Private Equity Opportunities in the BRICs and Beyond

By

Ralph Jaeger,
Managing Director
*Siguler Guff & Company, LP**

* BNY Mellon holds a 20% interest in Siguler Guff & Company, LP and certain related entities (including Siguler Guff Advisers, LLC).

September 2012

Executive Summary

Investors continue to be powerfully drawn to emerging markets (EM) for return and diversification opportunities, especially as deleveraging challenges persist and weigh down economic recoveries in developed countries. However, some of the most compelling growth sectors in emerging markets, such as services, IT and healthcare, and other sectors linked to domestic consumption, are less accessible through public market equities than through private market opportunities. This is especially true in the new frontier markets that have far less public market liquidity than their more advanced neighbors. As a result, inflows into emerging markets private equity (EMPE) have experienced tremendous growth since the mid-2000s, driven by the strong performance of the asset class and the increasing appetite of institutional investors for alternative investments in emerging markets. Moreover, we believe aggregate private equity fundraising volume for the major BRIC (Brazil, Russia, India and China) markets will dominate future EMPE fundraising.

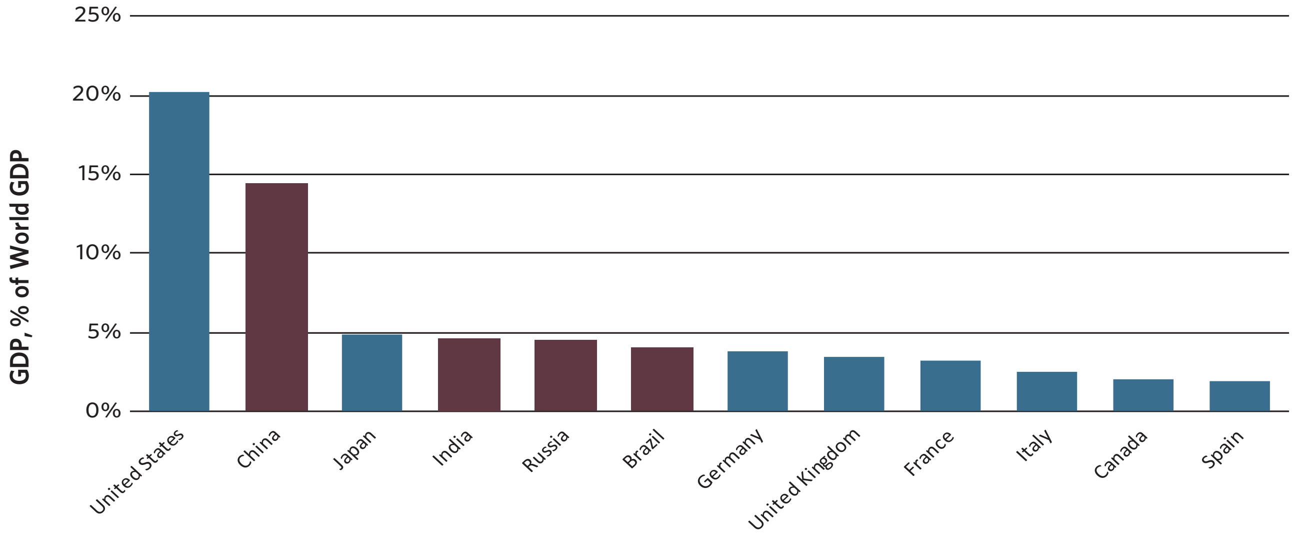
In addition to providing access to companies not listed on public stock exchanges, EMPE investments can also complement EM public market investment strategies, due to the relatively lower volatility of private equity investments and their low correlation to public equities. The following discussion takes a detailed look at the private equity opportunity in the BRICs and beyond, underscoring the need for deep and differentiated expertise for each of these countries. We argue that investors need to choose an EMPE investment strategy carefully and avoid sweeping generalizations about emerging markets. Based on our many years of experience, oversimplifying these markets is a recipe for failure. Patience, selectivity and a deep local understanding of the macroeconomic, regulatory and private equity dynamics in each market are key ingredients to investing successfully.

