KEYNOTE INTERVIEW

The return of the emerging markets

Private equity investments in emerging markets tailed off in the wake of the financial crisis and were further challenged by currency trends. But there are signs of a return, says Debevoise & Plimpton partner Geoffrey Burgess

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Q How would you describe the risks and rewards for LPs of investing in emerging markets?

There are a million ways to get exposure to emerging markets. Some limited partners get exposure no matter what they do because they invest in companies that have big interests in the emerging markets, and in fact almost every multi-national company today will have some level of growth or supplier relationships coming out of those markets.

That said, the general approach of most LPs is to invest across geographies and industries, as there is a need to balance and hedge in case the developed markets recede. That's when most LPs look to high-growth markets, as a place of much higher top-line growth in portfolio companies and potentially much greater profit. Those emerging markets are not as fully developed as others, whether because there is a smaller middle-class population and less wealth, or because there is greater political risk or other risks. On the risk-reward spectrum, most LPs like to have some exposure to that end of the investing range.

At any given time, returns in a particular market may fall below the acceptable threshold and not be commensurate with the risks being taken. In Africa today, private equity returns are lower than they are in Western Europe (by some measurement), so there is higher risk but lower reward. LPs need to look at countries or regions and if returns are low, they need to understand why that is and how it might change over time. The pendulum swings back and forth – it comes down to the supply and demand for good companies, and the supply of good companies in most frontier markets is pretty thin.

Q Despite growing fund sizes, why do opportunities in some emerging geographies still appear to be limited?

It is difficult to generalise. For example, people were really piling into India until six or eight months ago, but now that has slowed down, even though it is still a super healthy market. Africa slowed down about five years ago and I wouldn't say investors are yet increasing the investment pace, though they

Q Is there an argument for longer timescales for private equity in emerging markets?

Certainly, these days more and more people are questioning the standard life of funds, with an investment period of two or three years and then a hold period of seven to ten years. Many GPs would like that to be longer, because of course you can find and close a deal much faster in Sweden than you can in Sierra Leone, for example, so it makes little sense to adopt the same timescales for the two markets. A lot of funds get to the end of their lives, having extended as much as they can, without yet being in a position to make the returns to investors that they had anticipated.

Depending on the story, some investors will want to roll out or have some kind of structured secondary transaction in that situation. There is another time pressure compounding that, too, which is that if you think your portfolio company's currency is going to appreciate in the next couple of years, then it's going to be so much better to hold onto the asset than strictly observe the limited fund life.

We are likely to see more and more end-of-life restructuring opportunities in the emerging markets as a result. There have already been a number in India, and I think we will see more.

haven't taken their eyes off that market.

In some of the places I have been working, I would ascribe lower returns to currency variations. Certain countries had very strong currencies before oil and other commodity prices went down, but those currencies fell by as much as 20 percent against the dollar as prices receded. The impact was intensified by economic recovery in the US, such that suddenly the companies in those jurisdictions don't look so attractive to investors who are working in dollars.

The other reason is that when things were hot, prices got very high and it was hard to make big returns when you had paid a lot for certain assets. That's not to say there haven't been some excellent returns, because there have been, but it is a mixed story. There has been a dearth of interesting businesses that are being chased by ready capital such that demand has been outstripping supply, which has the effect of people either paying high prices or not deploying the money raised. I am speaking here of the whole market – there are many exceptions with very good GPs finding deals at reasonable prices.

Q Is there a trend towards more LPs investing directly via co-investments in these markets?

Yes. Fifteen years ago, in many markets the only private equity opportunity was a minority investment alongside a family or a local industrial group. That model has evolved, so funds now have more opportunities open to them today to take control, which means deal sizes have got bigger and funds have de-risked by removing the need to always work with a local partner.

If a private equity firm is buying 80-100 percent of a company, then there is more opportunity for LPs to co-invest, and LPs obviously feel more comfortable investing in companies where the GP has control. There were fewer co-investments in the past because LPs were weighing up going in alongside minority stakes and the ticket sizes were smaller, but as the markets have matured into larger control deals, there are certainly more LPs interested in co-investment opportunities.

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Q How do you see the outlook for private equity into emerging markets in 2020?

I'm bullish on global growth in the long run, but I can't tell you if investors will put more into emerging markets in 2020 than they did in 2019.

From our perspective, we are seeing a lot of activity in Africa, I think despite the market. East Africa has been very interesting to people over the last five years, and West Africa is always going to be very interesting given the size of the Nigerian economy, which is seething with opportunities and resources. We are also seeing people looking at more deals in North Africa now, too, where things have been a bit quiet.

India has been very busy, and Russia is obviously interesting because of the sanctions imposed in the last few years following events in Crimea and Ukraine. Those sanctions have done a lot to improve the economic infrastructure in the country – Russia now produces a wider range of goods than it used to and there is more diversification of the economy and less reliance on foreigner suppliers. When that economy opens up again, it will be much more robust and there will certainly be more opportunities for investors. ■