

Views from the Field: Reflecting on 2013 and the Outlook for EM PE in 2014

As the industry closes the books on 2013, several EMPEA Members provide their views on key trends and lessons learned in the past year for emerging markets private equity, and look to the opportunities and challenges facing the asset class in 2014.

The Global Firms' Views



Koenraad Foulon,
Co-Founder and
Senior Managing
Partner, Capital
International Private
Equity Funds

“ For Capital Group, 2013 was a year to invest beyond the BRICs. Our 2011 fund, CIPEF VI, completed four new investments—three of which were in emerging markets outside the BRIC countries. We made our first ever investment in Chile, while returning to Colombia and the Philippines, where earlier vintage funds made successful investments 12 years ago. While Capital Group covers and holds investments

in Brazil, Russia, India, and China, which saw increased competition and heated valuations, the most compelling value this year came from beyond BRIC markets.

Looking ahead to 2014, we can be sure that the fundamental long-term attractiveness of EM PE remains strongly intact. In particular, we believe that the consumer-driven and natural resources sectors hold distinct potential. Consumer-related stocks are underrepresented within MSCI and across emerging public equity markets more broadly. As a result, private equity offers investors unique access to this attractive growth sector.

In 2014, we are excited to continue to navigate the global EM PE landscape free of top-down country allocations, and seek to opportunistically identify and pursue compelling value in both BRIC and non-BRIC markets.



Viktor Kats,
Deputy Head,
Global Infrastructure
Fund, IFC Asset
Management
Company

“ 2013 saw many corrections in terms of private equity flows in emerging markets, making opportunities more attractive. A number of companies in big markets tried to list and were unsuccessful, so they went to private markets, where they had to adjust their valuation expectations. Hopefully, in 2014, the gap will narrow between sellers and what investors are willing to pay.

Furthermore, for those investors who have a lot of dry powder available, the market is very good right now. For instance, in India, because of currency depreciation and the overall economic slowdown, many investors have been hit. On one hand, investors really have to be careful to pick the opportunities that will survive this slowdown, but on the other hand, they have a greater choice.

Looking to 2014, there are several trends from the macroeconomic point of view that we see as favorable for infrastructure investing in emerging markets. First is investors' increased awareness of this sector/asset class, and second, there is less competition for some of the assets due to growing risk awareness, which translates to less capital available from capital markets, banks or private investors. However, growth for infrastructure assets is still high, and the need to deleverage is increasing. Therefore, terms of trade are shifting more toward investors, so those who understand the risk and have capital are in a good position.

We are also seeing pension funds that want to enter emerging markets directly asking us to participate in some of their deals. These types of conversations make for a dynamic infrastructure market. We see a good pipeline, and we plan to preach this “gospel” of emerging markets infrastructure to investors.

The View from China



Benjamin Fanger,
Co-Founder and
Managing Director,
Shoreline Capital

“ At the end of last year, a trade publication asked me what I thought would happen in 2013 in Chinese private equity, and now with hindsight I would not change a word: in 2013, the investing world woke up. GPs realized China cannot defy economics. LPs realized capital should be allocated toward niche managers with real ability to generate value. And we all realized the next decade will look very different from the last—that successful investing will focus on inefficiencies and value generation rather than just growth.

In China, distressed opportunities have been steadily increasing as the economy decelerates, companies face stress and banks begin to sell non-performing loans. Capitalizing on such opportunities requires a local platform and a long history navigating the illiquid credit environment in China. Looking ahead to 2014, I see an increased interest in Chinese distressed opportunities, though prospective investors and fund managers realize the barriers to entry are high.

The View from Asia



Andrew Affleck,
Managing Partner,
Armstrong Asset
Management

“ Within the context of our specialization as a GP in the clean energy field focused on Southeast Asia, we reflect on the main lessons learned from our fundraising in 2013, and key opportunities and challenges for the sector and region in the year ahead.

