Private Equity: Slowing Emerging Markets Will Create Private Equity Opportunities

In Part II of this interview, Knowledge@Wharton asks Michael Rogers, EY's global deputy private equity leader, and Stephen M. Sammut, senior fellow and lecturer at Wharton, to evaluate the outlook for private equity in emerging markets. Striking an optimistic note, they say that while it has been a challenging year, PE is one area where slowing growth can offer opportunities because it could reduce company purchase prices, a key factor tied to later performance. They also note that while some economies are suffering today, things tend to change "fairly quickly" in the emerging markets. An edited transcript follows:

Knowledge@Wharton: Would each of you to do a quick tour of the world and tell us what you think is happening in private equity in emerging markets?

Michael Rogers: It's been a challenging year for PE in some of the emerging markets. And part of it is that pullback that occurred on the rebalancing mentioned earlier.... The first place to start might be AsiaPac. We've seen a marked drop in activity this year, led largely by the macro issues you touched on in China. And from a fundraising perspective, that had focused on AsiaPac raising about $19 billion for the first half of 2015. And that's about a 30% decline versus the same period a year ago. Activity similarly saw a decline. And firms announced deals of about $14 billion, which is about a 44% drop by value.

These dislocations also present opportunities. One of the things we're starting to see is declining valuations in China, for example. It had been an extremely hot market. And that possibly could spur a little bit more investment in the coming quarters as PE tries to capitalize the lower entry points. But the IPO window opening and closing, that's not helpful for the PE business over there. And they're going to have to continue to find alternative ways of funding themselves in that market. So there is more to come on China, and the economy is the big story there. [Editor's note: these interviews were conducted before the major financial events in China's equity and currency markets at the end of August.]

Latin America is slowing a bit. A lot of fund raising held up pretty strongly. We've been pretty pleased with that — a couple of funds have really been nicely received. Carlyle did a second fund raise focused on Brazil. Advent had over a billion dollar fund raise as well. PE investments are about in line with last year. The exit side is a little slower than most people would like. Colombia's the exception – it seems to be where folks are still pretty excited. And the cycle of exits is actually gaining a little bit of momentum there.

In India they've seen a nice uptick in sentiment over the last year driven by the improving economic conditions and the election cycle, which has introduced some reforms into the country. Fundraising is up, a handful of large deals have been taking place, and PE is investing a nice amount of money in there. Again, it's kind of going sideways though in terms of size and dollars, but on a global basis or analysis, India looks like it's doing pretty well.

The interesting thing when you talk about these parts of the world is that emerging markets tend to move very quickly. This year's leader can easily be next year's laggard…. So the opportunity set as we talked about longer term is there. And this is really where PE should have a chance to shine. In many ways one other place that you can touch on directly is, for example, is the private equity activity in Brazil. Almost every economic trend you can think about had reported negatively in Brazil in terms of interest rates up, inflation up, GDP down - just all the challenges, corruption that had happened there with some recent public events. And you could say that that's a bad time for private equity to invest. But as I think we all know, oftentimes those can be some of the best opportunities to invest, particularly with a depreciated currency. So outside investors may find the valuation levels that make great entry points into those markets.

So I'm looking at this from a glass half full perspective. The opportunities are out there. And maybe valuations moderate a little bit and we might see it pick up as we go into 2016.

Stephen M. Sammut: The glass is half full in my view as well. Things tend to change fairly quickly in the emerging markets. So things that look negative this year can very easily turn around in the next. And we can only tell over time if these portend more macro trends, and I suspect they do not. Many of the private equity fund managers and general partners who I speak with from Latin America say that there may be some new macro factors or longer-term trends to consider. I'm hearing questions that I've never heard before. Michael I'll be curious to see if EY has picked up on this.

