AMSA
Asset Management Study Association

The Growing Importance Of Emerging Markets In Today's Private Equity Environment

Private Equity Team – June 2023

Ali Abdelhady – Analyst
Aron Ujvary – Analyst
David Martinez – Analyst
Jules Battaglia – Analyst
Peter Jagos – Analyst

Andres Torres Rodriguez – Head of Private Equity

Table of Contents

Emerging Markets Report

Introduction

Emerging markets have gained significant importance over the past few decades in the investment world, mainly due to their rapidly growing economies offering unique characteristics and opportunities that make investing in these regions more attractive. Although higher returns can be achieved by investing in these markets, the risk associated with the investment is also higher than in developed parts of the world, since emerging markets are more vulnerable in terms of political stability, or infrastructure. However, private equity funds have been able to take advantage of the higher growth rate, and economic conditions of these emerging markets, for higher returns, than in more developed countries. In this report, we will explore the growing significance of emerging market private equity, while also explaining why private equity investments are projected to flourish in the coming years.

1.1 A General Overview of Emerging markets

The term emerging markets is used to describe the markets of rapidly developing economies. Although a lot of the countries that we call emerging economies differ, there are certain characteristics that differentiate such markets from developed ones which can make investing more attractive.

As a general remark, investing in emerging markets can be considered a higher risk-higher rewards type of endeavor. Although emerging markets differ from one another, there are certain traits that characterize them. Such markets have often reached the stage in development when they have unified currencies, as well as a stock market and established banking system.

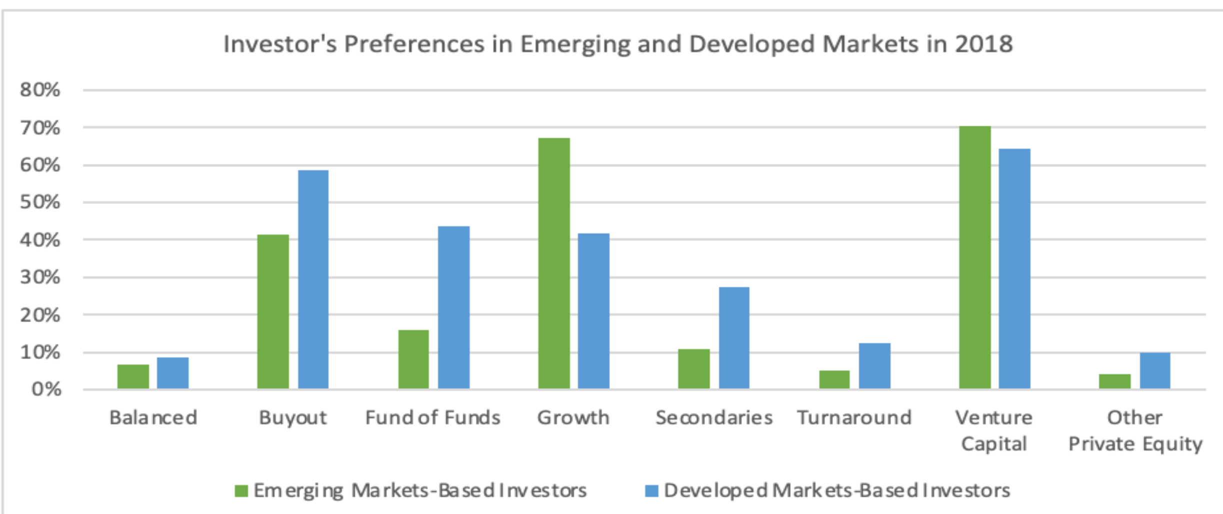
Emerging markets include China, India, and Brazil amongst many others. Although these economies might differ in certain merits, there are traits that they share which help us categorize such markets.

