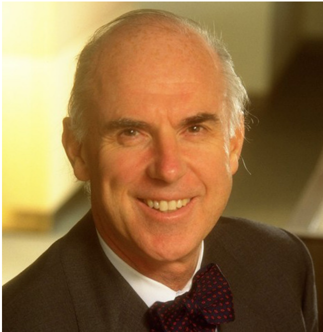
# Inside Perspectives: An Interview with Tom Barry of Zephyr Management

EMPEA
Emerging Markets Private Equity Association

February 2014



Tom Barry is the CEO and Founder of Zephyr Management, a global emerging markets investment manager that specializes in the creation and management of private equity and marketable securities funds. Tom discusses the rationale behind his firm's investment strategy and candidly shares his views on what he sees as the greatest challenges for the industry today. Since its inception in 1994, Zephyr has sponsored 22 funds with approximately US$1.2 billion in committed capital.

*What led you to the world of emerging markets private equity? You previously served as President of T. Rowe Price's New Horizons Fund, which seeks to invest in small, emerging growth companies. What lessons did you learn from that experience and others that have applied well to your current career?*

I started my career in international business and at a young age found myself addicted to multicultural activities. I became an advocate that private sector development was logical and superior to foreign aid and diplomacy. In other words, I came across what would now be called "doing good by doing well." I had to learn a trade so I focused on domestic fund management. While I was at T. Rowe Price, I helped form a joint venture, Rowe Price-Fleming, with a British company to start one of the first non-U.S. investment firms for U.S. clients. I then became the President and CEO of Rockefeller & Co., the entity that manages the personal money of the Rockefeller family, where I was active in international and emerging markets. In 1994, I founded Zephyr Management because my interests had progressed to the point where I wanted to focus on just emerging markets. And there I saw a tremendous opportunity to apply what I had learned about small, growth companies while at the T. Rowe Price New Horizons Fund toward those in emerging markets.

One of the greatest accidents of history was that as the developing countries' independence movement unfolded in the aftermath of the Second World War, the leaders of those emerging market countries were primarily trained in the British and French systems. During that time period, the dominant thought pattern was socialism and, interestingly, after the War, both Britain and France—which were happily socialist—eventually came back to more balanced economies. But the people they had sponsored—the "best and the brightest" of their colonies who had come to Europe to study before going back home to rule—were all socialists. As it happened, I grew up in an era in which the prevailing wisdom in developing countries was a belief in state control in the operation of assets. So when I first started working right out of college, I saw that I could demonstrate other ways to create jobs and wealth through private sector development. I still feel that way today.

*Zephyr sponsors a number of region- and country-dedicated funds. Why has the firm opted to adopt geographic strategies as opposed to a global or sector approach with its private equity funds?*

Private equity, as opposed to investing in listed securities, is labor intensive and involves a lot of local knowledge and content. There are only a few countries that follow the Anglo-Saxon model of contracts, law and regulation. For the rest of the world, this approach is some kind of joke. So the way a private equity firm protects its rights is by being on the ground. Woody Allen has a great expression: "90% of life is showing up." He's right, and this applies to private equity in emerging markets.

Each of the times Zephyr has considered investing in a market, we have asked ourselves: do we have the skills and the people on the ground that could make it work? And we have found that this is very difficult to do regionally. There are a few firms that can take a regional approach because they look at large, control deals. In our case, we focus on small- and medium-size companies and we rarely take control. We are working as the friend and supporter of management and need voluntary compliance, so we must

have a local team. Legal agreements are generally not enforceable in these markets so personal relationships are paramount to success. This strategy lends itself to a country or small regional fund.

*Zephyr also manages marketable securities funds investing in Latin America and Asia. Why did Zephyr expand into this space? What are the commonalities between private equity investments and those in public securities—if any?*

We are great believers in economic development in developing countries, and in some cases, that opportunity can best be accessed through listed markets. In most cases, it cannot. But you will find that in some of the larger listed markets, such as Brazil, India and more recently China, for reasons that are temporary, private equity can be much cheaper than listed markets. Similarly, listed markets can fall and present cheaper valuations than private equity. So we think you should be able to offer multiple options to investors who want the right to short-term liquidity. We don't start from the standpoint that we are private equity guys. No, we start from the standpoint that we want to be involved in economic development in a way that is cost effective and can get a good return to investors. One of the most significant costs of private equity is illiquidity for five years or more, and it's a big problem trying to determine the proper premium that a private equity fund should return over the long term.

*This issue on the cost of illiquidity is a real sticking point for the industry, particularly as private equity returns in several emerging markets have come into question in recent years. Have you found that the risk-reward tradeoff of being in a long-term private equity vehicle has held up in comparison to what one can get with emerging market public equities?*

Private equity is a highly cyclical business. If we look at venture capital, growth capital or buyouts in the United States, we can see this cyclicality. In reference to one particular vintage year, David Rubenstein of The Carlyle Group recently said that anybody who has a U.S. buyout fund that has a return above zero is in the top 10% of their category—but that doesn't hold over the long term. Take the case of India. There have been a couple of periods where any idiot could make huge returns in Indian private equity, and others where very capable people were struggling to make money. This is why consultants have started the concept of vintage funds, saying that if you are going to invest over 10 years you should invest equal amounts in every year because you can't guess which vintage is going to succeed.

