Expect Select Private Equity Markets Outside the U.S. to Perform Well in 2015

The second part of this two-part podcast interview on private equity with Stephen M. Sammut, a senior fellow and lecturer at Wharton, and Michael Rogers, EY's global deputy private equity leader, looks at how 2015 is shaping up for markets outside the U.S. In China, "offerings like Alibaba have captured the imagination of a lot of investors world-wide … so, the stage is set for tremendous continued activity," Sammut said. But some caution is recommended. According to Rogers, given the huge IPO backlog in China and a cautious regulatory stance for listing approvals, it will "take several years … before the pipeline normalizes…." Rogers was upbeat about certain markets in Latin America, despite recession in Brazil, and also about Asia-Pacific. In India, Sammut sees retrenchment while participants await word on whether planned economic reforms by newly installed Prime Minister Nerendra Modi can succeed.

A transcript of the full interview appears below.

Knowledge@Wharton: Thanks to Steve Sammut and Michael Rogers from EY for joining us for part two of this podcast about the current and future state of private equity. Michael is EY's global deputy private equity leader. And Steve is a senior fellow and lecturer here at Wharton. He closely follows private equity and is also involved directly in the business.

We want to talk about what's happening outside the U.S. I noticed there was an interesting quote from Maria Pinelli, who is EY's Global Vice-Chair of Strategic Growth Markets. She said that "a combination of good corporate earnings growth and a lack of alternative investment options mean that risk appetite is focused on equities and IPOs in particular. Global IPO activity this year could be the strongest since 2007 and the start of the financial crisis if macro-economic conditions remain stable, financial sponsors continue to favor IPO exits and more Chinese listings materialize."

Let's focus on the role of China. How have changes in China affected the market and how will they affect it in the future, with Alibaba's big IPO being the elephant in the boat right now?

Stephen M. Sammut: China's always interesting and there's a very important piece of background in this, because in our last broadcast we spoke of pent-up demand. I can't think of a better example of pent-up demand than China because the IPO market was essentially shutdown by government decree throughout 2013. There was a backlog of interest and an overall improvement in the global economy during that period. So, a lot of the activity that we're seeing in China is to some extent the opening of the flood gates. Despite the, from our perspective, modest decline in growth of China's GDP, that is still very significant momentum behind that. The offerings like Alibaba have captured the imagination of a lot of investors world-wide. So, the stage is set for tremendous continued activity.

Michael Rogers: I think that clearly IPOs are very much the preferred exit route in China and likely will remain so for the foreseeable future. The moratorium got more PE funds thinking about alternative exit strategies in some ways. During that window when they couldn't exit they had to look at trade sales and secondaries. Domestic firms have cash to spend on buying assets from PE and given the volatility of China's market in recent quarters, a full exit via M&A looked more attractive than it did when equities were rising consistently over that period.

Nonetheless, China's PE market is defined to a large degree by minority stake growth capital. Many family owners and entrepreneurs see an IPO as their ultimate goal — just from a personal perspective, a pride perspective almost. As a result, PE will remain an important driver of these Chinese listings. Because of that pent up demand, I think one of the local research organizations that we follow mentioned that they thought there was over 750 companies that have submitted IPO registrations when the market opened in January. About 40% were backed by PE, so you see a significant influence from PE in that market.

That's a larger percentage than we've historically seen in the U.S. or Europe. Given the backlog of these companies waiting to IPO and the cautious stance of regulators in approving new listings — it's going to take several years from our perspective before the pipeline normalizes in China.

Sammut: That's very consistent with ongoing research that I'm doing with the student team here. There's something else, too, for people unfamiliar with the Chinese IPO market to understand. That is unlike the NASDAQ or AIM, which are tolerant of not only pre-profitable companies but pre-revenue companies listing, in the emerging markets and particularly in China the bar is actually fairly high. Companies have had to enjoy at least three years of profitability at fairly significant levels in order to qualify for listing. From an operational perspective the companies that are listing have much more of a story to report and are likely to be more stable in the aftermarket, providing the market as a whole stays well.

The Chinese government has been very cautious and very conscious of wanting to protect the integrity of its markets. In a discussion I had with the head of the Chinese SEC a couple of years ago, I commented that the national interest in China in promoting the growth of high technology and more proprietary technologies in some ways ran counter to the listing policies of the country. He commented that that was quite right — that at the moment, the government is more concerned about protecting the interests of investors … and the global confidence in Chinese markets, and therefore wanted only those companies that could demonstrate that they knew how to run their businesses.

So, this is a dynamic that is very different than what we see in the United States. I think it will play out in a very positive way and will maintain confidence in the Chinese markets.

