ROOM TO GROW

Private equity in emerging markets offers more space for investors.

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The incentive for adding private equity to a pension plan's asset mix has always been to improve the risk and reward characteristics of the total portfolio. The expectation of higher returns and diversification benefits is especially attractive in today's so-called lower-return environment. For example, Cambridge Associates notes that, over the past ten years, the more mature U.S. and European private equity strategies have delivered from 300 to 900 basis points (bps) of excess returns. Such return profiles attracted a good share of new commitments to developed market strategies and these are now approaching the pre-NASDAQ cash funding frenzy. The question is, however, where are these commitments going?

For North American LPs, European strategies have been the second most popular choice after the U.S., with $50 billion making up about 29% of their total commitments. At the same time, the majority of the private equity commitments since 2000 has gone to buy-out strategies, leading to a much more competitive environment for buy-funds seeking sponsored deals. As a result, there are concerns about the over-saturation of private equity capital in the developed markets. To put this in perspective, there are now over 125 private equity funds with commitments greater than $1 billion compared to 1989 when there were just five. Today, only four of those funds include emerging markets.

Why emerging markets?

As the U.S. and European private equity markets reach maturity and present more competition and pricing challenges, a stand-alone case for emerging market private equity is more compelling, particularly when considering the macro improvements, better manager selection, and tangible exits.

For over a decade, emerging markets have been growing at more than twice the rate of the developed world and, on a purchasing power parity basis, they generate 49% of global economic activity. The gross domestic product of emerging markets is expected to overtake that of developed countries over the next 20 years, with the BRIC countries (Brazil, Russia, India and China) leading the charge. Much of this economic activity is taking place away from the listed public markets, as emerging market countries represent only 12% of global market cap.

Over the last decade, emerging markets have changed as the result of a number of positive reforms, including the reduced role of government, increased deregulation and reforms, fewer trade restrictions, increased governance and improved management quality and currency regimes that are moving from fixed to floating systems. Even with these reforms, however, it is crucial to have a good due diligence process in place for assessing not just company-specific risk but also risk in the local markets. Political risk can be a factor to consider, but it can also be an opportunity if and when future reform trends towards more investor-friendly markets.

When building an emerging market private equity portfolio, there is a natural inclination to pick and choose particular countries and regions for exposure. However, countries and regions might appear attractive at the outset, but they can also turn unattractive for private equity and remain that way for a long time. Ultimately, it's important to look at individual opportunities across all principal emerging market regions and to invest in the most compelling one from a bottom-up basis.

Today, the private equity space in developed markets is crowded. Competition for deals is fierce and the market is becoming saturated with capital. However, as emerging markets continue to grow, so too do the opportunities for investment as governance and reform continue to evolve in these areas. Looking ahead, such factors should lead to more successful investing in all of these countries and will help set the stage for emerging market private equity to become a more mainstream strategy. ■