Even though there are no clear definitions to emerging economies, it can be said that emerging markets are in a stage between a developing and developed market. This pertains to their efficiency, the types of prevalent investments and regulations. (Corporate Finance Institute, 2022)

1.2 Main differences in investment trends

As developed and emerging markets offer different climates to investors, the types of investments also tend to vary. As a general trend we can see that the increased growth opportunities in emerging markets are attractive to investors, even more so than in developed markets. Secondaries, however, are preferred in the latter. This reflects the general differences between emerging and developed markets. (Preqin, 2018) There are certain forces present in emerging markets that influence returns. When we look at the data of the International Finance Corporation (IFC), which is a branch of the World Bank dealing with the private sector, we can see that high returns can be achieved in economies in which there are barriers to investing. The relaxation of capital controls and the improvement of the banking system both have a negative effect on returns. It can also be concluded that macroeconomic factors such as growth potential of the economy can outweigh adverse effects such as political instability and lacking infrastructure. (World Bank Blogs, 2018)

Figure 1.1.2.1 Investors Preferences in Emerging and Developed Markets in 2018



Source: Preqin, 2018

1.3 Risks of investments in emerging markets

As a general trend, emerging markets tend to the standards of developed markets, and their governments generally pursue rapid industrialization. This high-paced growth allows for higher returns than in some well-established markets. Although rapid growth can yield higher and faster returns, there are certain adverse factors associated with emerging markets that can offset these gains.

Risk factors of emerging markets can vary but can mostly be associated with the fact that these economies, although catching up, are still in the process of development which bears some systematic risks. Some of these are political instability and infrastructural issues which vary from country to country but are still crucial to ensure the efficiency of markets. There are also economic adverse effects that are common traits of emerging markets. The fluctuation of the market's domestic currency can largely affect returns on investments. A highly volatile domestic currency adds an additional risk factor. The level of development in an economy can be a source of excess risk as well. Lack of liquidity and difficulty raising sufficient capital are two common byproducts of underdeveloped markets. A low rate of privately owned companies and the lack of market efficiency can also make emerging markets a less attractive option for investors. Furthermore, high rates of poverty and social inequality can also hinder a firm's ability to retain talent and operate successfully. There are also environmental risks involved, since the lack of regulations can cause high levels of environmental damage and externalities to arise. (Henisz & Zelner, 2005)

1.4 Performance of Emerging Markets

Although investing in emerging markets can be a lucrative business, it begs the question how such a market performs on a large scale. In 2019, MSCI, an American finance company that works with portfolio analysis and market indices, compared the return of several stock market indices with different components to determine and compare their respective returns. The index for emerging markets took funds from 24 emerging economies and covered around 85% of the market capitalization in the respective countries. Compared to an index, however, that aside from emerging markets also included funds from developed economies, the Emerging Markets index yielded systematically lower returns. (MSCI, 2019)

Cambridge Associates also published a study on the matter in 2020, which compared portfolios of emerging and developed markets. (Cambridge Associates 2020)

That study also arrived at the conclusion that emerging markets lagged behind developed ones in performance.

2. Reasons for growing importance

Having played an integral role in developed markets for decades, the importance of private equity funds to economies cannot be overlooked, controlling vast business, real estate and other investment portfolios, private equity funds have used the economic stability and preferable economic conditions in developed countries to their advantage for many years, but what makes emerging markets so valuable?

The rapid growth rates and unstable economic conditions in emerging markets allow for private equity funds to exploit these markets for higher returns than developed economies, being able to use the growth rate and economic conditions to their advantage, building preferable deals with governments, and being able to reel in steals in which could provide the firm with returns that would be impossible to happen in developed economies

Below we analyze the growing importance of emerging market private equity over the past years and why private equity activity in emerging markets will continue to prosper in the future.

2.1 Structural change in types of investments

In developed economies, most private equity funds are known for holding vast portfolios constructed of diversified investments in many areas, owning businesses in all areas of the economy. They finance their deals using debt and equity, regularly using leverage to put down a lower amount of equity upfront in the businesses (hence the name leveraged Buyout or LBO), they then streamline operations and restructure the business, turning it around from a struggling company, to a cash cow, then selling the business for a profit. The regular timeline for these LBO deals is usually 5-7 years from when the private equity fund buys the business, to their exit.

