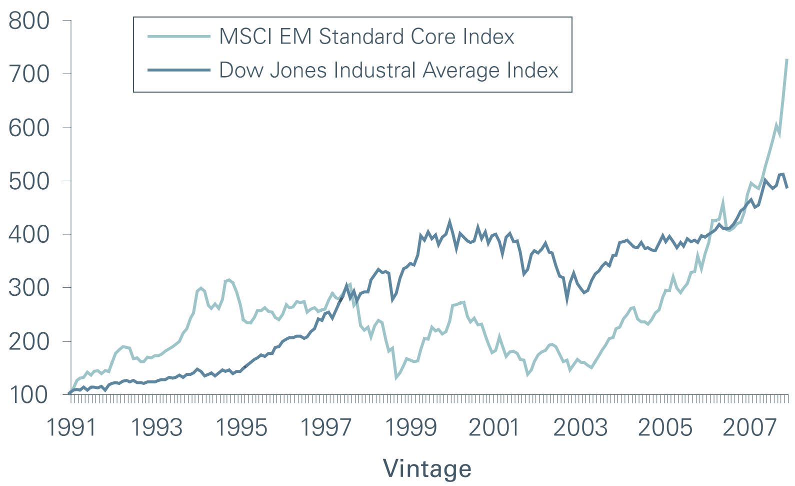
# You've Come a Long Way, Baby

Black Monday was much evoked in the business media this autumn of 2007, as investors recalled the steepest one-day drop in Dow Jones history. 2007 also brings an opportunity for anniversary-driven reflection for emerging market investors. July 1997 marked the beginning of the Asian financial crises, a cascading market convulsion that halved the value of many Asian exchanges and convinced a generation of investors that emerging markets were inherently too unstable and poorly governed for investment.

For those reflecting on Black Monday, the question today could well be what further shocks might be ahead for US markets. For emerging markets investors, by contrast, the markets have improved almost beyond recognition. Hong Kong now rivals London and New York as the world's leading exchange for IPOs; a Chinese company—PetroChina—is now the world's largest by market capitalization; and investors have clamored back into emerging markets equities, helping to drive up the market capitalization of emerging market exchanges nearly 8-fold in five years. (See Exhibit 1 for a comparison of EM Exchanges with the DJIA.)

> *"Never in my wildest dreams could I have imagined emerging markets would be where they are today."*
>
> **– Mark Mobius, Templeton Asset Management**

Exhibit 1: EM Vs. Dow Jones; Percent Change since Jan. 1991




*Source: MSCI Barra, Dow Jones*

To long-serving emerging markets investors, the change since the crisis years is phenomenal. "Never in my wildest dreams could I have imagined emerging markets would be where they are today," marveled one such veteran, Mark Mobius, Managing Director of **Templeton Asset Management**.

For private equity firms in emerging markets, the extraordinary rebound in public markets translates into new opportunities, along with some new challenges like higher entry valuations. Interviews with several leading private equity firms indicate that the impact of the long bull market has been different for different firms. Generally speaking, though, managers have been more than happy to see the huge upswing in emerging markets exchanges. As Ernest Bachrach, Chief Executive of **Advent International**'s Latin American investment program, put it, "It is a great thing to do private equity in a buoyant market."

## Comprehensive Changes

For many public market investors, the explanation of the great upswing begins with better public policy. "What's happened is that, quite amazingly, countries around the world have embraced the concept of a market economy, where governments keep their hands off business," said Mark Mobius. "When we started, Eastern Europe was still under communism; South Africa was still under apartheid. We had US$100 million in assets, and we weren't sure we would be able to invest it all because so many countries were in such bad shape."

"The fundamentals in so many of these countries have improved so much that you are significantly less scared of a top-down crisis," said Emily Alejos, who has been investing in emerging markets since 1991 with firms such as Tradewinds, Credit Suisse, Bankers Trust and GT Capital.

For Arjun Divecha, who has managed emerging markets portfolios since 1993 for **GMO**, an investment firm managing US$108 billion in non-US equities, the crises of the 1990s were the catalyst for improvement. "The crises gave countries no other choice but to start implementing better polices," said Divecha. He believes a particularly important policy change was

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the conversion from fixed to flexible exchange rates, which allowed for more accurate pricing of capital, more efficient capital allocation, and higher return on corporate investment.

