



INTERNATIONAL FINANCE CORPORATION  
WORLD BANK GROUP

# **IFC's Experience in Investing in Private Equity in Emerging Markets**

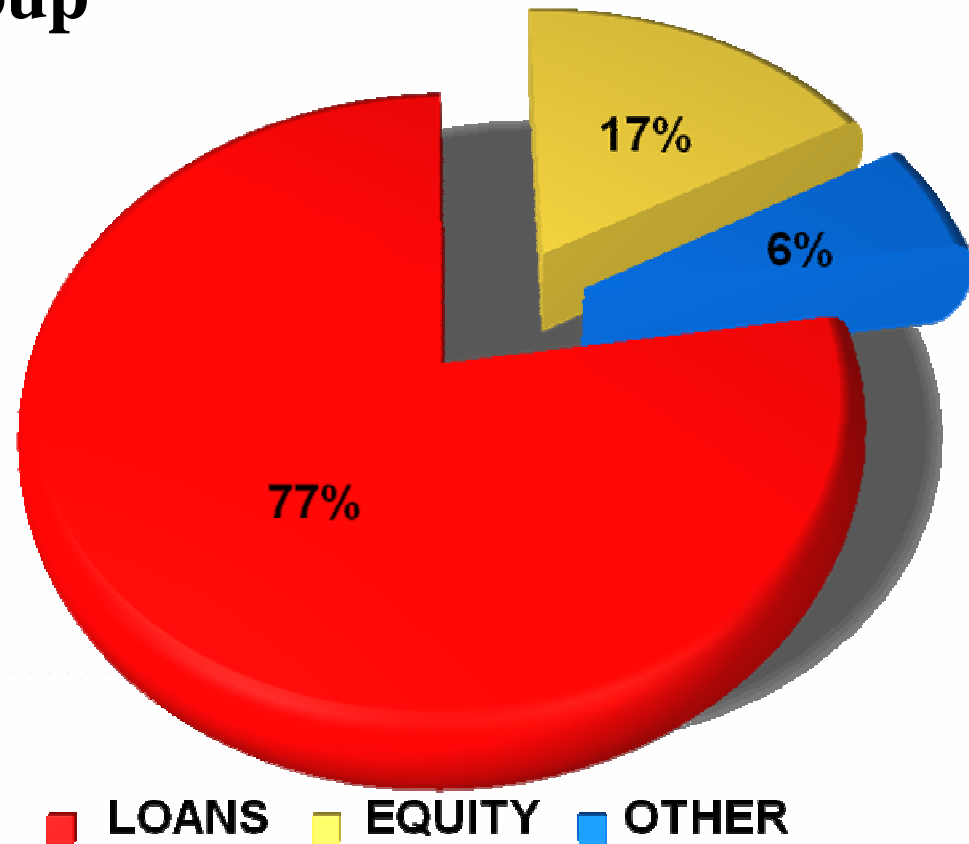
**Jiansheng Wang  
Internatioanl Finance Corporation**