What is explained above is the basic outline of LBO deals that occur in developed economies. However, in practicality, the differences between running private equity funds in emerging economies and developed economies go deeper. Fund structure in developed economies is usually a limited partnership agreement between the general partner (firm) and the limited partners (investors), while in emerging economies it varies, however some countries, such as China have come up with similar legal structures for funds to run like limited partnerships.

The deal volume in emerging economies is usually considerably lower, making the number of potential investments lower for emerging market funds.
Valuation is also an issue that is regularly encountered, as due to the strict bookkeeping laws in developed economies, it is incredibly easy to run valuations using company information that is always kept up-to-date. However, due to the hectic nature of accounting laws usually found in emerging economies, it is much harder to value businesses due to the fact that it is much harder to find accurate and reliable information on the firms.

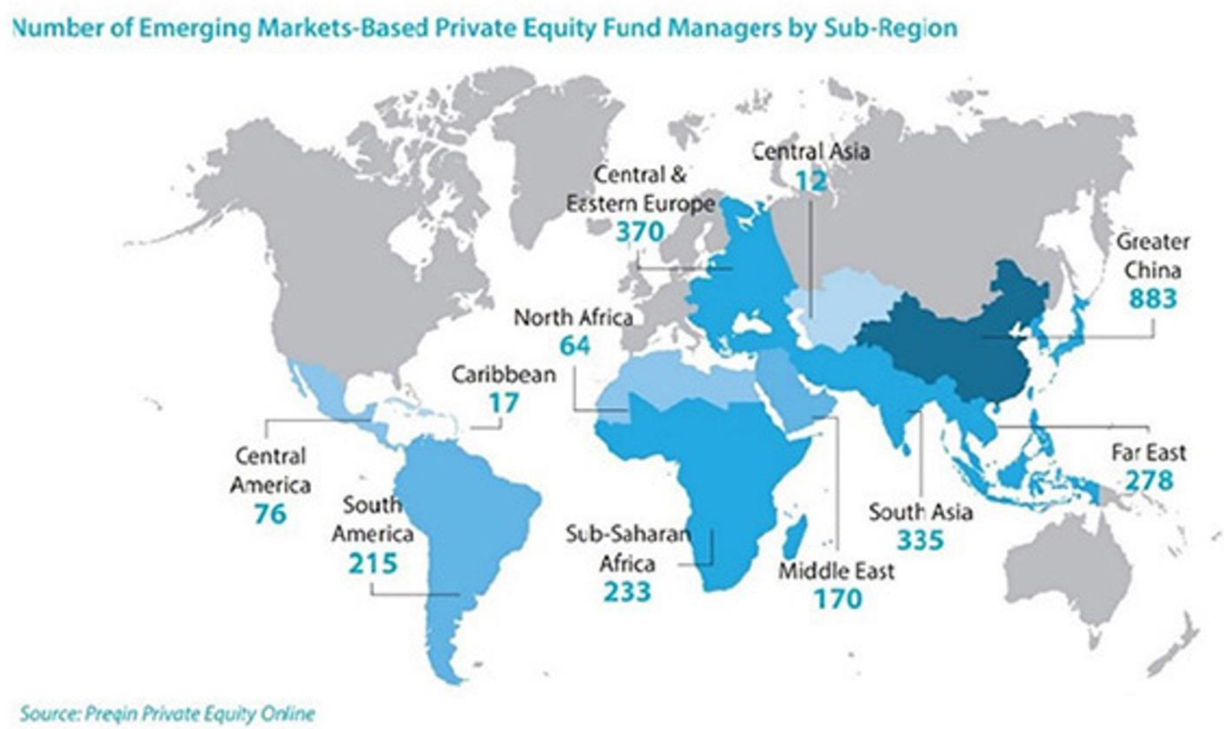
Regulation is also lack-luster to a degree in emerging economies, making contracts and agreements less strict and not giving as much rights or safety to the private equity investor due to the lack of regulation found in the country.