Emerging Markets — Growth and Performance of Private Equity

We believe that emerging markets will drive a major shift in global economic power and private consumption in the coming years. The BRIC countries already rank in the top 12 global economies by share of GDP, and they are expected to be in the top six by 2018, as shown in Exhibit 1 below. In addition, emerging markets are expected to exceed 50% of global GDP by 2018. By 2020, they are expected to exceed 50% of global private consumption.[1]

1 Source: Business Monitor International 2011.

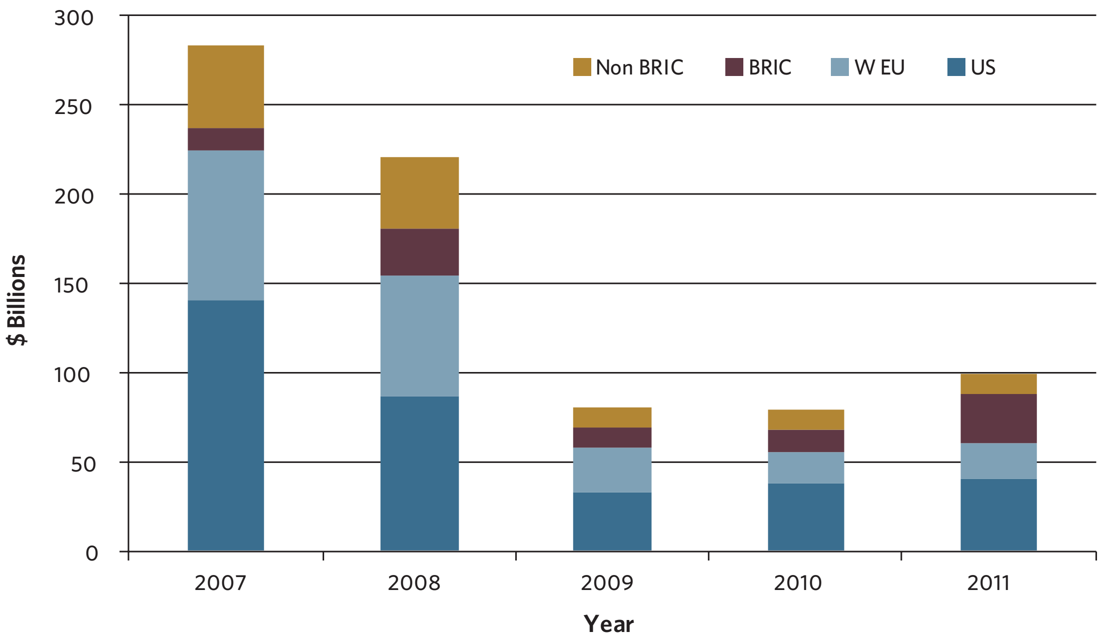
Exhibit 1: 2018 Projected Top 12 Countries by Share of Global GDP



Source: Business Monitor International 2010.

There has been a large inflow of private capital to the emerging markets during the past five years, as the EM opportunity has registered on the radar screens of many institutional investors. As shown in Exhibit 2, BRIC fundraising volume accounted for almost 40% of total fundraising volume globally in 2011. Since 2007, the BRIC countries have accounted for an increasingly large share of total EM fundraising volume, reaching almost 70% in 2011.

Exhibit 2: Global Fundraising During the Past Five Years



Source: Emerging markets fundraising data supplied by EMPEA as of December 31, 2011. Western European and U.S. fundraising data provided by Preqin as of December 31, 2011.

In parallel with this increasing investment appetite for emerging market exposure, the EMPE asset class has shown strong performance in comparison to that of EM public equities as well as to that of other private equity strategies, including those based on developed markets. Cambridge Associates' Global Emerging Markets Private Equity & Venture Capital Index (EM PE & VC) highlights EMPE's outperformance versus four other relevant indexes from 2007 through 2011 (Exhibit 3). The improving quality of local private equity managers, the strong growth of private companies, the value arbitrage of private versus public markets, and the resilience of private equity performance both during and after the global financial crisis are all factors that have contributed to the increasing outperformance of private equity versus public equity in the emerging markets.

