Emerging Middle Markets: Closing the Gap Between LP Ticket Sizes and Mid-Market GPs

We at EMPEA view the fundamental misalignment between the trend toward larger LP commitments concentrating on a smaller set of fund managers and the check sizes best absorbed by small- and mid-market private equity funds in emerging markets as a key challenge for our industry; and we know that many of our members are struggling as a result of this dynamic. We are committed to working with you to address this problem, including through LP education and working with funds of funds and other intermediaries, and we strongly encourage you to share your ideas with us as we look to develop strategies for unlocking capital for the middle market segment and below in the coming year.

Over the last few years, we have seen a significant drop in private equity capital flowing to emerging markets, with a greater percentage of this funding concentrating on a fewer number of larger funds active in a handful of core markets. Average fund sizes have more than doubled in the last three years, while the total number of funds holding closes has declined—96 emerging market funds held final closes on an average fund size of US$192 million in 2009 versus 84 funds closing on an average final fund of US$419 million in 2011. In fact, through the first three quarters of this year, the 10 largest funds raised accounted for over half of all capital going to the asset class.

As we near the end of 2012, fundraising continues to be a serious challenge for the emerging markets private equity industry, and for mid-market fund managers in particular. As institutional investors look to increase their allocations to our asset class, while at the same time reducing overall costs, many are choosing to focus on a small universe of fund managers, thus facilitating the conditions for ballooning fund sizes and effectively creating a financing gap for mid-size funds trying to raise capital. A cycle has come into play of larger LP commitments fueling larger funds, and larger funds necessitating larger checks.

A flight to perceived quality is a natural reaction for investors; however, the concentration of capital going to a handful of emerging market funds is also exacerbating the problem. If this trend continues, several key challenges for the asset class will arise—too much capital chasing a limited number of large deals will inevitably pressure valuations and drag down returns. But perhaps more importantly, LPs are not accessing mid-market growth opportunities, and viable emerging market-based businesses operating in the middle market segment and below will find themselves starved of crucial capital. This article takes a closer look at some of the market dynamics at play, with a focus on how LP commitments are driving increasing fund sizes in emerging markets, in hopes of setting the stage for greater industry dialogue on how to bridge the growing gap between LP ticket sizes and mid-market GPs.

The Middle Market Squeeze

Defining the middle market is no easy task. If you ask 10 middle market GPs how they characterize their investment mandate, you will likely hear 10 different answers. The middle market has been defined in the United States as those companies that have revenues between the broad range of US$10 million and US$1 billion.[1] In Europe, where the overall proportion of mega-sized companies is smaller than in the United States, the mid-market is estimated at a slightly lower scale on average. A study conducted by GE Capital and ESSEC Business School defines the middle market in Germany and the United Kingdom as those companies with revenues of €20 million to €1 billion; in France with €10 million to €50 million; and in Italy with €5 million to €250 million. In an emerging markets context, the middle market exists within a much smaller range.

Why should LPs care about the middle market segment in emerging markets, however defined? One key reason is that these are the companies that drive much of the greater macroeconomic growth in emerging markets. Furthermore, the scale of investible opportunities at the upper end of the market in these economies remains relatively small. For example, of the 21,800 Brazilian companies listed in S&P Capital IQ's research database as of August 2012, only 6% reported revenues of greater than US$200 million. Of the 45,700 Indian companies tracked in the database, less than 3% reported sales greater than US$200 million.

The prevalence of smaller businesses suggests the need for smaller fund sizes in emerging markets, in addition to larger ones, in order to access the bulk of available opportunities. As LPs flock to large funds, select markets and established brand names in today's environment, a fundamental misalignment has emerged between LP commitments and the sizes of private equity funds optimally scaled for the majority of the underlying investment opportunities available in emerging markets. Unless a portion of funds are "right-sized" for the small- and mid-market segment, many companies within the emerging markets will struggle to access capital.

