

Financial deepening, private equity and capital flows to emerging markets

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1. Introduction

Private equity activity in emerging economies has recovered appreciably since the steep contraction experienced during the global financial crisis in 2007-2009. Fundraising reached pre-crisis levels in the first half of 2011 and although investing has remained relatively subdued, the strong increase in commitments to private equity funds investing in the emerging markets suggests that acquisitions by financial sponsors should soon regain momentum as well. Therefore, it appears that the underlying trend of expanding the private equity model beyond the traditional markets in the US and Western Europe has remained intact, despite the large cyclical variation in fundraising and investing in the wake of the global financial crisis.

Against this background, this paper has two objectives: first, to identify the determinants of this long-term trend and second, to assess where emerging economies stand in their process of catching up with the mature private equity markets. Private equity is considered a form of financial intermediation and an integral part of financial deepening, which is generally regarded as a critical precondition for sustained economic growth. As this paper shows, foreign investors have played a pivotal role in this process by supplying significantly large amounts of private equity capital in

the emerging markets. While push factors have probably played a significant role, this paper argues that pull factors have probably been even more important. Specifically, emerging markets are found to generate considerable 'macroeconomic alpha', which is expected to be translated into higher investment returns. This is by no means an automatic process, but as this paper discusses, the prospects for financial deepening have improved as domestic private equity industries have emerged and foreign private equity firms have better adapted their business models to local conditions.

Looking forward, the recent trends in private equity fundraising and investing in emerging markets are likely to be further solidified. With the growth gap vis-à-vis advanced economies expected to widen further in the foreseeable future, emerging markets are primed to absorb a growing share of private equity capital worldwide. However, the speed at which these markets become further integrated will not only depend on the relative growth of economic activity; institutional and legal reforms will be critical in achieving higher investment-to-GDP ratios, thus contributing to the general financial deepening and economic development. This integration process is likely to be uneven among the various countries. While emerging markets as a

* The author has benefited from many discussions with his colleagues at Alpinvest Partners, notably Wim Borgdorff, Marek Herchel, Sander van Maanen, Elliot Royce, Maarten Verwoort and Wendy Zhu. However, this paper should not be reported as representing the views of Alpinvest Partners. The views expressed in this paper are solely those of the author.

whole are expected to see higher penetration rates, this paper finally argues that the process may lead to a bifurcated outcome. While some countries might become emergent by the end of the decade (by 2020), if not earlier, others could fall behind. Therefore, the paper concludes that despite the generally favourable prospects for private equity in emerging markets, investors will need to take a highly differentiated view in their due diligence approaches.

2. Financial deepening in emerging markets

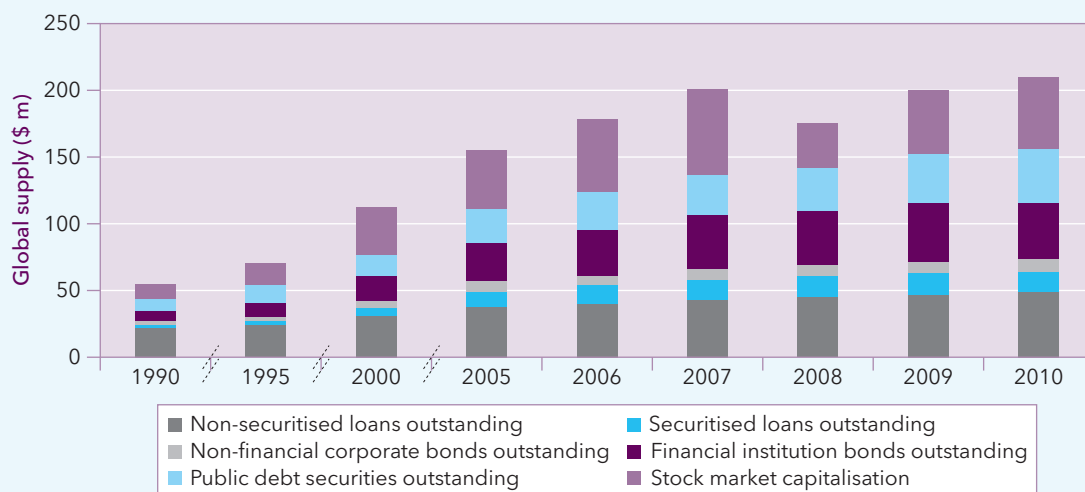
Financial development is a critical and inextricable part of the economic growth process. In fact, there is considerable evidence that the level of financial development is a good predictor of future economic growth (Levine, 1997 and 2005), suggesting that there is a causal relationship between the two. In explaining this relationship, academic research has pointed to the role of financial systems in promoting capital accumulation and technological innovation by facilitating the trading, hedging, diversification and pooling of risk; allocating resources; monitoring

managers and exerting corporate control; mobilising savings; and facilitating the exchange of goods and services (Levine, 1997).

A key indicator of financial development is the depth and breadth of an economy's financial markets.¹ Measured by the supply of equity and debt outstanding, emerging markets have made substantial progress in catching up with advanced economies. According to estimates by the McKinsey Global Institute (2011), the financial supply in emerging markets grew by an annual average rate of almost 18 percent between 2000 and 2010, compared with less than 5 percent in advanced economies. As a result, the share of emerging markets in the world's financial supply almost doubled to 18 percent, as global financial supply reached \$212 trillion at the end of 2010 (see Figure 1). During the same period, real GDP in emerging markets rose at an average annual rate of 6.2 percent, more than three times faster than in advanced economies.

The process of catching up with advanced economies has been particularly rapid in the equity markets due to a combination of higher

Figure 1: Global supply of outstanding debt and equity (1990-2010)

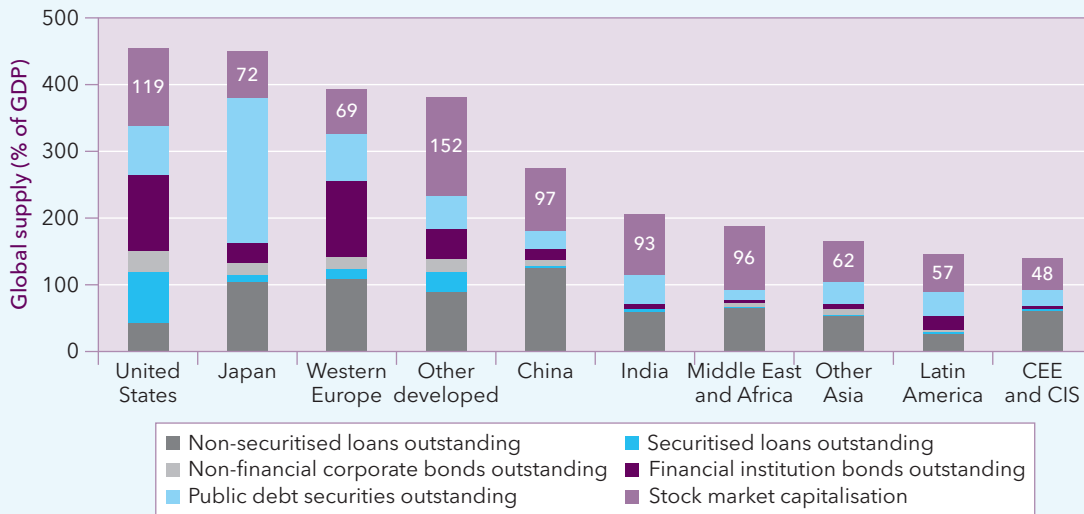


Note: End-of-period, constant 2010 exchange rates.

Source: McKinsey Global Institute (2011).

¹ The World Economic Forum's Financial Development Index (2010) also takes into account the quality of a country's institutional and business environment and the policies aiming at ensuring financial stability; the efficiency of financial intermediation in banking and non-banking financial services; and access by households and businesses to different forms of capital and financial services.

