PRIVATE EQUITY INVESTING IN EMERGING MARKETS

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By the mid-1990s, a broad global consensus had emerged that the private sector, rather than the state, should be the primary catalyst for new investment and development, and many emerging economies were demonstrating encouraging progress. Growth had finally picked up, inflation and interest rates were declining, and the political and regulatory environments had shifted in favor of open markets and lower barriers to competition. For the private sector strategy to succeed, however, the explosive demand for investment capital by a burgeoning number of companies had to be satisfied.

Private equity looked like a clear winner, offering many advantages to both the suppliers and users of investment capital. By "private equity" we mean financing for early- and later-stage private companies from third-party investors seeking high returns based on both the risk profiles of the companies and the near-term illiquidity of these investments (venture capital is a form of private equity that generally applies to start-ups). As the private sector expanded, an increasing number of firms had to move beyond their traditional reliance on so-called "friends and family" for financing if they were to continue to grow and be competitive. By virtue of their size and track record, however, many of these firms had risk profiles that were unappealing to banks and securities markets. Notoriously weak domestic equity and credit markets were closed to all but the largest companies, and international financial markets were even more impenetrable. Private equity offered an attractive midpoint along the financing spectrum.

Investors were attracted by the severe capital shortages in many emerging markets, which implied low valuations (and hence high returns) for the expanding number of companies hoping to raise capital. In addition, many prospective foreign investors were flush with funds, due to the booming performance of financial markets and venture capital funds in the industrialized countries during the late '90s. Encouraged by improving macroeconomic conditions, the new receptivity of governments to foreign investors, and the prospects of earning high returns, investors were willing to look at higher-risk investments in emerging markets. The factors of supply and demand appeared to be in perfect harmony for emerging market funds to succeed.

But the promise of private equity in emerging markets has failed to meet expectations. After an initial proliferation of new funds in the mid-'90s, growth has slowed to a trickle, and few practitioners believe that this trend will soon be reversed. Not only have results been disappointing in absolute terms, they are even worse relative to comparable funds in the U.S. and Europe, where the risks are measurably lower. In an understatement shared by many of his industry colleagues, one practitioner candidly noted, "Broadly, the asset class hasn't returned versus expectations."[1]

The obvious conclusion is that the venture capital model that worked so successfully first in the U.S. and then in Europe does not travel well to emerging markets. Virtually everyone involved in the early years assumed that a little tinkering around the edges would suffice to replicate the success achieved by private equity investors in the industrialized nations. Development finance institutions, as strong promoters of private sector development, encouraged investors to support identical fund structures and investment approaches even though the regulatory and legal frameworks did not provide

*We wish to thank the private equity fund managers and investors who agreed to be interviewed for this article as well as the participants in the ongoing seminar series at SAIS on this topic.

1. Quotes and anecdotes cited in this article are taken from interviews conducted by the authors and from industry sources including *Latin American Private Equity Analyst, Private Equity Analyst, Private Equity Week, European Venture Capital Journal, Asia Private Equity Review,* and *Venture Capital Journal*.

adequate investor protection. Fund managers used existing processes for identifying, analyzing, and valuing target companies as well as for structuring deals, despite dramatic differences in accounting standards, corporate governance practices, and exit possibilities. Investors willingly jumped on the bandwagon.

Faced with disappointing early results, however, all participants are being forced to rethink their approach. Although the rationale for private equity investing in emerging markets remains as compelling as ever, the original model must change on every level. The funds must become less foreign and more local. Emerging market governments must recognize the indispensable role that private equity can play in deepening and broadening the private sector, and willingly institute the necessary reforms. Development finance institutions must fulfill their catalytic role more effectively by sharing the financial risk with their private sector counterparts, cajoling and assisting governments to strengthen regulatory environments, and providing support for creative new approaches to private equity investing.

A SHORT HISTORY OF EMERGING MARKET PRIVATE EQUITY

Whether in developed or developing countries, a broad range of companies possess risk profiles that inhibit their ability to raise capital through conventional channels such as bank borrowings or public securities issues. Some are too new to have a convincing track record, others are overburdened with debt, and still others have opaque financial statements. At a certain stage of growth, however, these firms can no longer compete effectively without making new investments that are too large and costly to be financed internally. Private equity fills this gap between self-financing and conventional capital market activity.

