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Private Equity in Emerging Asia Continues to Intrigue and Confound

By [Markus Taussig](#)

Investor Intent vs. Investor Action

Private equity (PE) in emerging markets remains a hot commodity with limited partner (LP) investors, especially in South East Asia.¹ More than half of the respondents in the Emerging Markets Private Equity Association (EMPEA)'s 2014 "Global Limited Partner Survey" claimed that they will either be freshly entering or will be expanding their allocation to funds focused in the South East Asian region over the next two years.

But will we really see follow-through? Only time will tell. While capital flows to PE funds in emerging markets have grown enormously since a decade ago, recent years have seen LPs show much more bark than bite. At the heart of the matter seems to be that investors believe more in the general value proposition of emerging markets PE than in the actual PE fund managers offering to put their money to work.

Which begs the broader question: what type of PE firm is best equipped for emerging markets? The difficulty for even a very well informed emerging markets investor to identify these key characteristics goes a long way to explaining the distance between the intent and actions of LPs in this very challenging space.

The Lure of Emerging Asian Markets

The combination of attractive macro-level growth, inefficient financial markets, and the intangibles of entrepreneurial talent have long fostered dreams of big private equity returns across emerging Asia. The fundamental appeal lies in the perceived opportunity to reap profits by addressing clear market failures. A parallel exists with the higher returns expected of venture capital (VC) investments into risky startups. While the past 15 years have not borne out this risk-reward argument for the average VC firm, my recently published analysis of PE funds in frontier markets supported by the International Finance Corporation (coauthored with NUS colleague, Professor Andrew Delios) indicates that returns have indeed

¹ Limited Partners, usually institutional investors such as sovereign wealth funds, pension plans, endowments & foundations, etc., are those who do not have management responsibility in the private equity partnership in which they invest, and whose liability is limited to shares owned.

been systematically higher in host countries with unreliable market institutions.² Unpacking which PE firms are best positioned to seize on this opportunity is crucial to unleashing the potential of PE in emerging Asia.

Local Capabilities at Entry

The first couple of years of the normal 8-10 year life of a PE fund are crucial to determining the success of PE funds in emerging Asia. This is when the fund identifies, does due diligence, and negotiates terms for the best possible investments. All of these activities are more challenging in the less transparent environments of countries where formal government institutions are particularly weak, and information asymmetries are particularly large. It should come as no big surprise that PE investors who have local origins or significant local track records – or ideally both – are substantially better equipped to overcome these challenges. They have more location-specific capabilities for identifying and engaging with leading local entrepreneurs and business groups that themselves know how to thrive under local conditions and to manage these relationship in such a way as to maximize the likelihood those emerging markets investees will be willing to share their winnings.

Foreign Capabilities at Exit

Despite the clearly central importance of local capabilities for the success of PE funds in challenging institutional environments, the fact remains that foreign PE funds have played a leading role in the industry's spread into new markets. Furthermore, there is evidence that, on balance, foreign PE firms have actually outperformed their emerging market counterparts. This is, of course, affected by a wide range of confounding factors, especially the greater experience and associated greater access to financial, talent, and reputational resources of the average foreign PE firm.

But even controlling for these advantages, my latest research indicates that there are conditions under which being seen as foreign in emerging markets is beneficial to PE firms. Specifically, IFC-backed PE funds in emerging markets managed by PE firms with foreign origins and international experience have actually done better when the local institutional context did *not* improve (or even got worse) over the life of their investments. Figure 1 illustrates how the nature of the relationship between PE firm foreignness and two forms of host country uncertainty can flip from time of entry to the time of exit into PE deals in emerging markets.³