Lessons learned in 2013:

- Although we achieved a final close above our target fund size, the timeline from the start of fund marketing to final close was two years. As a first-time fund manager needing to scale the team while developing a credible deal pipeline to convince LPs of the value proposition, it takes a great deal of belief, commitment and patience.
- While this is more of a continued confirmation than a lesson learned, there is no shortcut to getting deals done quickly in Southeast Asia. Time must be spent developing relationships with local sponsors and winning their trust; with no prior relationship, deals can take 12 to 24 months to develop and close.

Opportunities for 2014:

- According to the International Energy Agency, fossil fuel subsidies within ASEAN amounted to US\$51 billion in 2012. Key markets in Southeast Asia, such as Indonesia, Malaysia, Thailand and Vietnam, are realizing they can no longer sustain subsidies on their domestic fossil fuel costs at current levels. Action is being taken to reduce subsidies, and therefore fuel and electricity prices are increasing, making the case for renewable energy investment more compelling.
- Growth rate projections in ASEAN are still at a healthy average of 6%. Domestic consumption is a key investment focus for general PE funds, which in turn drives energy demand.

Challenges for 2014:

- Given the degree of regulation impacting the broader energy sector, political uncertainty can lead to delayed policy implementation. This inevitably leads to uncertainty for deal sponsors and fund investors; as a result, rapid capital deployment can be a challenge. This risk can be mitigated by having a regional fund strategy.
- There has been a fair amount of capital raised by generalist funds with a full or partial investment focus on Southeast Asia. Some countries, like Indonesia, may see valuations increase through competition for deals.



Lê Hoàng Anh,
Managing Partner,
Private Equity,
Dragon Capital

“ Similar to other emerging markets, investors continue to see that a strong local team, coupled with the patience to promote a disciplined approach, are pre-requisites for private equity in Vietnam, where restructuring and re-stabilizing were key themes in 2013. Notably, the country undertook measures to rebuild its foreign reserves, close its fiscal and trade deficits and reform the state-owned sector.

Looking forward, the main challenge for Vietnam remains how to achieve balance between growth and stabilization. Constraints on the balance mostly are drawn to the banking sector, where the burning issues are non-performing loans and a shortage of liquidity, and it is yet to be seen if and when the government's solutions for these issues will deliver results.

In contrast, other macro indicators such as exchange rates, interest rates and inflation have improved. Furthermore, Vietnam will become a large beneficiary to a host of international trade agreements that have been—or will be—signed, including the ASEAN Economic Community (AEC) and ASEAN+6, the Trans-Pacific Partnership (TPP) and a foreign trade agreement with the European Union. These agreements are expected to help increase Vietnam's exports to large markets, such as the United States, European Union, Canada and Japan, as well as increase M&A activity in the country. A further boost to M&A activity could come from further easing of foreign ownership limits, with an expected increase in early 2014 from 49% to 60% for public non-financial companies, and from 20–30% to 49% or more for banks.

With all of these trends in mind, we expect to see more deal flow, which would benefit both buyers and sellers. For Vietnam, three strong themes are imminent: restructuring—particularly in the banking and real estate sectors; government divestments; and, private sector expansion.

The View from India



Shaji Varghese,
Partner,
EQ India Advisors

“ 2013 was a challenging year for the PE industry in India, as political uncertainty and policy paralysis contributed to economic growth reaching a decade low of less than 5%. Like other emerging market economies, India was adversely impacted by the talk of QE tapering in the United States, as the Indian Rupee faced high volatility and a sharp depreciation in value, which, along with the economic slowdown, added a new dimension to existing challenges faced by PE firms in India.

Portfolio performance and the ability of funds to deploy capital also suffered, as industrial and consumer demand fell, and corporate excesses of the high-growth period came into play. While the overhang of high entry valuations for 2005 to 2008 vintage funds remained, exits were hard to come by. Since Indian GPs largely depend on foreign capital for funds, most firms were forced to postpone fundraising due to the prevailing negative sentiment. Indian GPs will have to work harder and more closely with portfolio companies not only to demonstrate their value-add capability, but also to ensure exits with optimum returns. While Indian PE firms have to justify the continued relevance of the Indian growth story and attractiveness of the industry to foreign LPs, the latter will have to recalibrate their return expectations and investment timeframe.