Exhibit 3: Performance of EMPE vs. Other Indexes

Performance of EMPE vs. Other Indexes

	EM PE & VC	MSCI EM Index	Developed PE & VC	MSCI World Index	S&P 500 TR
2007-2011	10.12	2.70	5.83	-2.37	-0.25

Source: Cambridge Associates 12/31/2011 Reports, provided to Siguler Guff at no cost (Global EM PE/VC sample size 376 funds; Global Developed PE/VC sample size 2,909 funds). Global EM PE/VC and Global Developed PE/VC returns are pooled end-to-end returns net of fees, expenses and carried interest. Total returns for MSCI Emerging Markets indexes are gross of dividend taxes. S&P 500 Total Return Index assumes all dividends are reinvested.

The Key to Accessing Growth Segments at Attractive Valuations

A key difference between public and private equity investing in the emerging markets is the access private equity can provide to attractive growth segments that are largely inaccessible through public equity investing. An analysis of more than 900 investments made by over 50 leading EMPE funds exemplifies how investing in private equity provides investors with exposure to the high-growth consumer, healthcare, IT and services segments, which are nearly absent in the major public indexes (Exhibit 4).

Exhibit 4: Industry Sector Exposure of EMPE vs. Public Market Indexes

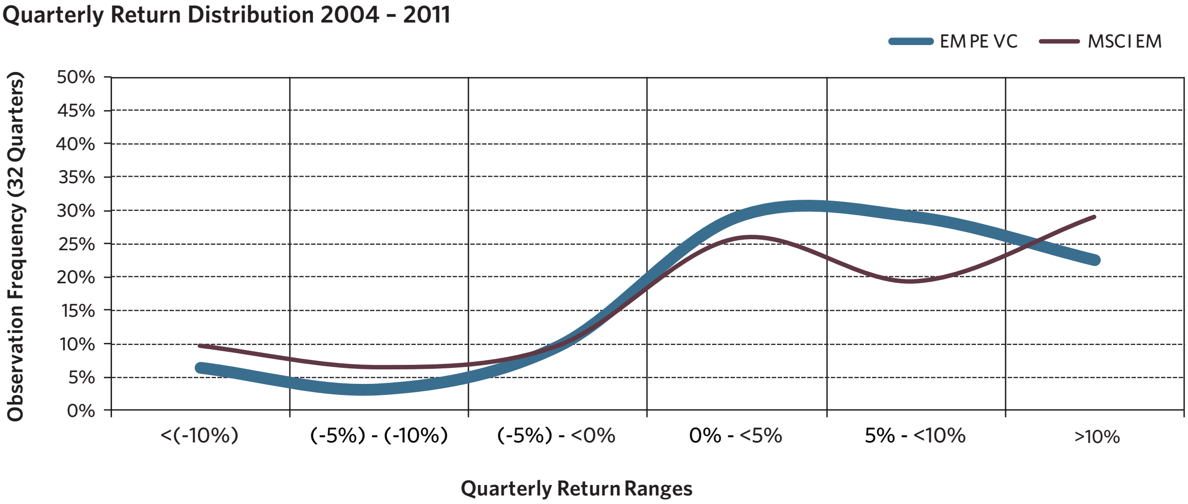
Industry Sector Exposure of EMPE vs. Public Market Indexes

	Representative PE Exposure	Brazil (BOVESPA)	India (BSE Sensex)	Russia (RTS)	China (SSE)	MSCI-Frontier Markets
Consumer	25.2%	15%	9%	1%	6%	6%
Energy & Utilities	6.9%	35%	31%	69%	31%	10%
Financial	16.6%	20%	16%	16%	39%	52%
Healthcare	9.8%	-	3%	-	3%	-
Industrial	15.9%	3%	13%	1%	12%	7%
Information Technology	16.8%	2%	18%	-	2%	-
Materials	5.2%	21%	5%	11%	6%	4%
Telecom	2.1%	4%	5%	2%	1%	17%

Source: Siguler Guff with data from Capital IQ as of December 2011. Note: PE company data and MSCI Frontier Markets contain ~1% and ~4% of "other" industries that are not included in the summation.

