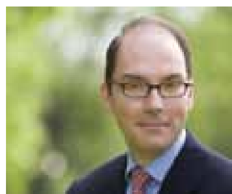
Guest Commentary: Emerging Market Secondaries Come of Age

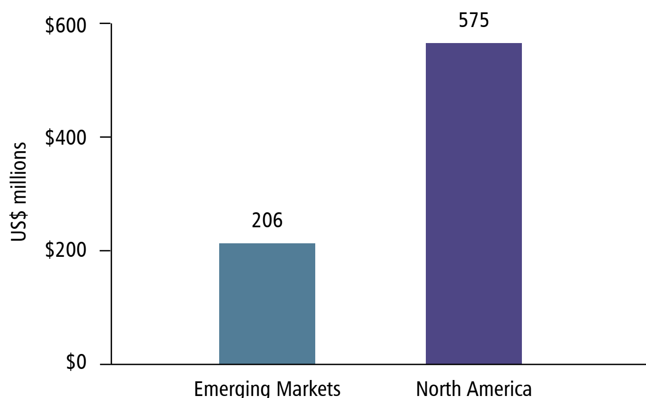


John Stephens, Managing Director of Pomona Capital, argues that as primary fund commitments in the emerging markets have grown, so have deal flow and the opportunity set within the secondaries market. Pomona Capital is an international private equity firm with approximately US$7 billion in capital commitments since inception. Since 1994, the firm has analyzed over US$225 billion in secondary transactions and purchased US$2.6 billion in secondary interests in over 500 funds with investments in over 5,000 companies.

For many investors, the central narrative about private equity in emerging markets seems to be this: fast economic growth plus armies of new consumers hungry for just about everything should result in handsome profits. As GPs and LPs have discovered, however, promising secular trends do not easily translate into returns. History, at least in part, is to blame.

Fifteen years ago, there was essentially no institutionalized private equity activity in emerging markets. Given this starting point, primary commitments naturally dominated LP activity. Since that time, Thomson Reuters data show nearly 2,500 private equity funds have been formed, and today there are nearly 1,000 managers investing US$100 million or more each across the full range of private equity strategies.

Exhibit 1: Average Fund Size, 2011 (US$m)



Source: Thomson Reuters.

Most institutional private equity activity began through small funds, which fit with the nascent M&A and commercial environments where they operated. In fact, according to Thomson Reuters, from 2000 through 2004, the average fund size in emerging markets was less than US$60 million, and by 2011, the average fund size had grown to US$206 million. By contrast, fund sizes in North America are much larger, averaging approximately US$575 million in 2011 (see Exhibit 1). Smaller fund sizes in emerging markets have resulted in smaller average LP commitments as well.

While big deals and large fund closings may dominate headlines, the real story of private equity in emerging markets is at the lower end of the market. According to EMPEA data, funds targeting less than US$1 billion accounted for 89% of all those raised in 2011 by number (see Exhibit 2), and 60% of all capital raised (see Exhibit 3). In the past three years, only four emerging market-focused funds have closed on US$2.5 billion or more. Despite the overall growth of the market, these proportions have remained consistent for the past decade.