Hopefully, a clear mandate in the general election to be held in May 2014 will usher in political stability and much needed positive movement on reform. Regulatory changes, such as the new Companies Bill 2013 and Alternative Investment Funds (AIF) Regulations, bring much needed clarity to the industry and will have a positive impact on PE activity in the country, which can expect a revival in 2014. While consumer-focused sectors remain attractive, opportunities in sectors like industrials and manufacturing and infrastructure will open up. Fundraising, pursuing M&A opportunities and corporate governance issues in investee companies will be some of the key focal points for Indian GPs in 2014, along with the impact of QE tapering at a macro level.

The View from Latin America



Roberto Terrazas,
Managing Director
and Chief Investor
Relations Officer,
Nexus Capital

“2013 has seen a significant fall—about 40%—in capital raised for EM PE over the prior 12 months. This was partly due to the fact that ten large EM PE funds raised over US\$1 billion each in 2012, absorbing some of the allocations LPs had set when rebalancing their portfolios to increase exposure to these regions. Nevertheless, slower GDP growth across the board—particularly in the largest markets of China, India and Brazil—has had an important impact. The more experienced GPs have been doing a pretty good job of maintaining pricing discipline and will have to balance that with a need to put capital to work.

Of course, global figures often obscure regional disparities, and in Mexico, for example, we are excited about the opportunities we are seeing, as this is still a relatively underserved market. Asia will continue to attract the greatest investor appetite; however, with investors already heavily exposed to China and generally sitting out the uncertainty in India following the currency devaluation and economic slowdown coupled with political uncertainty, Latin America is increasingly attractive to institutional investors, especially ex-Brazil, where their portfolios are underrepresented. Looking forward, the majority of LPs expect to increase commitments to emerging markets and continue to believe that these will outperform developed markets. Beyond the macro issues, performance, team stability, alignment of interest and transparency will be key factors in attracting global capital, and finding these attributes will be the key challenges for the asset class in 2014.



Diego Córdoba,
Director, Teka Capital

“Latin America has been growing at a fast pace in recent years, driven by a growing middle class and a global surge in the demand for commodities; and as a result, private equity in the region continues to expand. Regional M&A activity has been concentrated in large buyouts (greater than US\$200 million), but recently, middle-market deals are becoming more

attractive to PE investors, as the imbalance between capital demand and supply, as well as a competitive environment in higher segments, has reflected higher valuations for large transactions and lower valuations for small transactions, creating middle-market opportunities.

2014 will see an increase in fundraising, investments and exits in Latin America. However, as some economies have slowed and currencies have depreciated, the spotlight will continue to change from Brazil to Mexico, Colombia, Chile and Peru. Investors in private equity will look to experienced, seasoned GPs with proven track records who have been backed by local institutional investors.



Alex Rossi,
Managing Partner,
Latin Idea Ventures

“2013 was a great year for private equity and venture capital investment in Mexico. As more capital flows into the asset class, the sophistication of the companies and entrepreneurs we are seeing has increased in a truly positive manner, making for a much more compelling deal flow pipeline. As the asset class overall, and venture capital in particular, starts to truly segment itself, with fund managers having distinct strategies, sector interests, stage preferences and investment sizes, a broader cross-section of deals are getting

done. A challenge in this regard will be for fund managers to maintain discipline and rigor when it comes to negotiating deal terms and conducting due diligence.

Additionally, fund managers will need to be aggressive in looking for exit opportunities for their portfolio companies. The old adage that “it’s easy to call money and not so easy to distribute money,” will be on the minds of LPs as they watch significant capital being deployed around the region, but they will be keen on seeing realized returns and successful exit stories to remain confident about increasing (or at least maintaining) their commitments to the asset class throughout the region. Overall though, I believe 2014 bodes extremely well for PE and VC managers in Mexico.