Furthermore, diversified EMPE exposure has less concentration risk, and thereby less volatility, than EM public market indexes, which tend to have highly concentrated market capitalizations in financial services, extractive industries, energy and utilities. For example, the top ten MSCI Emerging Markets positions accounted for 16% of the index's total market capitalization, while the top ten MSCI Frontier Markets positions accounted for as much as 36% of the index's total market capitalization. A histogram chart comparison of quarterly EMPE and MSCI EM returns for the past eight years highlights the difference in return volatility (Exhibit 5). The chart also shows the more frequently observed positive quarterly returns and less frequently observed underperformance of EMPE versus the public market index. Stated differently, plotting the results along quarterly return ranges reinforces the observation of lower tail risk of private equity in emerging markets.

Exhibit 5: Quarterly Return Distribution 2004 – 2011

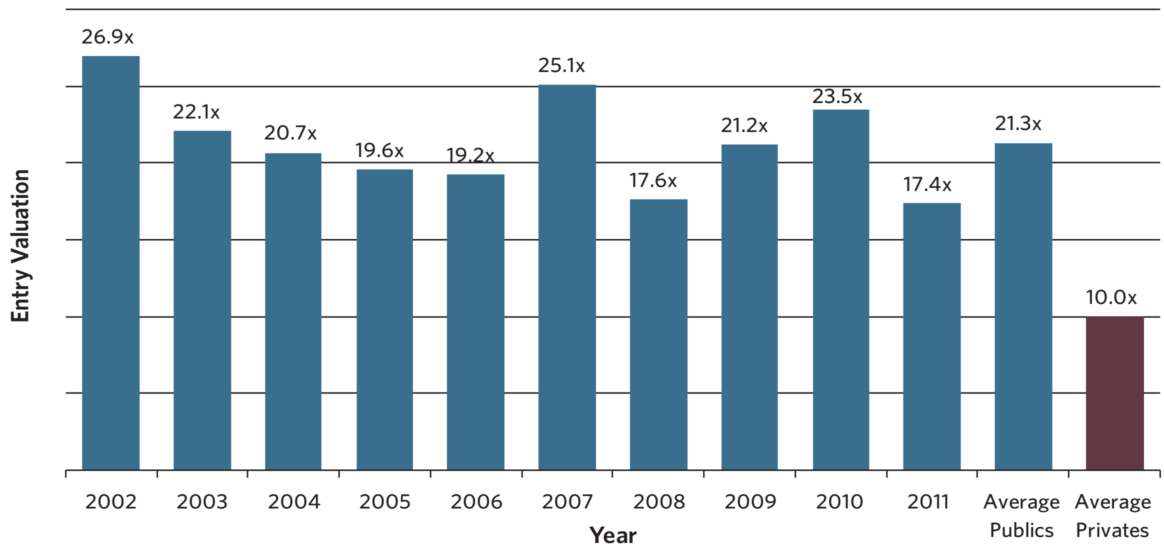


Source: Cambridge Associates 12/31/2011, Global EM PE/VC, provided to Siguler Guff at no cost; Siguler Guff analysis.

The information asymmetry and availability of smaller growth companies in the private market often generates investment opportunities that are priced below comparable publicly listed companies.

In addition to accessing attractive growth sectors, EMPE strategies may also benefit from the greater depth and selection of quality target companies that are privately owned and can generally be acquired at lower valuations than publicly listed companies. The information asymmetry and availability of smaller growth companies in the private market often generates investment opportunities that are priced below comparable publicly listed companies. In contrast, limited sector depth, scarcity of quality assets, external market factors and volatile public fund flows often result in elevated valuations for public companies. Based on the analysis of the private BRIC companies we track in our proprietary database, over the past decade, private equity entry valuations have been approximately 50% lower than those of investments in public equity (Exhibit 6). Thus, private companies not only represent more interesting and less volatile investments in growth sectors, they can also offer additional valuation arbitrage opportunities as compared to public investments.

Exhibit 6: PE Multiples – BRIC Markets (Average Yearly Trading)



Source: Capital IQ arithmetic average Price/Normalized EPS 2002-2011. "Average Privates" multiple calculated based on Siguler Guff's proprietary BRIC database of companies dating back to 2003; excludes venture/early-stage companies; includes a minimal number of EMPE companies outside of the BRICs. Public market multiples are calculated based on companies located in the BRIC countries.