Candidate firms may be entrepreneurial start-ups, more established small- and medium-size firms, or troubled companies that investors perceive as undervalued (such as buyouts). Because the risk associated with these firms is unusually high, private equity investors expect financial returns that exceed more conventional investments—typically 25% or more. The higher risk levels also spur investors to undertake rigorous due diligence and, once they have committed capital to a company, to play a far more active, hands-on oversight role than is the custom with shareholders of publicly traded firms. Because the shares are rarely listed on public stock exchanges, such investments are illiquid until a buyer can be identified or a public offering allows the private equity investor to exit with a profitable return.

Some of the most legendary high-growth companies in the U.S., including Federal Express, Oracle, Apple Computer, and Intel, were initially financed with private equity. As these success stories multiplied and became widely known, large institutional investors like pension funds and insurance companies were drawn to the asset class, fueling the industry's explosive growth in the 1980s and 1990s. By the early '90s, emerging markets seemed like equally fertile ground for this tested and successful paradigm. With the unprecedented returns generated from the surge in U.S. equity markets, institutional investors were on the lookout for new opportunities. They also began to worry that the enormous increase of capital flowing into U.S. private equity would outpace the supply of high-return investments. The door opened wide, therefore, for those attracted by the prospect of portfolio diversification and the opportunity to earn exceptional returns.

These developments were reinforced by events unfolding in many emerging economies. A resurgence of growth and new investment opportunities was attributed in large measure to a more receptive attitude towards the private sector generally and foreign investors in particular. Between 1992 and 1998, foreign direct investment increased at a compound annual growth rate of 19% in Asia, 27% in Eastern Europe, and 19% in Latin America.[2] Nonetheless, only a handful of the largest companies were capturing these private sources of financing. Governments compounded the problem with their excessive reliance on private savings to finance public sector deficits, crowding out private sector access to capital. In Brazil, for example, a World Bank report revealed that about 40% of private bank assets in 2000 were invested in government securities. With financing patterns heavily biased in favor of a relatively small number of large firms, the premise that demand for private equity financing would be strong was convincing. The case was further buttressed by the presumption of cooperative local

2. International Monetary Fund, *International Financial Statistics.*

governments, given their commitment to a heavier private sector role in the development process.

The Mid-'90s: Optimism and Growth

With so many factors pointing in the right direction, emerging market funds proliferated in the mid-'90s. By the end of 1999, there were more than 100 Latin America funds, where virtually none had existed earlier in the decade. Between 1992 and 1997, the peak years for fund-raising in Latin America, the value of new private equity capital grew by 114% annually, from just over $100 million to over $5 billion. In the emerging markets of Asia (excluding Japan), about 500 funds raised more than $50 billion in new capital between 1992 and 1999. As the transition to market economies in Eastern Europe took hold in the mid-'90s, the rapid growth of private equity told a similar story.[3]

This private equity expansion was strongly supported by bilateral development institutions such as the Overseas Private Investment Corporation and the U.S. Agency for International Development, as well as by the multilateral development finance institutions that focus on private sector development, such as the International Finance Corporation (IFC) and the European Bank for Reconstruction and Development. By the end of 1998, these institutions had committed more than $15 billion to some 220 private equity funds. Their participation was critical in the early years, when private investors were hesitant to commit capital to countries with unfamiliar local conditions and highly uncertain risk-return tradeoffs. As one fund manager acknowledged, "Having the IFC in our fund as an investor is important to assuring other investors."

In almost every respect, the new breed of private equity funds were clones of their U.S. predecessors in terms of fund-raising strategy, organization structure, investment processing, staffing, and exit strategy. Most funds were headquartered in U.S. or European financial centers, attracted staff trained by U.S. investment banks, invested in dollars, and expected to achieve U.S.-style IPO exits. The analytical skills were also the same, as was the step-by-step process of doing a deal: originate transaction opportunities through good market intelligence and word of mouth, conduct due diligence, build financial models that indicate future company performance and value ranges, negotiate with capital-hungry entrepreneurs, prepare documentation, and close the deal. As one veteran emerging markets investor acknowledged, "The idea was to adapt the U.S. venture capital model to promote private sector development in these countries."