**September 2006**

# International Finance Corporation

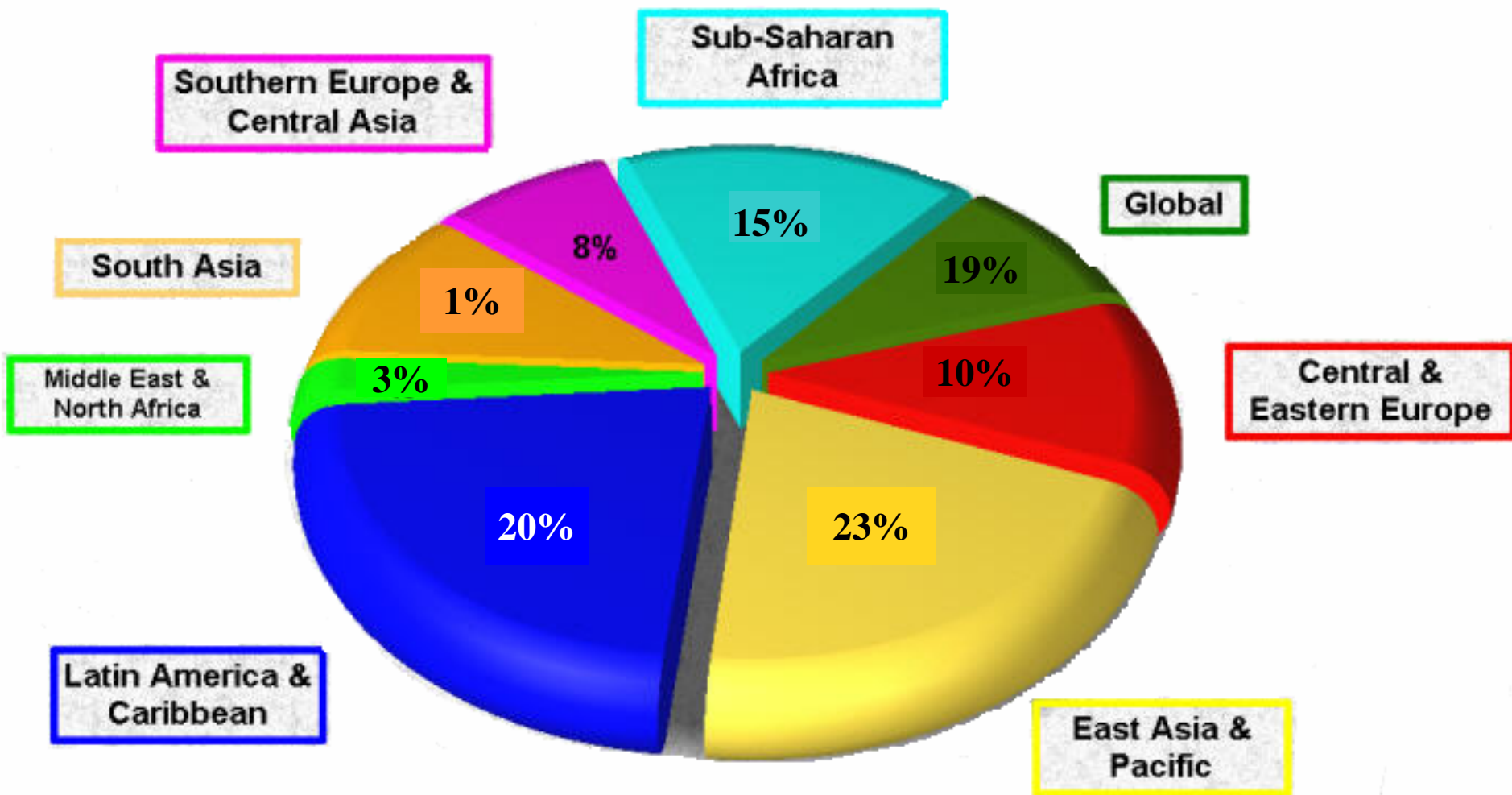
Investment Portfolio as of June 30, 2005

- **Part of World Bank Group**
- **Private sector focus**
- **\$19.3 billion portfolio**
- **17% of our portfolio is in equity**
- **1/4 of our equity is in funds, primarily PE**