The View from Brazil



Ettore V. Biagioni,
Managing Partner,
Alothon Group

“Economic growth in Brazil in 2013 was less than estimated, and is expected to be around 3% for 2014. Therefore, investors must ensure companies are properly positioned for a period of lower than expected macroeconomic growth, making operationally driven performance essential. General momentum will not increase companies’ top-line growth. Companies must increase market share vis-à-vis the competition, differentiate their product offering and increase efficiency. As a result, the operational side of the business becomes much more important than in the past, when growth pulled everything ahead.

Furthermore, in Brazil, we do not have robust IPO markets that will lift valuations at exits; it is almost the opposite. The IPO markets, generally speaking, have been weak. They have not been priced at exuberant levels, but rather much more conservatively. As such, the way to generate value from an investment is by growing the business and its financial performance, and not relying on capital markets multiple expansion.

In Brazil, there continues to be a limited amount of long-term capital for companies in the middle market segment, a space where we believe there are very compelling investment opportunities; and in fact, a lower growth scenario has its advantages for an investor, as it makes it easier to identify with more clarity the weaknesses of a potential target company since they are not masked by buoyant growth. For example, fast growth in the economy can also lead to easier financing from various sources, including suppliers and traditional lenders, because of general optimism, allowing a company to take on financing beyond what it can sustain. On the other hand, less growth in the economy limits these financing sources as they become more conservative, and working capital can get stressed, exposing the more sustainable financing capacity of a company. On the operational side, with slower growth, the level of a company’s efficiency, quality of IT reporting, processes and procedures weigh much more heavily on financial performance, as there is less momentum to smooth over operating weaknesses, and every single item carries more weight.

In 2014, we expect to continue to focus on the middle market, and on sectors such as healthcare, food and beverages and general services, which we believe will benefit from the evolution of the middle class and strong employment of Brazil. While the growth of both of these has a limit, we believe they will continue to evolve and have solid foundations for the future.

The View from Sub-Saharan Africa



André Roux,
Deputy Chairman,
Ethos Private Equity

“ The last ten years have indeed been a remarkable and successful period for leading emerging markets. Evidence would now seem to be building up of increasing headwinds facing these markets. These vulnerabilities have their source in falling commodity prices, slower growth in China, unfulfilled population expectations, higher inflation and the prospect of higher long rates in the United States, as Federal Reserve tapering becomes a reality.

2013 may well be defined as a sea change year in the emerging markets growth story, as questions are being asked whether these imbalances, in the absence of structural adjustment, will become meaningful obstacles to growth, value creation and, ultimately, macroeconomic stability. A major consequence of these developments for private equity in key emerging markets will undoubtedly be the need to put in place sustainable strategies for value-add at portfolio companies, and place less reliance on external growth drivers to generate returns.

Whilst private equity in South Africa has not been immune to these macro environmental challenges, the country continues to benefit from its geographic proximity to Sub-Saharan Africa and its institutional advantages, allowing it to play a significant role as a gateway to the rest of the continent.

Sub-Saharan Africa is now regarded as one of the fastest growing regions in the world, recognized by LPs and GPs with fundraising in the region increasing appreciably in 2013, and capital invested also increasing meaningfully over 2012 investment activity.

Given the early stage of the region's renaissance, 2014 should be a similar year of positive growth for pan-Sub-Saharan African private equity.



Ayisi Makatiani,
Managing Partner,
Fanisi Capital

“ 2013 was an exciting year for PE in East Africa. There continues to be a growing consumer market that is driving consumer-related industries, such as agribusiness, healthcare, education and the general consumer retail space. The growth is being driven more by the middle class and lower-middle class end of the market, which have access to disposable income and are demanding quality products and services at the right prices.

PE has matured, and there has been an increased level of activity, with more companies that may have been unwilling to do deals now open to the idea of having financial investors on board. The discovery of key natural resources has led to sectors such as oil, gas and mining receiving much more attention, and these sectors will become significant contributors to the region's GDP once commercialized.

Regional blocks have been very active in 2013, and this is expected to continue in 2014. The cross-border opportunities created as a result will continue to attract multinationals to the region, especially in consumer-related industries.