Figure 2: Global supply of outstanding debt and equity, as % of regional GDP (year-end 2010)



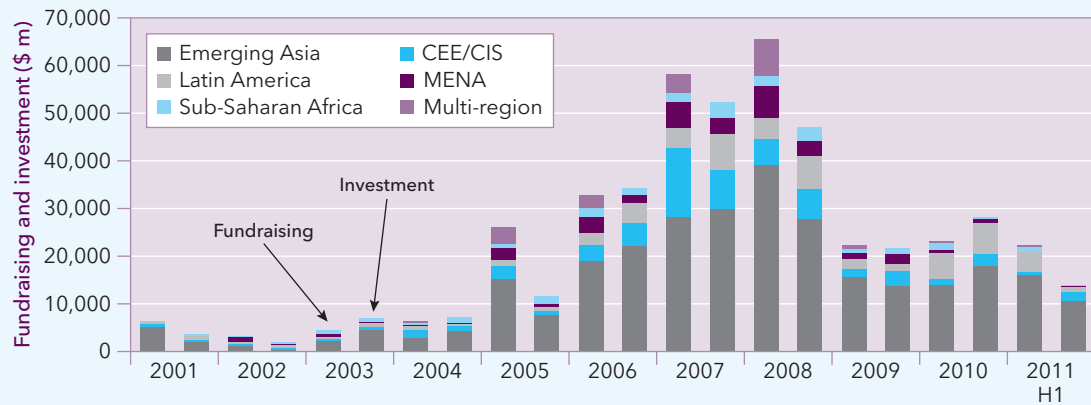
Source: McKinsey Global Institute (2011).

valuations amid rapid economic growth and a growing number of initial public offerings (IPOs) of emerging market companies. By the middle of 2011, the stock market capitalisation in emerging economies totalled \$17.7 trillion, comprising around one-third of the global stock market capitalisation of \$56.6 trillion, which is up from less than 10 percent in 2000. An important factor in this context has been the portfolio rebalancing by international investors in response to the changing composition of global investment benchmarks; the portion of stocks from emerging markets in the MSCI World Index has risen more than threefold to 14 percent since 2000. Therefore, several emerging markets now have stock market capitalisations that are broadly comparable with those in advanced countries, when normalised by the size of their respective economies. For example, the capitalisation of the Chinese and Indian stock markets amounted to almost 100 percent of GDP at the end of 2010, not much lower than in the US and greater than in Japan and Western Europe (see Figure 2). By contrast, bond markets in these emerging economies have remained relatively shallow compared with advanced economies.

Private equity investing has been an integral part of financial deepening in emerging market economies, with acquisitions by financial sponsors

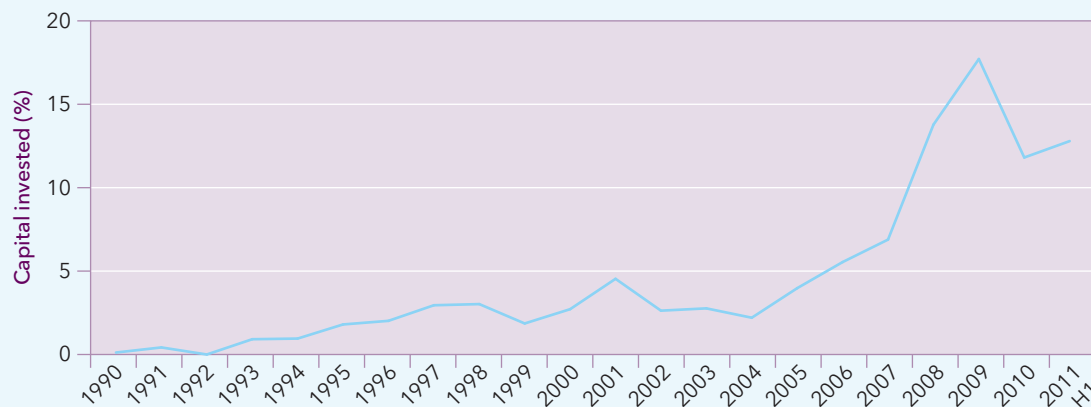
having increased nearly tenfold over the last decade. At the peak of the last cycle in 2007, private equity funds deployed almost \$55 billion in the emerging markets, up from just a couple of billions at the beginning of the decade (see Figure 3). Although investment activity has fallen considerably in the wake of the recent financial crisis, it has declined significantly less than in advanced economies. As a result, emerging markets have increased their share of global private equity investing to an average of around 15 percent in the period from 2008 to the middle of 2011 from just 3 percent in the first few years from 2000 (see Figure 4). The substantial rise in private equity investments has been made possible by a similar increase in commitments to private equity funds targeting emerging economies, as well as larger allocations to markets outside North America and Western Europe by global funds. In fact, in the first half of 2011 private equity fundraising for emerging economies returned to pre-crisis levels, with total commitments almost equal to the full year 2010 level. Finally, there are also more exits, an important precondition for sustained growth in private equity investing and fundraising in emerging economies (Cornelius, 2011). While some assets have been divested through trade sales to strategic buyers or to other private equity funds, others have benefited from a more buoyant IPO market. See Table 1 for a list of notable exits.

Figure 3: Private equity fundraising and investment in emerging economies (2001-2011)



Note: 2011 figure to June 30.
Source: EMPEA.

Figure 4: Private equity capital invested in emerging markets, as % of global investments (1990-2011)



Note: 2011 figure to June 30.
Source: Lerner, Sorensen Strömberg (2008); EMPEA; author's calculations.

Emerging Asia has attracted the largest share of private equity capital, in both absolute terms and in relation to its size (see Figure 5). In 2010, the region's penetration rate averaged 0.16 percent of GDP, significantly below its cyclical peak in 2007, but still considerably higher than in 2000. Latin America follows a similar pattern, whereas private equity investing in the Middle East and Africa and in Central & Eastern Europe/Commonwealth of Independent States region have yet to recover from the massive market correction associated with the recent global financial crisis. Overall, private equity as a form of financial intermediation has played a

growing role in the deepening and broadening of financial markets in emerging economies.

Penetration rates vary not only across regions, but also within regions. The BRICs (Brazil, Russia, India and China) are generally the most penetrated economies in their respective regions. These countries accounted for more than 50 percent of all private equity investments in emerging markets between 2005 and 2010 (see Figures 6 and 7). Although there remains a significant gap in penetration rates vis-à-vis mature private equity markets in the US and in Europe, this gap has narrowed noticeably in

Table 1: Notable exits in emerging markets (2006-2011)