They're wondering if they can still rely on the classic Latin American investment hypothesis, which is that we will generate growth, we will generate returns, alpha, on the basis of improving companies, which is what private equity is in the business of doing; and that we will achieve the gains and multiples for our limited partners on the basis of just doing our jobs well. I'm hearing for the first time a speculation that maybe it's time to be thinking of leverage as a component generating those returns, which classically has not been the case — in other words, make up the difference between indigenous growth and financial engineering, through financial engineering…. And that's bringing the banks along for that leverage is a considerable challenge. So I wonder if that's actually going to become part of the landscape or not.

Rogers: I think that you're right. Historically there's been a very under developed capital markets and senior lending environment in Latin America. It almost has been non-existent. I think the natural evolution of the industry will require the establishment and the utilization of debt capital more extensively in these transactions because … most of the transactions that have been done down there have been done with very little, if not zero debt, and have been funded almost entirely with equity capital. And many of the businesses are family owned, so they're unable to fund themselves through that mechanism. But we will need a robust capital markets in Latin America to make that work over time.

Sammut: And it may be a case where the private equity sector actually helps accelerate the development of the capital markets. It's something I have my eye on very closely.

Knowledge@Wharton: Do you think that since we talked about emerging markets having stepped down a bit that Africa will fare better than emerging markets in general, worse or about the same?

Sammut: If we have the liberty of breaking out certain African countries I think several of them certainly have the likelihood of out-performing other emerging markets. So the continent as a whole, it's more difficult to say. But certainly the rapid growth economies and in the EY report the graphics were beautiful in this regard, demonstrated which of the countries had significant growth rates. I think they will outpace emerging markets generally because there's just so much of a gap to make up, and the demographic trends are certainly supportive of how that is going to work.

And when you speak with young Africans, and this is not very scientific and it's anecdotal to be sure, and multiple anecdotes does not equal data, but the thing you keep hearing is "It's our turn. It's our turn. It's our turn." And that kind of human energy can carry things quite a long distance.

Rogers: It may be a little too early to tell whether Africa will out-perform other emerging markets. But the potential is certainly there. Despite a little bit of softness in Latin America, and certainly you would chalk a lot of that up to Brazil's struggle, they've out-fundraised Africa by multiples. And so it still is in its infancy relative to some of the other markets. And the region in many ways continues to suffer from a decades-long perception that it is an area of economic stagnation or has instability. And that's led to chronic under-investment.

Fortunately, a new African narrative is emerging. It's giving way to more of a rapidly growing middle class — there is rising consumerism — energy around it. I witness that as well when I'm on the ground there. You hear it in people's voices that they're excited about the opportunity in front of them. I think increased investment from local and foreign investors across the wide range of industries you talked about is really driving the story, and PE is becoming an important part of that narrative. Some of the local firms are seeing increased attention from global players and global LPs. That ecosystem needs to be developed as well.

If you look back at Latin America, a few years ago we talked about having local funds put that first level of professionalization into an entity, and then that makes it more attractive to the pan-regionals, and then ultimately that might be something that would be owned by a Carlyle or a KKR down the road. We need that ecosystem to continue to develop.

All the emerging markets offer deep opportunities but Africa sets itself apart. I'd agree with Steve on this. Many of the industries, that are more mature in places like China and Brazil, are still developing in Africa. Some might look at that and say, we're woefully under-penetrated from a private equity perspective. And then on top of that many of those initial plays that were very successful for private equity in China and in Latin America are still there, to be taken advantage of, like telecom and mobile banking.

So we tend to believe that the Africa story is real. That while volatility remains a big part of the African landscape, and it's not for the faint of heart, let's be clear. In terms of local expertise, with broad networks and good market connections, PE will have the opportunity to add value as they have in other markets.

I was at a conference in London for Africa last October. It was at the height of the Ebola discussion. And one of the speakers that we visited with there mentioned that Africa is a resilient continent. If you look back at the moment, that seemed to be the crisis that everyone was focused on. But the continent has suffered, and recovered from a lot of different challenges over time….

I think we'll see some folks that look at this and say the perceived risk is higher than the actual risk and will continue to try and make investments and do well — and have a first-mover advantage in many ways…. So we're hopeful and positive on the future here of Africa.