Private equity comes of age

By Cynthia Owens

Big potential exists in these large emerging markets, but for how long?

Private equity is coming of age in China, India and Brazil. While each market has its unique attributes, private equity in all of them performed strongly in recent years, leading to fresh investor interest and large money inflows. Yet the performance of any specific fund still primarily depends on the quality of the manager and his skills in finding and fostering the right companies and structuring the right deals, according to two INSEAD studies of private equity in those markets.

The INSEAD researchers at the Global Private Equity Initiative published two studies, one on China and India, and one on Brazil. Strong economic performances in all three countries, particularly after the 2008 economic crisis, and improved institutional frameworks contributed to making these markets more attractive for private equity, according to Professor **Claudia Zeisberger**, Academic Co-Director with the Global Private Equity Initiative at INSEAD and one of the authors of the study.

The China and India study showed that 70 percent of reported private equity exits beat stock market returns and 37 percent were at least double that benchmark. However, this reflects data that is heavily skewed towards larger, more successful or public transactions such as Initial Public Offerings (IPOs). The authors highlight that precise performance data across the whole industry is not available in emerging markets. In particular, data on investments that are written off or still in the portfolio are hard to come by.

“We found that private equity performance in China and India is less linked to public equity trends than in Western markets, but originates more from company and deal situation specifics. This is the result of inefficiencies in a still young industry, specifically due to the lack of transparency, low competition, low intermediation, imperfect transmission mechanisms for capital, etc,” says **Michael Prahl**, Head of Research with the Global Private Equity Initiative at INSEAD.

“It is hard to predict how long this opportunity set can persist, given that a lot of capital is currently flowing into these markets, rapidly increasing competition from both established players raising larger funds and new PE firms entering the market,” he says.

Stock markets still have role

While the performance of private equity funds 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 fund capital or, increasingly, as a source for deals,” says Prahl.

To succeed in emerging markets, fund managers need an extensive local network to gain deep knowledge and understanding of the cultural constraints in each country, and to leverage this knowledge in each target company. The challenge for investors in private equity lies in choosing the right manager and getting access to the right private equity funds, because there are wide variations in returns between top performers in the industry and the average returns.

“The variance in performance is much wider than in developed markets. This means the better managers have stellar returns yet the bad ones lose much more,” says Prahl.

Interestingly, he says private equity in several emerging markets has started to deliver strong returns, including a risk premium for emerging market risks, at a time when the risk between emerging and developed markets appears to be shrinking. While emerging markets seem less risky as a result of strong fiscal positions and improved institutional frameworks, developed market risk seems to have increased in the aftermath of the global financial crisis and the current sovereign debt crisis.

Private equity fund managers agree. “It’s picking those spots where we see long-term growth drivers. So it’s matching macro and micro analysis: micro, the intended company, and macro for the market drivers,” **Graham Oldroyd**, partner at Bridgepoint, a European private equity fund, told INSEAD Knowledge.

The two INSEAD studies are based on data from the Asian Venture Capital Journal, INSEAD’s Limited Partner Panel and PricewaterhouseCoopers Private Equity Brazil.

Despite the similarities between the private equity markets in China, India and Brazil, there are quite distinct differences when it comes to deal exits.

For example, in China, nearly 80 percent of private equity exits happen through public markets. The global financial crisis cut private equity exits in China in half, but the boom in mainland IPOs in 2010, with 182 sponsor-backed IPOs, returned the private equity market quickly to pre-crisis levels. In fact, in China, private equity investment gives local companies a chance to jump the IPO queue because an outside investor is seen as an endorsement of the firm. In India, on the contrary, mergers and acquisitions have dominated exits with more than two thirds of deals exited this way.

Therefore, in China, exits are clustered around times of strong stock market performance, while in India exits are spread out more evenly over time, according to the studies.

Shorter holding periods

In both markets, there is a clear trend toward a shorter holding period for private equity investments. In China, the holding period from the initial investment to the first exit had shrunk to just under two years and in India to just over two years prior to the financial crisis, although the authors believe holding periods may have lengthened since then. The strong returns over a shorter time horizon helped to generate more interest in private equity in these markets in the past few years.

However China and India saw almost three times as much private equity investment as Brazil in 2009, so the study suggests there is still room for investment to grow in Brazil. Domestic funds play a much bigger role in private equity in Brazil than in China and India.

“We have an interesting scenario in Brazil - more than 50 percent of the private equity transactions are actually done by local private equity firms,” says Professor Zeisberger.

The reports’ authors believe it will be interesting to watch the impact of the more recent arrival of global buy-out firms on the market in Latin America, and how those newcomers will tackle the challenging environment in Brazil. In 2010, a World Bank survey on the ease of doing business ranked Brazil 129th out of 183 countries. The main obstacles to stronger growth in investment are the tax system, availability of debt and the ubiquitous influence of the informal economy. Yet as in the case of China and India, public markets have taken the lead in improving corporate governance, reducing the risk of investing in listed companies in Brazil and offering an improved route for private equity exits. This has strongly increased demand for equities, leading to 182 equity offerings on the Bovespa between 2005 and 2010, including the largest share offering in the world, in 2010, of the Brazilian oil company Petrobras. The authors say this development bodes well for the private equity Industry and the continuous maturation of the asset class in Brazil.

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