LIMITED PARTNER magazine

The institutional investor perspective on private equity, venture capital and infrastructure funds

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Q1 2013

IFC's David Wilton on making PE work in emerging markets

Fundraising outlook: The insiders' view

CalSTRS recalibrates following mega buyout boom

Canada's LPs pioneer fresh approach to new markets

LPs look to bypass funds in infrastructure space

Outlook critical as Swedish VCs fail to capitalise on local talent

Plus: LP perspectives from leading institutional investors including PKA, UTIMCO, WSIB and SCERS

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Introduction

Providing the insider outlook on institutional investor activity in the global private equity industry, our first issue of *Limited Partner* for 2013 features in-depth conversations with some of the most high-profile LPs in the business.

For our lead interview we speak to David Wilton, head of private equity at the world's largest emerging-markets investor, the IFC, as he identifies new growth regions and the differing approaches needed to successfully carry out fund investment in frontier markets.

Moving on from private equity's emerging regions, we also return to the traditional stronghold of North America's private equity scene, and speak to some of its most active institutional investors. From industry powerhouses such as CalSTRS, WSIB and Canada's Caisse de dépôt et placement du Québec – each committing billions of dollars a year – to smaller but no less significant limited partners such as Texas-based UTIMCO and Sacramento's SCERS, we look at how they are planning to tackle the industry in 2013 and beyond.

Moving to Europe, we also speak to Danish pension fund PKA following the recent launch of its dedicated private equity investment group – a significant move, and one that signals recognition as to the growing role the asset class has to play in its investment portfolio.

In other features, we get the inside track on the fundraising market for 2013, including some frank discussions with placement agents from Europe, Asia and the US. With capital still in short supply, we delve deeper into a much-changed fundraising process and what it takes to find success in today's marketplace.

We also speak to LPs about the growing trend for taking the direct route to infrastructure investment, and look closer at the contradiction at the heart of Sweden's struggling venture capital scene, where a history of innovation has so far failed to ignite early-stage investment activity.

As always, the issue also includes regional and sector-specific analysis, along with insight on the last quarter's most eye-catching fund activity. Do be sure to check in online at ***www.AltAssets.net*** for the latest industry updates, breaking news and analysis.

Benjamin Chambers
Editor

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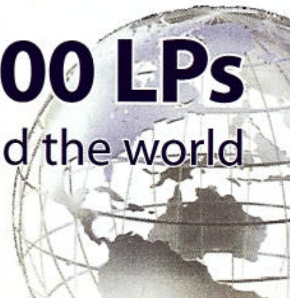