# IFC Investment in Private Equity

## Where We Are



112 funds, 19 fund managers, 850 investees

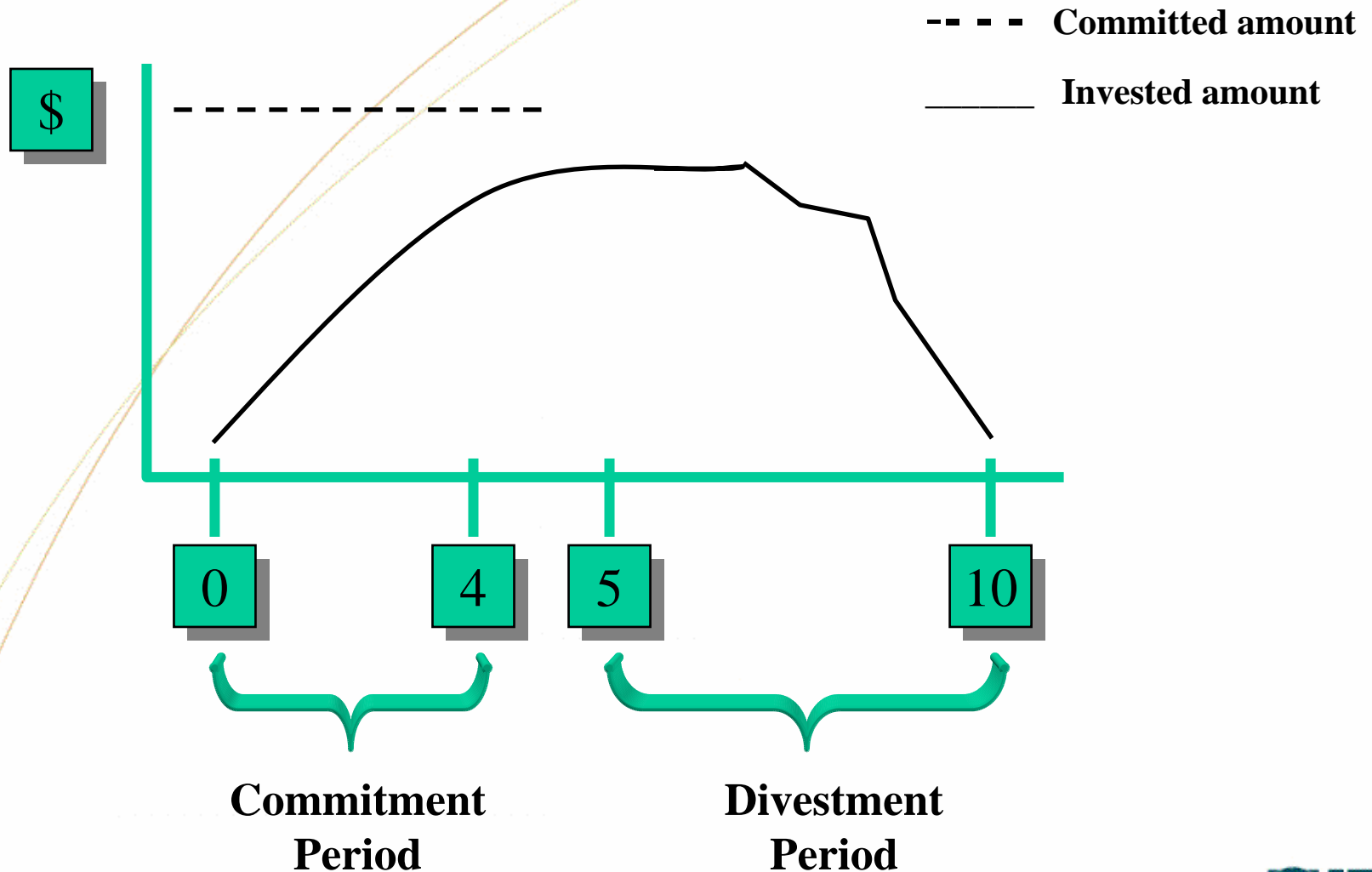
# Why Private Equity?

- Allows exposure to companies which are not yet listed
- Reflects belief in ability of good managers to add value to family-owned, small, mid-sized or other private companies
- Gives potential for exposure to very high growth companies
- In the U.S. and Europe, higher return over long periods compared to other asset classes

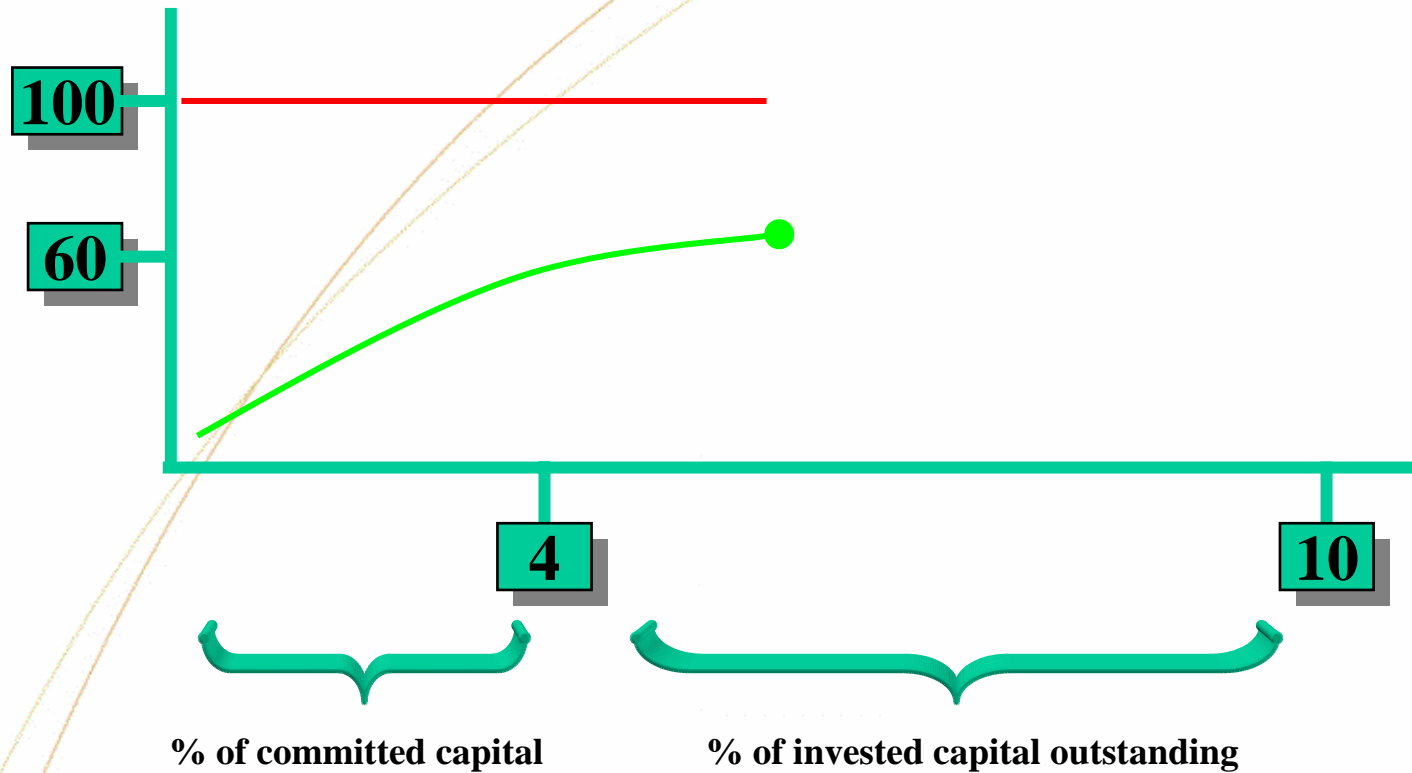
# What is a Private Equity Fund?

