantly over the past years. Demographics and the economic outlook furthermore underpin the attractiveness of emerging markets. However, there are many possible pitfalls and even experienced general managers with prior experience in the developed world are likely to face difficulties if they don't adapt their approach.

Private equity firms need to alter their strategy already when it comes to fundraising. Building track record in emerging markets is more challenging than in developed markets, as it is much harder to run consecutive funds with a similar structure and investment strategy. Limited partners therefore need to be addressed with a modified pitch, which illustrates the advantages they might enjoy for the shortcomings in structure and track record. Blind-pool structures should be avoided if possible and communication with limited partners needs to be intensified.

Due to the nature of emerging economies, consisting of many family businesses which are only led by the 2nd or 3rd generation, deal sourcing significantly differs from developed markets. Soft skills and emotional intelligence play a more dominant role in this kind of environment. Furthermore, it is more of a challenge to find the usual investment sizes of the developed world. Deal sourcing therefore needs to be geared towards the target's development potential, rather than its restructuring potential and capital needs to be deployed over time instead.

A solid due diligence is key in emerging markets. A simple checklist exercise isn't enough. It is recommended to get familiar with the business and the country before even starting the due diligence process. Due diligence advisors with local offices should be chosen and mixed due diligence teams with local and international staff assembled. The scope of work needs to be carefully determined. A common pitfall is to have a too narrow scope, as general partners tend to be too cost-conscious and vendors overly protective in terms of data provision. All numbers presented in financial statements need a critical review for their sustainability and future outlook and cannot be taken as a given. In addition to a traditional due diligence, it is recommended to conduct an investigative research with background checks on key personnel and associated partners, combined with field enquires and site visits. The collation of information from a multitude of sources helps spotting patterns and irregularities that might not be captured in a traditional due diligence.

Although the same valuation methods will be used as in developed markets, market data is often weaker and therefore requires more estimations and adjustments. Critical sense checks are mandatory as market information can be distorted or manipulated.

Before negotiations can be started, it is recommended to get a clear understanding of the cultural differences, different stakeholders, including invisible stakeholders behind the scenes, as well as having legal experts who assist throughout the negotiation phase and make sure to draft respective contracts that withstand a potential litigation in international, but also local courts.

Value creation post-closing requires strong management teams. In developed markets, private equity firms can usually rely on strong management teams within target companies. However, in emerging markets much more management talent needs to be added to the target company, especially since companies usually need to be developed, rather than restructured. General partners are therefore advised to adapt their staffing accordingly.

In emerging markets, the importance of evaluating exit scenarios, prior to investment, is of higher importance than in developed markets, due to the lower liquidity. Holding periods in emerging markets are less homogenous, as standardisation is harder to achieve. Sponsor-to-sponsor sales would help to reduce variability. However, they are less common than in developed markets. IPOs on the other hand are five times more likely.

If limited partners can cope with the additional variability of emerging markets and general partners manage to adapt their business model accordingly, emerging markets can be very promising. Or as one of the deal partners in Iran said: “Be thankful for those pitfalls and risks, they are providing our upside”.

## List of used resources

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[7] Bain & Company Global Private Equity Report 2015 - http://www.bain.com/Images/BAIN_REPORT_Global_Private_Equity_Report_2015.pdf

[8] Thomson One, based on 10,794 developed market exits; 1,010 GGM exits; and 599 non-BRIC GGM exits

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## Further resources

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