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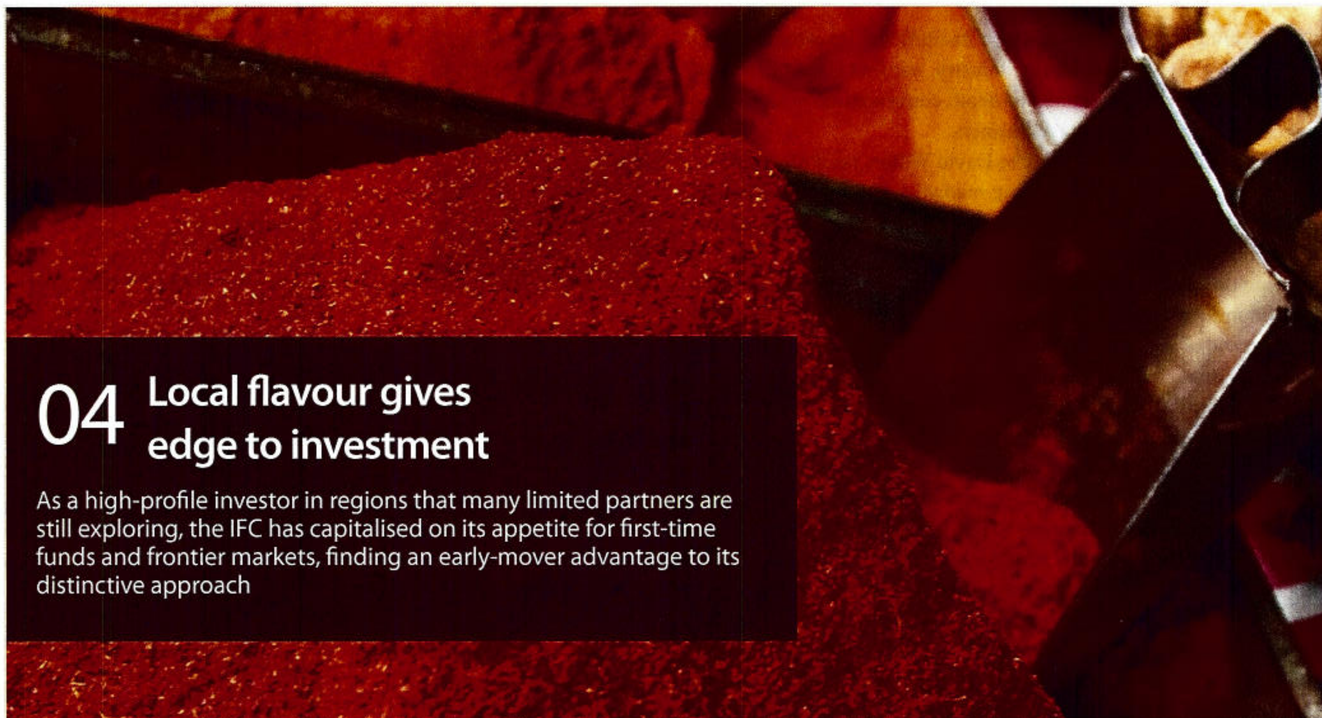

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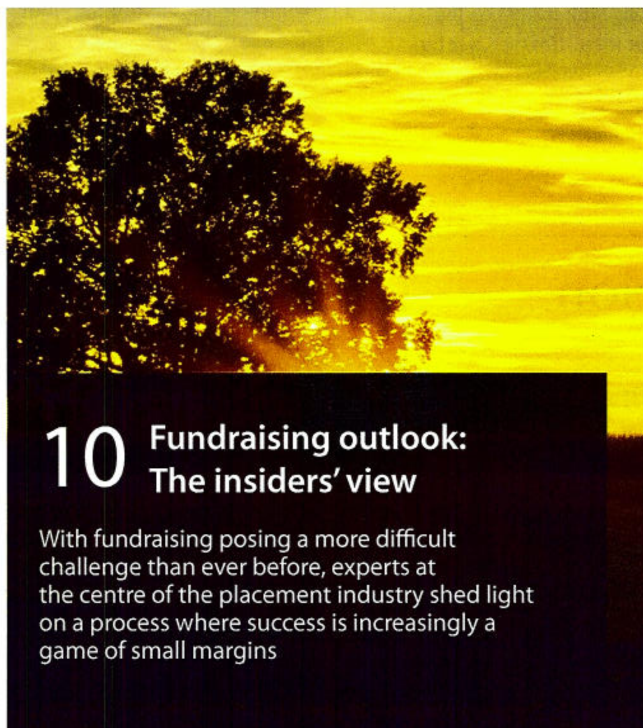
As a high-profile investor in regions that many limited partners are still exploring, the IFC has capitalised on its appetite for first-time funds and frontier markets, finding an early-mover advantage to its distinctive approach



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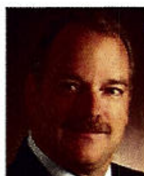

As a sizeable investor in private equity, WSIB likes to make its presence felt in the market, says CIO Gary Bruebaker

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Photo: Gaya M Gajewska

Local flavour gives edge to investment

As a high-profile investor in regions that many limited partners are still exploring, the IFC has capitalised on its appetite for first-time funds and frontier markets, finding an early-mover advantage to its distinctive approach

As the world's largest development finance institution, the International Finance Corporation (IFC) is one of the most active private equity investors in global emerging markets. And while its mandate dictates its activities in these up-and-coming regions, its focus on first-time funds and frontier countries differentiates it at a time when LPs of all kinds are keen to establish themselves in new markets.