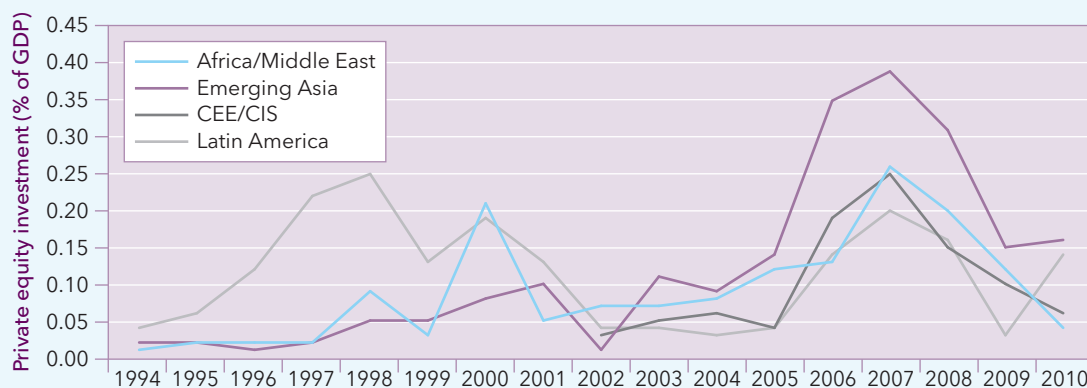
Year of exit	Year of entry	Amount invested	Type of exit	Country	Portfolio company	Sector	General partner
2011	2009	\$ 171m	Share sale	Brazil	CETIP	Financial services	Advent International
2011	2005	\$10m	Share sale	China	China Pacific Insurance	Insurance	The Carlyle Group
2011	2006	\$900m	Trade sale	Turkey	Mey Icki Sanayi	Food & beverages	TPG, Actera Capital
2010	2006	\$163m	Auction sale	Brazil	BR Malls	Shopping malls	GP Investments
2010	2006, 2010	\$134m, \$144m	IPO	China	Changsha Zoomlion Heavy Industry Science & Technology	Industrials	Hony Capital
2010	2007	\$1.4bn	Trade sale	China	China Network Systems	Cable TV	MBK Partners
2010	2009	\$95mn	IPO	China	Yashili	Food & beverages	The Carlyle Group
2010	2004	\$150m	Share swap	China	Shenzen Development Bank	Financial services	TPG
2010	2006	\$149m	Trade sale	India	Paras Pharmaceuticals	Health care	Actis, Sequoia Capital India
2010	2007	\$500m	Trade sale	Russia	Nidan Soki	Food & beverages	Lion Capital
2010	2006	\$167m	Trade sale	Uruguay	Nuevo Banco Comercial	Financial services	Advent International
2009	2009	\$171m	IPO	Brazil	CETIP	Financial services	Advent International
2009	2007	\$137m	Trade sale	Brazil	Hypermarcas	Consumer	GP Investimentos
2009	2005, 2007	\$800m	IPO	China	China Pacific Insurance	Insurance	The Carlyle Group
2009	2008	\$45m	Trade sale	China	Lenovo Mobile	Telecom	Hony Capital
2009	2007, 2009	\$242m	IPO	India	Adani Power	Power	3i Group
2009	2005	\$69m	Trade sale	Korea	The FaceShop	Consumer	Affinity Equity Partners
2008	2007	\$140m	Trade sale	Brazil	Lab. Amer. de Farmacoterapia	Health care	GP Investments
2008	2007, 2008	\$351m	IPO	China	Renhe Commercial Holdings		Capital International, Sequoia Capital China, Warburg Pincus
2008	2000	\$450m	Trade sale	Korea	Mando Corporation	...	Affinity Equity Partners CCMP Capital
2008	2004	\$40m	Secondary sale	Nigeria	Lagos Palms	Shopping centres	Actis, Tayo Amusan
2008	2004	\$87m	Trade sale	Philippines	Etelecare Global Solutions	Telecom	AIG global Investment, Crimson Capital, Electra Partners
2008	2006	\$40m	Trade sale	Russia	News Media	Media	UFG Private Equity
2007	2005	\$100m	IPO	Argentina	Empresa Distribuidora y Comercializadora Norte	Distribution	Dolphin Management
2007	2006	\$231m	IPO	Brazil	Comp Prov. Indust. e Comercio	Industrials	AIG Capital, GG Investments
2007	2005	\$158m	IPO	China	Belle	...	CDH Investments, Morgan Stanley Private Equity
2007	2006	\$125m	Share sale	China	Gome	...	Warburg Pincus
2007	2004	\$500m	IPO	India	Genpact Global Holdings	...	General Atlantic, Oak Hill

Table 1: Notable exits in emerging markets (2006–2011) *continued*

Year of exit	Year of entry	Amount invested	Type of exit	Country	Portfolio company	Sector	General partner
2007	2005	\$750m	Trade sale	Korea	Hi-mart	Shopping	Affinity Equity, Temasek
2007	2004	\$59m	Trade sale	Malaysia, Vietnam	Unza Holdings	...	Actis, Standard Chartered
2007	2003	\$35m	IPO	South Africa	Platmin	Mining	Actis
2006	1998	\$136m	IPO	Brazil	Odontoprev	...	TMG Capital
2006	2003	\$325m	Trade sale	Hungary	Invitel	Telecom	Mid Europa, GMT
2006	2003	\$135m	Secondary sale	Mexico	Convermex	...	JP Morgan Partners

Source: EMPEA (Quarterly Report, various issues).

Figure 5: Penetration rates in emerging markets (1994–2010)



Source: EMPEA; IMF; author's calculations.

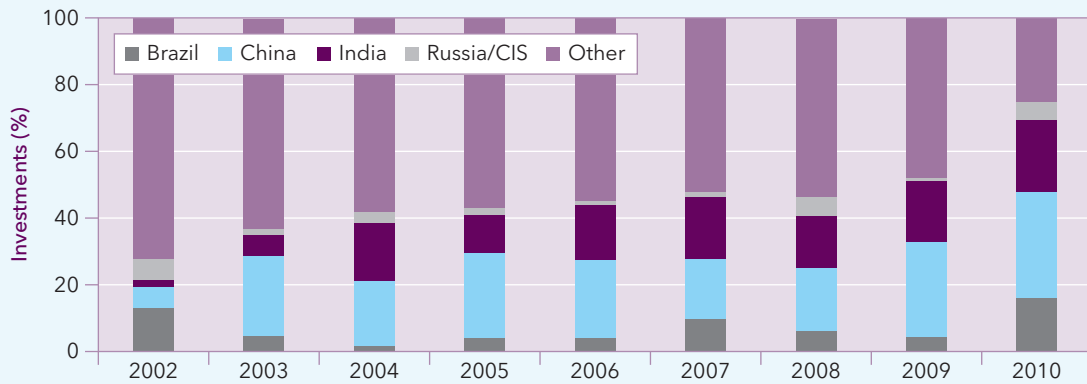
recent years. For instance, private equity investments were essentially non-existent in India in 2000. As of press time in October 2011, it is the most deeply penetrated BRIC economy, with an average investment-to-GDP ratio of 0.5 percent between 2005 and 2010, compared with 1.8 percent and 1.4 percent in the US and Europe, respectively.

Buyout fundraising for emerging markets has essentially kept pace with the rise in market capitalisation (see Figure 8). Although inflows to emerging market buyout funds accelerated substantially in nominal terms in the mid-2000s, this increase was significantly more moderate

relative to the size of public markets. This is an indicator that has been used in academic research on mature private equity markets to identify potential boom-bust cycles (Kaplan and Strömberg, 2009). This is in stark contrast to inflows to buyout funds targeting mature markets in the US and Europe, where commitments to buyout partnerships roughly quadrupled between 2004 and 2007, normalised by the capitalisation of their equity markets. In the mature economies, the subsequent decline in new inflows has been so dramatic that its ratio to market capitalisation essentially converged to the average level in emerging economies.²

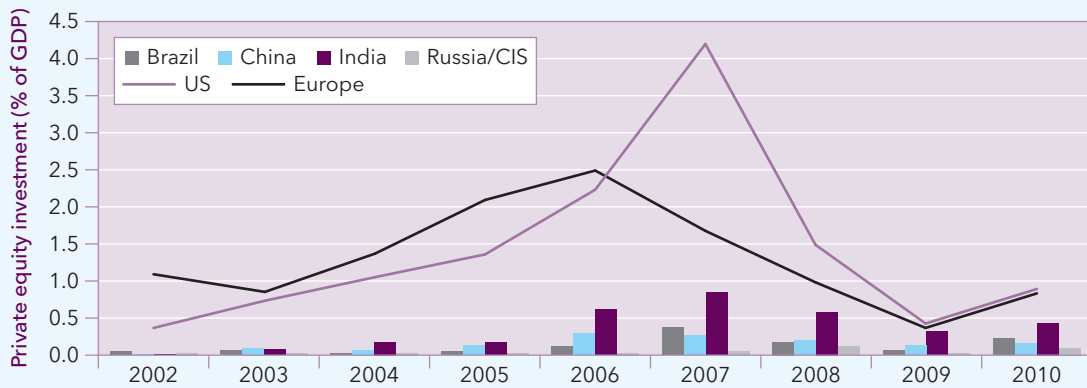
² This does not even take into account that global funds may actually deploy part of their capital in emerging markets as well.