Emerging Markets Are Different

While we have so far discussed emerging markets as whole, it is important to emphasize the degree of differentiation that characterizes these markets. A look at the highly varied private equity returns in the different emerging market regions across time underscores the importance of understanding the macroeconomic, regulatory and private equity dynamics in each market (Exhibit 7).

Exhibit 7: Annualized Returns

Annualized Returns				
Asset Class	**1 Year**	**3 Years**	**5 Years**	**10 Years**
EMPE returns	-1.5%	18.5%	10.1%	11.2%
Emerging Asia	-1.7%	21.3%	11.4%	11.4%
Central & Eastern Europe	7.7%	10.6%	6.7%	15.6%
LatAm	-10.0%	15.7%	11.1%	7.0%
China	15.3%	25.3%	18.4%	16.1%

Source: Cambridge Associates / AVCJ NY conference 2012; data provided to Siguler Guff at no cost. Note: Returns are end-to-end pooled means net of management fees, expenses, and carried interest. The pooled means represent the end-to-end rates of return calculated based on the aggregate of all cash flows and beginning and ending market values as reported by the General Partners to Cambridge Associates LLC in their quarterly and annual audited financial report.

These annualized returns show that correlations of EMPE sub-asset classes vary widely over different time periods and across different geographies, ranging from 0.28 to 0.95. Given that EMPE investment opportunities across the various regions do not perform in lockstep, this overview stresses the importance of selectivity based on local expertise. Private equity investment allocations must be carefully considered and adjusted over time, as well as across geographies and strategies within the emerging markets.

Differentiating Investment Opportunities

We believe an important component of a successful EMPE investment strategy is to identify local management teams that focus on the Tier II and Tier III cities in the BRIC countries. GDP and population growth across these Tier II and Tier III cities are increasing at an accelerated pace, offering a tremendous investment opportunity for private capital (Exhibit 8). Companies in these regions frequently exhibit high growth rates and lower valuations compared with companies in Tier I cities. Moreover, investments in these geographies are generally less intermediated or not intermediated at all, which typically results in lower entry valuations.

Exhibit 8: Population & GDP Growth Rates in BRIC Cities

		China	India	Brazil	Russia
Tier I	Population (Millions)	56	159	108	11
	GDP Growth Rate	10.1%	10.1%	4.3% - 5.6%	3.7%
Tier II	Population (Millions)	467	593	67	5
	GDP Growth Rate	12.6%	9.0%	5.6% - 5.9%	3.5%
Tier III	Population (Millions)	810	430	16	127
	GDP Growth Rate	15.7%	8.8%	3.2%	3.5%

Source: Siguler Guff analysis based on data from National Statistics Bureau of China, Instituto Brasileiro de Geografia e Estatística, CEIC database, India Ministry of Statistics, Russia Federal State Statistics Service, McKinsey & Company. Rates for China based on YoY in 2011; rates for India based on a five-year average from 2007 to 2011; rates for Brazil based on YoY in 2010; rates for Russia based on McKinsey's projected annual GDP growth rates between 2007 and 2025.

In our opinion, attractive investment opportunities exist across China, particularly in the early stage and growth equity space, although the larger end of the company spectrum is experiencing upward pressure on entry valuations. Local currency managers also invest aggressively in certain sectors and stages, frequently driving up the entry prices of target companies. We believe successful long-term investments in China will depend on avoiding these sectors and the corresponding competitive price pressures.

In contrast to China, Brazil and Russia, India is a difficult market for traditional private equity strategies.

The macroeconomic and structural improvements in Brazil and certain other countries in Latin America have created an attractive investment environment, with many private equity managers focused on generating returns through consolidation and growth opportunities in underpenetrated segments and regions. Based on our research, pricing has also been relatively attractive, with the majority of deals in the past five years executed at valuations of approximately 6.5x EV/EBITDA.[2] However, as in many other markets, we have seen some valuation bifurcation between large and mid-sized companies.

Russia benefits from an increasingly vibrant technology environment and is attractive to funds that focus on high-growth businesses in areas related to technology and innovation in Russia and the Commonwealth of Independent States. Sectors such as consumer, Internet, software development, offshore programming and IT infrastructure have achieved the highest growth rates and returns in the region. Given that IT spending per capita in Russia is expected to double over the next three years, the investment opportunities in these sectors are likely to remain attractive for the foreseeable future.