- Up-front commitment of capital for future investments
- Collective investment vehicle
- Defined life (10 years is standard)
- Professional fund manager / GP
- Management fees to cover costs (2% standard)
- Incentive for manager:
  - Carried interest  
(usually 20% after a hurdle rate of 6 – 10%)

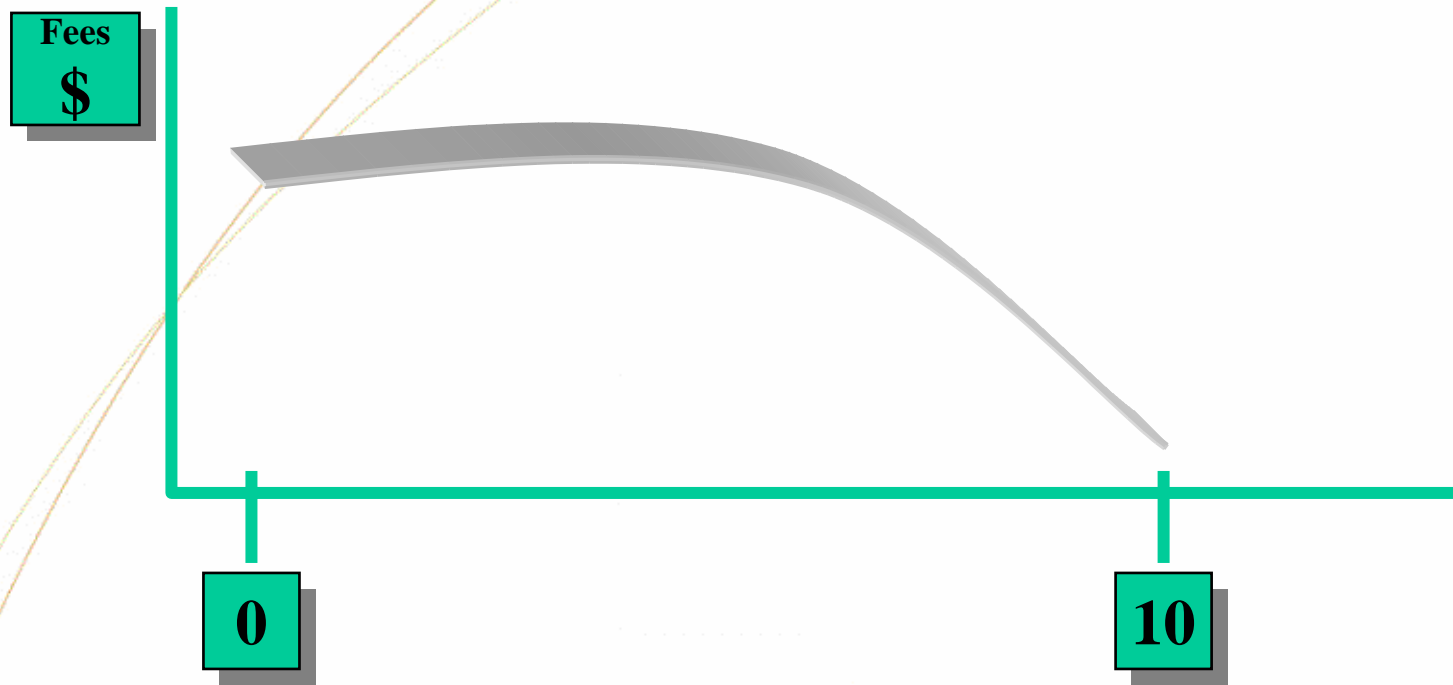
# Capital Base Overtime



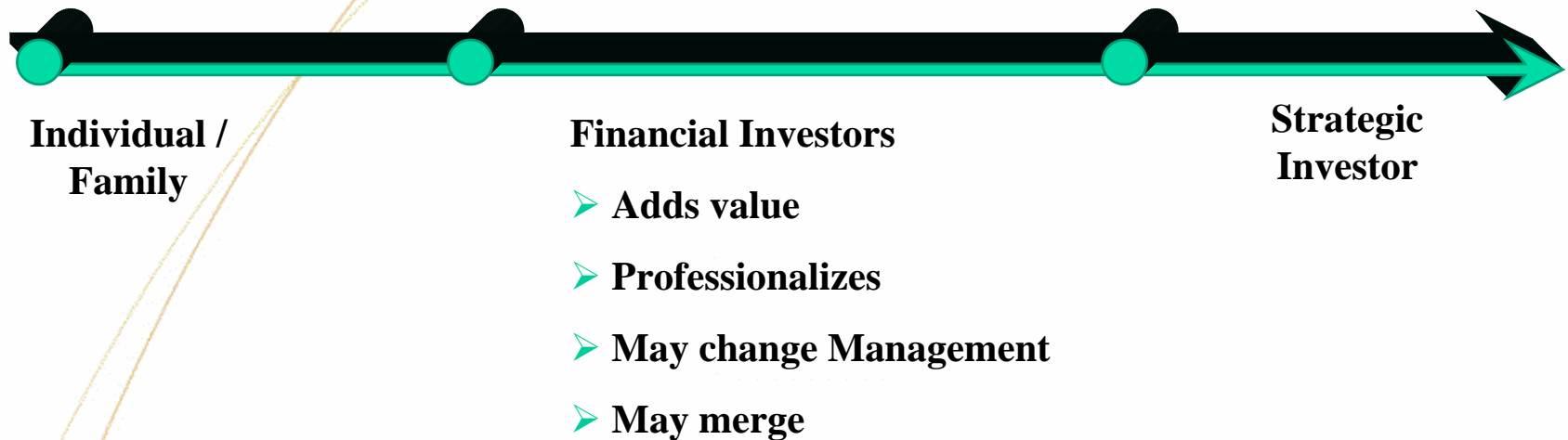
# Management Fees: Base



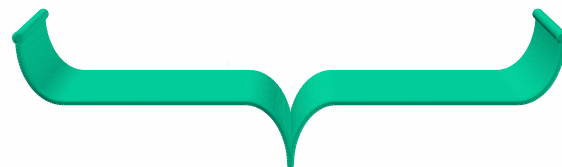
# Management Fees: Dynamics



# Investment Thesis: Private Equity



# Investment Thesis: Venture Capital



- **High growth**
- **Exceptional product / Intellectual property**
- **Need weekly & monthly board meetings;  
close monitoring**

# Economic Impact can be Significant

## Private Equity-Backed Companies' Impact on UK Economy, 1996-2001

	Private Equity Backed Cos.	FTSE 100	Overall
Increase in Employees	+ 29 %	+ 10 %	+ 2 %
# of Employees in PE-backed cos.	15 % of UK Workforce (2.7mm)		
Sales Increase (Average Annual)	+ 27 %	+ 13 %	
Exports Increase	+ 27 %		+ 4 %
Investment Increase	+ 24 %		+ 9 %

# Comparative “End to End” Returns

As of March 31, 2003

