What is it that makes us think these factors are important?

Private equity is a very local business

Access to deal flow, particularly truly proprietary deal flow, requires local contacts. Due diligence requires knowledge of the reputation of sellers (particularly in minority positions) and of local quirks in governance and transparency. Building teams in fast growing companies requires access to talented local management and the ability to win their confidence to leave stable, prestigious jobs. Capacity in each of these areas is enhanced if the GP's team is both locally based and has senior local nationals. Even something as basic as efficient communication requires mutual respect and understanding that is greatly facilitated by local presence, which can take the form of either a dedicated local operation, a partnership between a foreign GP and a local firm, or a local branch of a foreign GP.

PE investors in EMs must know how to pull the primary lever for EM returns—growth

There is very little leverage in most EM PE transactions. A survey of IFC-invested funds shows average portfolio company debt-to-equity ratios of 0.74 (median 0.33), indicating that financial structuring skill is not a big driver of returns. Most return comes from top line growth and efficiency improvements. The same survey also shows average revenue growth of 37.8% (median 19.5%), strengthening the case that the ability to help companies grow, become more efficient, and manage the risks of growth is key. This is important because, the way in which returns are made dictate which skills are needed in the GP team. As Figure 3 shows, if return is growth-focused, operational experience — as a senior manager, entrepreneur or consultant — is the most relevant prior experience.

Figure 3: GP Experience – Required Skills Depend on Model

Return Driver	Source of Profile	Skill Required
Arbitrage	Pricing multiple differential between private market and public/M&A markets	Investment or Merchant Banking Consultancy
Leverage	Leverage a company with stable earnings	Investment Banking
Earnings growth	Increase earnings through expansion or acquisition	Corporate Operations, Entrepreneurial, Consulting
Margin expansion	Increased profits via improved efficiency or shifting product to higher margin niche	Corporate Operations, Entrepreneurial, Consulting
Improved transparency and governance	Earnings attract a higher price, as buyers feel more informed and protected	Corporate Operations, Entrepreneurial, Consulting
Multiple expansion due to growth or profits	Earnings of company attract higher price/ earnings multiple	Private Equity—acquire based on what you can sell

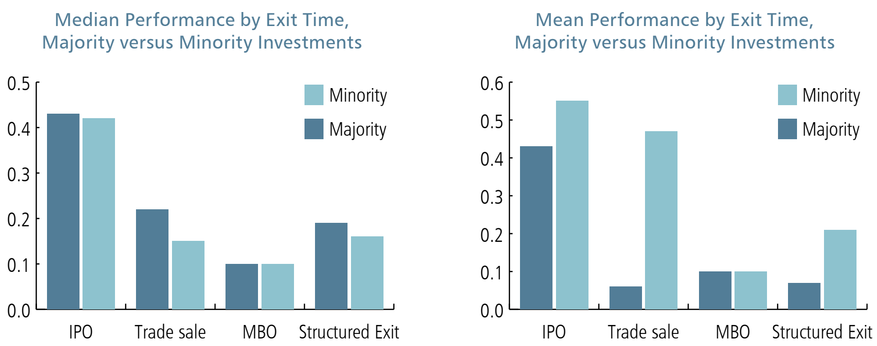
The ability of GPs to bring value-added skills to bear is made even more important in EMs by the prevalence of minority positions. While the fund will have elements of control and influence through a shareholders agreement, timely enforcement is usually very difficult. A successful relationship between the fund and the investee company depends much more on personal relationships than contractual terms. In particular, minority positions are successful when the GP is viewed as a valued partner by the majority owner. A valued partner is someone who has brought ideas to the table; actively helped the majority solve problems; stepped up in times of difficulty: these things are more than just attending board meetings and come more naturally to people with experience in operating companies than to finance people.

In good times, the benefit of being seen as a contributing partner is the majority's willingness to fully share the up-side on a successful transaction. We have seen cases where companies are unwilling to fully share the up-side with passive minority shareholders who 'had not done any of the work'. A resentful investee is often in position to manipulate accounts to deliver an enhanced-debt-like return to the minority on a structured exit. In bad times, the trust intrinsic to an active partnership enables transparency, discussion and mutual agreement on solutions. Without this trust, we have seen cases of investee managers re-reading the shareholders agreement and panicking at some of the actions available to the minority, leading to unilateral actions very damaging to the minority position.

Overall, the experience of funds in which IFC has invested with minority positions has been positive (see Figure 4) and we attribute this to the IFC-invested GPs being viewed as real partners thanks to their tangible value adding activities.

Figure 4: Comparative performance by Exit Type, Majority versus Minority Investments

Partnership has led to good performance from minority positions in all forms of exit, indicating that the risks associated with minority positions can be managed effectively.



Sample of 61 majority positions and 251 minority positions from IFC invested funds

Sample of 61 majority positions and 251 minority positions from IFC invested funds.

Characteristics of Successful GPs in Emerging Markets

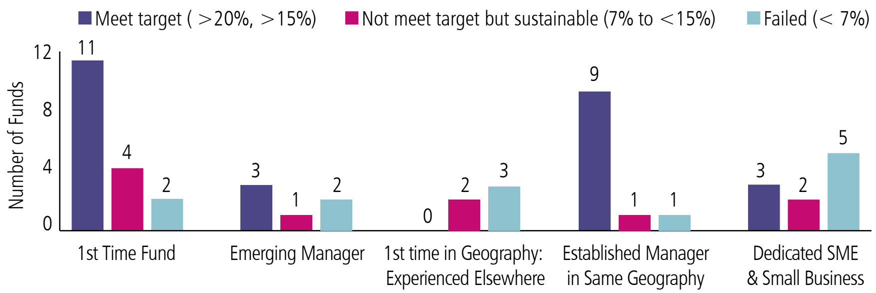
BY DAVID WILTON, INTERNATIONAL FINANCE CORPORATION

Investor interest in emerging markets (EM) private equity (PE) is on the rise. For many investors, however, concerns over a range of issues—perhaps most importantly lack of information, particularly on performance—may prevent them from actually committing capital.