In contrast to China, Brazil and Russia, India is a difficult market for traditional private equity strategies. Challenges faced by investors include significant competition for deal flow, a persistent mismatch between private and public company valuations, a difficult exit environment, and an increasingly hostile political and fiscal environment. Nonetheless, adverse market conditions can still present interesting investment opportunities, and some private equity investment firms have recently taken a contrarian view of the opportunity in India.

2 Siguler Guff's proprietary BRIC database of companies, as of March 31, 2012.

Over the past five years, select frontier markets have shown increasingly attractive fundamentals and look poised for strong future economic growth due to a burgeoning middle class.

Over the past five years, select frontier markets have shown increasingly attractive fundamentals and look poised for strong future economic growth due to a burgeoning middle class. This development typically leads to greater stability and better infrastructure for investors who wish to invest in these markets. As with the BRIC countries before them, we find certain frontier markets are developing these characteristics and have the potential for achieving strong future private equity returns with local or regional private equity managers. However, in our experience, the universe of quality managers in these countries remains quite limited.

The Next Frontier?

Investor sentiment regarding the relative attractiveness of markets changes quickly over time, as demonstrated by the results of the Emerging Markets Private Equity Association's annual investor survey. The 2012 results show that Latin America (ex-Brazil), Brazil and China currently lead the rankings with respect to market attractiveness for private equity investments (Exhibit 9).

Exhibit 9: Market Attractiveness for Private Equity Investments

	Overall Ranking		
	2012	2011	2010
Latin America (ex-Brazil)	1	4	5
Brazil	2	1	2
China	3	2	1
Other Emerging Asia	4	2	4
Sub-Saharan Africa	5	7	8
India	6	5	3
Turkey	7	6	N/A
Russia/CIS	8	10	10
MENA	9	9	9
Central & Eastern Europe	10	8	6

Source: 2012 EMPEA Global Limited Partners Survey. EMPEA / Coller Capital EM PE Survey (2010, 2011). Turkey replaced South Africa in 2011 Survey.

Given that access to high-growth private market segments and companies is not available through public EM strategies, we believe private equity can be a strategically important complement to public equity exposures in investor portfolios.

However, given that the frontier markets generally have limited capacity for new private capital inflows, the risk/return profiles of private equity strategies in these markets can change rapidly. Indonesia, for example, has rapidly morphed into what we consider to be an overhyped market, characterized by enormous fund inflows, which have led to upward pricing pressure on new investments. In order to help investors navigate the pitfalls of frontier markets, here are some of the dimensions we consider key for private equity investing:

- Macroeconomics: GDP size and growth rate, interest rates, inflation, external debt, government deficit, FDI, depth and stability of capital markets, etc.
- Deal Flow: availability of fundamentally strong companies in large, fast-growing sectors
- Managerial Talent: availability of experienced managers to manage funds as well as underlying portfolio companies, preferably with some degree of Western training
- Exit Environment: access to IPOs, trade sales, etc.
- Geopolitical: political stability, rule of law, degree of corruption, etc.
- Human Capital: level of education, literacy rates, life expectancy, etc.
- Technological: level of growth and penetration of mobile phones, PCs, Internet, etc.
- Openness of the Economy: share of trade as a percentage of GDP, membership in the WTO
- Legal/Regulatory: accounting, tax and legal framework, enforceability of rights, governance standards

Investment decisions should also be supported by an in-depth analysis of the fundamental market drivers that are relevant to private equity investing, which include: general partner manager talent, quantity and quality of deal flow, sources of deal flow, competition from domestic and foreign general partners, company/deal valuations, general partner to limited partner alignment of interests, and foreign exchange risk.

Conclusion

All signs indicate that emerging markets will continue to drive a major shift in global economic power and private consumption in the coming years. Given that access to high-growth private market segments and companies is not available through public EM strategies, we believe private equity can be a strategically important complement to public equity exposures in investor portfolios. The EMPE asset class continues to show strong potential for excess returns above the public markets, as well as better downside protection. Private company ownership also allows for increased risk mitigation through the use of control strategies, easier replacement of company management, the introduction of "best in class" management practices and improving corporate governance. Notwithstanding the illiquidity risk and long-term investment horizon of the asset class, we believe an allocation to EMPE has the potential to be highly accretive to overall portfolio performance and provide a significant degree of diversification for institutional investors looking to build out their exposures to alternative investments.