Figure 6: Private equity investments in BRIC economies as % of all emerging economies (2002-2010)



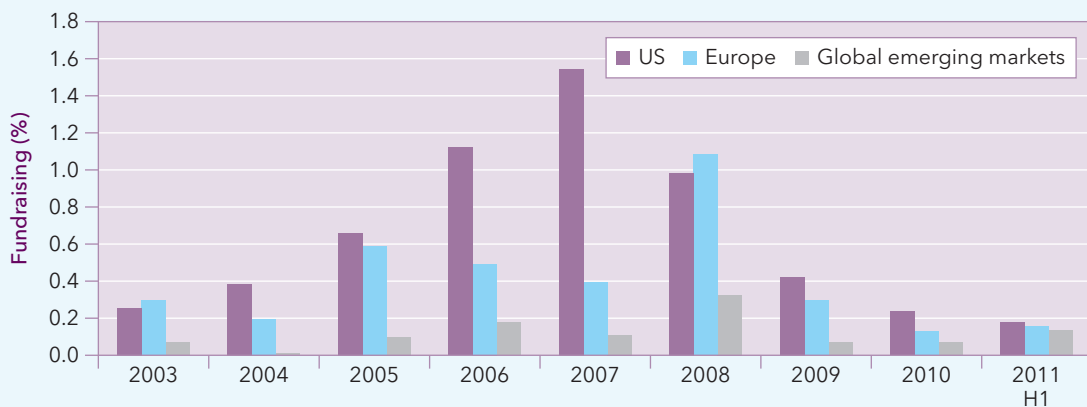
Source: EMPEA.

Figure 7: Penetration rates in BRIC economies and the US (2002-2010)



Source: EMPEA; IMF; Lerner et al.; author's calculations.

Figure 8: Fundraising by buyout funds as % of end-of-period market capitalisation



Note: 2011 figure to June 30.

Source: Preqin; World Federation of Exchanges.

3. Cross-border private equity investments in the emerging markets

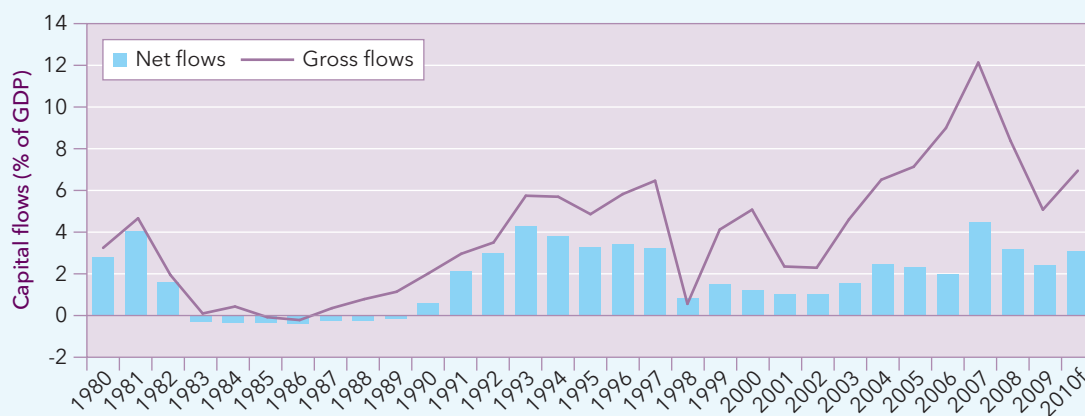
The preceding section discussed recent developments in private equity in emerging markets in the broader context of financial deepening. As observed, these economies have absorbed a substantially larger amount of private equity capital over the past decade, subject to significant cyclical variations. The discussion now turns to the supply side: to what extent has the emergence of a private equity market in emerging economies been driven by foreign investors as opposed to domestic funding sources?

Balance of payments statistics are of little help in this regard, as they do not identify cross-border investments by financial sponsors separately. Instead, private equity transactions are buried within labels such as 'direct equity investment' and 'portfolio equity investment'.³ Specialised data vendors, however, do provide detailed information about the acquirer in M&A transactions. It is from these sources we know the number and the volume of assets acquired by financial sponsors in individual countries, as opposed to strategic buyers. What is unknown, however, are the limited partners (LP) in the

private equity fund(s) that undertake(s) acquisitions. While certain data vendors identify some LPs in individual funds, this information is usually incomplete, as it is based on information from LPs rather than the general partners (GP) managing a fund. Further, there is no information on the capital commitments LPs have made to individual funds. Conceivably, the investor base of a domestic fund could largely, or even entirely, comprise of foreign limited partners. Conversely, a transaction in an emerging economy could be led by a foreign GP, whose fund has been raised to a significant or dominant degree from domestic investors in the target country.

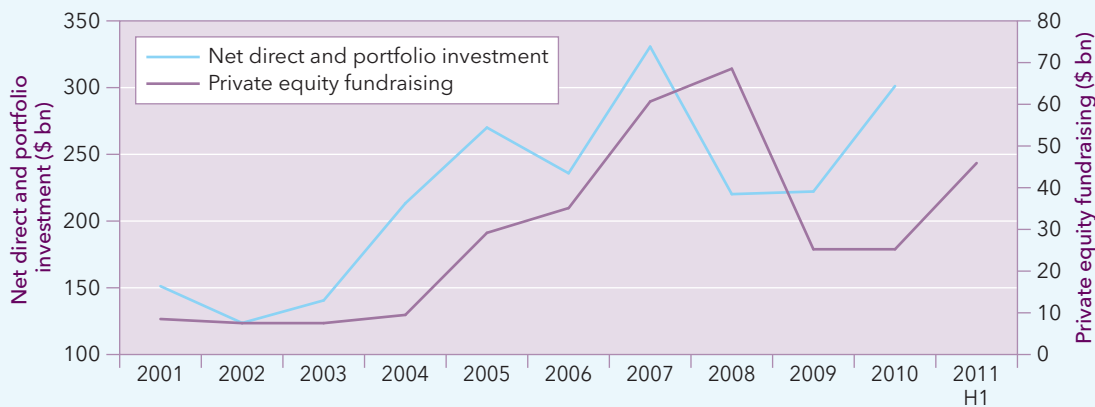
Nevertheless, there are good reasons to assume that non-resident investors have played a key role in the recent surge in fundraising for private equity acquisitions in emerging markets. First, inflows to private equity funds targeting emerging markets and financial-sponsor-led acquisitions in these economies show a profile that closely resembles the overall flow of capital (see Figure 9). Importantly, there have been two private equity cycles in the mid-1990s and an even more pronounced cycle in the mid-2000s that largely coincide with a substantial increase in gross (and net) capital flows to emerging markets, relative to the size of their economies. The

Figure 9: Gross and net private capital flows to emerging markets as % of GDP (1980-2010)

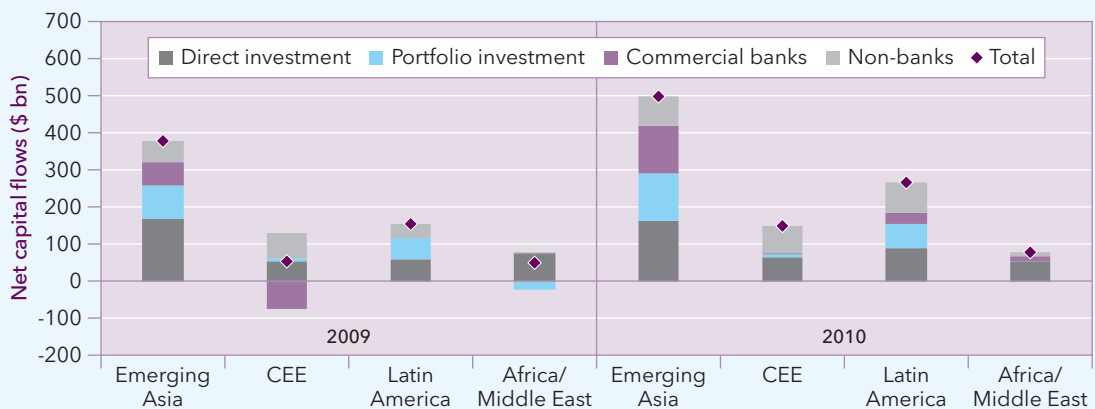


Source: IMF; author's forecast for 2010 on the basis of IIF estimates.