Finally one of the biggest differentiating factors between developed and developing economies is the exit strategies for the private equity funds. In developed markets, the most popular entry-exit strategy would be to enter at funding rounds C or D, exiting after at IPO as you then have the most potential for profits. In emerging economies however, IPO's are almost nonexistent, making the fund's only exit opportunity be to sell the business to potential buyers. This takes considerably more time and effort for the fund as you then have to search and assess all potential buyers for the business you are selling.

The investment types also differ between emerging and developed economies, with emerging economy private equity investments usually being centered around several sectors, some being; Infrastructure, emerging economies regularly need to update infrastructure in their country and having a company that is backed by foreign investment can make a difference as it provides certainty to the government of the emerging economy building the infrastructure. Another common investment is in the privatization industry of previously publicly owned companies. Due to emerging economies regularly being under monetary pressure, it often happens that in a crunch when the government needs a large sum of money, they offer a publicly owned business for privatization. This venture is usually extremely lucrative to the PE fund and provides large cash flow on the short and long run for the fund.

2.2 Analysis Of Market Potential by Region

Below is an infographic showing the number of private equity funds in emerging markets grouped by region.

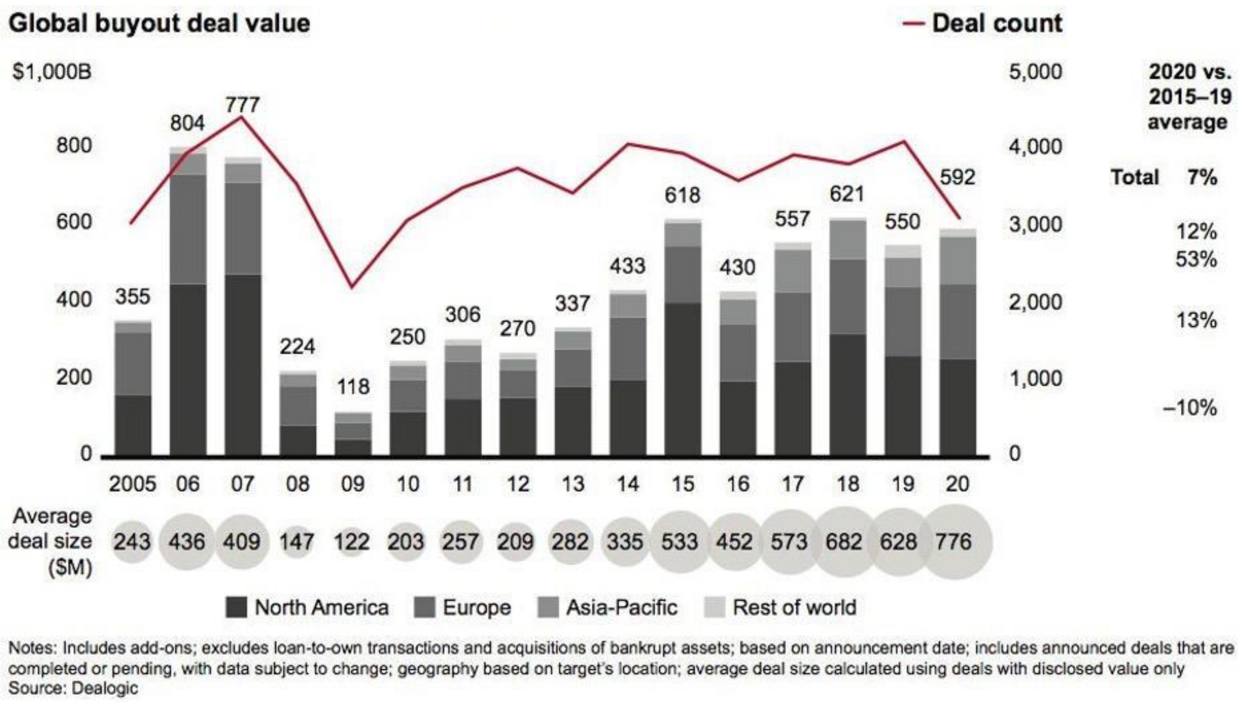


With emerging markets making up around 12% of capital raised and growing, this infographic shows us the current state of PE in emerging markets, with Greater China and Central and Eastern Europe taking the lead with 883 and 370 funds respectfully, while the list is bottomed by the Caribbean and Central Asia at 17 and 12 funds. Compared to the US, which alone has around 4,500 to 5000 funds, the private equity fund numbers in the rest of the world are relatively small, however, the US private equity market is near saturated, filled with dinosaurs of the private equity world, whilst these emerging economies hold a mere fraction of the number of the funds in the US, proving to have immense growth potential for running a PE fund.

Fig. 3.1: Emerging Markets that Will Present the Best Opportunities for Private Equity in 2021: Investors vs. Fund Managers

The chart above analyzes a survey done in which people determined what markets had the highest future potential, with a market such as China getting as much as a 55% response rate. This shows us the confidence people have in the emerging market private equity sector and will allow PE funds to become more confident whilst investing in the huge opportunity offered in emerging markets.

2.3 Assessment of buyout deals by region



