using headwinds to gain a foothold

Despite some current challenges, a strong case can be made for emerging markets private capital in a long-term portfolio.
Just a couple years ago, emerging markets were the place to be for institutions seeking outsized portfolio gains. Economic growth was chugging along at 5 to 6 percent, compared to 2 percent in the United States. Equity markets were outshining those of the developed world. Foreign currencies were appreciating, providing a tailwind for U.S. dollar investors. These factors added up to an attractive emerging markets advantage and an incentive to invest there.

Then, the macroeconomic and geopolitical winds shifted. Yesterday’s tailwinds have become today’s headwinds, and some emerging market countries that had enjoyed substantial growth rates, outperforming the U.S. and other developed markets, have lost that advantage. In response, many emerging market investors beat a hasty path to the exits.

One significant factor affecting the equation is commodities, including iron ore in Brazil, copper in Chile and oil just about everywhere else. The recent fall in global oil prices has hurt net exporters, such as Russia, Nigeria and Venezuela, while representing a net positive for two-thirds of countries in the MSCI Emerging Markets Index because they are net oil importers.

For savvy institutional investors, these recent doldrums have created a classic investing opportunity: the chance to buy low, zigging into emerging markets as the crowd zags out. But there is an important secular shift that should be addressed along with this change in the cycle.

There is now a critical mass of top-tier private equity and venture capital managers in emerging markets with proven track records. These managers bring excellence in governance, strategy and execution skills to emerging market private companies in contrast to the flawed governance structure in many of the large public emerging market companies that dominate the indices. We believe that skilled private capital managers may be well positioned to continue to be successful by taking advantage of market trends and focused investment execution.

**The emerging opportunity**

The challenges in emerging markets today can, in fact, easily be viewed as opportunities. One only need examine three trends—private valuations, consumerism and currencies—to find compelling reasons to retest the waters.

**Private valuations.** As public capital flows into emerging markets have slowed to a trickle, what often remains are cheaper valuations and opportunities for smart private equity investing. Lower entry price valuations have made private companies a more attractive investment value, particularly in countries such as Brazil and India.

Moreover, unlike in the U.S. and other developed markets, that value potential can be tapped through private investments with little to no leverage. Accessing multiple kinds of growth investments across myriad companies and sectors requires low leverage in Latin American countries and zero leverage in China, India and Africa.

Unlevered growth presents investors with a fundamentally different growth opportunity set than can be gained in developed markets.

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Consumerism. Emerging markets’ overall GDP rates and public equity markets may be lackluster. But one area has been resilient: consumer consumption. The decade-long investment theme of an ever-growing consumer middle class—especially in China, India, Latin America and Africa—has not slowed. Domestic consumption-driven sectors such as retail, healthcare, education and e-commerce continue to grow at a higher-than-GDP pace.

This trend shows no sign of abating. In fact, emerging markets’ consumer demands appear to be expanding faster than local governments and economies can keep up. A strong argument can be made that consumers are even more empowered now due to increased higher discretionary income created by lower energy prices. A clear opportunity set revolves around this consumerism—and top-tier investment managers continue to capitalize on this theme.

Currencies. Weak emerging market currencies have hurt U.S. dollar investors. But favorable exchange rates will strengthen the export component of emerging economies. The case for buying into F/X now: Currencies, like all investments, move in cycles. It’s important to invest across the entire currency cycle to average into lower exchange rates.

Particularly attractive opportunities may result from currency levels that are 20 to 50 percent lower than a couple of years ago—and which seem poised to rebound off recent lows.

The case for private investment
Typically, during downturns in emerging markets, capital flows out of public markets, which translates eventually to lower entry valuations for private companies. Many of the better-positioned growth companies in these markets are privately held and, thus, inaccessible through the public markets. As mentioned, GDP may have slowed in many countries, but private equity-backed growth remains stronger than that of overall economies.

Today may be an excellent opportunity for private emerging markets investment, which can be used to complement an investor’s existing
public “beta” with a different set of “alpha” opportunities. When uncovered by local private equity and venture capital firms, private companies can benefit from the active, hands-on approach taken by skilled managers and, potentially, generate alpha.

There are several reasons to consider adding an emerging markets private investment component to an institutional portfolio.

The governance model. Some large publicly traded emerging markets companies are not always managed solely to maximize shareholder value. Since state-owned or government-backed companies often represent large slices of public stock indices and/or important components of the economy, they can often suffer from conflicts between political and commercial interests. Conversely, private companies tend to have strong governance models mandated by private capital managers and are not burdened by social or government agendas. With a focus on shareholder value, these managers insert professional management, improve information systems to track profitability, tighten cash controls and recruit seasoned personnel—all of which contribute to strong alignment with and accountability to investors.

Diversification. Public investments tend to focus on bigger companies—often creating a portfolio that is overweighted to large caps and underexposed to smaller companies and growing sectors. Private capital investments diversify more heavily into smaller companies across a range of sectors, where significant value and higher growth opportunities typically are found. Private investing also identifies geographical and sector pockets with the potential for strong growth equity success, such as China.

Although headwinds may obscure local opportunities, a strong case can be made for growth if you know where to look.
brush. Each region presents its own opportunities (see chart on the prior page). For example:

**Emerging Asia.** Over the past two to three years, entrepreneur-driven, Silicon Valley-esque innovations are driving forces in emerging Asia in general, and China and India in particular. Business models, too, are innovative in companies such as Alibaba and Xiaomi in China and Flipkart and Snapdeal in India.

China remains the lead for investment returns in emerging Asia; 2014 saw several companies listed with multi-billion-dollar market capitalizations. Long-term investors should be bullish on domestic consumer-driven and technology-enabled investment themes (see table below).

In India, where a mixed economic picture has prevailed, the macroeconomic outlook appears to have turned stronger under the pro-business, Modi-led government. There may be opportunities in consumption-driven and technology-enabled investment themes here as well.

**Latin America.** Latin American countries have faced macro challenges of late, with a slowdown in overall economic growth, declines in public equity markets, political uncertainty and currency adjustments. However, the region’s long-term economic fundamentals remain intact.

Through skilled management, the investment environment here has created an attractive entry point for dollar-based investors. Double-digit revenue and EBITDA growth rates are expected to continue for select privately held companies.

**Africa.** Despite well-documented macro headwinds—falling commodity prices, fiscal deficits, the Ebola outbreak—certain regions of the continent display improving investment fundamentals and allocations to long-term portfolios are appropriate. Domestically oriented, consumer-driven companies that are growing should be the focus, as they may present an attractive entry point.

### A long-term focus is key

Recent short-term macro headwinds in emerging markets may obscure local opportunities for long-term growth. For institutional investors that can avoid myopia, there are attractive entry points in select countries. Investors would be well served to partner with talented managers who evaluate opportunities at the country and micro market levels. A strong case can be made for growth if you know where to look.

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**China still represents the most attractive investment opportunity in the emerging markets space, driven by the sheer enormity of the marketplace.**

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<tr>
<th></th>
<th>CHINA</th>
<th>U.S.</th>
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<tbody>
<tr>
<td>Internet users, 2014</td>
<td>632,000,000*</td>
<td>277,000,000</td>
</tr>
<tr>
<td>E-commerce spend, 2013**</td>
<td>$296,000,000,000</td>
<td>$250,000,000,000</td>
</tr>
<tr>
<td>Smartphones sold, 2013</td>
<td>351,000,000</td>
<td>138,000,000</td>
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*Of these, over 500 million are mobile Internet users.

**US dollars
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