Private Equity: New Markets, New Rules

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Private-equity investment in emerging markets has snowballed over the past 10 years, and is expected to continue growing.

Emerging markets are proving to be fertile ground for private-equity investment, and could soon account for the majority of deals.

Yet the key ingredients for success in these markets are strikingly different from those that have worked in developed countries.

The challenges posed by markets such as Brazil, India and Malaysia mean that Western investors will have to transform their business models in order to take advantage of this changing center of gravity.

In "New Markets, New Rules: Will Emerging Markets Reshape Private Equity?" Heino Meerkatt of BCG and Heinrich Liechtenstein of IESE show how emerging markets? share of private-equity deals has increased by around 25 percent over the course of a decade, almost bringing them in line with the United States and Europe.

On top of this, there are strong signals that investment in these emerging markets will continue to rise. Approximately $231 billion is currently earmarked for these markets, across all investment stages.

Forces of change

Fierce competition for deals, and the difficulties of rising debt in the wake of the crisis, mean that investors are turning away from developed economies. At the same time, the emerging

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markets are becoming increasingly eye-catching.

Four positive, long-term trends are drawing investors toward emerging markets: superior GDP growth; significantly higher net returns since 2000; greater resilience to the current financial crisis; and an increasingly attractive socioeconomic environment.

The shift toward these emerging markets can be partly explained in terms of the increasingly high returns they offer. Over the past 10 years, the average returns on private-equity investment in these markets have more than tripled.

Other factors include the widening gap between emerging- and developed-market GDP growth rates, and more attractive socioeconomic environments in emerging markets.

Alongside economic scale, a market?s degree of openness, legal protection for investors and the liquidity of its local stock exchange are other crucial factors affecting investment. This means that while scale is an important factor, the most attractive markets for private equity are not necessarily the largest economies.

The study uses a new way of assessing the relative attractiveness of markets. It takes into account GDP and the level of sophistication of the socioeconomic environments, based on IESE?s Global Venture Capital and Private Equity Country Attractiveness Index.

The study shows Brazil, India, Malaysia, Poland, South Africa and Turkey to be among some of the countries with the most potential.

Conversely, Russia and Argentina are less ripe, owing to their weaker socioeconomic situations.

While China does not boast a strong socioeconomic environment, it is still likely to become a major host to private-equity investment, simply because of its sheer size.

A new age for private equity

But for private-equity firms to succeed, it is clear they will have to adapt their business models, because the formula for success in these emerging markets is different from what has worked in developed economies.

A successful business model will accept minority rather than majority stakes in businesses, and will generate value via operational improvements rather than leverage.

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This study suggests that emerging markets have come of age for private-equity investors. The findings indicate that that the center of gravity in private-equity investment has shifted ? changing the rules, bringing new players to the table, and creating the possibility that local firms in emerging markets will break out as the giants of tomorrow.

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