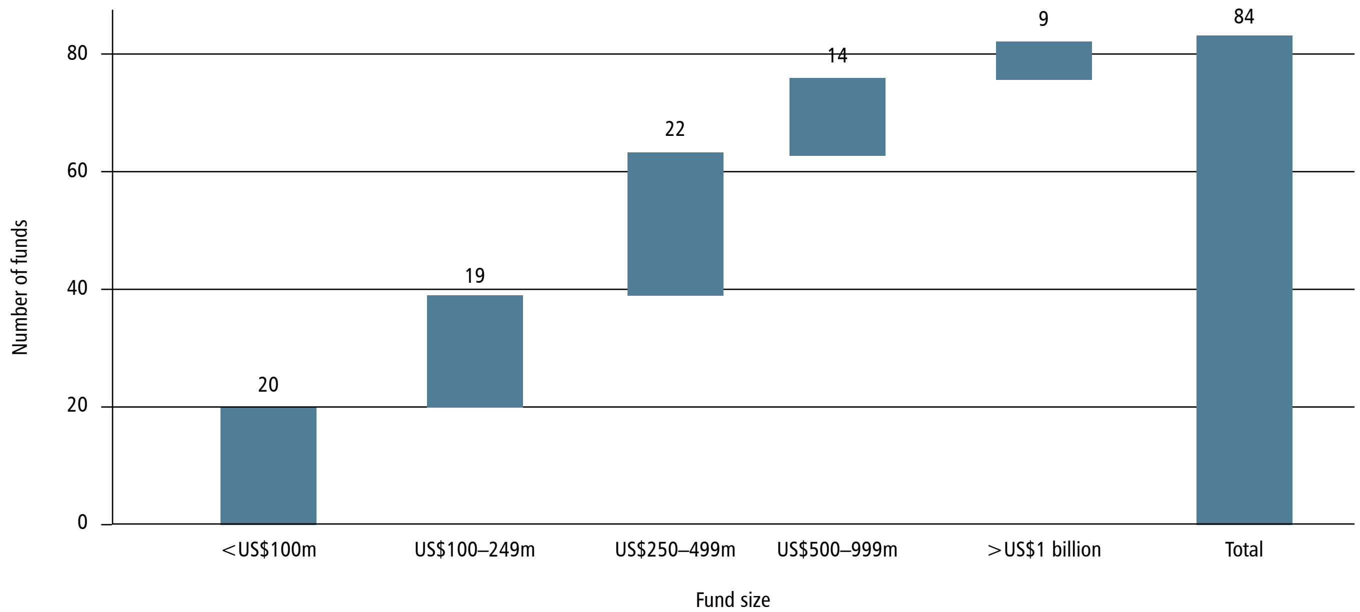
Against this backdrop, LPs have committed over US$270 billion to private equity funds in emerging markets since 2005. Every type of institutional investor can be counted among the LPs actively making primary commitments in these geographies. EMPEA's recent *Global Limited Partners Survey* suggests that LPs remain optimistic about emerging markets, and intend to increase their private equity commitments to these markets so that they represent up to 20% of their overall allocations.

Enter Secondaries

As the stock of emerging market private equity fund interests has expanded and matured, secondary deal flow has grown too. From nearly zero activity four years ago, the secondary market in 2011 grew to over US$2 billion of deal flow. Given metrics applied to secondary markets in the United States and Europe, deal flow in emerging markets could grow to represent 15–20% of global secondary activity. This figure also is consistent with the emerging markets' share of global primary fundraising, and reflects a two- to three-fold increase in deal flow over current levels.

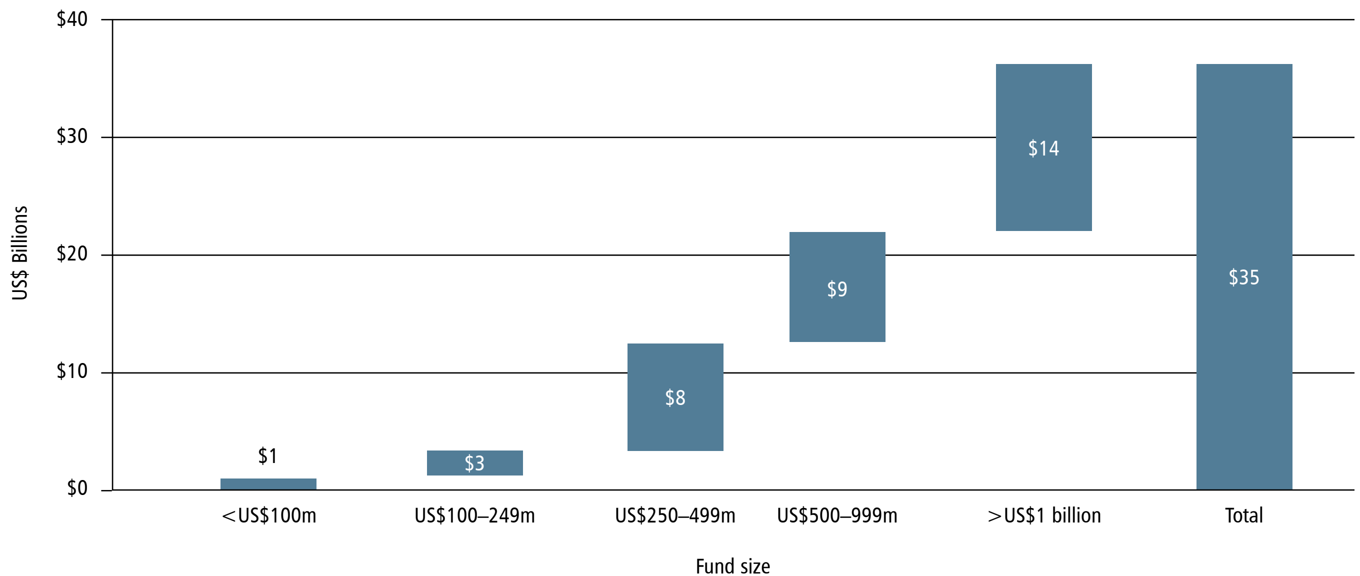
The same pressures driving limited partners to sell their interests in U.S. and Western European funds are leading them to sell their interests in emerging market funds. Regulatory change, over-commitments, portfolio rebalancing, changes in investment strategies, liquidity requirements, and efforts

