Private Equity Investing in Emerging Markets
An Interview with Richard H. Frank

Private equity investments in emerging markets are on the rise. In May, Investments & Wealth Monitor asked Richard H. Frank to comment on this increasingly popular investment field. Mr. Frank is chief executive officer of Darby Overseas Investments, Ltd.—the private equity arm of Franklin Templeton Investments—where he chairs the firm’s investment committees on private equity, mezzanine finance, and venture capital investment.

Mr. Frank joined Darby in 1997 after a long and distinguished career at the World Bank and International Finance Corporation (IFC) in Washington, D.C. In his last assignment there, he chaired the Private Sector Group, coordinating the private sector activities of the World Bank, IFC, and the Multilateral Investment Guarantee Agency. As a World Bank Group managing director, Mr. Frank oversaw the South Asia and Latin America operations and chaired the bank’s finance committee. At the IFC, he served as chief finance officer, leading the corporation to become a AAA borrower and securing two capital increases. Mr. Frank earned a B.S. in mechanical engineering from the South Dakota School of Mines & Technology and an M.S. from the Sloan School of Management at the Massachusetts Institute of Technology.

Monitor: What opportunities are available today for private equity investment in the emerging market regions of Asia, Latin America, and Central and Eastern Europe?

Richard Frank: The opportunities are bright. These three regions have traditionally relied on international firms to bring in investment capital to local companies enjoying booming local economies. Given the excellent investment opportunities and build-up of local institutional savings and reserve surplus, domestic private equity firms and investors are also starting to emerge. In Latin America, Brazil is further ahead than any of the other countries in developing a domestic private equity industry. In Asia, the leader is India, with over 300 domestic private equity firms and an active market. Korea also has a fairly well-developed domestic private equity industry. China’s private equity market, on the other hand, is in its infancy; it has thousands of small and medium-size companies that urgently need private equity or risk capital to grow. Central and Eastern Europe received a rush of international private equity during the transition to market economies after the Soviet Union’s collapse. This activity peaked in early 2001, dropped off sharply when the emerging markets PE industry went south, and has now resurfaced strongly.

International players, both management companies and investors, are now increasingly active in these regions. Domestic firms and investors investing side-by-side with their international counterparts is a powerful combination.

Monitor: How would you compare private equity opportunities in these emerging markets with opportunities in the developed world?

Richard Frank: Private equity funds raised in the United States in 2007 totaled around $300 billion. In emerging markets, the total was just over $60 billion. That means five times more capital was raised for the U.S. market than for all the emerging markets combined. Looking at the global economic pie, we now have almost an even split between emerging and developed economies. Thus, I believe the emerging market private equity field is still seriously underweight, even though it experienced a 10-fold increase in fundraising in three years (the level of fundraising in 2004 was only around $6 billion). Nevertheless, a 10-fold increase is a big surge for any asset class and this has led some people to conclude that we’re oversupplying these markets. However, still we see thousands of companies which do not have access to private equity, venture capital, or mezzanine financing. This is a new and large opportunity for private equity investors, either international or domestic players seeking to expand their commitment to alternatives in high-growth economies.

Monitor: Which emerging regions look most attractive to you and why?

Richard Frank: The three regions we like are attractive in different ways. If you consider the relative size of the opportunity, Asia is first, Latin America is second, and Central and Eastern Europe is third. Within those regions, I consider Brazil the most attractive...
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right now in Latin America, followed by Mexico and two Andean countries (Colombia and Peru). Chile probably has the highest performing economy in Latin America, but because it’s performing so well and has such deep capital markets, it’s hard to make money as an international private equity player there. Chile has had a lot of domestic capital going into this field for the size of its economy.

The situation in Asia is varied. There’s a vibrant, active private equity community in India with many companies receiving private equity and quickly listing on the exchanges. However, the Indians appear to be slowing down that process. Investors are now required to lock up their equity positions for a longer period after an initial public offering (IPO) than in the past.

China is virgin territory. The rules and regulations governing private equity have not been well developed. You can do private equity investing with companies domiciled outside China, or you can work with Chinese companies domiciled within the country, but this involves more regulatory and legal obstacles. The Chinese are starting to address this, but these are not opportunities you can just rush in and try to fill.