The nature of the investments and markets that it focuses on also informs its approach when it comes to fund selection and analysis, says David Wilton, chief investment officer of the IFC's global private equity activities.

"Because of our mandate we are looking at over 50 per cent first-time funds. We do not have track records for due diligence, so we have got to understand how the money is made for us to work out what skill-sets to look for in these new teams.

"This is where understanding the markets and what drives returns in the markets is important. If you don't understand what will drive the returns in a market, you do not know what skills to look for in private equity teams."

Currently 75 per cent of IFC's activities is taken up with lending, with the remaining 25 per cent made up of investments - both in funds and direct. In 2011, it invested $12.2bn in 518 projects, with an additional $6.5bn going into the private sector.

Its fund investment activities have not always proved successful since being launched in the late 1980s, however. At the time it was seen as an ideal way of getting the skill, knowledge and equity to companies in emerging markets, according to Wilton. "Private equity in emerging markets is not an LBO business model, it is almost entirely growth equity. At the time we believed that if we found the managers with the right skill-sets, then companies would grow in a more stable way."

Nascent markets

However by the late nineties it became apparent that these funds were underperforming IFC's direct investments. He explains, "We created a dedicated funds department to look at the problem, pulling all the existing fund investments together – at the time around 120. We analysed the portfolio to try and work out what had gone wrong, and whether it was something the IFC should continue doing, or whether the markets were too nascent for this kind of approach."

The conclusion was that emerging markets fund investment remained a good business, but just needed to be carried out differently – particularly in markets that in hindsight had been too nascent for this kind of investment.

He adds, "We had looked at the growing demand for equity finance, and presumed that it must equate to good private equity opportunities – but it doesn't. There is no necessary link between the two. Private equity needs control or influence, and in the 1990s the demand was more for passive equity. We hadn't been doing the right analysis."

As a result, from 2000 it changed its approach, which has continued to this day. Wilton says, "We start off by looking at each new country where we are considering a fund, and ask what is driving deal-flow that is suitable for private equity – be it generation change, growth that can't be financed internally, conglomerates selling off non-core businesses, privatisation, distressed sellers, or simply hand-holding to support sustainable expansion."

Speed bumps

"Often fast-growing companies hit a lot of speed bumps and need help to be able to grow in a sustainable way. If there are enough of these factors, then we decide a dedicated country fund is viable and look to find a manager."

If there isn't deemed to be enough deal-flow, there is also the option to pull up to a sub-regional or regional level. And while back in 2000 it was only the BRICS and South Africa that arguably merited single-country funds, a regional approach did not always sit well with a strategy that depended on understanding businesses at ground level.

"The problem with doing that is that it can be a very local business and you do need teams that are embedded in the local business community and markets. If you pull up to regional level you lose some of that contact," he adds.

"This has changed an awful lot, and there are now 20 to 30 countries where you can do a dedicated country fund. As the deal-flow has grown over the years, the quality of the opportunity and the quality of the business has improved a lot. Once you have these teams embedded they get better deal-flow, they understand how to do due diligence better, they can identify problems and improvements and it is a much better proposition.

"The quality of the opportunity has improved and de-risked. Now it is a much higher-quality, lower-risk opportunity than it was back in 2000." ▶

The IFC is a member of the World Bank Group and is the largest development institution focused exclusively on the private sector.

Established in 1956, the IFC's work in more than a 100 developing countries allows companies and financial institutions in emerging markets to create jobs, generate tax revenues and improve corporate governance and environmental performance.

IFC Asset Management Company mobilises and manages funds on behalf of a wide variety of institutional investors—including sovereign funds, pension funds, and development finance institutions. It has approximately $4.1bn in assets under management.

