

The State of Emerging Markets Private Equity: Turning a Corner

If 2006 was the year that emerging markets private equity regained the attention of institutional investors, the year 2007 will be remembered for a number of milestones in the development of the asset class. Fund sizes broke records, investing began to stretch to new frontiers and industries, IPO opportunities deepened in some local markets, and local institutions became active investors in their own markets. 2007 also saw the emergence of new challenges and uncertainties—a credit crunch spidering out from the US into other markets, and intensifying scrutiny of our industry's impact on investee companies and economies. While it's too early to predict what impact these challenges will have on the asset class, the numerous breakthroughs of 2007 suggest that private equity in the emerging markets is better positioned than ever before to weather any coming storm.

Becoming Mainstream: the Abundance of Fresh Capital

Emerging markets private equity has made remarkable strides. What was once primarily a development finance-backed experiment is now a credible, commercial asset class in some emerging markets, attracting sizable investments from well-known institutional investors, including public pension funds. In 2007, fundraising broke all historical records, as new emerging market-dedicated PE funds raised US\$59 billion for the year, nearly doubling the US\$33 billion raised in 2006. (See Exhibit 1 for year-over-year fundraising totals.)

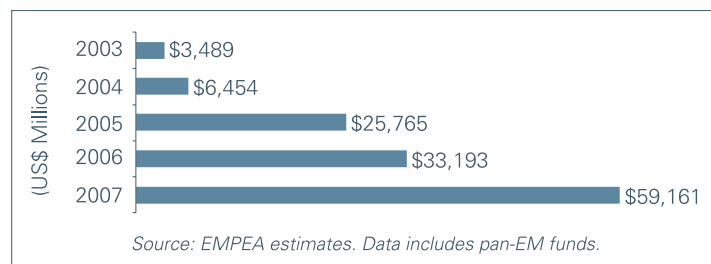
Fundraising hit records across the emerging markets. Latin America fundraising reached historical highs; Central/Eastern Europe fundraising rose more than 300%. Billions were raised for investments in the Middle East—a PE market only beginning to emerge two years ago. In Sub-Saharan Africa, three funds alone raised US\$2.3 billion in total capital (US\$1.7 billion of that in 2007), while an additional US\$5.4 billion is being raised across the continent in 2008. (See Exhibit 2 for regional fundraising totals.)

Fund sizes also shattered past records. Asia witnessed its first so-called mega-fund, a US\$4 billion oversubscribed regional fund. In Brazil, China, and India, local managers raised the first billion-dollar-plus country-dedicated funds. Central Europe now has a US\$2.1 billion fund. (See Exhibit 3 for a sampling of some of the largest funds raised for emerging markets in 2007.)

Local Industries Develop

This tremendous growth has been fueled by increasing foreign and local investor participation in many countries. With growing fund sizes—some surpassing US\$1 billion—local players increasingly compete against or collaborate with major global PE players in their home markets.

Exhibit 1: EM Private Equity Fundraising Totals, 2003-2007



The development of a local PE industry has become a priority in a number of markets. In China, new regulations encourage the formation of domestic funds in local currency, backed by local institutional investors. The transformation of the Middle East from solely a source of capital for Western funds to a cradle for a rapidly developing local industry is being fueled by local investors backing local fund managers. Similar growth in local investor participation is benefiting the asset class in Brazil and South Africa.

Groundbreaking Deals and New Frontiers

At the same time, well-capitalized Western buyout shops are breaking new ground with large investments in emerging markets. The two largest PE deals in Turkey's history followed in close succession: BC Partners' US\$3.2 billion for the Migros Turk TAS supermarket chain, and KKR's acquisition of Un Ro-Ro Shipping for US\$1.2 billion. Bain Capital's US\$3.5 billion take-private of South Africa's biggest retailer, Edgars Consolidated Stores, topped that country's prior record for deal size. AIG's US\$1.5 billion investment in Bulgaria Telco was the largest PE transaction in Bulgaria to date. (See Exhibit 4 for a sampling of notable deals in emerging markets in 2007.)

In 2007, investments also continued to spread to new frontiers. Seminal deals took place in Serbia (US\$81 million investment in a cable TV company), Egypt (US\$1.4 billion buyout of a fertilizer manufacturer), Nigeria (three notable bank deals totaling US\$421 million), and Ghana (an airport cargo company), to name just a few.

Many emerging market fund managers themselves are expanding their reach into other developing countries. Middle Eastern fund managers are capitalizing on the region's historic ties with Africa and South Asia. Brazilian funds are setting up shop in Mexico. South African funds are expanding their investment horizons north to the rest of sub-Saharan Africa.