It's not the case that private equity worked great five years ago and now it doesn't—there are cycles. And this opens a larger question about returns and risk, which is: should the vehicle that deploys private equity have more flexibility? I believe that it should, and not incentivize the local team to keep investing if the relative aspects of what it is doing are not as attractive as they could be. I think there is room for experimentation because if it is a cyclical business, there should be a way to mute the cycles. And we have to ask the managers to do that because history shows the institutional investors won't. These institutions will make commitments at the peak rather than the bottom, and this is why the concept of an efficient market is poppycock. The market would be efficient if it weren't for humans.

*Rumor has it that you are planning to raise the first private equity fund dedicated to Sri Lanka. Why do you think this is a market ripe for private equity investing?*

Zephyr seeks to identify markets that are ready for private equity, which means there has to be some acceptance of third-party owners of private businesses in the society as well as some acceptance in the government in terms of regulation or currency controls. If we are early, we can invest at a low valuation and get a good return for what is perceived to be a high risk. Three years ago, Indonesia fit that mold and there was a rush into the country for businesses. Today, some people think Nigeria, Turkey, Morocco, Vietnam or Myanmar are ready. Different people have different views.

Sri Lanka is a country of 20 million people. We believe it is an opportunity for Zephyr as the larger private equity firms will probably not go there because they need to invest a minimum amount of capital—and we don't focus on the size; we focus on trying to get a good return. In the five years since its brutal civil war ended, there have been no incidents at all and the country has had several continuous years of 9% growth. It has an excellent educational system with a literacy rate that is almost 50% higher than any other country in South Asia. It doesn't have a caste system, which has been a huge impediment in India, and Sri Lanka has never had the level of corruption in government that India has had. In addition, it is a highly productive society. If you buy low-quality cloth, it is often made in Bangladesh; if you buy an upscale polo shirt and look at the label, you will find that it was made in Sri Lanka. Being situated between the Middle East and the Far East, Sri Lankans have been exporting for 500 years. This is a society that is very comfortable with foreigners and trade.

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Sri Lanka could be a little gem that is overlooked. We have already publically announced a joint venture with NDB Bank, a local institution that lends to SMEs in the country. The airplane flight from Colombo, Sri Lanka to our office in Bangalore, India is one hour and 15 minutes—the same time for a flight between Bangalore and Bombay, which we take every week. So it's convenient and gives both us and the Sri Lankans a chance to excel in terms of hiring and training that wouldn't be possible for somebody who is only in New York or Europe. So here is a situation where we think we are the right guy in the right place at the right time. We have looked at a lot of countries and felt we were not the right guy or the timing wasn't yet right. For instance, everyone loves Myanmar. We looked at Myanmar and in my opinion, it is at least five years away or more before the sanctity of a private contract would be kept. Today, possession is the law in Myanmar and that just doesn't work.

*In your experience, what is the hardest thing for a private equity investor to get right?*

Cultural understanding and getting in the head of a local group, manager or entrepreneur is the biggest challenge in emerging markets private equity. Private equity was started, built and enhanced in the Anglo-Saxon world, and the British and the Americans have all kinds of underlying assumptions about contracts, appropriate behavior, shareholders, etc. Many of these things don't exist in other parts of the world and there can be huge cultural misunderstandings that arise out of not knowing that the other person's basic framework is different from yours. He or she may be completely honest and ethical but do things that you think are not right. And so, the challenge is to understand what is going on and why. Once you have cultural empathy, you can address the issues that investors tend to bring up, such as business ethics or accounting or legal concerns, which are really symptoms of cultural issues; they aren't the problem.

For example, many entrepreneurs only want to do business with one particular ethnic group or tribe. You can see this in New York where the newsstands in a lot of the subway stops are controlled by Pakistani groups. I remember once buying something at one of these shops and a little girl who could barely see over the top of the counter took my money. At the same time, there were grown men stocking the shelves. But the little girl was a family member while the men weren't of the owner's tribe, so they were not allowed to touch the money. And to all of them, this arrangement was 100% logical, whereas Americans would think this is nutty—why would you let an 11-year-old girl run the cash register?

This is why we generally do not like to buy control of businesses. We think it is a good idea for locals to be in charge because they understand the way things work in terms of the regulations and cultural aspects related to customers and employees. Of course, there are times when you have to say that this may be the way you do it here but we don't think we can do it that way because our investors would find it inappropriate—for instance, with issues around labor practices, taxes or the environment—and you have to try to persuade the other person that it is in their selfish interest to change, because doing so will enable them to do such things as list on the stock exchange or sell to a multinational. Incidentally, our biggest allies for change in most emerging markets are the sons and daughters. When an entrepreneur makes some money, what does he or she want to do? They send their kids to the United States or United Kingdom to study. And when these kids come back home, they want to take what they have learned and help their family businesses go to the next level.

*Which book are you recommending to your friends this year?*

Nassim Talib's *Fooled by Randomness*. Talib highlights how so many people, including myself, are fooled between luck and skill. He points out that if 1,000 people flip a coin five times, a whole bunch of them will get either five heads or five tails in a row. This is no different from a mutual fund or private equity investor who gets lucky. You can call them a genius but they are no better than the other guys. Just because there is growth in the business or a rise in prices, those occurrences do not necessarily mean that some management skill has been exercised. This perspective is essential for emerging markets, which are volatile, and investors can get confused with the ups and downs between luck and skill. There needs to be a valid analysis among investment actions as to which were random or lucky, and which were evidence of thoughtful value-added.

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