	US Venture Capital Index <sup>1</sup>	US Private Equity Index <sup>1</sup>	Emerging Markets VC and PE Index <sup>1</sup>	MSCI EMF Index	S&P 500 Index
1 Qtr	(3.8)	(0.6)	(2.3)	(5.9)	(3.2)
1 Year	(26.3)	(8.8)	(14.3)	(20.6)	(24.8)
3 Year	(25.6)	(10.7)	(11.1)	(16.4)	(16.1)
5 Year	46.3	0.3	(6.1)	(6.9)	(3.8)
10 Year	36.5	9.3	(5.1)	0.2	8.5

<sup>1</sup> **Cambridge Associates LLC Proprietary Index; pooled end to end returns, net of fees, expenses and carried interest**

# Asset Allocation

- Long-term strategic asset allocation (3-year view) with short-term, tactical adjustments (quarterly, etc.)
- Approved by investment committee or board
- Private equity is typically small % of total assets
  - 7.5% of total assets for U.S. institutional investors
- Rationale for private equity:
  - Incremental returns with low correlation to other asset classes
  - Long-term investors (pensions, insurance cos.) can take long-term view, accept low liquidity for extra yield

# Key Principle: Persistency

**Success in Private Equity is not Luck, it is Skill.**

McKinsey finding in Europe:

“If your first fund was top quartile, there is a 45% chance your next fund will also be top 25% and a 73% chance it will be top half. A new fund management team has a 16% chance of being in the top quartile.