³ These labels depend on the share of capital acquired in a transaction. Generally, acquisitions of 10 percent or more of a firm's capital are recorded as 'direct investment', whereas smaller acquisitions are recorded as 'portfolio investment' in balance of payments statistics.

Figure 10: Net direct and portfolio investment in emerging markets and private equity fundraising (2001–2011)


Note: 2011 figure to June 30.
Source: IIF; EMPEA.

Figure 11: Net capital flows to emerging economies, by region and investment type


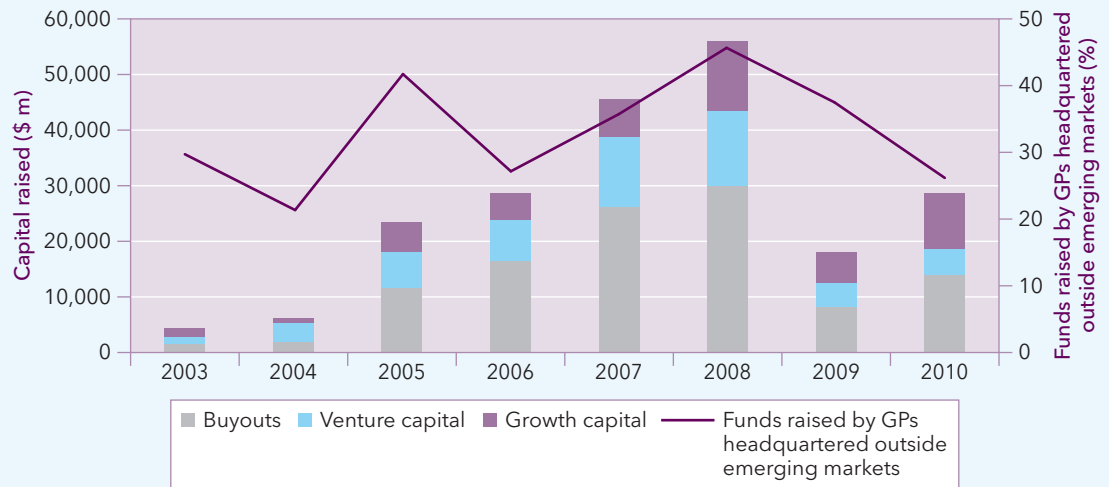
Source: IIF (2011).

similarities are particularly striking when compared with direct and portfolio investment flows (see Figure 10). The profile of private equity activity is also broadly consistent with the regional distribution of overall private capital flows to emerging economies (see Figure 11).

Second, a substantial portion of capital commitments to emerging market funds have been made to partnerships formed by GPs that are headquartered outside of emerging markets (see Figure 12). While commitments to buyout, venture capital and growth capital funds managed by GPs from emerging market economies

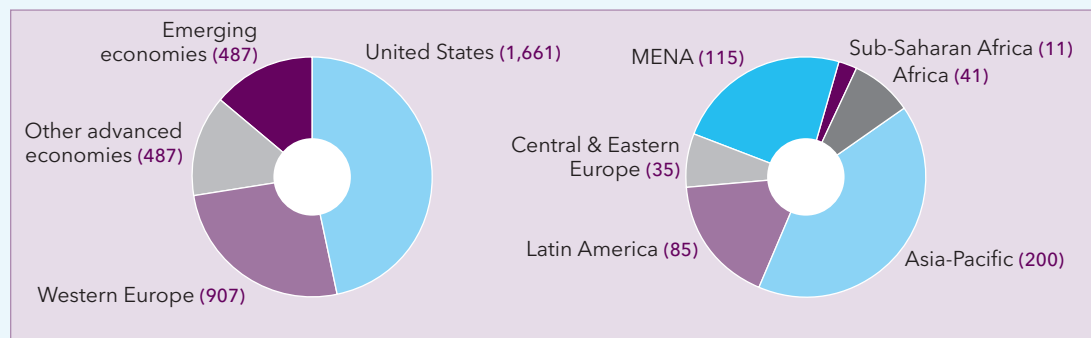
rose tenfold in 2003–2008, commitments to such funds managed by GPs from advanced economies grew even faster. Inflows to the latter rose particularly strongly during the peak years from 2006–2008, allowing foreign funds to increase their market share to more than 45 percent from around 28 percent pre-peak. Examples include multi-billion-dollar funds raised by: The Carlyle Group (Carlyle Asia Partners II, 2006, \$1,800 million); Kohlberg Kravis Roberts (KKR Asia, 2007, \$4,000 million); CVC (Capital Partners Asia Pacific III, 2008, \$4,119 million); and TPG (Asia V, 2008, \$4,250 million). This implies that funds managed by GPs

Figure 12: Emerging market capital raised and share of GPs headquartered outside emerging markets (2003-2010)



Source: Preqin; author's calculations.

Figure 13: Emerging market LPs, by geography



Source: Preqin.

headquartered outside of emerging markets were the main driver behind the fundraising and investment boom during this period. Since then, however, their share has fallen back amid a recovery in inflows to funds managed by GPs from emerging economies.

Third, although the investor base of individual funds - whether managed by foreign or domestic GPs - is unknown, it is important to note that of the 3,542 LPs listed in Preqin's global database, only 487 are headquartered in emerging markets

(see Figure 13).⁴ Similar to the US and Western Europe, the largest group of LPs in emerging market private equity funds comprises public and private pension funds and insurance companies. Apart from a limited number of large pension reserve funds, such as Korea's National Pension Fund (\$235 billion in assets under management at the end of 2009), China's National Social Security Fund (\$114 billion) or South Africa's GEPPF (\$111 billion), these institutions generally manage smaller resources than their counterparts in more mature economies. Of the \$11.3 trillion

⁴ Downloaded on July 15, 2011.

managed by the top 300 public and pension funds at the end of 2009,⁵ only 11.1 percent (\$1.26 trillion) was held by pension funds in emerging markets. Many of these funds, however, are subject to restrictions in particular asset classes, which often rule out or restrict investments in alternative assets, such as private equity (Cornelius, 2011). Furthermore, even where regulatory caps do not exist or are set at relatively high levels, many pension funds maintain internal restrictions on private equity investments (EMPEA, 2011).

Sovereign wealth funds (SWF) are usually less constrained. Few disclose their investment strategies in terms of asset classes and geographies. However, Bernstein, Lerner and Schoar (2009) suggest that a non-trivial share of SWF capital is actually invested outside their home market. While there is no information on SWFs' commitments to private equity funds, the authors examine their direct private equity investment strategies. Merging three publicly available investment databases (Dealogic's M&A Analytics, Security Data Company's (SDC) Platinum M&A and Bureau van Dijk's Zephyr), Bernstein et al. identify 2,046 and 532 transactions made by seven Asian SWFs and 15 Middle Eastern SWFs between 1984 and 2007.⁶ On average, these funds are estimated to have had \$132 billion and \$124 billion in assets under management, respectively. For Asian funds in particular, around three quarters of their investments were made in Asia itself, but only slightly more than one-third were made in the actual home nation of the fund. Outside of their region, the Asian SWFs were found to invest predominantly in Europe and North America. By contrast, Middle Eastern SWFs invested mostly outside their region (83.5 percent). Within their own home countries, direct private equity investments accounted for only 9 percent.

4. Push versus pull factors

What has caused the recent surge in global investors' interest in private equity in emerging

markets? Are these the same factors that have led to a general recovery in private capital flows? Additionally, to what extent is today's situation different from the 1990s that had already seen a wave of private equity flows to emerging economies, which, however, proved short-lived?