Going forward, local GPs and foreign GPs with local offices will play a bigger role in deal making. Challenges will exist, key among them being the lag between the supply of, and demand for, capital. This will not be because there is more capital chasing after few quality deals, but because targets will pick GPs based on softer issues, such as how comfortable they are with the relationship. In addition, political challenges, though gradually reducing, will also continue to exist.

The View from the Middle East and North Africa



Sharif A. El Akhdar,
Partner,
Beltone Private Equity

“ 2013 was a challenging year for the Middle East and North Africa region. Following the political transformations that took place as a result of the Arab Spring, little capital was left to chase an increasing number of opportunities. GPs continued to engage

with LPs and portfolio companies by playing a greater role in trying to match the right LPs with the right investment opportunities. In today's challenging times, GPs play a much bigger part in identifying opportunities for LPs. Investors recognize the role of private equity in creating long-term value and sustainable business models for Egyptian businesses as something that could be replicated for the rest of the region.

These challenges and opportunities allow us to place capital where it belongs to build true partnerships among all stakeholders. Going into 2014, the biggest challenge, in my view, is continuing to build trust and confidence among GPs, LPs and portfolio companies.

The year 2013 has proven, and 2014 will continue, to be rewarding vintages for private equity in Egypt.



Leith Masri,
Founding Partner,
Foursan Group

“ Foursan Group is a private equity specialist with a focus on the Middle East and Africa. Looking back at 2013 and previous years in the region, we have identified three key lessons learned:

- 1. Be patient.** Building trust with owners, especially families, takes time. It can take as long as two to three years from engagement to closing a transaction. If the owner continues as a partner in the business, this courtship period is critical to building trust and highlighting the benefits of bringing in a private equity partner. For the PE firms, while we tend to be impatient, this period is helpful to assess the objectives and time horizons of an owner who will continue to be an important driver of the business.
- 2. Be clear.** It is critical to address valuation and operational matters clearly and early, both in contracts, as well as during negotiations. This will save time, and in the case of an ongoing partnership, it is important that governance, management and exit expectations are fully addressed before executing the deal in order to avoid problems down the road.
- 3. Be active.** Both a) in the community before doing deals, in order to build networks to support deal generation, and to understand the landscape and players before investing; and, b) once deals are done, the more active you are with the business, the more likely you will build value, exit successfully and pass on a stronger business to the next owner.

Looking ahead, we see political uncertainty leading to economic uncertainty as the main challenge in 2014, likely posing significant risks to investors. The more experienced and talented managers will be able to mitigate these risks and may find reduced competition, potentially leading to superior, risk-adjusted returns.

Unlocking complex markets will be an opportunity for investors in 2014. Markets that are very challenging to navigate, but hold tremendous macro potential—such as Iraq today and possibly Libya tomorrow—can yield tremendous dividends for direct investing or portfolio companies in other countries tapping those markets. While activity in such markets is more difficult on virtually any level, niche players with a differentiated approach can do very well.

The View from Russia



Tim Demchenko,
Global Head of
Private Equity and
Special Situations,
VTB Capital

“ In 2013, LPs frequently asked us why they should invest in emerging markets when developed markets, notably North America, are showing positive, healthy dynamics and GDP growth during a period of recovery. One strategy for emerging markets that we are exploring is shortening the investment cycle to reduce the risk profile of investment, and these shorter time horizons have been welcomed by many LPs. Since it is difficult to predict ten years ahead due to the changing landscape, the potential to deliver exits within three or four years feels much more comfortable to investors.

Another trend we have seen is the whole emerging markets landscape becoming more specialized and focused, by country and by sector. We see a proliferation of GPs focused on just one country or further focused within that country on just one sector, as spreading capital across a variety of markets in an arbitrary way is no longer good enough. For example, Russia is not quite an emerging market, but one that has experienced a severe transition from a state-owned and -controlled, monopolistic economy to a more market-driven one for the past 20 years, which does not define Russia as “emerging” in the same way that Africa or India are “emerging.”