On average, funds in emerging markets invest in 10 to 15 companies, and this seems to be the norm across small to large funds. For example, a fund of US$1 billion would likely have an average ticket size of US$50 to US$100 million, so its investee companies would have to be fairly large. Summing up this predicament, Hany Assaad, Co-founder of emerging markets-focused fund of funds Avanz Capital, remarks, "Very few emerging market countries have a sizable number of companies capable of absorbing such large investments by a

[1] The National Center for the Middle Market.

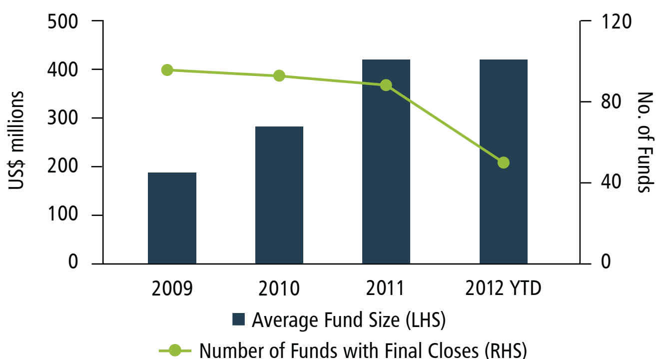
PE fund. One has to look at the size of the market, how many investible companies exist that meet the strategy of the fund, and then determine what size fund can reasonably be raised. We have to ask ourselves: are we pushing funds beyond what they can (and should) do?"

The Rush to Scale

It is clear that private equity funds in emerging markets, on average, are rising in size (see Exhibit 1). In 2009, a total of 96 emerging market funds held final closes on an average fund size of US$192 million versus 84 funds closing on an average final fund of US$419 million in 2011. Through the first three quarters of 2012, we are continuing to see this development, with 51 funds raising an average final fund size of US$419 million. Included in this total are several multi-billion funds, such as Capital International Private Equity Funds' US$3 billion close on CIPEF VI—the largest emerging markets-dedicated fund raised to date.

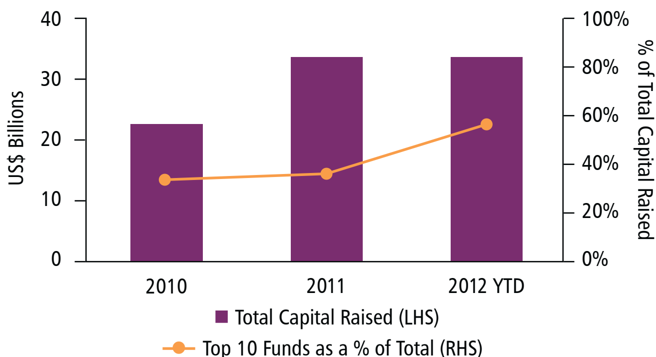
Looking at the data in a different way, the 10 largest funds holding a close (inclusive of incremental closes) through September 2012 accounted for 55% of all capital raised (see Exhibit 2). This compares with the 10 largest funds accounting for 37% of capital raised in 2011 and 35% in 2010. A cycle has come into play of larger LP commitments fueling larger funds, and larger funds necessitating larger checks.

Exhibit 1: Average Final EM PE Fund Sizes, 2009–2012 YTD (US$m)



Source: EMPEA.
Note: YTD 2012 data as of 30 September 2012.

Exhibit 2: Concentration of EM PE Fundrasing in Top 10 Largest Funds



The Rush to Core Markets

Alongside a trend toward larger fund sizes is a growing concentration of capital in a handful of markets, primarily the BRICs (see Exhibit 3). Regional funds, mainly focused on Asia and increasingly Latin America, have historically dominated the fundraising landscape, with the bulk of this capital flowing to China, India and Brazil. Regional funds are important to many of the large institutional investors because they typically raise multi-billion dollar vehicles, and are therefore capable of absorbing large commitments. Paulus Ingram, a Senior Portfolio Manager of Netherlands-based pension fund asset manager APG Asset Management, states, "Our institution prefers country-focused funds. Managers have specific local insights, and countries within a region can be very different, diluting these insights. However, we are often forced to allocate to regional funds due to size constraints. APG prefers to write checks for more than US$100 million and to still be a minority investor in a fund."