> "If you don't understand what will drive the returns in a market, you do not know what skills to look for in private equity teams"

Market characteristics

External investors often find that new markets frequently display different approaches to making money, whether through top-line revenue growth, margin improvements, financial leverage or expansion through acquisitions.

Fund investments therefore take on a different complexion depending on the region in question, according to Wilton. "Emerging markets have very limited leverage, bar a few places such as South Africa, or at the larger deal sizes where some international banks can be found. Generally, there is not much leverage and it is all growth equity."

He adds, "In a market with a lot of leverage, a lot of returns will come from financial structuring, and in these markets investment bankers make fine private equity people. In markets where it is mostly growth equity, investment banking and structuring skills are not as relevant, and this is not what you want in a GP. We want people that have run companies, that have been entrepreneurs or have been consultants in that region and have the necessary operating skills.

"These skills provide the ability to add value and, importantly in countries where enforcement of a shareholders' agreement can be difficult, they can help the GP be viewed as a partner by the companies in their portfolio, so the relationship helps to enforce the agreement."

IFC steps up game in changing Asian markets

Investment strategies can vary from country to country – particularly with those exceptions, or "oddities" as Wilton calls them, where the local public market is very active and it has historically been easy to list.

While regions such as Africa have a culture of growth equity and teams with good operating skills, identifying capable managers in some Asian countries can often prove a more challenging task – having historically relied on momentum strategies in sympathetic share markets.

Wilton says, "India, Vietnam and China have had their private markets distorted in different ways by the listed markets.

"In Vietnam, for example, pre-crisis there were about 65 private equity funds. Looking closer, maybe three were actually recognisable as genuine private equity, the rest were just guys playing the valuation-multiple game. The government was corporatising state-owned enterprises, listing them on the OTC market and then taking them to the listed market. Each step in that you got a pop in the valuation multiple, so if you got in early, there was a nice conveyor belt you could ride."

Although it was labelled private equity and the companies were technically private, it was not how you would view it traditionally. Wilton adds, "The focus is on passively getting a valuation multiple pop, and that game ended very suddenly when the share market went. Then the only people left standing were the ones who were actually doing real private equity."

He says, "There is a similar thing going on in India, and many of these funds are just doing a lot of PIPE deals.

"Regardless of what they said, much of their strategy relied on the public market momentum. The people that ran them were mainly investment bankers and very few of them had any operating ability – I can think of two that had real value-added operating skills. Consequently we didn't do much in India. We like guys that have that skill-set to do growth equity.

"After the share market declined significantly that strategy was clearly not viable and the type of managers coming to market now are very different to what we saw before the crisis. Now, there are teams with a lot of operating capacity, as you can't play a nice easy game of momentum – you need to roll up your sleeves and actually do growth equity.

"India has a pretty deep bench of management talent, so these funds are staffing up with this operating expertise."

Wilton adds, "In my view the qualities of the GPs coming to market now are much higher than what we saw pre-crisis.

"Also the amount of dry powder is declining and private market prices are beginning to show signs of softening. Consequently we have really stepped up what we are doing in India."

"We don't think fly in, fly out, works" – David Wilton

"The quality of the opportunity has improved and de-risked. Now it is a much a higher-quality, lower-risk opportunity than it was back in 2000"

In practice, private equity investments in these markets usually take the form of minority positions. Often company owners might be looking for help and guidance as much as money – and the ability to source deal flow is better if you can also offer this business support.

"Obviously, if you can add value then the outcome should be more favourable," Wilton says. "We have seen, say, in China, in the early 2000s companies were growing at 50 per cent top-line growth and, in these circumstances, if a few mistakes are made and growth drops by a few per cent, you are still going to get a good IRR.

"These days, growth is more 20 to 30 per cent, and if you don't have leverage, to get that 25 per cent gross IRR you need to make sure that growth is consistent. Operating skills help to ensure you stay on a steady course and, with a greater need for consistency, the value of operating skills has gone up."