Divecha also sees an important change at the micro level, in the attitude of corporate managers. "Ten years ago minority shareholders were seen as a bunch of patsies to be taken advantage of, now there is a real focus on shareholder value. Managers now understand that they can make a lot more money by being honest than by being crooks," he said.

One implication of this environment is a significant increase in liquidity, as total value of share trading has doubled or tripled since 2000 in many of the leading emerging markets.[1] "Ten years ago the investors were almost all dedicated players, now you have local investors, hedge funds, global investors," said Divecha. "Liquidity and trading volume have increased tremendously." (See Exhibit 2 for a size comparison across leading EM exchanges.)

Divecha noted that the increase in liquidity is also being driven by much improved access to markets in most countries. To illustrate, he said that GMO's average trading cost has dropped from .70% of the value of a trade in 1995 to .13% today.

Increased liquidity has also meant increased local participation. "Local investors are much more important now—whether it's individual investors in China or the pensions, which in many countries have increased their exposure to equities as interest rates have come down." said Alejos. "Generally, where there are more local investors and more sophisticated local investors, that is often seen as a good reason for companies to trade at a premium to other emerging markets."

To Alejos, the traditional position of emerging markets vis-à-vis developed markets is changing. "It used to be you absolutely had to have a discount to invest in these markets to adjust for the risk.

### Exhibit 2: Change in Trading Volumes

| | Trading Vol. '06 (US$Bn) | Increase since '01 | No. of Listed Companies (09/07) | Change since 12/01 |
|---|---|---|---|---|
| Bombay SE | $214 | 113% | 4,871 | -924 |
| Bovespa | $276 | 335% | 390 | -51 |
| Hong Kong Exchanges | $832 | 245% | 1,210 | 343 |
| Johannesburg SE | $311 | 349% | 388 | -144 |
| Shanghai SE | $736 | 153% | 855 | 209 |
| Singapore Exchange | $180 | 153% | 739 | 247 |
| Warsaw SE | $56 | 467% | 335 | 105 |
| NYSE Group | $21,791 | 108% | 2,262 | -138 |

*Source: World Federation of Exchanges*

### Exhibit 3: 12-Month Trailing Price Earnings Ratios for MSCI Indices

| | Oct 31 2007 | Oct 31 2006 |
|---|---|---|
| Asia | 20.26 | 18.23 |
| Emerging Markets | 18.53 | 14.34 |
| Developed Markets | 16.51 | 16.68 |

*Source: MSCI Barra, Wall Street Journal, November 19 2007*

Then people embraced the idea of emerging markets trading on par, and now many have gotten comfortable paying a premium in emerging markets," she said. (See Exhibit 3 for recent changes in MSCI P/E ratios.)

## Structural Implications for Private Equity

For private equity investors in emerging markets, the huge public market transformation has meant many different things, depending on where they invest, how they approach exits, and other factors. One implication that resonates across markets is that the surge in public markets has changed the overall image of emerging markets in the minds of institutional investors.

As Ernest Bachrach of Advent International explained, "We are benefiting from the success that institutions are having in other emerging markets asset classes. Now, when we approach an institution," said Bachrach, "they are aware that the listed equity people have done well in these markets, and that increases the receptivity."

A second important implication is that the much-increased activity on emerging markets exchanges has brought more attention to companies in these countries, which in turn increases the incentive for transparency and good corporate governance, according to GPs.

Ashish Dhawan, co-founder and Senior Managing Director of the India private equity firm **ChrysCapital** explained this dynamic in India: "There is a much larger pool of large companies, large enough to attract institutional capital. There are over a thousand foreign institutional investors registered to invest on Indian exchanges, and over 400 companies that now receive reasonable coverage. The discovery process is much enhanced, and given this scrutiny, companies know that it pays to be honest," said Dhawan.

Thomas Smith, Managing Partner of **Lombard Investments**, agrees. Lombard invests in Southeast Asia and China, focusing on some of the countries hardest hit by the 1997 crisis, such as Thailand. "Ten years ago we had to explain what corporate gov-

[1] Source: World Federation of Exchanges

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ernance and transparency were. Now good governance is practiced by many leading Asian companies," said Smith.