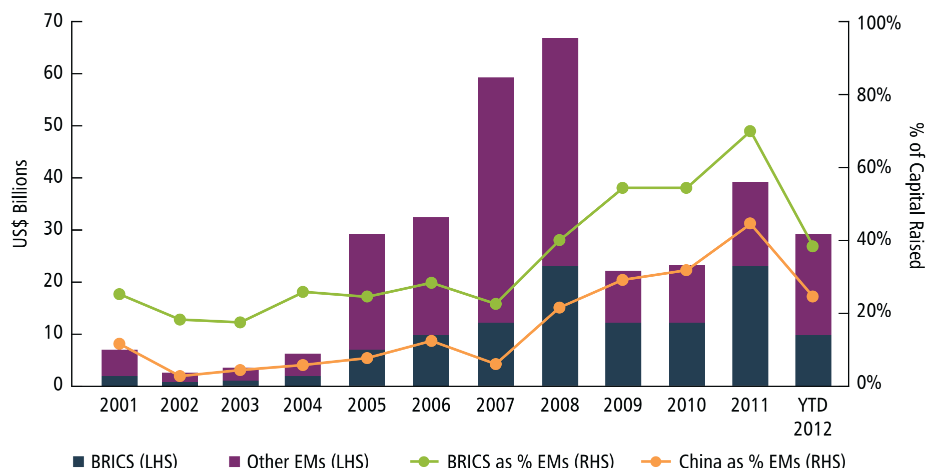
However, a noticeable shift has taken place in recent years, with regional funds giving way to local funds focused on single countries. Go to any private equity conference today and you'll hear fund managers discussing the importance of being local. The private equity model in emerging markets has evolved to a stage where "fly-in" executives have been replaced by those with well-connected "boots on the ground," capable of not only sourcing transactions, but also managing deals through exit with the highest degree of efficiency.

As a result, whereas all 10 of the largest known emerging market funds raised in 2008 were regional funds, only one of the 10 largest emerging market funds raised in 2011 was a regional vehicle. In 2011, BRIC-dedicated funds accounted for slightly less than 70% of all funds raised for emerging markets private equity, with China alone representing 43% of total capital raised. In Brazil, five funds that raised more than US$1 billion each accounted for a remarkable 95% of all new capital raised in that market last year.

Through the first three quarters of 2012, the BRICs accounted for approximately 36% of total funds raised for emerging markets through single country funds. Sizable BRIC-focused funds raised thus far this year include Hony Capital's US$2.4 billion final close on its fifth China-focused fund and FountainVest Partners' US$1 billion first close on its second China-focused growth capital fund. While classified as a regional fund per EMPEA's methodology, much of Baring Vostok Capital Partners' recently closed US$1.15 billion fifth fund, with an additional US$350 million raised for a supplemental vehicle, will go to Russia.

2012 is showing signs of greater demand for emerging market diversification as LPs increasingly want to access markets beyond the BRICs. Fund managers focused on non-BRIC markets, including Turkey, Indonesia and the MENA region, have successfully closed large funds this year. Actera Partners and Turkven raised US$962 million and US$840 million, respectively, for their latest Turkey-focused funds. A number of funds focused on Indonesia are also in the market, including Saratoga Capital's recently closed US$600 million

Exhibit 3: Geographic Concentration of Emerging Market PE Fundraising, 2001–YTD 2012 (US$B)



Note: YTD 2012 data as of 30 September 2012.

vehicle. Abraaj Capital closed their fourth MENA-focused private equity fund with US$1.6 billion in commitments; though they remain an outlier, with most funds in the region raising funds of US$100 million or less.

However, size constraints limit the ability of LPs to enter most emerging markets, thus highlighting a tension of LPs wanting greater geographic diversity but not being able to access it. In general, the markets outside of the BRICs that have been able to attract greater pools of capital are those that are large enough at the macro level to sustain a single country fund. While other emerging markets such as Colombia, Peru, Vietnam and the latest hot spot Myanmar have all attracted greater interest from the private equity community in recent years, it is unlikely they will achieve the scale required in the short term to attract sizable country-specific commitments from large institutional investors.