Success in private equity is **persistent.**”

*Conor Kehoe, Partner, McKinsey & Co., EVCA, June 13, 2001*

# A Primer on Private Equity Funds

- Closed-end structures with investment period (typically 3-5 years) and fixed term (7-10 years)
- Annual management fee
- Carry incentive for fund manager → investors receive back 100% of capital + expenses + hurdle rate (6-10% p.a.), then share proceeds (80% to investors, 20% “carry” to manager)
- Types of funds: venture capital (seed/early stage, growth/late stage), buyout, mezzanine, other → the more developed the market, the greater the specialization by funds
- Ownership stakes: minority to control positions (varies by manager), may have Board representation

# Generic Private Equity Deal Types

(typical deals are a blend of several of these)

Type	Source of profit	Discussion
Arbitrage	Pricing multiple differential between private market and public/M&A markets.	Simple arbitrage is rare and due to inefficient markets. Investment banks best positioned to spot it.
Leverage	Leverage a company with stable earnings.	Requires a stable environment, low real interest rates and access to debt.
Earnings growth	Increase earnings through expansion or acquisition.	Requires quality corporate management and stable/growing economy.
Margin Expansion	Increased profits via improved efficiency or shifting product into higher-margin niche.	Requires quality corporate management and flexibility of labor and capital.
Improved transparency and governance	Earnings attract a higher price.	Company attracts more buyers as it is easier to understand and buyers have more protection. Do via improved accounting and reporting standards and greater minority rights.
Multiple expansion due to growth or profits.	Earnings of company attract a higher price.	Company reaches a size at which it is a viable IPO candidate or attractive M&A target; or high expectations of future profit growth are built into pricing..

# Building Blocks of Private Equity

## Deal Flow

	Basic question	Discussion
<b>Control</b>	Is it possible to obtain control through either majority positions or shareholder agreements?	Private equity relies on control in order to make required operating changes and strategic decisions.
<b>Exit</b>	Can you buy things that you can re-sell?	Exits are easier for companies large enough to list; larger companies with attractive market share; companies with high expected profit growth. Minority stakes in unlisted companies are very difficult to sell. Drag-along and tag-along rights are useful but need to be enforceable.
<b>Growth</b>	Is there enough growth potential to create an exit?	Growth, or high expectations of growth, create exits. Simple concepts are backable in large economies as they can grow to listed company scale, while the same concept in a smaller economy will plateau at family company size.

# Exit Strategies

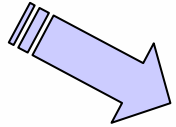
- Sale to strategic buyer
- IPO on local market
- IPO on international market → *rare!*
- Management buyback
- Self-liquidating instruments
- Pre-structured exits (e.g., put options) → *may be untested*

# Building Blocks of Private Equity

## Other Issues

	Basic question	Discussion
<b>Property rights</b>	Will the buyer be secure in ownership? Is ownership clear and easily transferred? Enforceable?	In many countries title to land and other property is not clear. You improve a company – and then someone claims it as theirs! Poor contract enforceability undermines private equity.
<b>Transparency</b>	Can you really understand what is going on?	Are accounts transparent and reliable? Are relationships with suppliers and buyers arms-length?
<b>Regulation</b>	Capital controls? Tax? Foreign purchase of assets?	
<b>Financial structuring</b>	Is both term debt and working capital available? Are different classes and structures of capital recognized?	Lack of debt finance has a negative impact on private equity returns. Lack of flexibility in structuring may hinder debt-based strategies to exit and structure risk.
<b>Managerial talent</b>	Can you get good management to implement your strategy?	Good management is key to any strategy relying on growth or margin expansion. US GPs have stables of on-call managers. In emerging markets quality management is at a premium.