Central and Eastern Europe is divided into countries that are part of the European Union (EU)—for example, Poland, Hungary, the Czech Republic—and those that are not yet members or part of the euro system. In the EU nations, there’s a fairly smooth flow of capital from old Europe into new Europe, and there’s a lot of competition from U.S. and European players who feel comfortable they’re operating in countries with lower macroeconomic risk than in more easterly European nations such as Romania, Bulgaria, and Ukraine. Russia is in a category by itself. It offers great opportunities—some investors are doing very well there—but it poses more systemic risk for private equity.

The other country that should be considered in the Central and Eastern European theatre is Turkey. At our firm, we like Turkey, partly because we think it will continue to reform its economy in preparation for eventually joining the European Union. It has a good-size economy but few local private equity firms, so we find it a good place to operate.

Within these regions a wide spectrum of investment strategies is being followed. Our firm is a mid-cap private equity player emphasizing growth capital. Some large buyout firms have come on the emerging market scene aggressively, particularly in Asia, where they have set up in Hong Kong. We are not in this space and thus we are not looking for big leveraged buyouts. Big buyout opportunities may pick up eventually, but right now the pace is slow. Of course it has slowed in the United States, but it’s even slower in Asia, not only because leverage is harder to obtain but also because in the growth economies—China, India, Korea—there is political and business resistance to big leveraged buyouts.

This differs from other parts of Asia such as Japan and Australia, which is active in this field. It will be interesting to see how the landscape evolves over the next few years between types of private equity in emerging markets—mid-cap growth or expansion capital versus large leveraged buyouts.

Monitor: Is the drying up of credit having an impact? Is it making deals harder to finance, or is it keeping competitors out and giving you better pricing?

Richard Frank: It’s certainly giving us better pricing for our private equity and mezzanine capital. For example, the kind of borrowers we like for our mezzanine financing—well-established companies with strong cash flows—are now paying two to three percentage points higher for corporate bank debt than in July 2007. The fact that bank credits are more expensive and harder to get means our mezzanine product has more and better opportunities. We can also get better overall terms because our mezzanine product has both a debt component and equity kickers.

As for pure private equity investments, the lack of readily available credit doesn’t make private equity a complete substitute for corporate debt, but I think companies need to be prepared to take on more private equity. Lower leverage—even at the cost of dilution—will be prudent for both investors and companies. Company valuations in the private market, as in the public market, have come down.

Overall, the credit crisis has helped our business to the extent that we’ve been competing with other types of capital—highly leveraged hedge funds, for instance. Leveraged buyouts have also been affected significantly. For us, it’s a clear positive. For others, it’s created a pause or slowdown in the pace of business.

Monitor: Why is mezzanine financing an appropriate tool for investing in emerging markets from the viewpoint of both the investor and the borrower?

Richard Frank: Borrowers in countries without a good supply of corporate debt, either from banks or through a corporate bond market, have faced constraints in getting the leverage to build their businesses. An extreme example
occurred a number of years ago in Brazil, where medium-size companies had to pay two percentage points a month for corporate debt. These companies couldn’t be leveraged with a standard debt product, so mezzanine capital was attractive to them.

Our coupons were in fact lower than the rate for very high-cost, short-term corporate debt from commercial banks even being subordinate to senior debt. The companies would borrow cautiously from commercial banks and add leverage in a subordinated way through mezzanine financing. They paid our ongoing coupon and then gave up substantial equity upside or potential for gain. This allowed them to expand in situations in which local debt markets weren’t very friendly or robust.

Mezzanine capital offers borrowers another advantage. When private equity investors want to take a substantial ownership position in a company, this means dilution. Many family-owned companies have had to accept dilution at some point, though they hold off as long as they can. In Asia, there is a belief that selling control of your family business is considered an admission of failure. In the case of mezzanine capital, companies get the benefit of expansion capital, and the dilution—conversion of part of the loan into equity or warrants—comes at a later stage. From the borrower’s point of view, certainly in Asia and some parts of Latin America, this is a desirable way to get growth capital without so much front-end dilution and loss of control.

For the investor, mezzanine financing provides a current return because there’s a coupon being paid based on the strong cash flow of the companies. The fund distributes these returns to investors, and the wait for an exit from a mezzanine position is shorter than with pure private equity investing. Thus, investors get both a current return and also an equity kicker at some point down the road. On average about two-thirds of the return comes from the coupon and one-third comes from the equity kicker.