## Enhanced Local IPO Markets

Beyond these structural changes, the most important implication for private equity investors of the buoyant public markets has been a more reliable demand for emerging market IPOs. IPOs on emerging markets exchanges have grown at a rapid pace in recent years, surpassing 50% of the global total. In the third quarter of 2007, 13 of the 20 largest offerings came from emerging markets, and China and Brazil placed first and second—ahead of the US—in total capital raised from IPOs, with US$14.4 billion and US$9.3 billion respectively.[2]

Interviews with a range of private equity firms illustrates that the way firms are benefiting from high interest in emerging markets IPOs varies. In certain markets—most notably Brazil, India, and Poland—GPs see enough depth and liquidity on their local exchanges that they rely primarily on local listings when they take companies public. Other GPs are looking primarily to list offshore, where they tap into institutional appetite for emerging market issues on the major exchanges of London, New York, and Hong Kong. (See Exhibit 4 for details on new listings.)

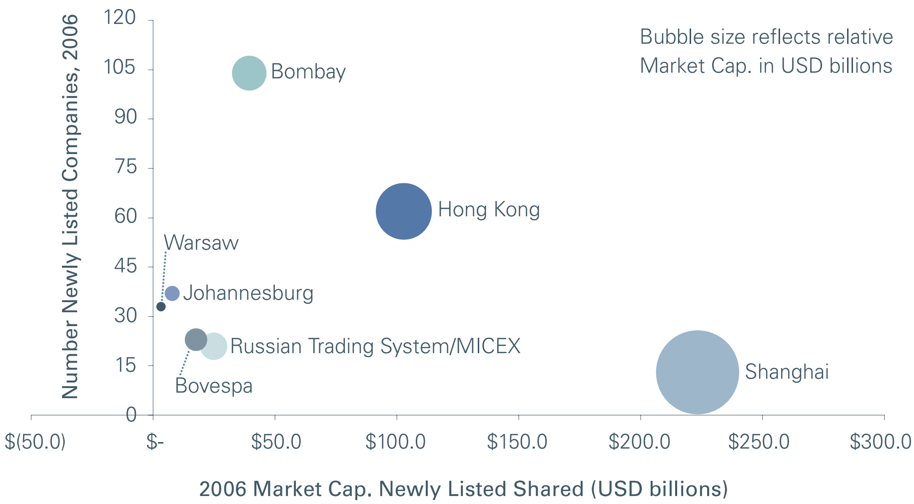
The country with the most dramatic turnaround in private equity exits via local exchanges is Brazil, where there have been 34 private equity-backed IPOs since 2004—more than half of the total new offerings during that period. Asked what the changed public market environment has meant for his firm, Antonio Bonchristiano, Co-CEO of the Brazil-focused private equity firm **GP Investments**, said, "From 1994 to 2004 we had 25 exits, only one of which was an IPO; since 2004, we've had ten exits, only one of which was not an IPO."

### Exhibit 4: Market Cap. Of Newly Listed Shares in 2006 vs. No. of Newly Listed Companies

| | No. of Newly Listed Companies | Market Cap. of Newly Listed Shares in 2006 (US$ Bn.) |
|---|---|---|
| Shanghai | 13 | $223.3 |
| Hong Kong | 62 | $102.9 |
| Bombay | 104 | $39.5 |
| Bovespa | 21 | $24.9 |
| Russian Trading System/MICEX | 23 | $17.7 |
| Johannesburg | 37 | $7.9 |
| Warsaw | 33 | $3.3 |

*Sources: Country stock exchanges, World Federation of Exchanges*

Market Cap. (US$ Bn.) and Number of Newly Listed Companies in 2006




Bonchristiano believes that, although there will be variation in risk appetite among investors in Brazil, a critical mass has been reached that will sustain a viable IPO market. "When you look at the investments that international institutions have made in building a presence here and understanding this market," he said, "you have to conclude that this is not just a short-term window—this is a permanent feature of the Brazilian market."

Much of the rapid growth in appetite for Brazilian equities can be explained by macro-economic factors, including export-driven improvements in the country's foreign reserves, and declining interest rates, stemming from increased fiscal discipline. Structural changes to the country's equity markets, such as the introduction of the Novo Mercado (a listing segment of BOVESPA with voluntary higher corporate governance and transparency standards), have also played a role. Nine out of 11 private-equity-backed IPOs in 2007 have been on the Novo Mercado.