Another criterion that understandably sits high up on the list is locality, and as Wilton says, "We don't think fly in, fly out, works." He adds, "We don't think track record can transfer between countries. A GP might have a gilt-edged track record from the US or Europe, but unless we like the look of the local team, we just don't think it is transferable. They need to be physically there, ideally locals, or expats who have been there long enough to understand how things work."

Early mover

Because of its development mandate, IFC tends to be an early mover going into markets, and by definition this means backing inexperienced teams. Having managed the World Bank pension fund's private equity portfolio back in the 1990s, Wilton is familiar with the established practices of institutional investors. In that context, you simply "would not touch" a first-time fund, he says.

"The guys we are looking at are not spinning out from anything – they are often coming together for the first time. However, it has proven successful. When we first started doing this I thought we were taking a very big risk, but it turns out the risk wasn't as big as I thought it was. It turns out there is a pronounced early-mover advantage.

"If you understand how the money has to be made, and find the team with the right skill-set, in a less penetrated market they will have time to understand the company, to identify the problems, and then they can price it properly. In a more competitive market, you do not have that time and a neophyte team under pressure will make mistakes." ▶

"A GP might have a gilt-edged track record from the US or Europe, but we just don't think it is transferable to other countries – unless we like the local team"

And while on the one hand you may find yourself dealing with a team that might be less experienced, on the other, competitive pressure won't drive them to make the same mistakes that are often seen in more populated markets.

Wilton says, "If a group we back is successful and gets to a third or fourth fund, then we pull out, as we are not needed as the commercial money has come in. We will then move onto the next thing – another first-time fund.

He adds, "There is no magic to first time, it is more about being an early mover."

First time for everything

Having seen IFC's success in this area, it begs the question as to why more LPs do not venture further afield and broaden their traditional fund-selection criteria. According to Wilton, it could be that most institutional investors' due diligence templates simply don't work unless there is a good-sized track record to analyse.

He says, "A lot of LPs still don't like being in at a first close, partly because there is the risk these days about whether a fund will even reach its target and get going. By going in at a second close there will also be a couple of investments for you to be able to diligence and get that bit more comfort."

And with traditional due diligence heavily reliant on analysing track record, LPs are limiting themselves to those funds that can tick the familiar boxes.

Wilton continues, "In private equity, past performance has some predictive ability. If a fund manager has been in the top quartile in fund I, there is a good probability he will at least be in the top half for the second fund.

Development finance

"This is not true of managers for listed equity or debt funds. Track record is a good indicator of future performance, so diligence relies heavily on this, and the process is automatically biased against first-time funds and many people simply won't consider the first-time funds.

"We will, because of our mandate, and it's turned out that because we are going into less penetrated markets and choosing early movers, it has worked for us."

As a result, the LPs that the IFC sees consistently coming into first-time funds in its 180-strong portfolio are the development finance institutions – names such as CDC, FMO, Proparco, Africa Development Bank and Asia Development Bank. For these funds, other LPs often tend to be friends, family, or one-off plays from a pension or an endowment and will rarely be a consistent part of their activity.

Wilton adds, "Their template simply doesn't fit. They also have a fiduciary duty to manage the risks and the returns. In general, most people's experience of first-time funds is in developed markets, where they are quite risky. You can understand why they choose to stay away."

Hundreds and thousands

In practice, resourcing and market knowledge clearly play a huge part in these investment decisions, and the IFC is in the fortunate position of having teams in each of its regions of focus. Wilton oversees 30 staff, with the bulk out in the field – in offices based in Mumbai, Jakarta, Nairobi, Istanbul and Washington, focusing on Latin America.

This presence in the market clearly grants it an enviable view on prospective investment opportunities, he says. "There may be hundreds of funds in India or thousands of funds in China, but once you start looking at them you can weed through most of them quite easily. With your core group, at that point you can start applying filters. I'm not sure how many thousands of funds there are in China, but in practice, you don't need to wade through all of them.