The Rush to Brand

As LPs invest into larger funds operating in just a few markets capable of sustaining these bigger commitments, it is inevitable that they will have a limited list of fund managers from which to choose. In each of the emerging markets to which LPs are flocking, there are only a handful of names per market that are attracting the bulk of capital—and in many cases, it is the same set of names that have dominated their respective markets over the last several fund cycles, thus making it difficult for a new generation of fund managers to emerge.

LP Preferences: A Closer Look at Five North American Pension Funds

We looked at a handful of leading North American LPs for which information on private equity fund commitments was publicly available to evaluate their ticket size preferences. Exhibit 3 shows the median and mean private equity commitments made in 2011 and 2012 (through mid-November) by five major pension funds: California Public Employees' Retirement System (CalPERS), California State Teachers' Retirement System (CalSTRS), New York City Employees Retirement System, New York State Common Retirement Fund and Canada Pension Plan Investment Board (CPPIB), all of which rank in the top 30 pension funds worldwide by assets under management.[2]

In 2011 and 2012 year to date, new private equity commitments made by these U.S.- and Canada-based pension funds across all geographies averaged US$160 million, with a median commitment of US$120 million (see Exhibit 4).[3] Among these five pension funds, the smallest commitments made to private equity funds, excluding separate accounts, averaged roughly US$30 million; however, most LPs did not make any commitments smaller than US$45 million. CalPERS' smallest private equity fund commitment during this time period was US$100 million, while CPPIB did not commit less than US$75 million.

[2] Towers Watson, 2011.

[3] Note: Those funds that invest in emerging markets, but whose primary mandate is North America, Western Europe and/or Japan, Australia or New Zealand were not classified as emerging market funds.

Exhibit 4: Sample LP Private Equity Commitments, 2011–YTD 2012

	Global Private Equity Commitments			Emerging Market Commitments		
LP	**No.**	**Mean (US$m)**	**Median (US$m)**	**No.**	**Mean (US$m)**	**Median (US$m)**
CalPERS	12	223	188	2	100	100
CalSTRS	21	118	100	3	125	125
CPPIB (Canada)	15	301	300	4	241	220
NYC Employees	16	84	90	0	-	-
NYS Common ex separate accts	24	130	120	5	79	75
NYS Common incl. separate accts	40	84	75	8	55	63
Total (ex NYSC separate accts)	**93**	**160**	**120**	**14**	**138**	**100**

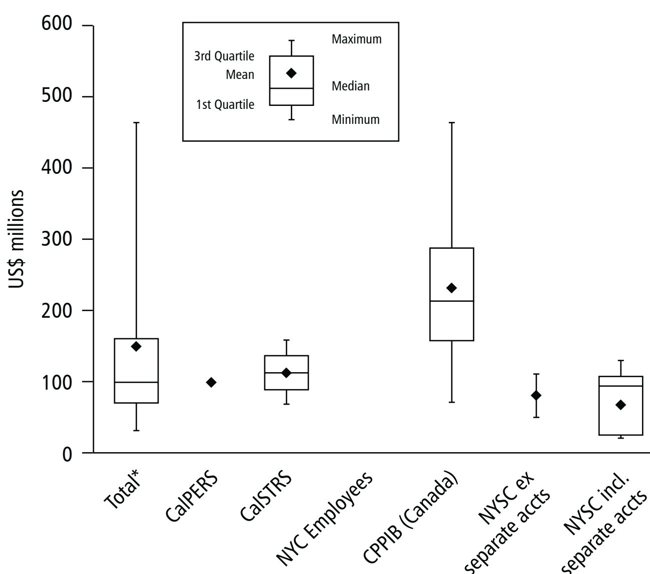
Source: Pension fund websites and investment summaries.
Note: Global statistics exclude venture capital investments. YTD 2012 as of mid-November.