Late '90s: Unmet Expectations

By the late '90s, however, the emerging market private equity funds were seriously underperforming. Even though the funds have no obligation to publicly divulge their results, there is considerable anecdotal evidence that exits are taking longer to materialize than expected, and when they do, returns are not commensurate with the higher risk levels associated with emerging markets. IFC officials, managers of the largest portfolio of emerging market private equity funds, have acknowledged that cumulative returns on its investments in private equity funds are in single digits or lower. One survey of 227 Latin American private equity investments between 1995 and mid-2000 indicated that only 15 investments had been exited, or 7% of the total. Performance has been only slightly more encouraging in Asia, where capital markets are more developed and liquid. Divestitures in 1998 and 1999 averaged about $2.5 billion per year in the region, a paltry proportion of the $35 billion invested between 1992 and 1999.

Of course, many of these first-generation funds have been in business for only three or four years, far too short a time frame to begin measuring results. Even in the U.S., most funds have a ten-year life and do not begin generating positive returns until about five years into the cycle. Until mid-2000, emerging market funds also bore the unenviable burden of comparison to their industrialized country counterparts at a time when returns in the U.S. and Europe were at historically unprecedented levels. The National Venture Capital Association reported that the average return for all venture funds in the U.S. was a staggering 146% in 1999, and the five-year average was 46%, setting a pretty high—and probably unrealistic—standard. Defenders also point out that emerging market funds have been victimized by the

3. The authors compiled and analyzed all of the statistical data in this article on fund capital flows and performance from *Latin American Private Equity Review & Outlook* 2000/2001; *2001 Guide to Venture Capital in Asia*; European Venture Capital Association *European Private Equity Statistics*; Venture Source; OPIC (James C. Brenner, Direct Equity Investment Funds: Public-Private Partnership Experience, 1999); and IFC documents (Annual Report, 2000).

dollar's sharp appreciation against most currencies in Asia and Latin America since the mid-'90s, eroding real returns to foreign investors.

Still, the conclusion was inescapable that the industry had performed poorly both in absolute and relative terms. Private equity investors responded by turning away from emerging markets. Funds raised in 2002 by Latin American private equity funds were at the lowest level since 1993, when the industry first began to take off in the region, and Asian funds last year also (excluding Japan) had their worst fund raising year since 1993.[4] "After three or four years of lousy returns in Asia, Latin America and Russia," one fund manager lamented, "it's going to be very difficult to find new money. Investors do not have any high profile role models of consistently successful funds to demonstrate that this type of investing works well. The publicity is bad, and getting worse." An institutional investor in Latin America explained, "Basically, we don't want to increase our exposure in the region, and only when money starts coming back will we re-invest."

EXPLAINING UNDERPERFORMANCE

The private equity industry evolved gradually in the United States over a 30- or 40-year period in response to strong demand from cooperative entrepreneurs, a sympathetic public policy environment, a reliable legal system, political and economic stability, and well-developed financial markets. These success factors, however, are demonstrably absent in emerging markets. Three shortcomings in particular highlight the contrast between the two environments and explain why emerging market funds have underperformed: low standards of corporate governance in terms of the quality of information required to make investment decisions and monitor performance once investments have been made; the weakness of legal systems in enforcing contracts and protecting all classes of investors; and the inability of domestic equity markets to offer a reasonable prospect of exit through the IPO market.

Low Standards of Corporate Governance

The first gaping imbalance in the emerging markets private equity equation was the accuracy, timeliness, and transparency of financial and operating information provided to investors, and the willingness of managers to subject themselves to some degree of accountability to outsiders. Even in the best of circumstances, relationships between investors and the managers of their portfolio companies are complex and often contentious, but the absence of sound corporate governance practice has sharply accentuated that tension. Nowhere does this issue become more problematic than with family-owned firms. Although widespread in all countries, family ownership tends to be even more prevalent in developing countries. The prototype is an entrepreneur who has built a successful business with virtually no capital or shareholders beyond his or her immediate family and close friends. Absent any accountability to outside shareholders, the interests of the owner and the firm are indistinguishable, and financial accounts are frequently intermingled. These traditions of autonomy, secrecy, and independence run deep within the corporate culture of most developing country firms, rarely challenged until the need for outside capital becomes imperative.