The infographic above shows us the global private equity deal buyouts divided by region. We can see that the graph is dominated by the North American market as well as a large part going to the European market. The Asia-Pacific and Rest of World markets played a relatively small and stable role from 2005 to 2013/14, when their contribution to the buyout deal size started growing, which can be seen on the bar chart by seeing the Asia-Pacific and Rest of world markets take up a larger proportion of the global buyout deal value.

3. Driving factors behind high returns

It has been determined that for LBOs, returns are on average higher for developed economies. However, the returns of LBOs during a period of high economic growth is higher for emerging economies relative to developed economies Lloyd Blenman and Nischala Reddy (2014). This is because, during periods of high economic growth in both developed and emerging markets, the growth rate for emerging markets tends to be higher. On the opposite end of the spectrum, if the growth rate of the economy is moderate or slow, then the returns of LBOs in developing economies do not compensate for the risks inherent in investing in them. For GDP Growth, within the GDP brackets of, GDP between 0%-2%, GDP between 2% and 5% and then GDP over 5%, the observation is that if the GDP growth rate is less than zero percent at the time of exit, then the effect of LBO returns is negatively impacted, and improves as the GDP growth rate increases. Therefore, if the GDP growth rate is greater than 5% at the time of exit, then the impact of LBO returns is substantially high. Now for emerging markets these outcomes of GDP growth rate to LBO returns hold a larger range of returns between the less than 0% and more than the 5% bracket. This supports the statement 'if the economy is booming then returns in developing countries are higher and in periods of low economic growth, returns in developed nations are higher'.

Reputation between various Private Equity firms has been determined as a factor that influences the average returns of LBOs. Firstly, this is due to the respective Private Equity firm containing more leverage in terms of negotiation when it comes to the initial prices of LBOs. This reputation then translates to the improved loan terms that the Private Equity firm would inherit to facilitate the transaction. Now, since LBOs are highly leveraged, the lower costs that the reputed firm has received can produce more substantial results in terms of returns. 'LBOs that are associated with reputable Private Equity firms exit sooner due to the experience of the reputed Private Equity firms' Lloyd Blenman and Nischala Reddy (2014). Now, Stromberg (2008) determined that the LBOs under more experienced Private Equity partnerships tend to stay in LBO ownership for a shorter duration of time. As a result, are more likely to then go public and not reach a point of financial distress or bankruptcy. Through Lloyd Blenman and Nischala Reddy (2014) regression results, it has been shown that reputation has a positive coefficient. These results show that if the firm is reputable then the value of the deal is higher by $400 - $450 million.