# Process: Deal Pipeline



## Survey markets

- \* Deal flow potential
- \* Opportunities for private equity
- \* Market impediments
- \* Viability of exit
- \* Means to watch players develop

Track private equity players & funds

# Process: Due Diligence



## What do we look for?

- \* Fund managers with proven track records
- \* Team cohesiveness
- \* Positive reference checks
- \* Deal sourcing capabilities
- \* Value addition skills
- \* Proven ability to exit
- \* Deep understanding of fiduciary responsibilities
- \* Broad, achievable mandates

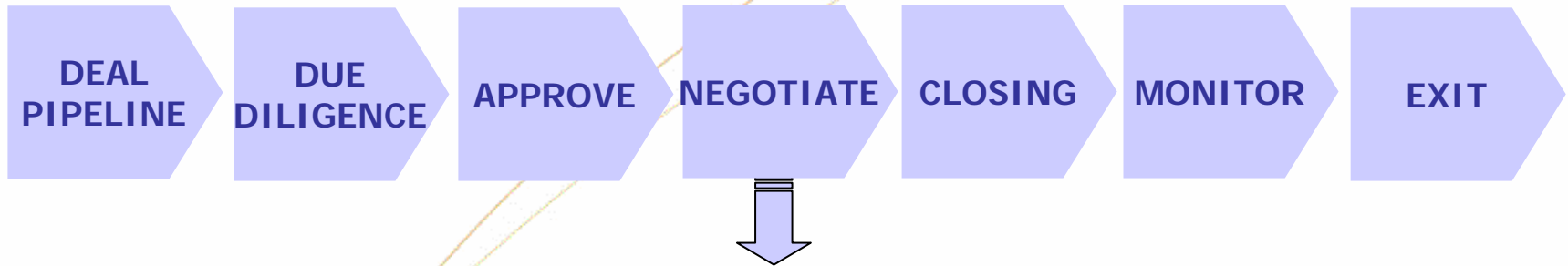
# Process: Approve



## Approval process:

- \* Due diligence paper prepared for management
- \* Right investment opportunity + manageable risks & issues + right fit for our portfolio
- \* Two-tier approval: IFC management then IFC Board

# Process: Negotiate

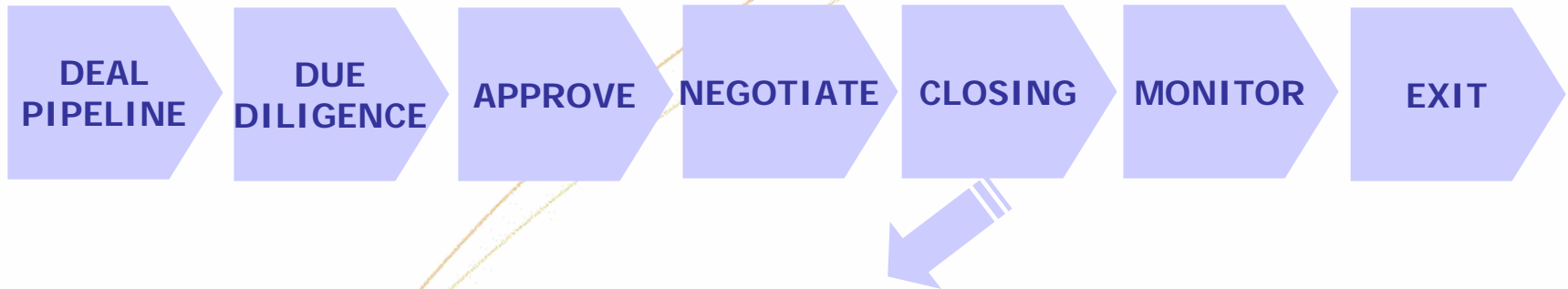


## Alignment of interest is critical

### Key terms & conditions:

- Fund structure
- Fund term & investment period
- Investment policy & limits
- GP commitment
- Management fee & fund expenses
- Distribution waterfall
- Hurdle rate & carry
- Advisory Board
- Conflict of interest provisions
- GP removal / “pull the plug”
- “No fault divorce”
- Wind-up provisions
- GP clawback
- Reporting requirements

# Process: Closing of the Fund



- \* Sign documents, fee starts accruing right away
- \* “Dry close” or actual close
- \* Minimum capital is raised
- \* Conditions of disbursement are met
- \* Governance structures are ready to be put in place