The mezzanine structures we’ve used provide different ways of getting that equity upside. If the company goes public, we get the benefit of the IPO process by exercising our conversion options or warrants. If the company is sold to a strategic investor, that likewise triggers a conversion. If neither of these events happens because the stock markets in these countries slow down or close, we can get a contractual return to produce on the equity upside. We just convert part of the loan into a profit participation. Investors in these funds are attracted to the idea of a current return, plus we have a contractual way to get their principal back through the loan repayment as well as a contractual way to get some of the upside.

Some people think mezzanine financing doesn’t offer as much upside as a pure private equity play. In fact, we’ve gotten private equity-type returns from mezzanine financing from our private equity funds and, at the same time, had more protection on the downside.

Richard Frank: Investors considering private equity investments in emerging markets are faced with a challenge—picking a region, or in some cases a country, in which to invest and then finding management firms, either international or local, they want to marry. Investors in private equity funds can expect their money to be locked up for 10 years—somewhat longer than in developed markets—so this is a long-term relationship. Choosing a private equity fund manager is a key step. Some investors do this on their own, some through consultants, and some through a fund of funds.

Local knowledge—certainly in the mid-cap space—is essential, and our firm believes as well in a local presence. Most of our investment officers live in the countries where they do business, so they know the economy, speak the language, and can identify which companies our funds can invest in without getting involved with unethical partners, legal problems, or hidden financial liabilities. Conducting due diligence to uncover these types of problems is crucial in emerging markets. Of course, shades of these problems are present in U.S. or European markets, but the degree of due diligence a fund manager must carry out in emerging markets goes far deeper and has to be much more creative since information is less available and less reliable. There are few well-established accounting firms to conduct audits, so managers have to bring in their own auditors, and a lot of legal due diligence is required.

From an investor’s point of view, it’s important to determine how long and what kind of presence a fund management firm has had in a particular country, how well it knows the local environment, and how well it sources its investments. This is not as easy as in some developed markets because the private equity industry in emerging markets is relatively young—in Latin America it’s been around 15 years at most, in Asia maybe 20 years—and not many firms have been successful through several macro-economic cycles of sequenced first, second, and third funds. This means investors have to spend more time sizing up a management company and its reputation. Maybe this gives some investors pause, but the increase in commitments to this field indicates they’re navigating their way through these hurdles.

Monitor: Is there an arbitrage opportunity between private equity Asia and public equity Asia as there was in the United States 25 years ago? With the public markets in Asia priced as they are, is it possible to buy private equity companies inexpensively enough to create an arbitrage opportunity by selling them publicly?
Richard Frank: Opportunities like this have occurred—particularly in Asia, where private company shares have hit high multiples in the face of extraordinary investor demand. For example, we were involved in a privately owned Chinese company, a well-known producer of a basic bathroom fixture, that got approval for listing on the Hong Kong Exchange. When the company went public, the offering wasn’t very big, but the institutional component was oversubscribed 40 times and the individual component was oversubscribed 80 times. Under the rules of the Hong Kong Exchange, the company had to keep its pricing within an offering range but because demand was so high, the share price really took off for three or four months after the IPO. Although opportunities for these short-term plays have been happening, there’s some cooling off now, given the sharp volatility in the public markets. In the case of Chinese companies, it’s also partly because the Chinese want their companies to be listed within China.

Our firm is more of an “old-school” private equity player. We want to buy into good companies at prices that are lower than what we think they will be worth three or four years down the road when we can get scale and can take them to a public offering or arrange a strategic sale. We help them with strategies to build up their operations, acquire other companies, and generally expand and improve their business. We get their accounting and corporate governance in shape and improve their management. This can be at least a two- or three-year process, but if you can help a company reach these conditions, the investment will give you excellent returns.

**Monitor:** Does private equity still offer value compared with a long–short equity manager taking very concentrated positions?

Richard Frank: Long-only emerging market public equity investing has performed well, although these returns haven’t been as high as top-quartile private equity returns. Adding long–short positions has gained in popularity. Certain hedge funds are doing this, but the track record of these positions in emerging markets isn’t that long. I’d be reluctant to say whether that will be a better way to make money in emerging markets or not. Top-quartile private equity players are beating the public equity index, and some top-quartile public equity investors are beating the indexes too.

Investor interest in emerging market private equity is coming somewhat from the desire for an absolute return, but it’s also part of the growing interest in alternative investments generally.