Exhibit 2: Size Distribution of EM Funds, by Number (2011 Vintage)
By number, 89% of EM funds are less than US$1 billion



Source: EMPEA.

Exhibit 3: Size Distribution of EM Funds, by Size (2011 Vintage)
By value, 60% of EM funds are less than US$1 billion



Source: EMPEA.

to reduce the number of GP relationships are among the pressures that confront limited partners today. These forces have persisted through multiple economic cycles and should continue to support increasing secondary deal flow.

A large and growing inventory of mature fund interests is another factor supporting deal flow. According to EMPEA, roughly US$300 billion of capital has been committed to private equity funds in these geographies over the past decade. This supply will continue to be supported by new LP primary fund commitments. Emerging markets now appear to be an enduring part of LP's private equity programs as institutions capitalize on the higher growth rates, growing consumer class, and maturing capital markets often found in these markets.

In addition, secondary opportunities in these geographies can provide an attractive value proposition for private equity investors. When compared to primary commitments, secondaries present funded portfolios that provide greater insight into the potential return of a particular fund. That transparency into—and the shortened duration of—the underlying investments may blunt some of the long-term risks posed by currency, legal, macroeconomic, political and other uncertainties.

Meaningful discounts to NAV can be achieved, which also may further mitigate the unseen risks posed by emerging markets investing. While funds managed by a handful of the most well-established firms can trade at single digit discounts, a majority are priced at higher discounts consistent with funds in developed markets.

The Execution Challenge

Yet, while secondary deal flow volumes are growing, sourcing and execution can be challenging.

One difficulty facing buyers is the vast distance between owners and assets. On the one hand, a majority of emerging markets fund interests are owned by—and generally are sourced from—limited partners who reside in the United States and Western Europe, and occasionally the Middle East and Asia. While some GPs are involved in the sales process, many learn about secondaries only after a transaction is initiated by the seller. A global and LP-centric sourcing effort can be beneficial.

On the other hand, the assets being purchased reside within emerging markets; local presence and expertise can help support adequate due diligence. Vast distance also can separate the assets themselves. "Emerging markets" are words, not places, and each market presents distinct cultural, language, legal and other nuances that must be considered when underwriting investments. As a consequence, investors should consider combining global sourcing with local execution.

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Secondaries also involve specialized expertise. Unlike primary fund of funds investing, secondary purchases require judgments about companies' future performance and liquidity, with less emphasis on a manager's likely deployment of blind pools in the subsequent three or four years. Volatility in exit windows, public equity exposures, and currencies are further challenges to be factored into pricing.

Furthermore, the sizes of LP commitments in emerging market funds cross a large range, but on average are concentrated in smaller interests of US$5 to US$25 million each. As a result, secondary specialists who focus on middle market-sized transactions generally can consider a greater number of the opportunities in these markets.

Conclusion

While emerging market secondaries are a fairly new development, they are a natural extension of the industry, and one that follows patterns set in the United States and Europe. For secondary specialists, they can present meaningful opportunities, particularly when combining global sourcing and local execution to address the emerging markets' unique characteristics. Given the shorter duration of these investments and the visibility through to exits, secondaries also may be a way for limited partners to mitigate emerging market risks, and to bridge the gap between the long-term secular trends and profits.

Based in Hong Kong, John Stephens is a Managing Director of Pomona Capital, where he focuses on sourcing and investment analysis for Pomona's Asia and emerging markets business. Prior to joining Pomona, John was a co-founder of EMAlternatives, LLC, and served as a Managing Partner. He has over a decade of experience investing and advising companies in emerging markets, including with the Global Environment Fund. John received an MBA from Dartmouth College and a BA from the University of Washington.