Index Definitions

The MSCI Emerging Markets is an index created by Morgan Stanley Capital International (MSCI) that is designed to measure equity market performance in global emerging markets. The Emerging Markets Index is a float-adjusted market capitalization index consisting of indices in emerging economies.

The MSCI World Index is a stock market index of 1500 world stocks created by Morgan Stanley Capital International, and is often used as a common benchmark for 'world' or 'global' stock funds. The index includes a collection of stocks of all the developed markets in the world, as defined by MSCI. The index includes securities from 23 countries but excludes stocks from emerging economies.

The S&P 500 Total Return is a broadly used index which is used as a general indication of U.S. equity market returns as the S&P 500 index is an index comprised of 500 U.S. public companies representative across all industries/sectors. The index assumes that any cash distributions, such as dividends, are reinvested back into the index.

Cambridge Associates' Global Emerging Markets Private Equity & Venture Capital Index is an end-to-end calculation based on data compiled from 348 global emerging markets private equity and venture capital funds (includes funds investing primarily in Africa, emerging Asia, emerging Europe, Latin America and Middle East ex-Israel), including fully liquidated partnerships, formed between 1986 and 2011.

The Bovespa Index is a total return index weighted by traded volume and is comprised of the most liquid stocks traded on the Sao Paulo Stock Exchange.

The BSE Sensex or the Bombay Stock Exchange is an index of the 30 most actively traded stocks on its floor that is considered one of the most important benchmark indices in India.

The RTS Index is an index composed of 50 Russian stocks. These stocks are traded on the Russian Trading System Stock Exchange of Moscow.

The Shanghai Stock Exchange Composite Index is a capitalization-weighted index. The index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange.

The MSCI Frontier Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of frontier markets. The index consists of the following 25 frontier market country indices: Argentina, Bahrain, Bangladesh, Bulgaria, Croatia, Estonia, Jordan, Kenya, Kuwait, Lebanon, Lithuania, Kazakhstan, Mauritius, Nigeria, Oman, Pakistan, Qatar, Romania, Serbia, Slovenia, Sri Lanka, Tunisia, Ukraine, United Arab Emirates, and Vietnam.

The indexes are trademarks of the foregoing licensers and are used herein solely for comparative purposes. The foregoing index licensers do not sponsor, endorse, sell or promote the investment strategies or products mentioned in this paper, and they make no representation regarding the advisability of investing in the products or strategies described herein.

BNY MELLON

The Alcentra Group
BNY Mellon ARX
BNY Mellon Cash Investment Strategies
BNY Mellon Western Fund Management Company Limited
The Boston Company Asset Management, LLC
The Dreyfus Corporation
EACM Advisors LLC
Hamon Investment Group
Insight Investment
Mellon Capital Management Corporation
The Newton Group
Pareto Investment Management Limited
Siguler Guff & Company LP
Standish Mellon Asset Management Company LLC
Urdang Capital Management, Inc.
Urdang Securities Management, Inc.
Walter Scott & Partners Limited
WestLB Mellon Asset Management

本情報提供資料は、BNY メロン・グループ（BNY メロンを最終親会社とするグループの総称です）の資産運用会社が提供する情報について、BNY メロン・アセット・マネジメント・ジャパン株式会社が審査の上、掲載したものです。当資料は情報の提供を目的としたもので、勧誘を目的としたものではありません。当資料は信頼できると思われる情報に基づき作成されていますが、その正確性、完全性を保証するものではありません。ここに示された意見などは、作成時点での見解であり、事前の連絡無しに変更される事もあります。

BNY メロン・アセット・マネジメント・ジャパン株式会社
BNY Mellon Asset Management Japan Limited

金融商品取引業者：関東財務局長（金商）第 406 号
〔加入協会〕社団法人　投資信託協会
　　　　　　一般社団法人　日本投資顧問業協会