Another market that has been very friendly to private-equity-backed IPOs is Poland's Warsaw Stock Exchange; and, as with Brazil, structural reforms are part of the story. Changes in the Polish pension system in the late 1990s increased both the assets of Polish pensions (currently above US$15 billion) and their allocation to domestic equities, while restricting pension investment outside of Poland to 5%. The resulting local institu-

[2] Source: Ernst and Young Press Release, October 23, 2007

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tional investor base, combined with international interest in the growing economies of Central and Eastern Europe has fueled a strong IPO appetite, yielding 104 IPOs in the 2004–2006 time period.

The private equity firm that has taken most advantage of this demand in Poland is Warsaw-based **Enterprise Investors**, which in October 2007 announced its 25th IPO on the Warsaw Stock Exchange, representing 27% of all exits for the firm.

"Where we are now is very different than where we were several years ago," said Piotr Augustyniak, a Partner at Enterprise Investors focusing on exits and IPOs. "In the late 90s, before the pension reform and before there were many international investors, gaining liquidity was difficult. We had two or three companies that we IPO'd during that time and then held for seven or eight years before exiting. Now we typically sell at least some of our shares at the IPO."

According to Ashish Dhawan of India's ChrysCapital, a robust IPO market is particularly important to Indian private equity because a larger share of the investments is minority stakes in businesses under family or individual control. "It is much harder to get an owner to sell to a strategic as compared to going public," he said. Dhawan estimates that 75% of exits in Indian private equity are via IPO.

For Dhawan, there is little reason to consider exchanges outside of India, where 19 private equity-backed firms went public in 2006. "There is no real value in listing offshore because all of the buyers that would be offshore are here as well," he said. Dhawan noted that India has developed an efficient listing process and regulatory environment, modeled on the US Securities and Exchange Commissions, and including new regulations to strengthen company oversight that parallel the Sarbanes-Oxley Act.

Exhibit 5: Minimum Requirements and Restrictions

| | Important Minimum Listing Requirements | Current Lock Up Periods on Recent IPOs |
|---|---|---|
| Bombay SE | Track Record: Income for small cap companies at least US$760,000 over preceding 3 years. Min Market Cap: US$6.4m for large cap, US$1.3m for small cap. Min Issue Size: US$2.5m for large cap, US$760,000 for small cap. | 12 months. 36 months for promoters on up to 20% of company, then 12 months on remaining shares. |
| Bovespa | (Novo Mercado) Min Issue Size: Issue and maintain a minimum free float corresponding to 25% of the company's capital stock. Public distribution of US$6.5m. | Novo Mercado: 6 months. May sell max. of 40% of shares from 7th till 12th month. |
| Hong Kong Exchanges | (Main Board) Track Record: Profit over preceding 1 year of US$2.6m, and aggregate over preceding 2 years of US$3.9m. Or, market cap of US$257m, revenue of US$64m over most recent year, and US$12.9m positive cash flow in aggregate over preceding 3 years. | 3 to 18 months |
| Johannesburg SE | Track Record: Audited profit history over previous 3 years, with final year profit at least US$1.2m. Min Market Cap: Main board valuation US$3.7m. Min Issue Size: 25,000,000 equity shares in issue, at least 20% held by public. | 6 to 12 months |
| Russian Trading System | Track Record: In business at least 3 years, with 2 of which having positive balance. Min Market Cap: US$410m for equity shares, US$123m for preference shares. | 6 to 12 months |
| Shanghai SE | Track Record: Maintain profits over preceding 3 consecutive years. Min Market Cap: Total share capital not less than US$6.8m. Min Issue Size: 25% of company's total share capital. For company's whose total share capital exceeds US$54m, the ratio of public. | 12 to 36 months |
| Warsaw SE | Track Record: Published financial statements for previous 3 consecutive years of sufficient quality for investors to effectively evaluate the company. Min Issue Size: Value of issuer's equity at least US$15m. | 12 to 24 months |

## Preferences for Off Shore Listings

The question of where to list is more complicated in China, a country that embodies the massive economic growth of emerging markets, but has the least accessible and transparent of the major emerging market stock exchanges. In the eyes of one of China's most experienced private equity investors, Jean Eric Salata, Managing Partner of **Baring Private Equity Asia**, China "is making great strides" at improving the listing process, "but further reform is still needed."

"China is going to be largest economy in the world," said Salata, "and it should have the largest, most liquid and most efficient capital markets. It would be a huge advantage in terms of reducing the cost of capital to businesses if China had better capital markets."