Few entrepreneurs, for example, have ever undergone an independent audit or adhered to international accounting standards that are the prerequisites for virtually every professional investor. The prospective investor is thus at the mercy of the entrepreneur for access to information necessary to make critical judgments about company performance and value. The common practice, for example, of maintaining two or even three sets of accounting records in order to avoid the tax collector frustrates the due diligence team's task of gaining an accurate picture of performance. Opaque bookkeeping and disclosure habits also may impede access to other important information that might alter investor perceptions of company value, such as environmental liabilities or unresolved legal disputes. As one investor noted, "One big problem is skeletons in the closet. Many of these great companies have hidden subsidiaries, offshore sales and other tax avoidance schemes." Nor is the lure of badly needed capital likely to overcome resistance to outside investors who are inclined to push and prod management to make painful changes they believe are needed to increase transparency and enhance company value. It is not surprising, there-

4. *Asia Private Equity Review*, 2002 Year-End Review, and *Venture Equity Latin America* 2002 Year-End Report.

fore, that most fund managers cite the difficulty of assessing the competence and integrity of the entrepreneur as their most difficult task during the due diligence phase.

The corporate governance problem does not lessen after the deal is consummated. The investor needs a regular flow of accurate financial and operating information in order to monitor company performance and participate in major decisions that are likely to affect future results. Normally, a newly structured board of directors is established, along with a clear set of governance procedures that define relations between management and the new board. In many emerging markets, however, minority shareholders encounter a much different reality, where new board members have little leverage to exact the necessary information if management chooses to circumvent agreements, further undermining the outside investor's ability to orchestrate an acceptable exit.

Limited Legal Recourse

Weak corporate governance is compounded when legal systems do not offer a reliable outlet for resolving disputes. Carefully constructed and enforceable legal contracts serve as the bedrock for all financial transactions, regardless of the country. Indeed, whether as banks or equity providers, financiers normally have little direct control over the firms in which they invest and depend heavily on the legal system to protect their rights.

Early private equity experience in emerging markets demonstrates too frequently that regardless of the soundness of the signed agreements that define the terms and conditions of the relationship between investors and the company, there is minimal legal recourse in the event of serious differences with management. As one law firm opined about Latin America, "...there are significant issues of 'enforceability' of key contractual rights and statutory protection for minority rights, [which] collectively act as an unintended disincentive to private equity investors."[5] The problem often is accentuated because local owners tend to be exceedingly adept at navigating the ins and outs of the legal system, placing investors at a distinct disadvantage in the judicial resolution of disputes.

Inadequate shareholder protection has created a severe backlash, with many fund managers altering their investment strategies or pulling out of countries entirely unless they can gain majority control, all because of their painful experience as minority shareholders. One fund manager acknowledged that because of low confidence in local laws and courts, "It is a fact that we have become more and more rigid in regards to investment terms." These are reasonable responses, but they also undermine the expanded use of private equity as a financing tool.

Dysfunctional Capital Markets

Every aspect of the private equity cycle is driven by the imperative to orchestrate a profitable exit within a certain time frame. In the U.S. and other developed nations, a well-functioning IPO market provides *the* fundamental underpinning for the success of the entire private equity industry. Without a credible IPO market, exit options are limited to management buyouts and sales to strategic investors or later-stage financial investors. According to most empirical evidence, exits achieved through IPOs tend to maximize firm value, relative to the alternatives of selling shares to strategic investors or back to the original owners (through management buyouts). In the U.S., for example, venture capital funds have earned an average annual return of about 60% when exit is by IPO, compared to 15% when the sale is to private investors. Yet in Eastern Europe, 38% of all private equity exits in 1998 and 1999 were sales to strategic investors, compared to only 3% through IPOs and 16% through secondary offerings. Of the 18 large exits in Latin America between 1998 and 2001, only two were IPOs. In Asia, IPO activity has been somewhat more encouraging, albeit dominated by technology companies that have suffered share price declines as severe as their counterparts in the U.S. and Europe.

But equity markets in even the most advanced emerging economies fail to provide a viable outlet for the sale of companies in private equity portfolios. The primary market functions as a vehicle for raising capital for only a handful of the largest companies, and secondary market trading is dominated by an even smaller number of big firms. In Latin America, 58% of the average daily trading volume on the major

5. Morrison & Forrester LLP, "The Need For Legal and Regulatory Reforms in Argentina, Brazil, Chile, El Salvador and Mexico To Promote Risk Capital Investments in Small and Medium Size Enterprises," Washington, D.C., February 2001.

stock exchanges is dominated by the ten largest firms in each country; the percentage in Asia is only slightly lower at 42%.[6] In many countries, already weak stock markets are getting worse, leading some major companies to delist their shares locally in favor of more established foreign or international exchanges.[7] "You are going to be discouraged," explained one fund manager, "if you think the only way to exit is to go public."