IFC reorganized the way it invested in funds in 2000, creating a department dedicated to fund investing. From January 2000 until December 2009, the return on IFC's private equity funds (excluding real estate, debt and listed equity funds) was 18.1%, compared to the top quartiles of Cambridge Indices over the same period of: Emerging Markets 16.2%, Asia ex-Japan 14.5% and US 14.1%. This is a significant improvement on the 4-5% return on IFC's 1990's funds and the 1990's top quartile of 11.9%.

Figure 1 compares results with expectations at the time of investment for mature funds invested since 2000. Two points stand out: (i) the success rate with first time funds has been higher than expected, and (ii) track record is not automatically portable between different geographies.

Figure 1: Comparative Performance by GP Experience Level



Note: First Time funds are new teams raising their first fund; Emerging Managers are teams on their second fund lacking a full exit track record; First Time in Geography are established US or European funds moving into the country/region for the first time; Established Managers are those on fund 3 or more in the same geography; and Dedicated SME & Small Business are funds expected to have lower returns in the 7-15% range, typically due to focusing on a less remunerative market segment such as small business (other funds are expected to return 20%). Data is pre-crisis 2008.

The Impact of Certain Risks taken by IFC as a Development Institution

In its development role IFC backs a majority of first time funds as well as funds in poorer countries, so it is reasonable to ask if these two higher risk activities influence performance. Figure 2 compares (i) the outcomes of the top 10% and bottom 10% of all mature private equity funds in the IFC portfolio as of March 2009 (a blend of pre- and post-January 2000 investments) and (ii) characteristics of funds in the two groups. Figure 2 illustrates the lack of negative differentiation in performance: first time funds were represented equally in the top and bottom 10% of funds in IFCs portfolio; and funds in IDA (countries with less than $1000 per capital annual income) are a greater percentage of top performing funds than bottom performing ones.

The differentiating factor between the top and bottom 10% of funds was the quality of the GP. Figure 2 measures this with an average deal score (in the final column). All funds were assigned a score between 0 and 1 depending on the extent to which they met criteria we consider important to successful private equity investing in emerging markets: was the GP locally based?; were a meaningful number of staff local nationals?; did the team possess experience that would enable them to add value to companies such as prior experience in running companies, as entrepreneurs or as consultants?; did someone in the team have prior experience in private equity? Funds in the top 10% overwhelmingly met these criteria while funds in the bottom 10% failed to meet them. Interestingly, the top 10% not only delivered superior financial returns but also performed significantly better in terms of development impact.

Figure 2:
IFC's experience is that the differentiating factor in fund quality is the manager's skill set, not first-time fund risk or a frontier focus

	IRR as of March 2009 (simple avg %)	Development Impact Score (1 to 3, 3 = Highly Successful)	First Time Funds %	IDA % (<$1000 GDP per capita)	Average Deal Quality Score (Max = 1, Min = 0)
Top 10%	46.6%	2.1	53%	27%	0.97
Bottom 10%	-38.3%	0.14	53%	13%	0.17

Sample of 150 funds in IFC portfolio (invested pre- and post-2000) as of March 2009, excluding those in the J-curve.

Why do we focus on local presence; local nationals as staff; value-addition capacity through past experience in running or advising companies; and private equity experience; as primary indicators of potential success?

The obvious answer, as backers of first time funds, is that in the absence of track record we are forced to identify other indicators and these are the indicators we have found most useful. Clearly a long and successful track record replete with exits would be even better as an indicator (with the usual caveats on team stability, motivation when fees become large at bigger fund sizes and the scalability of the investment model at larger investment sizes), but the entire asset class is still nascent and drawing new entrants, so we do not usually have the benefit of long track records.

Knowing how to identify and manage a path to exit takes experience

The task of the GP in bringing an investee to exit is to ensure the company is attractive to potential trade buyers or the IPO market: transparency, good governance, a certain scale or market share, certain profitability or growth levels, valuation levels. Experienced PE professionals know what sells, know how to develop (and agree with the majority) on plans and milestones that will move the company towards that exit window, and know how to work with company management to execute the plan and exit within the target time frame. This thought process – backward from exit to acquisition – comes naturally to experienced PE professionals but is not necessarily obvious to people from other backgrounds who may be more easily distracted by single pieces of the equation – 'its cheap!', 'the growth is fantastic!'. An experienced PE professional can weed out companies with limited exit prospects and focus on the most promising opportunities.

A limited window of opportunity: prospects for first time funds in more crowded markets

IFC's success investing in first time funds has been noted already. While we think part of this success is due to good selection criteria focused on the skills of the individuals in a team, a large part of it is also due to the under-penetrated nature of many emerging markets. IFC's experience backing many early-mover funds has shown that with less competition for deal flow, novice GPs have more time to spend on due diligence and understand companies, helping them to avoid mistakes of haste. As PE penetration in emerging markets rises we think the risk of backing new teams will also rise.