Salata's preferred IPO route for mainland Chinese companies is via a listing in Hong Kong. "The listing process is more transparent, predictable and efficient. Onshore in China there is still a queuing system and an approval process that is not completely transparent. The Hong Kong Stock Exchange is a better barometer of value because the market clears every day, the Chinese markets are still a closed market."

Another concern for Salata is the question of what it would take to generate dis-

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tributions for dollar-based LPs from a mainland listing. "There's plenty of liquidity in the mainland markets, so you could sell your shares, but could you convert the renminbi easily? There are procedures but the process is still not proven. If you had, say, US$500 million in proceeds, it's not clear that in the conversion process you wouldn't be delayed or taxed."

Issues such as these are coming to the fore because the Chinese government is looking to limit offshore listing of mainland companies and encourage companies to list in Shanghai or Shenzhen. These policies are driven in part by the need to provide additional investment vehicles for the massive amount of domestic liquidity in China, which has bid up mainland companies to extraordinary valuations.

> *"Private equity is a long term business. IPO markets will open and close, so the key isn't the markets, it's doing good deals."*
>
> **– Jean Eric Salata, Baring Private Equity Asia**

Salata isn't tempted to reconsider his preference for Hong Kong in light of the much higher multiples investors are paying on the mainland. "We are not banking on those 40–50x multiples being there for long," he said.

Michael Calvey, Co-Managing Partner of Russian private equity firm **Baring Vostok Capital Partners**, is another GP who prefers listing offshore, specifically in London, which has become the prime destination for IPOs of Russian companies.

"When we started in 1994, there was no public market in Russia," said Calvey. "A market began to form in the late '90s and then fell by 95% in the 1998 crisis. We took the view that we'd only be able to make money from trade sales."

"London has been the main destination for us in terms of public markets. A lot of global emerging market funds are based there, and the London-Moscow trading corridor is huge." Russian companies going public are required to list 30% of their offering in Russia, but many also list offshore. In 2006, 8 Russia-domiciled companies listed in London.

Calvey noted that for private equity players the IPO route has been particularly attractive because, as with Brazil, there has been a premium of 30–40% in the IPO valuation implied by the listed markets compared to prices offered by strategic buyers. Calvey explained that this disconnect has come about because "the strategic investors are paying more attention to Russian politics and policy issues, while the listed markets just focus on earnings and growth."

## Exchange Options Beyond the BRICS

Private equity players in markets outside of the BRIC countries and Poland are also seeing improvements in local markets, though many are not yet counting on the local IPO as their primary exit route. For example, Andre Roux, CEO of South African firm **Ethos**, noted that although the Johannesburg Stock Exchange has performed very well in recent years and supported an increasing number of IPOs, his firm has focused on trade sales rather than listings. "Maybe we could squeeze a higher value at an IPO, but with a trade sale we get a 100% exit then and there, and that's worth something," he said.

Lombard's Thomas Smith sees a lot of improvements in the exchanges of Southeast Asia. "Extremely bright, well-educated and dedicated people have worked very hard since the 1997 crisis to correct and improve capital markets," he said. "Their success is obvious and we've benefited through profitable IPOs. But not every public market has regained the buoyancy of the mid 1990s. There's been significant rotation in terms of which markets are the most active, the most liquid." Lombard has taken companies public recently in Thailand and off-shore on the Singapore Stock Exchange.

Fred Sicre, Executive Director of **Abraaj Capital**, predicts that the increasing liquidity of the Gulf States will make the Dubai International Financial Exchange an important new IPO location and private equity exit route. "The region is still young," he noted, "but it has the financial resources to enact its aspirations of being top class by world standards."

## Competition and Other Challenges

Although the huge increases in the value and liquidity of emerging markets exchanges has generally been a very positive development for private equity investors, these developments can also create new competitive forces. One factor is that the increasing viability of IPOs in these markets gives companies a public alternative to capital from a private equity firm. "When you get momentum of the kind were seeing now in Brazil, a lot of companies get ahead of themselves and go public before the necessary systems are in place to manage being public," said Advent's Bachrach.

"Public markets are often competition for us in the sense that a public market can offer capital with fewer strings attached," said Lombard's Toby Smith. "However, public market equity doesn't bring with it a team of local professionals motivated to help a company's management. It's a very different choice."