Another factor that influences returns is whether the Private Equity firm and the target firm are derived from the same industry, then the value of the LBO deals is higher. This is because LBOs between firms in the same industry tend to have a higher performance due to more knowledge in the field and economies of scale in the combined business Lloyd Blenman and Nischala Reddy (2014).

Through the finding of Lopez-de-Silanes, Phalippou and Gottschalg (2010), it has been determined that there is a significant correlation between returns of the LBO and the duration it takes to exit. The faster exits (investments held for less than 2 years have high IRR (85%)) and the investments that are held for more than 6 years have IRR of 8%. Now through the regression results from Lloyd Blenman and Nischala Reddy (2014) have concluded that a lower quantity of days to exit is associated with higher returns of LBOs. The regression results conclude that faster exits result in higher returns of about 7% on average.

‘Club transactions’ which are transactions that include a syndicate of Private Equity firms have been determined to reduce the prices paid to the target firm for the initial LBO transaction, this is due to a reduction in competitiveness since the nature of the ‘Club transaction’ involves a syndicate of Private Equity firms, which alternatively would have more separate parties competing for a acquisition of the target firm, leading to more propositions as there are more active competitors. Officer, Ozbas and Sensoy (2010). Now in terms of the returns upon exit of the LBO between the ‘club transaction’ and non-club transaction Lloyd Blenman and Nischala Reddy (2014) analysis has determined that club transactions do in fact result in higher returns upon exit and exit sooner, which is the case only in developed markets.

A considerable factor that is able to have an influence on returns of the leverage buyout transaction is the sizing of the target firm. Demiroglu and James (2010) and Lopez-De-Silanes, Phalippou and Gottschalg (2010), have found that smaller investments tend to outperform the large ones. This is due to the matter that there are more exit options for a smaller target firm than a larger one. Now in terms of exiting, a public offering is deemed as the most lengthy due to its respective complexity and the surrounding regulations that need to be met prior to exit. Other methods that take a long duration are the strategic sale and bankruptcy methods, the shortest exit falls in the secondary LBO method.

Geopolitical risks within an emerging market could have a detrimental effect on the expected returns, which involves the investment from the Private Equity Firm. Geopolitical risks can create a large amount of uncertainty from foreign investors, which can undoubtedly lead to a change in capital flows. Where an increase in capital flows between developed markets can occur while simultaneously the capital flows to emerging markets shall reduce. Some of the events that could lead to major uncertainty in emerging markets are political elections, sudden nationalization, civil unrest, etc.

Detrimental outcomes on returns due to Geopolitical risks include some of the following:

- The lost investment thus far without compensation - which tends to occur when a structural change occurs within the government during the investment timeline. Concisely speaking, it is a form of nationalization.

- Forced project abandonment – an example of this could be politically motivated violence within the vicinity of the business operations. Or the occurrence of a natural disaster, such as the 7.4 magnitude earthquake in north-eastern Japan that caused the temporary closure of the Chip-manufacturer Renesas. These are Geopolitical examples that point towards a safety threat forcing the abandonment of projects.

- Longer exit times – due to government effectiveness and rule of law.

Following on to the next factor that has an influence on returns, is the respective company performance of Environmental, social, and governance matters (ESG). According to Schroder's analysis of a large number of studies into the 'influence of these issues on investment performance' within emerging markets, there is a strong correlation between investment performance and high respective ESG scores. The Schroders table below highlights the correlation between various markets and ESG analysis.