This is all self-evident, but identifying the winning model in these various markets is the key challenge. We have discovered that what we call operational arbitrage—transferring competencies, business models, and very often management teams from developed countries, mainly Western countries—has worked extremely well in Russia. And this strategy complements the idea of a shorter investment duration.

Many of the products and services in Russia are identical to those in other European countries, but the consumer experience and price ratio are out of sync in comparison to developed countries. Because Russia traditionally has been—and still is, to some extent—a fairly closed society, there is little knowledge or human capital transfer between the country and developed markets. While Russia already houses a number of large, operational companies and investors do not have to start from scratch, they must enable existing businesses by bringing external know-how and business models that do not exist in the country. Looking ahead, we will continue to embrace these ideas and implement them across our portfolio.

The Fund of Funds’ Views



John Stephens,
Managing Director,
Pomona Capital

“ As we reflect on 2013, we are reminded that straight lines can be a bit like unicorns. They may exist in our imagination or in financial models, but rarely do they appear in reality or in companies, at least not for private equity investors in Asia and emerging markets.

Over a short period in China, we have seen the rise and decline of local-currency (RMB) fundraising, and a rise, fall and perhaps a rise again of its IPO market. Across most emerging markets, currencies and capital markets were once a source of strength, but they recently have played havoc with LP returns and exits. After years of growing LP enthusiasm for emerging markets, fundraising has turned challenging for nearly all managers.

While these challenges are serious, it is probably incorrect to extrapolate from them with a straight line. 2013 also showed the promise of these markets: the largest fund ever raised in Asia; a landmark private equity-backed IPO in Indonesia; growing secondary activity; and, sustained investor interest in frontier markets such as Myanmar. Long-term LPs also saw distributions keep pace with capital calls, as underlying fund managers recapitalized portfolio companies and sold businesses.

The dynamism of these markets may continue in 2014, driven in part by the same secular trends that drove initial success for Asia- and EM-focused PE managers. Increasing GP engagement with portfolio companies is also helping, as many extend their strategies to apply industry and operating expertise that can drive growth, improve margins and generate new avenues for exit. With these factors working together, 2014 will surely be an interesting year.



Steve Cowan,
Managing Director,
57 Stars

“ As a global EM-focused fund of funds manager, in 2013, we continued to identify pockets of inefficiency and often found them in places that might appear unlikely on the surface. These pockets may be in markets that are out of favor and where we have developed a contrary view; or they may be within large markets that have received significant attention from investors, but lie in a largely ignored subsector. For example, the Brazilian PE market has seen considerable inflows of capital at the larger end of the market. In the

mid-market, though, there is significantly less capital, and, in fact, as a percentage of GDP, less capital than a decade ago. This difference has yielded opportunities for GPs who know the market well and who are thus in a position to take advantage of the relative lack of capital.

In terms of LP sentiment on the market now, we find they are a heterogeneous group. In 2013, we saw an interesting dichotomy. Some LPs became concerned with the volatility surrounding the U.S. Federal Reserve’s QE tapering and its effect on EM listed markets and exchange rates. On the other hand, however, many viewed this occurrence as a prospective PE opportunity, stemming from a combination of investors leaving the market and the levels of some public markets decreasing. Thus, we saw some LPs shying away from, but other LPs moving toward, emerging markets in a way that they might have been reluctant to do prior to that volatility.

Generally, we find the most significant challenge that PE investors continue to face is execution. Many of the GPs with whom we work continue to confront challenges finding talented management, backing talented teams and ensuring that they are able to execute on the strategy that has been articulated. These issues are at the core of PE returns in the markets on which we focus, in particular Asia, Latin America, Central Europe, Turkey, Russia, the Middle East and Africa.

In 2014, we will continue to focus on opportunities similar to those we did in 2013, specifically looking to markets with relatively less liquidity but with the potential to yield interesting prospects in terms of risk and reward.

Commonly Used Abbreviations in this Publication:

EM.....Emerging markets

PE.....Private equity

GP.....General partner

LP.....Limited partner