A second challenge is that higher valuations on local public exchanges inevitably put pressure on entry prices for private transactions. "Sellers are always trying to have some benchmark for a transaction, and public markets offer a benchmark," said Augustyniak of Enterprise Investors. "But there is no automatic

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link between public and private prices. If an entrepreneur sees value in what private equity has to offer, than they are typically more reasonable about valuations."

Roux of Ethos agreed that the increasing multiples on the JSE are affecting private equity prices, and he cited the example of retail stocks in South Africa as a sector trading higher than peers in developed markets because of the much higher growth. "We are certainly willing to look at those companies even at that level of valuation if there is real evidence that the growth is sustainable," he said. "You'd pay more, but because of the growth, you'd get a lot bigger opportunity."

Another challenge that comes from buoyant local stock markets is performance pressure. In principle, private equity should provide a premium to an investor, in exchange for the long lock-up on their capital and the higher risk of a more concentrated portfolio. Looking at industry level averages within the Cambridge Associates indices, it seems that US private equity has generally provided that premium, while emerging markets private equity has not. (See tables on page 3.) "Yes, we keep these [public] benchmarks in mind," said ChrysCapital's Dhawan. "Our focus though is really on absolute not relative performance. We are shooting to deliver net returns in the mid 20%, and on a five-year view the returns from public markets are going to go down." •

# Member News

**Actis** joined a consortium of Pine Brook, AES, Temesek, and others to make a US$380 million investment in oil and gas exploration firm Asia Pacific Exploration Consolidated LP (APEC).

**Abraaj Capital** announced the second closing of its Infrastructure and Capital Growth Fund at US $1.2 Billion. This fund will focus on the MENASA region and has already made five investments.

**Advent International** acquired 100% of Grupo Gayosso, Mexico's largest funeral services company, from private investors in a leveraged buyout valued at US$317 million.

**Aureos Capital's** Aureos Central Asia Fund achieved a first close of US$50 million and has a target of $100 million. It will make investments ranging from $2 million to $10 million in Kazakhstan, Azerbaijan, the Kyrgyz Republic, Georgia, Tajikistan, Turkmenistan, and Uzbekistan.

**Baring Private Equity Asia** and **ICICI Ventures** invested US$127 million for an approximate 20% stake in India's Karvy Stock Broking Ltd.

**CDC Group** invested $30 million in a microfinance hedge fund called Minlam Microfinance Offshore Fund. The fund will provide credit to microfinance investors.

**Cordiant Capital** completed a second close of US$250 million to its Cordiant Emerging Loan Fund III. This brings the total capital raised for the fund to US$450 million.

**Emerging Capital Partners** and Truffle Capital completed a joint 100% acquisition of Compagnie Miniere de Touissit (CMT), a mining company in Morocco that focuses on silver-bearing lead and silver-bearing zinc. The acquisition was for a total of US $53 million.

**Euroventures Ukraine Fund** invested US$5 million for a 25.86% stake in Anthoreal Estates Limited, a company formerly known as Food Master, which runs a chain of fast food restaurants in Ukraine.

**Global Investment House** invested US$5 million in Reach (Cargo Movers) Pvt., Ltd., a ground transportation logistics company based in India.

**GP Investments** announced the close of GP Capital Partners IV, L.P. at US$1.3 Billion.

**Great Circle Fund LP** completed an investment in Turkey's Balnak Logistics Group, a freight forwarding, warehouse operations, and international and domestic transportation and distribution firm.

**IDFC Private Equity** invested Rs 350 million (US $8.9 million) in Doshion Ltd, an Indian water management company that has operated in over 40 countries around the world.

**Mekong Capital** completed a US$5.4 million investment in apparel manufacturer Venture International (Vietnam) Joint Stock Company (VIVCO).

**NBK Capital** exited its investment in Yudum Foods of Turkey through a trade sale to Afia International Company for US$70 million. **Swicorp** acted as financial advisor to the deal.

**Penton Partners** invested US$9.5 million in Pellet-Art, a large pellet production firm based in Poland.

**SigmaBleyzer** purchased over half of Sumatra, Ltd., a company based in Kyiv that owns a retail chain of 51 stores called Kosmo, for an undisclosed amount.

**The Carlyle Group** acquired Arabela from **Advent International** and Procorp for an undisclosed amount. Mexico-based Arabela sells beauty products door to door.

**Warburg Pincus International** acquired a majority stake in the No. 2 Czech web portal NetCentrum SRO for an undisclosed amount.