"You do have to be pretty active, go out in the market and meet as many people as you possibly can. If you are really trying to work with the best managers you don't find them by sitting in your office waiting for them to come to you – particularly with first-time funds," he says.

"Many people do come to us as we have a name for backing first-time funds, but you do need to make sure you are out in the marketplace so that you get to see everything. There are two ways of making the wrong decision – you could back the wrong fund, or miss out on backing the right one."

Triple threat approach to tackling new markets

IFC's private equity approach currently encompasses three separate investment strategies.

The bulk of its focus, with about ten to 15 funds and $300m, is growth equity. And this is the area where its dollars get the best all-round impact, Wilton says. "The expected return is good, and it creates the biggest amount of jobs. It also provides support to SMEs – on average the growth equity funds at the time of initial investment have backed around 30 to 40 per cent of SMEs.

"We recently concluded that the best way to encourage job creation is with larger companies, simply because in a growth environment, the larger companies grow more slowly, but at scale. SMEs may grow more swiftly, but it is off a small base, so the quantum of jobs is not so big.

"The bigger companies are growing more slowly, but they are still growing at more than ten per cent. In a low-growth environment, the contribution of SMEs may be more important, but in these high-growth environments, it looks like the larger companies that are making the impact."

At the other end of the spectrum, it is also looking to commit to up to three funds per year in the small business space, offering a slightly different model to private equity. Wilton explains, "It is a business model that was developed by business partners in South Africa which finances companies that are bigger than micro-finance but a lot smaller than what a private equity fund would back. Each investment officer in one of these funds handles about 30 different investments.

"A lot of these companies are quite small. They are not going to get to an IPO or trade sale, so the investments are structured as debt or quasi-equity.

"We are not expecting high returns – if we get eight per cent per annum to cover our cost of capital then we are doing well. The reason this interests us is that it takes us to some fairly 'frontier' places. We have backed one of these funds in Sierra Leone, we are about to do another one in Nepal and one in Bhutan.

"It is a way of providing assistance and finance to companies in new countries to us, and serving as something of an introduction to these areas as well.

"Each of these are very labour intensive to set up, they take more than twice as long to process as a standard fund."

Finally, IFC is also targeting five to seven funds in the green and environmental space, which proves a particularly active deal-flow currently, Wilton says.

"We have a couple of industry groups in IFC active in energy efficiency, renewable and clean technology. Globally they felt deal-flow was improving as conditions were coming into line where these technologies were becoming commercially viable, but not a lot of expertise was being spent on developing them.

"We felt that if we encouraged funds in this area, you would then get the knowledge and expertise alongside the capital. The applications for energy efficiency and renewables products were becoming commercially viable and independent of subsidies.

"There is a wide range of things you can do, and it varies across countries given the variety of regulation and the variety of energy sources in different countries. There was a feeling that the expertise and the capital had not yet been brought to bear on this opportunity.

"If we backed some funds in the space with guys who had the skill and understanding of the sector, then it would speed development."

Through IFC's asset-management company, it recently set up a fund of funds focused on energy efficiency, renewables and cleantech, which should have its first closing in early 2013, at more than $200m.

New frontiers

For an organisation that is constantly pushing the envelope in terms of breaking ground in new geographies, its outlook is on an ever-more navigable universe. The investment frontier for emerging markets is shrinking, Wilton says.

"Each year there are another couple of countries that have increased their deal-flow to merit an individual country fund. We are currently doing our first country fund in the Philippines, for example – a modest-sized fund, but the deal flow justifies that focus."

He adds, "In India we have been looking at funds that focus on the tier-two and tier-three cities, as well as frontier provinces. Likewise in China, we are looking more there at the western regions. In these markets there is usually less competition and better pricing."

Even though IFC's annual $500m fund investment programme may be dwarfed by some of the larger institution's private equity allocations, the potential impact for the 20 to 25 GPs it commits to is arguably comparable to larger allocations elsewhere.

And despite an increasingly global marketplace, its considerable market presence and understanding should see it continue its position as the prime mover across private equity's new frontiers. ■

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