RETHINKING THE APPROACH

These fundamental shortcomings magnify the reality of a private equity environment that is starkly different and more difficult than what practitioners were accustomed to closer to home. The basic assumptions underlying the U.S. venture capital approach are largely missing in emerging markets, with a predictably adverse effect on performance. Results will improve, therefore, only if the fund managers align their business model more closely with emerging market realities.

Go local. Initially, many funds preferred to locate in the U.S. or Europe, bowing to convenience and the preferences of Western professional staffs. But just as a vibrant venture capital presence mushroomed in Silicon Valley in response to the proliferation of new technology clients, fund managers belatedly are recognizing that a local base of operation is even more necessary when the target companies reside in distant, unfamiliar emerging markets. Generating market intelligence, investigating new investment opportunities, conducting due diligence, and maintaining ongoing direct involvement can be much more complicated and less effective when the investment team literally commutes between the home office and company headquarters on other continents. As one badly burned Latin American private equity pioneer—who originally located most of his professional staff in New York—acknowledged, "We will no longer do an investment in a country where we don't have eyes and ears on the ground." More fund managers now recognize that it makes sense to hire local professionals who are culturally attuned and have a deeper understanding of the unique circumstances that differentiate emerging markets from countries with more hospitable investment climates. "You need to have people that live there," explained one fund manager, "have the passport, and are committed to the community. That is the only way you will gain the critical intuitive sixth sense about what is going on, what are the good deals and who are the people you want to work with."

Add value. The management role of the private equity investor in emerging markets is even more important than in developed countries, given the extraordinary challenges of creating a viable exit opportunity. Fund managers must re-think the professional expertise required for these tasks, recognizing that the analytical and negotiating skills required to *make* an investment are not same as those required to *enhance corporate value* during the post-investment phase. Initially, the industry relied too heavily on former investment bankers trained to "do deals," collect their fee, and move on to the next transaction. They badly underestimated the amount of hands-on time required to monitor portfolio company performance. Attending periodic board meetings, reading financial reports, and observing performance from afar is not sufficient. Instead, professionals must take on the difficult and time-consuming tasks of strengthening corporate governance practices, restructuring management, and positioning the company for a profitable exit. "Value enhancement is becoming the most important part of this business," noted one fund manager. "When you sign the deal is when the real work starts, not ends. Finding the right skill set in emerging markets is tricky. We need to know how to build company value—to say: 'Your brother has to go, or you must sell this subsidiary.'"

More discerning deal selection. After years of working with a range of mid-size companies, one fund manager concluded that he could no longer justify the time, expense, and frustration of investing in traditional family-owned firms, regardless of the sector or historical performance. "It simply is not worth the aggravation and tension," he explained, "so we are concentrating only on the 'new economy,' where both the firms and the managers are younger, more flexible, and less likely to have acquired many of the bad habits that hinder good relations with traditional family firms." Funds also are becoming

6. Information on stock market performance is compiled from IFC/Standard & Poor's *Emerging Market Fact Book*, 2000.

7. In Latin America, the number of listed firms declined by 2% annually between 1995 and 1999, causing secondary market trading volume also to shrink. In Asia, the number of firms stayed flat in 1998 and declined slightly in 1999.

more proactive in deal selection, rather than waiting for business proposals to land on their desks or for investment bankers to make a pitch on behalf of a client. Echoing a growing consensus, one prominent Asian fund manager observed, "The best deals are ones we create. In our most successful transaction, we proactively approached the company once we had decided that we wanted to be in the sector. We looked for an attractive company where we would not be in a bidding auction." Good deals must fit the skill set and industry knowledge of the fund manager, and offer identifiable opportunities for enhancing value.

Creative exit strategies. "Now, every time we look at a new investment opportunity we rigorously assess our exit strategy *before* deciding whether to make the investment," according to one emerging markets fund manager. Notwithstanding the inevitable uncertainties about an event that will not occur for at least three to five years hence, there is increasing rigor applied to the exercise of mapping out a viable exit at the outset, whether by an IPO, a management buyout, or a strategic investor, and then ensuring that company management understands and commits to the strategy. Are the owners willing and able to execute a management buyout after a prescribed time period? Or if a strategic investor is the preferred alternative, who are the likely candidates, and what must be achieved by management during the intervening years to attract these buyers? One practitioner explained his fund's approach to attracting a strategic investor: "We try to get into the head of the strategic corporate planner. What's *their* strategy? We are starting to think like a consulting firm, trying to think through industry strategies, understand industry trends, learn about the key players and whether consolidation is likely to occur."