Knowledge@Wharton: So, the Chinese are saying in effect, "We realize we only have one chance to make a first impression on investors"?

Sammut: I hadn't thought of it that way but that's one way of looking at it, yes.

Knowledge@Wharton: Pinelli also says that a consistently high number of companies are choosing to go public on exchanges right across Asia-Pacific. Please comment on how you view the landscape in Asia apart from China?

Rogers: I think PE continues to expand across the Asia-Pacific region. A big part of that is a lot of companies are trying to move to where the consumers are. I've seen some very high profile deals move in that direction. I think so far this year PE firms have announced — I think our research showed — about $25 billion of deals across Asia-Pac excluding China — this is deals outside of China.

Knowledge@Wharton: So, they are following that growing middle class?

Rogers: Yes, exactly and consumers in the South there. That puts this year on pace for a 7% increase over last year and be the best year since

2010. So, firms are clearly making investments in that arena. Today we've seen a handful of major PE-backed deals listed on the regional exchanges outside Hong Kong, China and Australia. However, as they continue to grow and mature, they'll increasingly become visible alternatives to Hong Kong…and give investors a range of options in terms of where to lift. We just continue to see a big trend under current co-listings — multiple markets where they are listing to get access to the markets in which they want to sell their stock or they're selling their product.

Sammut: That's always a good strategy, especially if you're expecting your stock to move among middle class buyers. As Peter Lynch so long ago recommended, "Buy what you understand." And if you're talking about consumer products, people are familiar with the brand, they're familiar with the company and are [they are] going to support those stocks as well.

This diversification is an important factor. By diversification I mean across multiple exchanges in listings. What it signals are a couple of things — increased harmonization in terms of securities oversight, because any company that lists basically has to conform to the higher standards of one particular exchange over another. That's in terms of securities compliance. But it also means that if I'm listing in Shenzhen and if I want to list on AIM or NASDAQ I'm listing a company that is performing according to the standards of the Shenzhen or Shanghai. And this brings to market a type of offering that is new and unique in a sense of performance. And that inspires confidence as well.

So, there's an interdependency here that I think may improve the strength of markets globally. This, I think, is a positive trend and it's only going to help private equity.

Knowledge@Wharton: Let's move to Latin America. The outlook there for private equity — I'm thinking of Brazil in particular — it started out pretty bullish I believe in early 2014. But Brazil at least had a little bit of an economic slowdown and there were currency issues and that sort of thing. There, at least, the PE market proved more sluggish…than many had anticipated. But recent reports are suggesting that fund-raising for PE and venture capital firms this year were very positive — about $3.5 billion was collected for the region in the first half of 2014, according to the Latin American Private Equity and Venture Capital Association.

Rogers: Well, I am in Bogotá, Columbia today. And we're visiting with a number of clients down here and so it's a great opportunity to get a pulse for this market. But I think that overall — just an over-arching statement — it seems to be in some ways a little bit of a bifurcation in the market. We see a little bit of slowdown from Brazil. It had a pretty good start to 2014, but seems to have moderated a bit, while at the same time the Pacific Alliance countries seem to be doing much better. They may be benefiting from the policy issues that they've taken on and the improvements they've made in regulations and in search of trade.

So, we're very bullish on the Pacific Alliance countries. In particular we really have been impressed with Columbia and what they've done down here and how they've attracted capital. But as you mentioned, the Latin America and many other emerging markets are experiencing a measure of economic slowdown — slowing domestic demand and currency devaluation are challenges facing this region.

Brazil fell into the recession in the second quarter of the year. But I think a lot of funds are taking long term views and acting accordingly, because the secular growth trends remain on an upward trajectory. The growth of the middle class continues…. Maybe more importantly, private equity penetration in Latin America is just such a small fraction of what it is in the U.S. and Europe, especially next to your farms, if you will, beyond Brazil — like Columbia, Mexico, Chile — where GPs are putting increased attention. And the regular reforms are opening up these countries as a touchstone to increased investment.

For that reason the global GPs are interested in the region and they continue to fund farms with differentiated approaches, compelling value proposition and established teams and track records. I think we've seen some great deals set down here — witness Advent International recently closing a large fund. And they've done a number of deals here — right here in Columbia and been very successful with that.

So, I think they will actually have a better environment to invest in because valuations are a little lower, and there are some large companies out there that maybe some of the strategics have stepped away from. So, the industry's seen a lot of capital flow into the region over the last several years. I think it's imperative now that these folks demonstrate that they can gain returns that are attractive in the marketplace. And we're just starting to see the first wave of exits.

In fact, I'd refer folks to our most recent Latin American exit study, which just came out a month or two back, called "Great Expectation: What's Next for Latin American Private Equity?" And in there we talk a lot about the exit process and the beginning of the monetization of the initial investments that were made over the last few years.