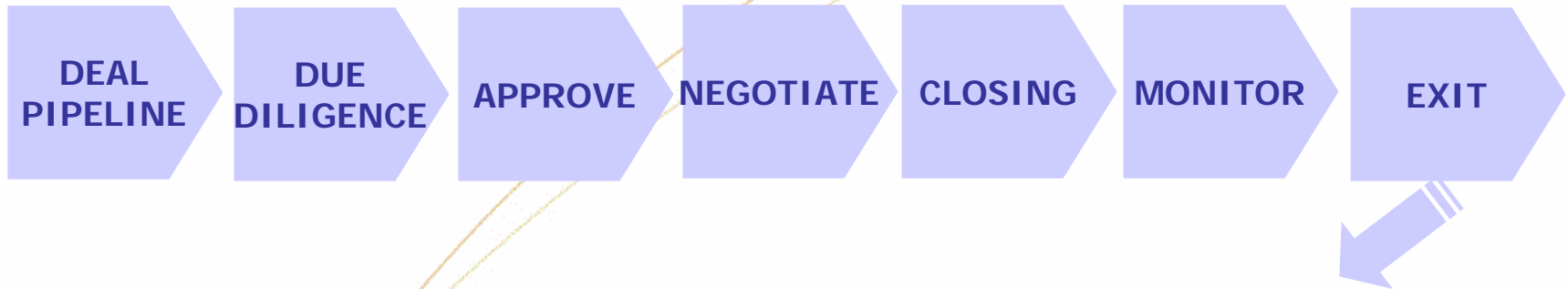
# Process: Monitor



## Regular review process:

- \* Dedicated investment officer for each fund
- \* Regular visits to fund managers, their offices and, where possible, their investee companies
- \* Advisory Board representation
- \* Detailed capital call requirement
- \* Quarterly & annual reporting requirements
- \* Quarterly IFC credit review, annual project supervision report
- \* IRR/return analysis

# Process: Exit



## Exit process:

- \* Tend to see “low hanging fruit” harvested first
- \* Can be difficult to exit last few portfolio companies
- \* Exit on term contracts
- \* In-kind distributions

# Emerging markets pose unique challenges



**Macro/Currency Risk**  
**Legal & Accounting**  
**Tough to Exit**  
**Lack of Leverage**  
**Need to Build Trust**  
**Less Robust Deal Flow**  
**Few Experienced Managers**

# “Shop of Horrors” and “Garden of Delights”

## STRUCTURING BOUTIQUE

“The Partnership Agreement doesn’t say anything about that.”

## BOARD MEMBERS SLUMBER PRODUCTS

“Was I asleep for that item?”

## FLEECE THE INVESTORS TOOL SHOP

“It’s not really the investors’ money anyway, is it?”

## REMOTE CONTROL AND OTHER ELECTRONICS

“You mean I should live in that godforsaken country?”

## BARGAIN BASEMENT

“Value for money”



Manager: “**IF THE INVESTORS NO LONGER WANT ME AS MANAGER, YOU SHOULD FIRE ME**”

Sends **MONTHLY REPORTS** even though only quarterly are required

Makes a phone call to investors to **ALERT US TO POSSIBLE FRAUD** in a portfolio company

Earns the **CARRY** but **INVESTS** it in the next Fund

Provides **TRANSPARENCY** re budgets, expenses, board fees, etc.

Tries to measure **DEVELOPMENT IMPACT**

# Little Shop of Horrors



- **Cannot fire manager without his agreement**
- **Manager charges fees to companies and pockets all income**
- **Front running (... but it's legal in this country")**
- **When a rights issue comes up after investment period, Manager assigns the fund's rights to himself personally**

# When things go wrong . . .

- **Renegotiate the terms**
- **Fire the manager**
- **Close the fund**
- **Start litigation**
- **Hire a forensic accounting firm to investigate**
- **Always build relationship with other LPs**

# Painful lesson

1. **Manager**
2. **Manager**
3. **Manager**

**You can't structure  
around a bad  
manager**

# Select better quality GPs

## ➤ *Know the market:*

- Survey each market to identify the top quality GPs

## ➤ *Do not:*

- Use industrial companies as GPs
- Invest alongside dominant industrial company LPs
- Use GPs who lack the relevant background and local connections
- Invest in the latest fad that walks through the door

# IFC looks for fund managers who:

- **Identify good opportunities to create value (e.g. new products, ability to dominate their markets, etc.)**
- **Negotiate control mechanisms (e.g. veto rights, right to appoint CFO/CEO, tag along and drag alongs, meet milestones or else management loses shares, etc.)**
- **Invest with owners who want to develop a company and then sell it**
- **Combine track record, team cohesiveness, value-added skills and deep knowledge of local market**

# Shift the economics in favor of LPs

- Set management fee at 2% or less, or base it on a budget
- Structure carried interest on an aggregate basis, not deal-by-deal
- Strictly limit the costs that the GP can pass on to LPs
- Insist on disclosure and sharing of fees charged to investees by the GP

# IFC Funds Strategy – The Big Picture

- Focus on end product: building great companies that build strong economies
- Promote professionalization of the industry and market best practices
- Disseminate knowledge of emerging markets
  - maximize chance of a good outcome!

# IFC has dual goals

**IRR**

**Development  
Impact**