There also must be a greater willingness to experiment with new, more creative approaches to exit. One Latin American fund, for example, launched a mezzanine fund that offers debt financing with many of the same characteristics as equity, but provides investors with a greater assurance of a steady fixed income stream. Another has begun to recapitalize some successful portfolio companies, which allows the fund to realize some capital gains while waiting for a more opportune time to exit. And some are seeking to take control over underperforming funds, positing that the key to success is more effective, hands-on fund management.

LOCAL GOVERNMENTS MUST PROMOTE EMERGING MARKET DEVELOPMENT

Given the magnitude of the financing gap that needs to be filled, most governments have done surprisingly little to institute reforms that would improve the environment for private equity and seem indifferent to their own role in attracting private investment capital. As global competition intensifies, local policies, regulations, and business practices become increasingly important in attracting investment. Private equity investors, ever more sensitive to location-specific problems, are beginning to distinguish sharply among countries based on criteria such as the protection of shareholder rights, tax treatment of capital gains, and securities markets development.

Protecting shareholder rights. Few reforms are more important to strengthening investor confidence, or more within the control of local governments, than regulations that affect minority shareholders, such as voting rights and timely and reliable enforcement of shareholder and creditor disputes. More countries must follow the example of the Chilean and Brazilian legislatures, which have passed new laws designed to better protect minority shareholders. Perhaps more important, reform-oriented countries also must demonstrate to investors that they are capable of effectively enforcing these new laws.

Promoting sound corporate governance standards. An international consensus also is emerging on acceptable standards of corporate governance, another increasingly important benchmark for investors. Countries will be at a distinct advantage with private equity investors if they effectively promote and enforce a set of rules and conventions that establish standardized public disclosure and management accountability, including internationally accepted accounting practices, independent audits, and defined responsibilities of boards of directors.

Liberalizing investment restrictions for local institutional investors. Contrary to conventional wisdom, the growth of private equity in emerging markets is rarely constrained by a shortage of local sources of capital. Many Asian nations, for example, have savings rates that reach 30% of GDP or more, creating a flow of investment capital to pension funds, insurance companies, mutual funds, and other financial intermediaries. Until recently, however, most countries had placed burdensome restric-

tions on how these institutions could invest, effectively eliminating private equity as an option. But some governments are beginning to respond. India recently revamped national regulations governing investment practices and rescinded some taxes in order to encourage a higher level of venture capital investing by overseas firms. Similarly, in 1998 Korea began to allow pension funds to invest alongside venture capital funds, and a number of the major Latin American nations also have initiated regulatory reforms.[8]

Improving access to public equity markets. In a statement that resonates for virtually all emerging markets, one survey of Latin America concluded that in order for private equity to realize its potential, "…a significant number of legal and regulatory changes will need to be implemented" to strengthen local stock exchanges. When public securities markets function well, institutional investors invariably become a major source of investment capital for private firms.

DEVELOPMENT FINANCE INSTITUTIONS MUST PROVIDE LEADERSHIP

The IFC in particular, as the oldest, largest, and most experienced of the development finance institutions, has a responsibility to lead the way if there is to be a private equity rebound. By 2001, it had investments in 142 private equity funds and another 45 management companies, with total commitments of about $1.7 billion. When resources from other investors are added to IFC-sponsored funds, it can claim responsibility for channeling approximately $5 billion in private equity to firms in developing countries. But this broad experience has not translated into a track record that is any better than the private funds. Understandably disappointed by subpar performance, some senior IFC decision makers have advocated an institutional retreat from private equity investing. Such a retreat would send a strikingly negative message to governments and private investors alike and do untold damage to the future of private equity in emerging markets.

Instead, the private-sector-oriented DFIs should capitalize on their deep reservoir of knowledge and practice to re-energize the industry. They are uniquely qualified to play this catalytic role because they alone combine three essential capabilities critical to spurring a private equity turnaround: financial resources that are leveraged against private investor funds; credibility with local governments that can be used to initiate much-needed policy and regulatory reform; and powerful influence with private investors that can be applied to encourage more active participation in private equity.

