PRIVATE EQUITY INVESTING IN EMERGING MARKETS

Opportunities for Value Creation

ROGER LEEDS

GLOBAL FINANCIAL MARKETS

Private Equity Investing in Emerging Markets

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with

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For Ellen, my role model in life.

Exhibits

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Many of the earliest ideas that found their way into the pages of this book germinated during a lively monthly dinner/seminar series I organized in the early 2000s when I first joined the SAIS faculty. Among the seminar participants were some of the first emerging market private equity investors and thought leaders; many have remained close colleagues and friends ever since, including Thomas Barry (Zephyr Management), Scott MacLeod (Global Environment Fund), Teresa Barger (Cartica Capital), Donald Roth (EMP Global), Sam Santos (Darby Private Equity), and Robert Stillman (Small Enterprise Assistance Funds). I am especially grateful to these individuals for their thought-provoking insights, many of which are reflected in what follows.

A byproduct of those SAIS seminars was the creation of the Emerging Markets Private Equity Association (EMPEA) in 2004. Many of the dedicated professionals working at EMPEA have given generously of their time and knowledge. They also deserve special mention because they are among the most genuine believers in the

central importance of private equity as a driver of private sector development in emerging markets.

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(In order to maximize the likelihood of candor, every interview was conducted on the condition of strict confidentiality, and therefore these individuals are not identified by name in the text without their express permission.)

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Quick Reference Guide

100-day plan: An action plan mapped out by a private equity fund in collaboration with the senior management of a portfolio company to be implemented during approximately the first 100 days post-investment. The plan is designed to outline which value-enhancement initiatives should be implemented during the initial months of a private equity partnership, when management is believed to be most receptive to making important changes.

Angel investor: A high net worth individual, often with extensive industry expertise, who invests her own capital in entrepreneurial start-up companies.

Asset class: A classification of financial assets based on assumptions about the similarities of their risk, return, and liquidity characteristics. Private equity is considered its own asset class, and this book contends that emerging markets private equity, which has a unique set of characteristics, should also be considered a separate asset class.

Asymmetric information: A term that refers to a reality in nearly all transactions: one party (e.g., a company owner) possesses more information that is relevant to the transaction than the other (e.g., the investor). In private equity, the company management knows more about the underlying operations of the business than the investor, which may result in the investor making decisions regarding the investment that are based on incomplete or inaccurate information.

Carried interest (carry): The share of profits from a private equity fund's investments that are allocated to the general partner, typically after the limited partners receive their original investment and agreed-upon preferred return (or hurdle rate). The standard practice in private equity is a 20 percent carry (also known as a performance fee) allocated to the GP.

Committed capital (commitments): The total amount of capital from limited partners and general partners that is allocated to a particular fund. The term also refers to the specific amount of capital a limited partner contractually commits to a private equity fund.

Comparables (comps) analysis: A valuation methodology that involves comparing a company's historical performance with similar companies in the same industry, usually by using financial ratios.

Convertible securities: A debt or equity security that under certain specified conditions related to company performance may be converted into another security (usually common stock). There are various types of convertible securities, each with its own well-defined rights and conversion conditions.

Deal flow: A term used by asset managers (e.g., venture capital funds and private equity funds) to refer to the availability of new investment opportunities. In private equity, it refers to companies that are likely to meet the fund manager's investment criteria.

Development finance institutions (DFIs): Institutions that are backed by governments to provide financing and technical assistance for projects in developing countries for the purpose of spurring economic growth and development. Examples of well-known multilateral DFIs that focus on the private sector include the World Bank's International Finance Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD).

Discounted cash flow (DCF) analysis: A valuation methodology that measures the profitability of a prospective investment by projecting a company's potential cash flows over a period of years and then discounting these financial flows back to the time of the initial investment to establish a present value. According to this methodology, a potential investment is generally considered attractive if the present value of the discounted cash flows is higher than the anticipated initial investment.

Distribution waterfall: The method of establishing the order of financial distributions as a private equity fund realizes its investments. For example, usually a distribution waterfall specifies that general partners only receive profits from an exited investment after the limited partners receive their original investment and a specified preferred return.

Due diligence: The evaluation of a potential investment. With private equity, due diligence refers to the process undertaken by the fund manager to assess the operational, financial, and managerial strengths and weaknesses of a prospective portfolio company in order to determine whether the company satisfies its investment criteria.

EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization): A common measure of a company's net income (profitability) before making adjustments for interest expense and/or tax obligations.

ERISA: The United States Employee Retirement Income Security Act of 1974, which established minimum rules for pension plan investing activity, as well as the tax effects of such investments. ERISA is relevant to private equity in particular because it included the so-called Prudent Man Rule, which forbade pension fund managers from investing in alternative assets such as private equity because of their risk profile. Once the rule was repealed in 1979, pension funds quickly became a major source of funding for private equity and the industry began to experience explosive growth.

Exit: Refers to a private equity fund's sale of all or a portion of its stake in a portfolio company, usually via an initial public offering (IPO), trade sale, or sale to another financial investor.

Fund of funds: An investment fund that raises capital from institutional investors, and then functions as a limited partner, making investments in a number of individual private equity funds. Fund of funds offer their investors greater diversification by holding a portfolio comprising a number of GPs, typically with differentiated strategies, which in turn invest directly in companies.

General partner (GP or fund manager): One or more individuals who are responsible for the day-to-day operations of a pool of capital (the fund), usually structured as a limited liability partnership. In private equity, the GP is responsible for raising capital from a group of institutional investors (the LPs), identifying potential companies in which to invest, and actively overseeing the companies within its investment portfolio until the exit.

Growth capital: A term that generally describes significant minority private equity investments in companies that are relatively well established and seek to increase their growth and profitability by improving and maximizing efficiency within their operations, and expanding into new products, industries, or markets.

Hedge fund: A pooled investment fund that differs from private equity in that it targets investments in liquid assets, such as securities, instead of illiquid assets, such as private companies.

Hurdle rate (preferred return): The minimal acceptable return a limited partner must receive from a private equity fund investment before a general partner may begin to share in the profits generated.

Initial public offering (IPO): The first-time sale of shares to public investors by a company that previously was not listed on a public stock exchange. An IPO is often the preferred method of exit for a private equity fund investment, as it provides liquidity for any remaining shares in the company and generally, but not always, generates the highest financial returns.

Internal rate of return (IRR): The discount rate that makes the net present value of all future cash flows from an investment equal to zero. Generally speaking, the higher the investment's internal rate of return, the more desirable it is. As such, IRR is often used by private equity investors to rank prospective investments they are considering. IRR is also used as a means of measuring the real financial returns on an investment at the time of exit.

Institutional Limited Partners Association (ILPA): A global member-driven not-for-profit organization that represents the interests of limited partner investors in the global private equity industry by conducting research, engaging in advocacy and education campaigns, and fostering networking and collaboration opportunities for LPs engaged in private equity investing.

Institutional Limited Partners Association (ILPA) Private Equity Principles: A detailed list of suggested guidelines and best practices published by ILPA (see above) to clarify the terms and conditions governing the relationships between general partners and limited partners in a private equity fund. The Principles focus on such key