Richard Frank: They’re not entirely decoupled from established markets, but they’re less linked than they used to be. We used to say that when the United States sneezes the rest of the world gets a cold. That was true for Latin America and Asia, but this kind of relationship is gone. It is a fact that some of our companies are having a harder time exporting consumer products to the United States because of the slowdown here. However, the dynamics within these economies are strong. Per capita income and consumer purchasing are growing, creating strong domestic markets—for consumer products, automobiles, and housing, etc. Trade among emerging market countries is also increasing. The Chinese are importing huge amounts of raw materials and commodities of all types, particularly from Latin America, Africa, and even India. This is stimulating demand and growth in these countries from what is called “South to South” trade and investment.

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Monitor: When should clients use small boutique firms versus larger private equity shops, or when should they use regional specialists versus global firms?

Richard Frank: Our firm works with all types of clients, and the common denominator they’re all looking for in a private equity fund manager is a close relationship over a long period of time. The relationship, starting with one fund, can be equivalent to a 10-year marriage, and if it works well it will be repeated every three or four years. For emerging market investments, it’s harder to choose who you want to start this relationship with because most of the firms are newer or have limited experience in this area. The first step is to find out how long a firm has been in the business and what kind of approach it’s using. I would be cautious about using a firm merely because it has a good record in the United States or Europe but doesn’t have experience in emerging markets. It’s a question of which investment style works best in an emerging market, and that won’t necessarily be the one that worked in the developed markets.

If you think investing in China is appealing, you might pick a firm that works only in China and has demonstrated the ability to navigate in the complex and risky domestic private equity field. Although there’s nothing wrong with investing in a one-country fund, there’s more volatility in these economies than in the United States or Europe. Our firm manages country funds, regional funds, and global funds. But investors need to realize that country-specific funds narrow their diversity and concentrate their risk.

Some sector specialty funds have surfaced in these emerging economies. The most active sector right now is infrastructure; it’s the category that has huge investment needs and will attract the largest amount of capital. Emerging market infrastructure had a great run raising and investing money in the late 1980s and early 1990s when privatizing infrastructure was very much the rage in Asia and Latin America. Subsequently, these countries went through a lot of economic volatility and, because of massive devaluations, many couldn’t honor the concession agreements to ensure attractive U.S. dollar returns. This resulted in failed investments. But the emerging markets infrastructure sector has come back from those difficult times and is now the single largest sector attracting new capital.

From a risk–reward standpoint, the profile of emerging market infrastructure is kind of a barbell. There are opportunities to invest in toll roads and concession-type projects, where the government will endeavor to help you get a reasonable return, but it will be on the low end—probably low double digits. Or you can invest in green projects like building a power plant, take your chances on selling power to a grid as a merchant plant, and find returns in the twenties. Some investors prefer a long-term steady return with low risk; others prefer a higher return with more volatility. Another sector specialty is financial services. We’ve done well buying small banks and building them up to sell to larger banks. Banking and financial services is a field of endless consolidation. The health services field is gaining interest but is not as well established. Most firms invest in manufacturing and retailing. Within the infrastructure field, the power industry is probably the most popular, given that telecom has had an erratic run. We have been supporting conventional power generation but increasingly investing in renewable energy.

Emerging markets are attracting new entrants as investors. Some investors are interested in specific countries such as India, China, Korea, and Brazil. Others would rather diversify not only on a regional basis but also on a global basis. We offer a mid-cap global play, which includes mid-cap investments in all three regions. Our teams are investing in country funds and regional funds, and they can deploy capital through a global feeder fund. Another approach is through a fund of funds that focuses on emerging market private equity. For some investors, this is a way to get started because someone else picks the fund managers. This approach is more expensive, and the investor doesn’t have a direct relationship with the managers, but it gives first-time investors diversification.

Monitor: How would you characterize emerging market private equity at the moment?

Richard Frank: We’re well along in creating a whole new field of investing through private equity funds in emerging markets. It’s taken the investor world some time to get comfortable with this field, but people are beginning to realize that their 401(k)s give them some exposure to emerging markets, whether they like it or not, in the public equity and fixed income fields. Private equity is the next, logical step.

I’m on the board of Georgetown University, and we talk about being a global university—preparing students to be citizens of the world. In business law and in other fields, this means preparing them to operate across the global economy, not just learning other languages or spending a semester abroad. The world economy is changing, and this is an exciting time for companies and young people to go global.

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