Generally speaking, capital flows may be driven by 'push' and 'pull' factors. Push factors tend to be more cyclical. In the current global economic environment, the substantial increase in private capital flows to emerging markets has been in part attributed to exceptionally low interest rates in advanced economies, motivating investors to chase potentially higher yields in emerging economies. Recent research by International Monetary Fund (IMF) (2011b) finds that short-term bank credit is particularly sensitive to a widening in interest-rate differentials. However, push factors are likely to have also played an important role in explaining significantly larger inflows to emerging market equity and bond funds. Yield differentials may be compounded by the growing risk appetite among foreign investors who generally consider emerging market investments as a higher-risk asset class. While global interest rates and risk appetite have not always moved in tandem, in the post-crisis era extremely low bond yields in the US, in the core economies in Europe, and in Japan are believed to have encouraged investors to accept greater risk.

While access to foreign savings may generally be considered to be a good thing, the sharp rise in capital flows to emerging market economies in 2010 and the first half of 2011 has raised considerable concern. As IMF (2011b) has pointed out in the April 2011 edition of its World Economic Outlook: "...policy makers in many (emerging market economies) have eyed the recent turnaround in capital flows with mixed enthusiasm", as such flows "... may fluctuate unpredictably, exacerbating domestic or financial boom-bust cycles." More recently, this warning has gained renewed relevance, as the repricing of macro risk and renewed turmoil in financial markets in the summer of 2011 led to

⁵ Towers Watson.

⁶ Their analysis also includes 84 observations from seven SWFs in the US, Australia and Europe. As we are interested in investment strategies of investors in emerging economies, we ignore these transactions here.

significantly weaker net capital inflows, and in some cases outright outflows, including from emerging market equity funds.⁷

Pull factors tend to have longer-term characteristics. Foreign capital may be pulled into a particular country or region by a stable macro and political environment supporting sustained economic growth and promising investors attractive returns. Although push factors have gained importance over time, recent IMF (2011b) research concludes that economy-specific (pull) factors remain dominant and explain around two-thirds of the variation in capital flow movements in emerging market economies, with the remainder due to common global and regional factors. IMF (2011b) interprets the findings of its research as: "...suggestive evidence in favour of a secular trend of capital flows to recipient economies driven by the economies' structural characteristics. Thus, any formal analysis of the role of global cyclical variables as causes of capital flows must control for these economy-specific characteristics."

The recovery in investors' risk appetite and the record-low level of interest rates in the post-crisis era may have also played some role in explaining the recent growth in commitments to private equity funds for emerging markets. Further, private equity investors may have been pushed to new markets by the high degree of competition in the traditional markets of the US and Western Europe, a factor that has been compounded by the huge inflows to private equity funds during the last cycle. Acquisition prices in mature markets have remained surprisingly robust despite sharply lower transaction volumes in the aftermath of the crisis, which has been attributed to the substantial amount of dry

powder that private equity funds continue to have at their disposal as well as huge cash reserves held by strategic buyers. In addition, investors' desire to diversify their private equity portfolios have likely further pushed investments outward into emerging markets.

The long-term nature of private equity investing suggests that pull factors have probably been far more important. In fact, many investors view private equity as an additional asset class that allows them to participate in the growth potential that emerging markets can offer. However, an individual economy's size, stage of development and potential to achieve sustained growth over the medium-to-long-term varies substantially, which is particularly critical for investors that essentially lock in capital for a period of ten years or more, as do LPs in a private equity fund. The deployment of such funds has been highly concentrated in a small number of economies, to an even higher degree than investments in emerging economies in other asset classes. Therefore, it seems that investors are predominantly pulled by the perceived attractiveness of, rather than pushed into, such investments.

Pull factors played a key role in the first investment wave in the 1990s. At the time, private equity had already looked like a clear winner when the emerging Washington Consensus postulated that the private sector, rather than the state, should be the dominant driver for new investment and economic growth (Leeds and Sutherland, 2003). As the private sector expanded, it became necessary for firms to move beyond the traditional financing model. However, their risk profile and lack of track record prevented many private investors from borrowing from banks or raising equity and debt capital in the securities markets. Private equity

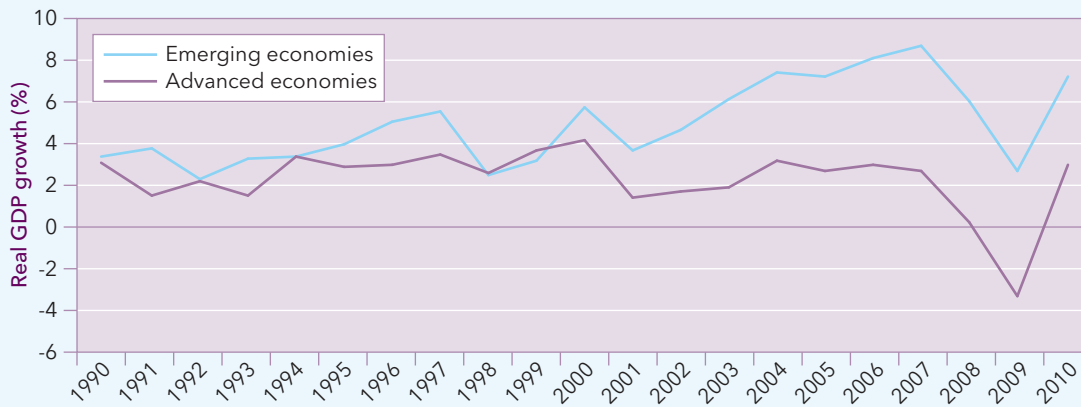
⁷ Several emerging market governments have put in place policy measures that aim at discouraging excessive capital inflows (IIF, 2011; IMF 2011a). Introduced as defences against imported irrational exuberance (Davies and Drexler, 2010), some countries have relied on quantitative capital controls, including China whose authorities have imposed limits on Hong Kong banks' net open positions and their ability to access renminbi (RMB) through China's foreign exchange market; Indonesia where short-term external bank borrowing has been limited to 30 percent of capital; and Korea whose government has introduced a cap on the size of banks' foreign exchange derivatives books. Other countries have favoured tax measures. Examples includes Brazil's IOF tax, which has recently been raised from 4 percent to 6 percent; Korea's reintroduction of a 14 percent withholding tax on foreign holdings of government bonds and central bank securities; and Thailand's reintroduction of a 15 percent withholding tax on non-resident interest earnings and capital gains on new purchases of government bonds. Others countries have decided to impose unremunerated reserve requirements, such as Brazil's 60 percent reserve requirements on banks' short dollar position in the spot market and Turkey's reserve requirements that have been expanded to repo transactions. Finally, some countries have taken measures to encourage outflows, either on a standalone basis or coupled with measures focusing on controlling inflows, by raising existing ceilings on outward investments.

appeared to be ideally positioned to fill this gap. On the capital supply-side, investors were attracted by the potentially highly attractive returns in a high-growth environment with low valuations. As it turned out, however, returns fell significantly short of investors' expectations because of a combination of macro and micro factors. On the macro side, investors found out that they had substantially underestimated country risk, as a huge correction in asset prices and massive depreciation of local currencies in the Asian, Russian and Latin American financial crises in the late 1990s wiped out a substantial part of private equity returns. In some cases, the absence of well-functioning institutions and a predictable legal

framework aggravated the situation further. On the micro side, many foreign private equity firms had failed to adapt to local conditions; they had simply tried to transplant their traditional business models to very different markets. Therefore, the early investment boom in the 1990s was short-lived, with private equity failing to gain traction as a form of financial intermediation.