So, we're pretty supportive and high on Latin America, particularly the Pacific Alliance countries.

Sammut: I agree completely with Michael's comments. And I'd go so far as to say the universe of limited partners seems to be agreeing as well in that same Latin American Venture Capital Association — or LAVCA — report which, by the way, I want to say very proudly that those studies originated here at Warton in concert with LAVCA.

What seems to be the case right now is that limited partners who've been polled have almost uniformly expressed interest in reinvesting. What they're hearing for the first time is that a number of parties that had never been active or invested in Latin American oriented PE funds are now considering deploying capital for that purpose. So, there is a momentum in place.

Interestingly enough, this is part of the counter cyclical story that we mentioned earlier. Just as things are slowing down, private equity is heating up. "Why?" you might ask. Well, the valuations are probably good, companies are going to be looking for alternative sources of capital and the next couple of years from an operational perspective should be very strong. And I do agree — despite that, we're seeing, as Mike points out, some very interesting exits in play.

Knowledge@Wharton: Steve, would you give us a sketch of the private equity landscape in India … and how the election of the new Prime Minister, Narendra Modi, could affect markets given his reputation as a pro-business politician and the kind of structural changes he made in the state where he was the governor.

Sammut: Well, in much the same way that Mike is in Bogotá, I returned from India last night after being there for six weeks. So, yes, I do have some immediate observations.

First of all, the private equity practitioners — the general partners — I think would complain about the fund raising trends. And at the same time they would complain about the valuations that they have paid in order to participate in the market. So, we're starting off from a platform of adjusted expectations. This was despite in the Indian economy that we saw up to the elections. Things are only gradually improving.

Having said that, right now, there is a lot of faith and hopefulness that Prime Minister Modi will turn things around. He has a number of longer-term visions. He's focusing on some of the areas that have been problematic in the Indian economy, most notably the issue of corruption. And corruption is a horrible friction on the practice of private equity because it slows down transactions. It disqualifies many transactions because the private equity funds simply will not play under those circumstances.

This is a period of confidence rebuilding. And I think when we begin to see some signs the limited partner world will be reinvigorated and we may start seeing some more transactional activity among PE funds.

On the whole I'm fairly confident that the trends in India will restore to really what they had been going back four or five years ago.

Rogers: Obviously, Steve's got some on the ground experience there recently. Our view [is] from a little bit afar because it's been a few months since I've been over to India — what we hear from a lot of our folks that we deal with is that it's a little bit of a fits-and-starts market — kind of a love and a hate, right? Because the funds — the first several waves of the PE investors that went there, some of them get frustrated and they give up on it just because of the complexity of the market and some of the bureaucracy and those sorts of things.

Then another wave will get more excited about it and they'll go back and try and attack it. I think it just speaks to an evolving market. That's the way many of these emerging markets have moved forward. But the general mood and our sense of the economy, and among the investor community, has been reasonably positive the last couple of quarters anyway. We've seen some record highs in the stock market — the barometer that tests that.

But it really hasn't manifested itself in the number of PE deals yet. There are a number of issues Steve touched on – inflation, there's a tight monetary policy, and the manufacturing performance has been subdued. Such challenges are keeping India from getting back to its 7%-plus GDP growth scenario, which I think is what people were anticipating.

All this has had an impact on the capital needs of Indian corporates and PE activity in general. But there have been a few positives globally, which hopefully will impact deal activity. I think stable or lower crude prices help some of the manufacturing in India. S&P raised the outlook on India's sovereign debt recently.

I think the new Prime Minister is having an impact — getting around, meeting with many of the top trading partners from the U.S., Japan and China etcetera. That's just trying to drive more coordination, cooperation and investment back and forth.

There's a program that Steve may know about called "Make in India," which I think is starting to get the manufacturing cycle back and get demand kicked up a little bit, which I think could bode well for private equity because private equity tends to like those types of entities. This should all bode well for the overall prospects and sentiments of investors towards India. The [sentiment] should continue to improve. But it will be slow and it'll move in waves.

Sammut: Mike's analysis is right on target. Just about everyone who travels to India, their first impression is that it's a country of opposites. That I think holds true in the financial markets and in private equity as well. So, there is this punctuated equilibrium, as it were, in the growth of just about anything in India. In the case of private equity, a new wave of investors will encounter some of the same problems. But things will gradually get better.

The expansion of trade relationships and the enticement of bringing Japan, among others, into India to do manufacturing, I think, will have a very positive effect. Essentially the whole time I was there, every day in the financial press there was discussion of Modi's initiatives in this regard. That can be the booster shot that the Indian economy really needs. But we'll see how it plays out. ■