4. Leverage in Emerging Markets

As emerging markets have grown over the years, the corporate debt in these very markets has become more than just a trend. Emerging Market Debt (EMD) refers to bonds issued by Less Developed Countries, excluding government or supranational organization borrowing as well as private sources, although securitized loans issued to the markets would be part of it. While emerging markets have booming potentials, to sustain this growth, emerging market countries often need to borrow money to finance their investments in infrastructure, education, and technology. This borrowing is usually done by issuing bonds, taking loans from international financial institutions, or by issuing sovereign debt. Debt of non-financial firms across emerging markets have been seen to quadruple between 2004 and 2014, jumping from 4 trillion to 18 trillion in forms of traditional loans to new bond issuances. In 2021, Approximately 63.69 percent of the GDP was accounted for by the national debt of emerging market and developing economies in 2021. Debt in emerging markets has become a tool enabling access to increased liquidity and higher growth returns, an attractive point for investors interested in the booming growth of developed countries. Firms in emerging markets are seeing greater incentives and opportunities to increase leverage.

The use of leverage has grown impressively in emerging Asia, Europe, Middle East and Latin America, especially in China, due to interconnected factors of financial conditions, capital flows and real estate price developments. It is important to note that these key drivers are positively associated with favorable global and country specific conditions.

Global financial conditions can impact borrowing costs in emerging markets. One way that global financial conditions can impact leverage activity in emerging markets is through changes in interest rates. When interest rates are low in developed countries, investors may seek higher returns by investing in emerging markets. This can lead to increased borrowing activity in emerging markets as governments and companies seek to finance their investments. However, if global interest rates rise, borrowing costs can increase for emerging market countries, making it more difficult for them to borrow and potentially leading to a reduction in leverage activity. In addition, changes in global interest rates can impact exchange rates, which can further impact borrowing costs for emerging market countries. Global financial conditions can impact leverage activity in emerging markets through changes in the availability of credit. When credit is readily available in the global financial system, emerging market countries may be more able to borrow money to finance their investments. However, if credit conditions tighten, it can become more difficult for emerging market countries to access credit, potentially leading to a reduction in leverage activity. Global financial conditions are a significant factor in the activity of leverage use in emerging markets, therefore it is important for policymakers and investors to carefully monitor global financial conditions and their impact on emerging markets to ensure sustainable economic growth and financial stability.

Another important factor in the use of leverage through emerging markets are the country-specific financial conditions. Emerging markets typically have less developed financial markets and institutions, which can create greater risks for investors and borrowers. In these markets, the availability and cost of credit are heavily influenced by country-specific factors such as macroeconomic conditions, government policies, and the quality of financial institutions. If a country's financial institutions are weak or unstable, investors may be reluctant to lend money or invest in the country, which can further limit the availability of credit. This can create a vicious cycle where a lack of access to credit leads to slower economic growth, which in turn makes it harder to attract investment and credit. In contrast, if a country has a stable financial system and low interest rates, investors may be more willing to lend and borrow, which can encourage greater use of leverage. This can help to stimulate economic growth and promote investment in the country. Overall, country-specific financial conditions play a crucial role in determining the use of leverage in emerging markets. Investors and borrowers must carefully consider these factors when making decisions about whether or not to take on debt, and how much leverage to use.

In recent years, there has been a noticeable shift towards bonds in the emerging markets leverage activity. Emerging market economies have traditionally relied on bank loans to finance their growth and development, but this trend is changing as bond markets become more developed and attractive to investors.

One of the primary drivers of this shift towards bonds is the low interest rate environment that has persisted in developed markets. This has encouraged investors to seek higher yields in emerging markets, which in turn has led to a surge in bond issuance by emerging market countries and companies. As a result, the size of the emerging market bond market has grown significantly in recent years, with many countries and companies now able to raise funds through bond issuance.

Another factor driving the shift towards bonds is the increasing regulatory scrutiny of bank lending activities. In many emerging market economies, banks are highly concentrated and tend to be dominated by a few large players. This can limit access to credit for smaller businesses and individuals, and can also increase the risks associated with lending activities. As a result, regulators are increasingly encouraging the development of bond markets as an alternative source of financing.