At a recent conference hosted by the Brookings Institute and the Private Capital Research Institute, Pierre Lavallée, VP and Head of Funds & Secondaries at CPPIB, discussed the challenges of managing a large amount of capital while having a team that is capacity constrained. As a result, their firm has established "basic ground rules" on the funds that they will look at: (1) they only invest in funds raising US$750 million or more, and (2) they want to write checks for at least US$150 million. He pointed out that an LP commitment of US$150 million to a US$350 million fund is not necessarily desirable for a GP—if the LP doesn't come back for the next round, a gigantic hole will be created for the fund.

Taking a closer look at emerging market private equity allocations, commitments made by these five pension funds were slightly smaller than the average across all geographies at US$138 million, with a median commitment size of US$100 million (see Exhibit 5). Exemplifying the trend of capital concentration around core markets, the vast majority of emerging market private equity commitments made by these LPs went to large regional funds (focused on Asia or Latin America) or BRIC country-specific funds (targeting China, Brazil and Russia) targeting a US$1 billion dollar final close or higher. Outside of the BRICs, only Turkey-focused funds received country-specific allocations from these investors.

Analyzing the emerging market commitments made, we can also see a demonstration of capital going to brand names. Only 12 fund managers were represented in the 17 total commitments (inclusive of separate accounts) made to emerging market private equity funds (see Exhibit 6). Further, over half of all commitments went to fund managers that are on their third fund or beyond. In fact, only one fund manager received commitments for a first-time fund, but the fund in question is PAG Capital Asia's debut fund, run by former TPG executive Weijian Shan.

Exhibit 5: Major LP Commitments to Emerging Market PE Funds in 2011 and YTD 2012 (EM only)



* Excluding NYSC co-investments.

Exhibit 6: Sample Pension Fund EM PE Commitments

Pension Fund	Fund Commitment	Commitment Size (US$m)	Year
CPPIB	KKR Asian Fund II	450	2012
CPPIB	Actera Partners II	240	2012
CPPIB	Hony Capital Fund V	200	2011
CalSTRS	New Enterprise Associates XIV	175	2012
CalSTRS	PAG Asia I	125	2011
NYS Common	Hony Capital V	119	2011
CalPERS	PAG Asia I	100	2012
CalPERS	PAG Asia I	100	2011
CalSTRS	Hony Capital Fund V	75	2011
CPPIB	Victoria South American Partners II	75	2012
NYS Common	Clearwater Capital Partners IV	75	2012
NYS Common	FountainVest China Growth Capital II	75	2012
NYS Common	Patria-Brazilian Private Equity Fund IV	75	2011
NYS Common	Asia Alternatives Capital Partners III	50	2011
NYS Common	Actera Partners II*	15	2012
NYS Common	Baring Vostok Fund V*	15	2012
NYS Common	Turkven Private Equity Fund III*	15	2012

*Investment made through separate account.
Source: Pension fund websites and investment summaries.

Conclusion

Increasing fund sizes, in itself, is not a detriment to the industry. In fact, it can be a signal of not only growing investor confidence in the asset class, but also maturing markets that have bred homegrown businesses capable of absorbing larger pools of capital. However, given the vast number of companies operating in the small to mid-market across the emerging markets—and the fact that the sheer volume of these companies dwarfs the number of operational large-cap companies—larger funds need to be evaluated alongside a rising number of funds appropriately sized to invest in this market segment. Thus far, this development has not yet materialized.

As we think through the middle market dilemma, a number of questions arise: What is the role of intermediaries, including funds of funds and consultants, and how can they best funnel capital to this segment of the market? What is the role of the development finance institutions? Will greater education on middle market companies and funds, inclusive of performance, make an impact? Should the private equity model in emerging markets change, and if so, how should it evolve? We look forward to discussing this topic over the coming year with our GP, LP and service provider members and exchanging ideas on how to address this industry challenge of ensuring capital is flowing to the vast array of opportunities available in each emerging market.

If your firm is interested in working with EMPEA to develop strategies for unlocking capital for the middle market segment in the emerging markets, please contact Nadiya Satyamurthy (satyamurthyn@empea.net).