Stronger Exit Environment

Clearly, part of what's driving continued investor interest is the continuation of strong performance in emerging markets. Average returns for emerging market PE funds have steadily improved over

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the last 5 years, now performing on par with their Western peers. As of June 2007, three-year net returns for EM funds were 31%, compared to 30% for US PE and 12% for the S&P 500.

Improved corporate governance, liquidity and valuations in local stock markets are creating new IPO opportunities for PE-backed companies. The hot public markets offer great opportunities for PE-backed companies to IPO at high valuations. The MSCI Emerging Markets Index gained 37% in 2007, versus 3.5% for the S&P 500. 2007 saw the increasing use of domestic stock markets as an attractive IPO route. Research by the Committee on Capital Markets Regulation that shows none of the 20 largest global IPOs in 2007 were done in the US.

Adding to the attraction of local IPOs is the improved liquidity in local stock markets, such as the Novo Mercado in Brazil, and the A share market in China. Although things have since cooled, the Shanghai Composite Index was up nearly 100% as of mid-September 2007, following on a doubling of value in 2006. Brazil's Bovespa has moved into 10th place among global markets, with free float market capitalization of US\$509 billion.

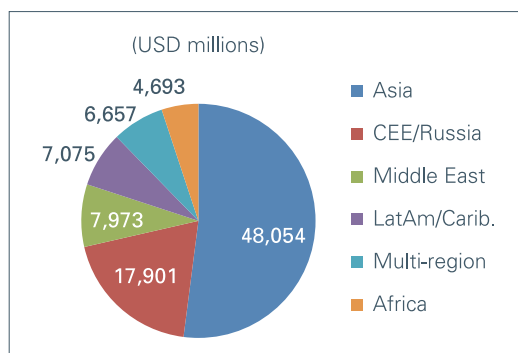
In addition, many PE-backed emerging market companies continue to successfully IPO on developed market exchanges. Consulting firm Richlink International Capital reckons that 99 mainland Chinese companies launched offshore IPOs in 2007, versus 70 in 2005.

No Overhang in Sight

Emerging Asia continues to draw the lion's share of attention and capital, with roughly 49% of the capital raised in 2007, compared with 58% in 2006. Adjusting for two very large Central and Eastern Europe funds—the US\$7 billion Marfin fund, and the US\$2.1 billion MidEuropa fund—Asia's share of the total remained constant in 2007 at 57%.

Investors are understandably wondering whether there is sufficient deal flow to absorb the recent flood of capital to a select few markets, particularly deals of the US\$100 million+ size, i.e., the target of the largest funds. As of December 2007, 190 of the approximately 370 emerging markets funds in the market were focused on emerging Asia, 117 of these on China and India. Additionally, valuations are on

Exhibit 2: EM PE Funds Raised by Region, Share of Total, 2006-2007



EM PE funds by Region, 2006-2007

USD millions	2006	2007
Asia	19,386	28,668
CEE/Russia	3,272	14,629
Middle East	2,946	5,027
LatAm/Carib.	2,656	4,419
Multi-region	2,580	4,077
Africa	2,353	2,340
TOTAL	33,193	59,161

the rise in some markets, particularly India and China, and competition for deals has intensified.

Headlines in early 2008 have been rife with news of a deal slowdown, primarily concentrated in very large leveraged deals in developed markets. However, preliminary data in fact shows that investment volumes in emerging markets continued to increase in 2007, suggesting less overhang in these markets than one might think.

2008 Outlook: Credit Crunch Fallout

The impact of the credit crunch on the US private equity market has yet to be felt in a major way in most emerging markets, and in some ways might be a boon for these funds. Most private equity deals in emerging markets are growth capital investments, and therefore use little leverage. When leverage is used, local banks not affected by the sub-prime crisis are beginning to provide

debt that was previously provided by Western banks, one notable example being KKR's acquisition of UN Ro-Ro, financed with debt provided by Turkish banks.

With the credit crunch lowering expected returns from Western public markets and US and Western Europe buyout funds in 2008, many institutional investors are looking to emerging markets for higher returns and diversification. Institutional investors appear to be putting more of their assets to work overseas generally, although most of these flows will be to public equities.