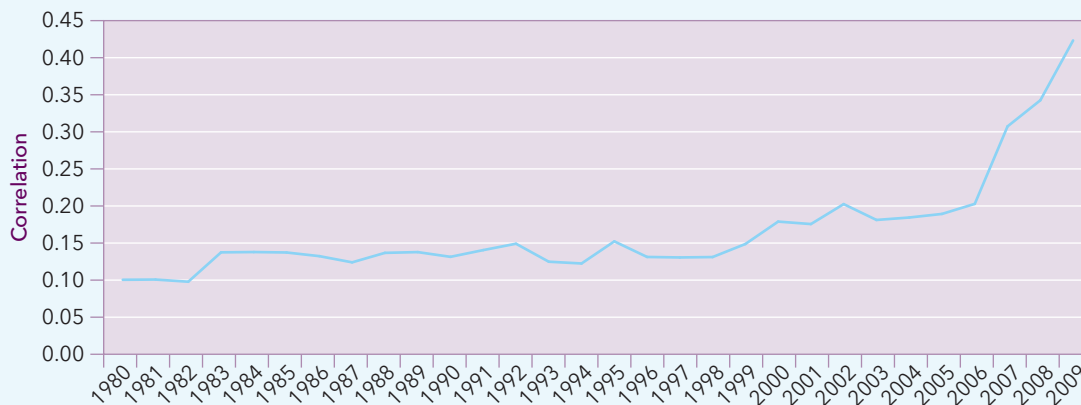
Is this time different? From a macro standpoint, there is a tendency towards answering this question in the affirmative. Today, the macro-economic situation looks substantially more robust, with emerging markets having outperformed advanced economies by a wide margin

Figure 14: Real GDP growth in advanced and emerging economies (1990-2010)



Source: IMF WEO Database, April 2011.

Figure 15: Correlation of advanced and emerging economy de-trended output (1980-2009)



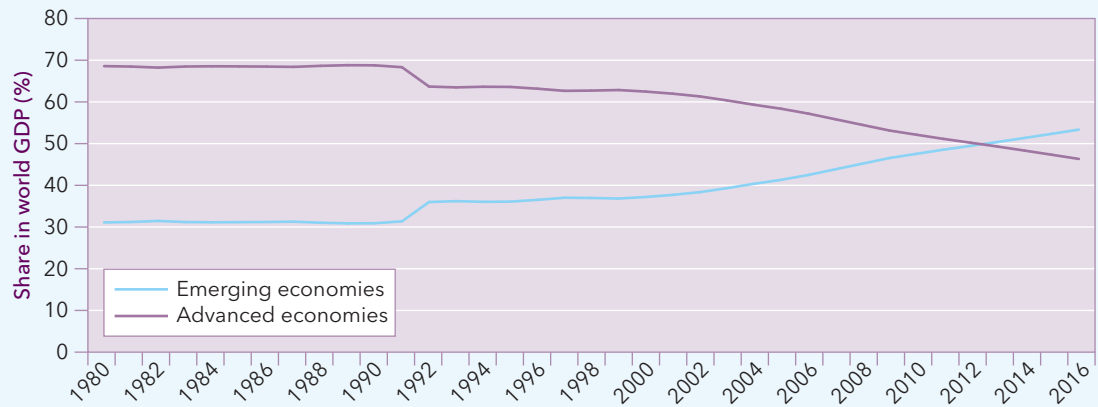
Note: Rolling correlations, 20-year window, window-end years on x-axis.
Source: IMF (2010).

in terms of economic growth. This divergence between emerging and advanced economies has gained considerable momentum since the year 2000 (see Figure 14). At the same time, business cycles have become increasingly synchronised, as emerging markets have become more integrated into the global economy (see Figure 15). Although emerging markets were also substantially affected by the recent financial crisis, as a group they have been able to avoid an outright contraction in output, and even helped to pull the global economy out of its steepest downturn in at least three generations. Therefore, emerging markets are said to have generated considerable 'macroeconomic alpha', while providing

less scope for diversification due to a rise in their 'macroeconomic beta'.

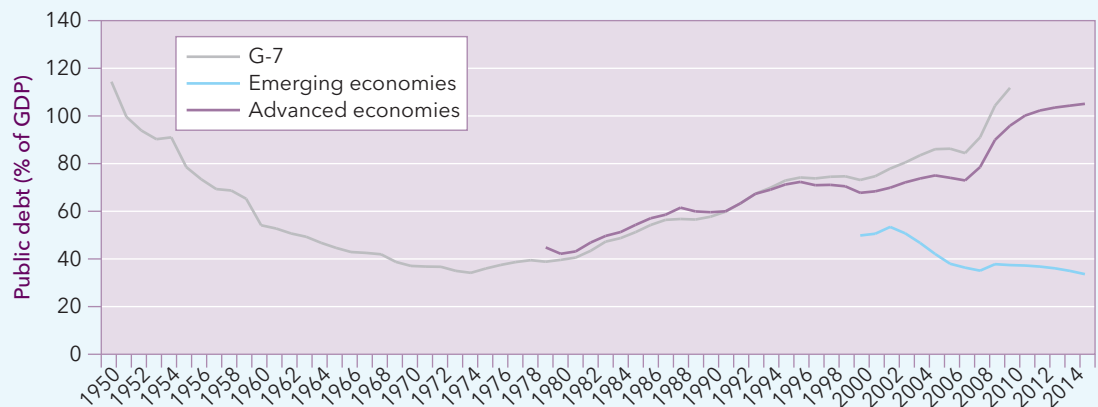
The share of global output of emerging markets vis-à-vis developed markets is progressively closing. IMF projects that, in purchasing power parity terms, emerging economies will actually have a relatively larger share by 2013 (see Figure 16). These shifts in the global economy, whose extent has become increasingly visible only in the last few years, are underpinned by macroeconomic fundamentals. Whereas the fiscal situation in most advanced economies has deteriorated sharply in the wake of the crisis, debt-to-GDP ratios in emerging economies are on average

Figure 16: Advanced and emerging economies share in world GDP (1980-2016)



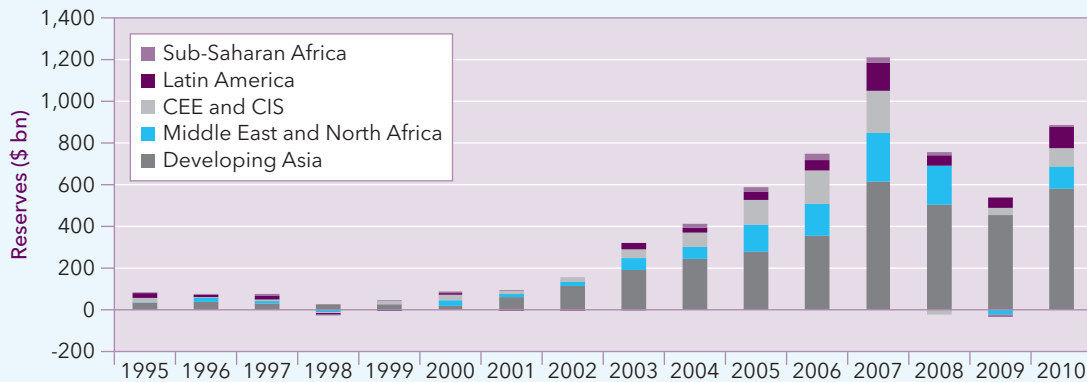
Note: Based on purchasing power parity.
Source: IMF WEO Database.

Figure 17: Public debt as % of GDP (1950-2015)



Source: IMF (2010).

Figure 18: Reserves (1995-2010)



Source: IMF WEO Database.

substantially lower, with most countries running significantly smaller deficits or even surpluses (see Figure 17). Likewise, several emerging economies have continued to accumulate large foreign exchange reserves by running sizeable current account surpluses, amplified by strong capital inflows (see Figure 18).

There are also microeconomic reasons to believe that today's situation is significantly different from the 1990s. Importantly, private equity fund managers have fundamentally adjusted their global expansion strategies. One of the reasons why early efforts often failed is the fact that many foreign GPs simply tried to transplant their operating models, largely ignoring important institutional, legal and cultural differences in their target markets. The lessons learned from this experience has encouraged fund managers to adopt local strategies, open new offices, develop strategic alliances with local firms and hire investment staff with expertise in the target markets. Some firms also require experienced partners to move to foreign locations instead of just parachuting them in periodically to help source and execute deals. At the same time, local GPs that tend to have a competitive advantage due to their local knowledge have become more sophisticated in financial, operational and governance matters. Some GPs have been able to raise multi-billion-dollar funds, ensuring an increasingly competitive private equity industry in emerging economies. Finally, in sourcing and undertaking acquisitions in emerging markets,

both domestic and foreign investors can rely on an ecosystem of accounting firms, law offices, business consultancies, investment banks and other intermediaries that is substantially more developed today than it was just 15 years ago.

