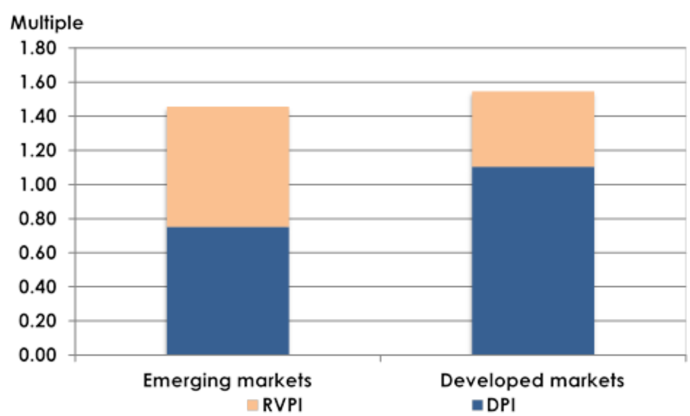
Private equity in emerging markets: worth the risk?

Paris, 12 June 2018 – Emerging market private equity funds offer institutional investors diversification, differentiated return drivers and an exposure to sector and geographical areas not accessible through stock exchanges. However, their performance is still unclear.

Data from eFront, the world's leading alternative investment management software and solutions provider, shows that the pooled average performance of emerging market funds is lower than in developed markets, with returns of 1.46x and 1.55x respectively (see Figure 1).

Figure 1 – Pooled average multiple of emerging and developed markets private equity funds



Source: eFront Insight, as of Q4, 2017.

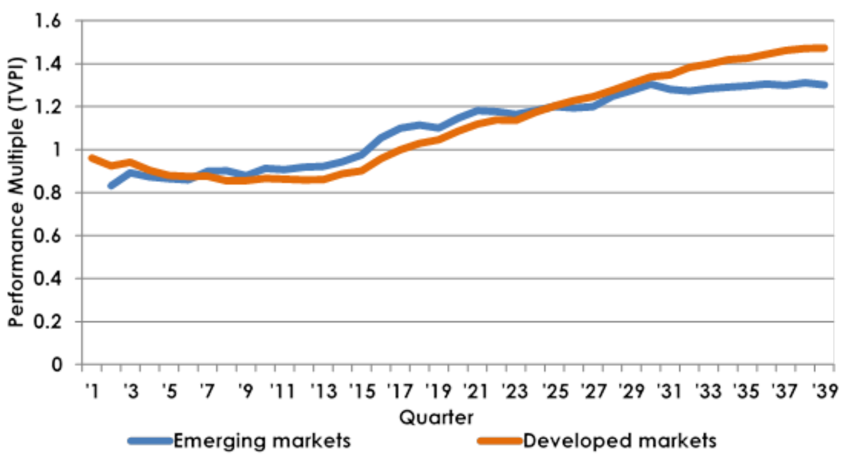
However, as a result of emerging markets being heavily focused on venture and growth capital investments, which have a longer time to liquidity and report the value of their portfolio as the historical value, rather than fair market value, the performance of emerging market funds might be significantly understated.

A like-for-like comparison between emerging and developed markets funds in terms of strategy provides further insights:

- Emerging market venture funds outperform (1.58x) their developed market peers (1.52x)
- However, on a risk-adjusted basis (5% spread), developed market funds outperform
- This outperformance disappears if the 25% spread is used
- For LBO, developed market funds outperform (1.55x) their emerging market peers (1.39x)
- However, on a risk-adjusted basis (5% spread), emerging market funds outperform
- As with venture capital firms, this outperformance disappears if the 25% spread is used

In addition, LBO fund managers in developed markets seem to be able to maximise performance during the harvesting period, while LBO funds in emerging markets seem to exhibit a different pattern: assets not sold before the eighth year of the life of a fund generate only modest incremental returns (see Figure 2).

Figure 2 – Performance of LBO funds in emerging and developed markets



Source: eFront Insight, as of Q4, 2017. Vintage years in sample are 2006, 2007 and 2008

The positive news for investors in emerging markets is that, assuming that residual values are converted in equivalent or higher distributions, the risk-return profile of emerging market private equity funds is similar to those of developed markets.

Tarek Chouman, CEO of eFront, commented:

"Integrating emerging market private equity funds to portfolios comes down to risk, return and liquidity expectations, as well as a tolerance for a certain level of uncertainty surrounding unrealized performances. Such a conclusion may not be surprising to the experienced investor, but given a certain engrained negative sentiment towards emerging markets, it is a meaningful step to demonstrate such funds operate along a familiar risk-return progression, and that the data is out there, for those who seek it."

For the full eFront FrontLine report, visit: https://www.efront.com/research-papers/frontline/frontline-research-paper-private-equity-in-emerging-and-developed-markets-a-comparative-approach/

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