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Exhibit 3: Largest Emerging Markets Funds Raised in 2007

Fund Name	Region	Size (USDm)
Marfin PE Fund	Southeastern Europe	7,000
TPG Asia V	Asia	4,250
KKR Asian Fund LP	Asia	4,000
Affinity Asia Pacific Fund III	Asia	2,800
Mid Europa Fund III LP	CEE/Russia	2,100
Abraaj Infrastructure and Growth Capital Fund	MENA, South Asia	1,700
Morgan Stanley Private Equity Asia III LP	Asia	1,500
GP Capital Partners IV ("GPCP IV")	Latin America	1,300
Pamodzi Resources Fund (PRF)	Sub-Saharan Africa	1,300
Advent International LAPEF IV	Latin America	1,300
ChrysCapital V	India	1,250
SAIF Partners Fund III, LP	Asia	1,100

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Still, there is potential for some impact. Volatile emerging market stock markets could make exits more difficult and pressure returns downward, though this is balanced by potentially lower entry valuations. A US recession will clearly impact growth prospects for some—if not many—of the companies in fund manager portfolios.

The Public Side of PE

Another challenge for fund managers in emerging markets is to get in front of the debate about the value private equity brings to companies and countries. While recent public attacks on the industry have been most vociferous in developed markets, managers in developing countries should not be sanguine. Already, regulators and thought leaders in many countries are raising questions about private equity's employment impact, excess gains for foreigners, and transparency issues relating to taking public companies private.

Fund managers must begin now to track the impact of their investments on companies, to build a dataset and case studies demonstrating the value of the asset class. EMPEA is taking the initiative in this area by working with the development finance community to

provide development indicator tools for fund managers to track their investments' impact (see EMPEA's web site).

Markets Still Under-Penetrated

While 2007 was yet another banner year for the asset class, private equity in emerging markets is still in its infancy. Emerging markets represented roughly 11% of global PE funds raised in 2007, versus 48% of global GDP and 69% of global GDP growth. Capital raised for country-dedicated funds in Brazil and China represented only 0.17% and 0.05% of local stock market capitalization, respectively. Additionally, the concentration of investment in India and China leaves significant opportunities in other emerging PE markets, such as Turkey, Nigeria, Brazil and Mexico.

Nevertheless, private equity is becoming accepted as a legitimate financing tool in many emerging economies. Absent any major economic dislocation across these markets, we expect continued growth and penetration, providing critical financing options for growing companies. •

Exhibit 4: Sampling of Notable 2007 Private Equity Investments in Emerging Markets

Investor(s)	Date	Company	Country	Amount (USDm)	Sector	Notes
Abraaj Capital	Jun-07	Egyptian Fertilizers Group	Egypt	1,400	Fertilizer manufacturing	Largest PE transaction to date in MENA
AIG Capital	Aug-07	Bulgaria Telecom	Bulgaria	1,500	Telecommunications	Largest PE transaction to date in Bulgaria
Bain Capital	Apr-07	Edgars Consolidated Stores	South Africa	3,500	Clothing retailer	Largest PE buyout to date in South Africa
Blackstone	Sep-07	China National BlueStar (subsidiary of China National Chemical Corp.)	China	600	Chemical production	First Blackstone deal in China since CIC purchase of \$3B stake in May 2007
Colony Capital	Jun-07	Colony Capital buys Tamoil (Libya)	Libya	5,400	Oil & gas	Largest foreign transaction to date in Libya
GP Investments	Aug-07	Pride International Latin American Land Drilling and E&P Services	Latin America	1,000	Oil & gas exploration	GP's first regional investment since raising \$1.3B fund targeting investments beyond Brazil
Helios Investment Partners	Nov-07	Equity Bank	Kenya	166	Bank	Largest private investment to date in Kenya
KKR	Oct-07	UN Ro-Ro Shipping	Turkey	1,300	Shipping	Largest buyout to date in Turkey (since eclipsed by BC Partners' US\$3.2B investment in Migros Turk)
Lion Capital	Aug-07	Nidan Soki	Russia	ND	Beverage company	First western-style LBO in Russia
Mid Europa Partners	Jun-07	Serbia Broadband	Serbia	81	Cable television company	First leveraged buy-out in Serbia
Pamodzi Investment Holdings	Dec-07	Harmony's Uranium	South Africa	252	Uranium production	New venture expected to produce 2% of global uranium supply
Permira	Oct-07	Galaxy Entertainment Group	Macau	840	Casino operator	
Temasek Holdings-led consortium	Dec-07	Bharti Infratel	India	1,000	Telecommunications	Largest Indian buyout in 2007
Texas Pacific Group, Northstar Pacific of Indonesia	Nov-07	PT Bank Tabungan Pensiunan Nasional	Indonesia	200	Bank	TPG's first deal in Indonesia
Vectis Capital, EMP Africa Fund II, AIG Global Emerging Markets Fund II, L.P.	Apr-07	Intercontinental Bank	Nigeria	161	Bank	Other recent PE investments in Nigerian banking sector: Actis in Diamond (\$134M), Ethos-led consortium in Oceanic (\$130M)