Overall, these changes in macro and micro fundamentals suggest that private equity in emerging markets is coming of age both as an integral part of financial deepening and as a secular trend of capital inflows to these economies. This trend is widely expected to gathering increased momentum - unlike in the 1990s when a combination of macroeconomic imbalances and inadequate investment strategies prevented private equity in emerging markets from getting sufficient traction. While there are good reasons to expect emerging economies to become increasingly integrated into the global private equity market, this does not mean that this process will be smooth. From the mature markets, we know that private equity is a high cyclical, which has been attributed to imbalances between the demand for, and the supply of, private equity capital (Gompers and Lerner, 2000). Little suggests that boom-bust cycles in private equity are confined to the US and Western European markets, and fears that the substantial increase in private equity capital inflows from abroad could exceed the absorptive capacity in emerging markets would therefore appear to be legitimate. If this were the case, the performance of recent private equity investments in emerging markets would be likely to fall short of investors'

expectations, with an ensuing, expected reduction in their supply of capital accordingly. However, this scenario of a cyclical adjustment around a longer-term trend needs to be clearly differentiated from the expected slope of the long-term trend itself.

5. Outlook and conclusions

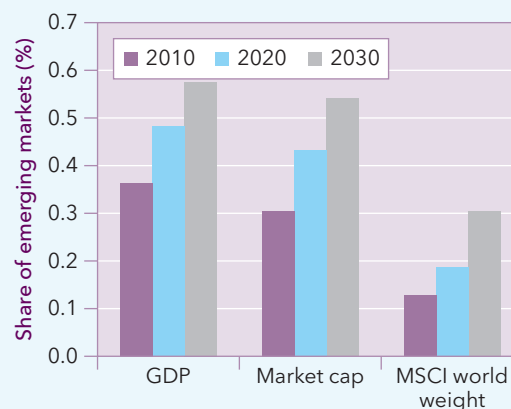
Emerging economies are widely expected to continue to play catch-up with the advanced economies in the coming years and decades. In the study *Dreaming with the BRICs* (2003), Goldman Sachs projected that Brazil, China, India and Russia would belong to the world's five largest economies by the middle of the 21st century. The recent growth trajectory of these countries relative to today's industrial economies suggests that this milestone could be reached significantly earlier. In a post-crisis update, Goldman Sachs (2009) brought forward the projected date when the BRICs would become as big as today's G7 (Canada, France, Germany, Italy, Japan, UK and US) to 2032. Goldman Sachs also expects China to take over from the US as the world's largest economy by 2027. Even this date may be a significant underestimation of the underlying growth dynamics, as argued by Subramanian (2011). The catch-up process is not confined to the BRICs; this process has been more broadly based, which has caused growing interest among institutional investors especially in countries that rank after the BRICs in terms of the size of their economies and growth potential. Conveniently, Goldman Sachs has coined the term 'N-11' - the next 11 emerging markets - for a group comprising Bangladesh, Egypt, Indonesia, Iran, Korea, Mexico, Nigeria, Pakistan, Philippines, Turkey and Vietnam.

Even if penetration rates in emerging markets remain unchanged in the medium-to-longer term, their expected macroeconomic outperformance should result in a growing share in global private equity activity. A simple back-of-the-envelope calculation may help illustrate this scenario. Let us take medium-term GDP projections from the IMF's World Economic Outlook. Assume that emerging markets' average penetration rates stay at their 2005-2010 level. Under these assumptions, the annual volume of private equity

transactions should reach around \$80 billion by 2016. Under similar assumptions for advanced economies, the share of emerging economies would increase to around 15 percent from 12.5 percent in the first half of 2011. Importantly, this share refers to the expected volume of private equity transactions, rather than the equity investments made by private equity firms. Assume, finally, that deals in emerging markets are, on average, 20 percent debt-financed, compared with a ratio of 60 percent in mature markets. Under this additional assumption, the former would account for around 25 percent of global equity investments by the middle of the decade.

However, penetration rates may not remain unchanged. Instead, they are likely to increase as financial deepening gathers further momentum as part of the general development process. Goldman Sachs (2011) projects that the market capitalisation in emerging economies may increase from \$14 trillion to \$37 trillion and \$80 trillion in 2020 and 2030, respectively, due to real GDP growth, higher valuations and market deepening. This implies a compound annual growth rate (CAGR) of 9.3 percent. However, as the market capitalisation of advanced economies is projected to grow at a CAGR of 4 percent, emerging markets' share in global market capitalisation is forecast to grow to 44 percent and 55 percent in 2020 and 2030, respectively, from a share of 31 percent today (see Figure 19). The weight of emerging markets in the MSCI World Index

Figure 19: Share of emerging markets in world economy (2010-2030)



Source: Goldman Sachs (2011).

could thus reach almost one-third by the end of the projected horizon.

If private equity fundraising and investment were to grow more or less in line with the projected long-term trajectory of market capitalisation in emerging economies, this would imply a significant rise in the average penetration rate. Suppose, finally, that private equity investing would average 0.3 percent of GDP by 2016. Although this would be a considerable increase from the average rate between 2005 and 2010, it would still fall far short of the current penetration rates in advanced markets. Under this assumption, emerging markets could account for almost 20 percent of global private equity transactions by 2016, and represent some 30 percent of equity investments, other things being equal (especially with regard to the use of debt in acquisitions).

While these scenarios are subject to substantial uncertainty about the global macroeconomic outlook and economic policies, they do indicate that private equity markets in emerging economies look set to continue to become more integrated. As discussed in this paper, this process is now well underway. Considering private equity as part of a broader process of financial deepening, this integration is fuelled by increased cross-border fundraising and investment activity. While private equity capital flows to emerging markets may in part be due to push factors (by global financial conditions and highly competitive private equity markets in advanced economies), to a larger extent it seems that they are attributed to pull factors (by economy-specific conditions in the recipient countries). More specifically, foreign investors are attracted by strong economic growth in emerging markets, with private equity representing an additional entry route to gain exposure to 'macroeconomic alpha'. As emerging markets continue to play catch-up and advanced economies face a 'new normal' where economic growth is set to remain flatter due to continued deleveraging, fiscal restraint and more

regulation, this alpha is expected to increase even further in the next few years.

However, emerging markets are far from homogenous. For buyouts, the most important category of private equity investing, Lerner, Sørensen and Strömberg (2009) find that cross-country variations are largely explained by differences in the potential for operational engineering (that is, measures to improve portfolio companies' production processes, working capital management and marketing and production mix). Implementing appropriate measures requires adequate corporate governance standards. In cross-country analyses, corruption is generally found to hamper operational improvements and is therefore associated with fewer buyouts. Similarly, barriers to entrepreneurship - in empirical estimates sometimes proxied by the number of procedures required to start a new business and the costs associated with them - is usually found to be inversely related to the volume of buyout deals. Additional factors hampering buyouts include high regulatory trade barriers, international capital controls and high taxes on international trade. While several countries have taken important measures aiming to improve the business environment of their economies (see the yearly World Bank Report on Doing Business), this process is often difficult and time-consuming, as private equity country attractiveness indexes show (Groh, Liechtenstein and Lieser, 2011).

In conclusion, several economies are likely to see further significant increases in their penetration rates as their institutional and legal frameworks continue to improve. By 2020, if not earlier, some of today's emerging private equity markets might become emergent, exhibiting a substantially improved country-risk profile. Others, however, may fall behind even further. Although emerging markets as a whole may absorb a growing percentage of the world's available private equity capital, this possible bifurcation makes it essential for institutional investors to clearly differentiate investments in this broad asset class. ❖

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