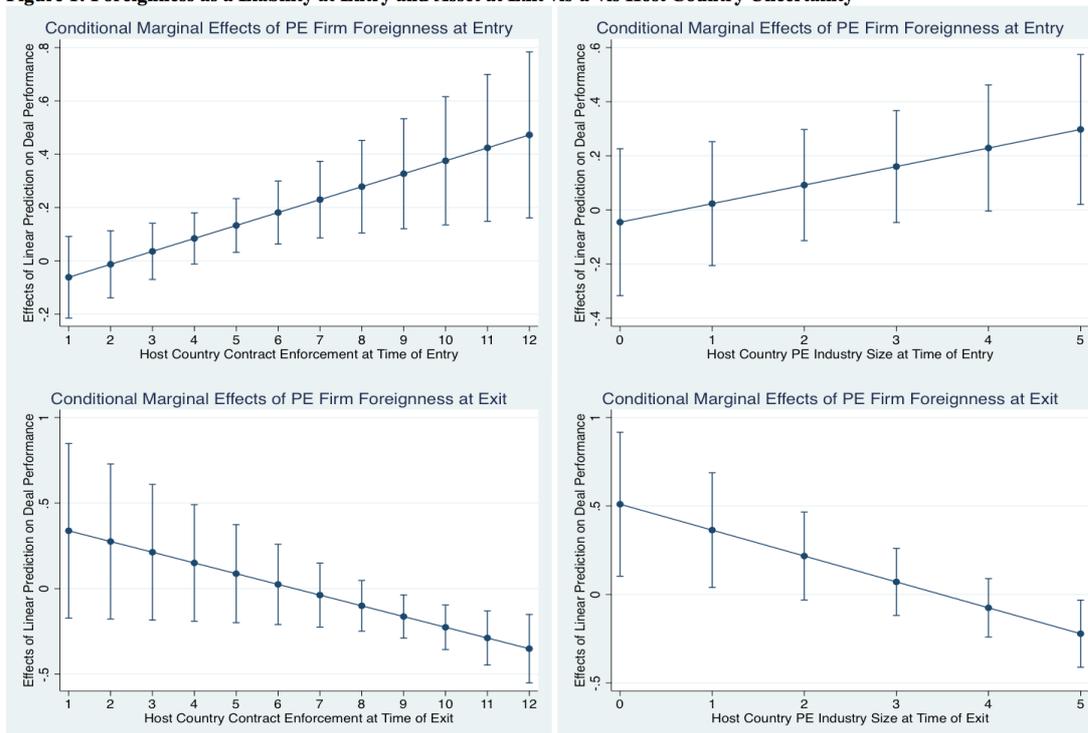
The rationale is as follows. After a PE fund has selected an emerging market company to invest in, worked with the company's management to add value over a few years, and is ready to exit and return money to its LPs, the key remaining challenge is maximizing the value of

² M. Taussig and A. Delios (Forthcoming). "Unbundling the Effects of Institutions on Firm Resources: The Contingent Value of Being Local in Emerging Economy Private Equity", *Strategic Management Journal*.

³ Taussig (2014). "From Host Country Liability to Global Asset: The Shifting Value of Foreign Capabilities Across the Investment Cycle in Emerging Economies Private Equity", Working Paper.

the company in global markets. A PE firm is ideally able at this point in time to provide assurance to a wide range of potential investors around the world that the investee company is legitimate and works well with others, including foreign owners. A PE firm that is itself foreign may help in this regard. Furthermore, global markets may view with skepticism the certification of a PE firm that is itself a product of, and deeply embedded in, the same institutionally challenged environment as the investee company. It is important to note that global markets have an enormous influence on the final sale price, even if, in the end, the final buyer turns out to be local.

Figure 1: Foreignness as a Liability at Entry and Asset at Exit vis-à-vis Host Country Uncertainty



Note: Brackets represent 90% confidence intervals

Where We Are Today

Former EMPEA Executive Director, Roger Leeds, has called emerging markets PE “an entirely separate asset class” and the differences between how PE works in advanced economies and in emerging markets is reflected in the rise of new industry leaders specifically focused on emerging markets. While big brand name PE firms like Blackstone, KKR and TPG have extended their reach into many emerging markets, the PE firms with longer track records in emerging markets are globally less well-known names like Actis and Abraaj Capital. The big familiar names are generally more likely to do big, more familiar looking deals, while their more locally experienced competitors venture into smaller, more adventurous, growth opportunities.

Given the dynamics described above, it should be of little surprise that some of the bigger deals in Asia have involved big global names investing into companies initially identified by the more locally embedded country specialist investors. In this way, beneficiary companies

in Asia are able to benefit from both the local and the foreign capabilities of PE investors. And, in fact, for larger, global PE firms, such syndication arrangements may prove preferable to investing in localization beyond mammoth markets like China and India for many years to come.

Markus Taussig is an Assistant Professor in Strategy and Policy at the NUS Business School in Singapore. Markus' research focuses on the interaction of government institutions and firm resources and how this impacts on firm strategy and performance in emerging economies. He has based his research primarily in the industry setting of emerging markets private equity and the geographic setting of Vietnam. During over a decade of work in Vietnam, Markus carried out numerous national surveys of local entrepreneurs, contributed to audits of state-owned enterprises, and was directly involved in starting up two companies. While working on his dissertation at Harvard Business School, Markus spent two years working closely with the PE group at the International Finance Corporation on analysis of their portfolio of investments. His research has been published in the Strategic Management Journal, Journal of Law, Economics, and Organization, Journal of East Asian Studies, and Business Horizons.

For more information, please contact camri@nus.edu.sg