Financing that attracts additional investors. The very purpose of these development institutions is to attract *additional* private investment on the basis of their own participation. DFIs will be credible in the eyes of investors and their client governments only if they sustain their financing role. This does not suggest that they should throw good money after bad. Instead, they should redouble their efforts to screen and select competent fund managers and then promote strict accountability to achieve solid results.

Assist with policy and regulatory reform. Up till now, there has been little evidence that policy reform is a DFI priority, although these institutions are uniquely positioned to exert pressure on governments to undertake necessary reforms. Local officials view the DFIs as honest brokers who objectively promote private sector development, in contrast to private fund managers. The DFIs thus have unparalleled sway over public sector decision makers, and can directly influence policy outcomes on such issues as liberalization of pension fund investment guidelines or establishing and enforcing international accounting and auditing standards.

Support creative new initiatives. DFIs should play a stronger leadership role as incubators for new private equity initiatives that draw on best practices from other countries. Successful private-public partnerships in numerous developed countries have included government-sponsored financial incentives designed to encourage private sector financing of small- and medium-size companies. Under the U.S. Small Business Investment Corporation (SBIC) program, for example, specially licensed venture capital funds raised more than $1 billion in 2001 in private capital markets on competitive terms to invest in pre-IPO companies because the U.S. government guaranteed a portion of the amount raised. Israel's Yozma program, launched in the early '90s, also had remarkable success using government

8. The Brazilian regulatory authorities, for example, recently liberalized some restrictions on the amount that pension funds can invest in so-called alternative asset classes such as private equity. Chile recently raised the amount that pension funds can invest in any way they see fit, which represents about $1 billion.

funds as seed capital to encourage private investors to participate in the initial development of the Israeli venture capital industry. DFIs should more actively support local governments that launch similar programs, rather than reflexively dismissing any public sector initiatives that involve financial incentives for private sector development.

Training for fund managers. Many of the early private equity failures were rightly attributed to the poor quality of fund managers, which is hardly surprising since few individuals in these countries had previous experience in the screening, financing, and overseeing of companies that typically receive private equity. "The principal reason that we are not providing more funds to private equity," explained a senior official at Brazil's development bank, "is our inability to identify fund managers with the requisite experience." Yet training for private equity fund managers is virtually nonexistent. DFIs are in the best position to assist and encourage the strengthening of indigenous capabilities, perhaps through local training of professionals as a condition for their financing of private equity funds.

FUTURE PROSPECTS

Regardless of the country or culture, successful entrepreneurs share numerous traits, particularly during the critical start-up phase of launching a new business—they tend to have an uncompromising, single-minded persistence, a fierce determination to overcome adversity, and unbridled optimism, regardless of the odds. Successful private equity investors in emerging markets must cultivate a similar arsenal of personal characteristics, not unlike the U.S. venture capital pioneers in the '60s. Early U.S. venture capitalists were hard pressed to convince skeptical investors to commit capital in high-risk companies with no track records; they complained about inexperienced and secretive entrepreneurs; and, long before the NASDAQ emerged as an IPO outlet for small companies, they had difficulty effecting profitable exit opportunities. Then as now, failures outnumbered successes and naysayers had more credibility than the innovators and risk-takers. But U.S. venture capitalists rapidly ascended the learning curve, demonstrating an uncommon capacity to make creative adjustments along the way.

The new generation of emerging market private equity managers must follow a similar trajectory, and not permit early failures and disappointments to obscure a number of factors that bode well for the future. As long as there is an international consensus about the private sector's important role in the development process, alternative financing techniques such as private equity must remain on center stage. Globalization, with its emphasis on open markets, lower barriers to trade and investment, and cross-border competition, will reinforce this trend by fostering intense competition among both countries and firms for scarce financial resources. Some governments already are responding by passing legislation to better protect the rights of minority shareholders and by liberalizing onerous tax regulations that discourage foreign investors. This new environment also favors so-called new economy companies, with managers who are less resistant to third-party investors and more accepting of international standards of corporate governance.

Thus, despite some early setbacks, there are encouraging signs that a private equity rebound in emerging markets is not only desirable but plausible. However, the key players must make innovative adjustments that reflect the realities surrounding this type of investing. With a different approach, the promise of private equity will begin to be realized.

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