Moreover, bond markets offer several advantages over bank lending for emerging market borrowers. Bond issuers are able to access a wider pool of investors, which can lead to lower borrowing costs and greater flexibility in terms of funding sources. Additionally, bond issuers are typically able to structure their debt in a more flexible manner, with longer maturities and lower amortization requirements than bank loans.
Overall, the shift towards bonds in emerging markets leverage activity represents a significant development for these economies. As bond markets continue to grow and mature, they will offer a valuable alternative to bank lending, promoting greater financial stability and providing more diverse funding sources for both countries and corporations in emerging markets.

In conclusion, the shift towards bonds in emerging markets leverage activity reflects a growing maturity of these economies and their financial systems. While bank lending will continue to play an important role in financing growth and development in these markets, the increasing availability of bond financing offers a valuable alternative for borrowers and investors alike. As emerging market bond markets continue to grow and develop, they have the potential to become a significant source of funding for both public and private sector entities, promoting greater financial stability and contributing to the long-term growth and prosperity of these economies.

Conclusion

In conclusion, emerging markets have established unified currencies, stock markets, and banking systems. Investing in these emerging markets can be considered high risk-high reward, as these markets differ from developed markets and offer different investment climates. Emerging markets tend to attract investors due to their increased growth potential, even more so than in developed markets.

However, investing in emerging markets comes with certain risks such as political instability, infrastructural issues, currency fluctuations, lack of liquidity, and environmental risks. While investing in emerging markets can be lucrative, the performance of emerging markets tends to underperform developed markets. Private equity funds have also seen a growing importance in emerging markets due to rapid growth rates and unstable economic conditions that allow for higher returns. The high return potential in emerging markets is mainly due to elevated yields, which provide a cushion for investors against potential future volatility. Emerging markets central banks began tightening monetary policy earlier than the Fed, which helped them weather some of the storm in global yields in 2022. While emerging markets have largely relied on China's economy, there is a growing need to diversify supply chains away from China to reduce dependency. Geopolitical risks pose a threat to expected returns, and these risks can lead to a change in capital flows.

In the future, private equity activity in emerging markets is expected to continue to prosper due to structural changes in the types of investments made and the increased focus on ESG factors.

Bibliography:

Cambridge Associates. (2020). Selected Developments in Emerging Markets and Developed Markets ex-U.S. Retrieved from https://www.cambridgeassociates.com/wp-content/uploads/2020/07/WEB-2020-Q1-ExUS-Dev-EM-Selected-Book.pdf

Corporate Finance Institute. "Emerging Markets: Definition, Characteristics, and Examples." Corporate Finance Institute, https://corporatefinanceinstitute.com/resources/economics/emerging-markets/. Accessed 15 March 2023.

MSCI. (2019). Global Investing Trends in 2019. Retrieved from https://www.msci.com/documents/10199/c0db0a48-01f2-4ba9-ad01-226fd5678111

Preqin. (2018). Private Equity in Emerging Markets May 2018 [PDF file]. Retrieved from https://docs.preqin.com/reports/Preqin-Special-Report-Private-Equity-in-Emerging-Markets-May-2018.pdf

World Bank Blogs. (2018, April 4). How to Win with Private Equity in Emerging Market and Developing Economies. https://blogs.worldbank.org/allaboutfinance/how-win-private-equity-emerging-market-and-developing-economies

Zelner, B. A., & Henisz, W. J. (2005). The hidden risks in emerging markets. Harvard Business School Strategy Unit Working Paper, (06-056). Available at: https://www.researchgate.net/profile/Bennet-Zelner/publication/228882032_The_hidden_risks_in_emerging_markets/links/544eaa4d0cf26dda089018da/The-hidden-risks-in-emerging-markets.pdf

Leverage Buyouts: Evidence from Emerging and Developed Markets Deals. Available at: https://www.researchgate.net/publication/269576795_Leverage_Buyouts_Evidence_from_Emerging_and_Developed_Markets_Deals https://www.schroders.com/bg/insights/economics/five-charts-that-explain-the-case-for-emerging-markets/

https://www.morganstanley.com/im/publication/insights/articles/article_emergingmarketssteppingintothespotlight_us.pdf?1679056749237