Emerging markets – control is the key to success

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Partners Group
Passion for Private Markets

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EXECUTIVE SUMMARY

In the past decade, emerging markets have attracted a greater level of interest and capital from investors in search of higher returns regardless of the higher level of risk. Despite the strong growth resulting from the powerful long-term fundamentals in emerging markets during this time period, the returns generated by private equity firms have been largely disappointing. This is a consequence of too much capital inflow leading to excessive valuations and over-dependence on growth for returns. At the same time, many managers lacked the requisite skill set to steer companies through economic down cycles and create a sustainable growth trajectory.

Today, many institutional investors are questioning emerging markets. In contrast, Partners Group continues to believe the emerging markets story is a compelling one and that an allocation to emerging markets private equity is accretive to investment portfolios, given the sustainable and strong underlying fundamentals in these markets. Most of these economies continue to exhibit favorable tailwinds, including the attractive demographics in younger economies in Asia, Latin America and Sub-Saharan Africa. Governments in several larger economies, such as India and China, have also been introducing positive structural and regulatory reforms to create a more conducive investment environment for the private sector. These trends support our conviction that emerging markets will continue to experience higher growth relative to developed markets, while market opportunities requiring private capital will remain abundant.

However, the private equity landscape in emerging markets has evolved significantly in terms of scale, quality, and complexity. Partners Group has seen the emergence of more control-oriented transactions requiring active ownership and a different skill set to help drive change in companies and play a pivotal role in value creation. This compares to the previous prevalence of often rather passive, minority investments in fast-expanding, founder-led companies, driven by the need for expansion rather than transformational capital and requiring little expertise on the part of the manager. These deals were constrained firstly by the relatively new concept of private equity in many emerging markets and secondly by regulatory barriers restricting foreign ownership in certain sectors. While the arguments in favor of growth investing continue to hold true for newer markets such as Indonesia, Vietnam, or Colombia, Partners Group sees new themes emerging in the more mature developing economies such as China, India and Brazil, which lend themselves well to more control-oriented transactions.

As investment opportunities continue to evolve in size and complexity, the need for private equity firms to have sufficiently built-out resources, strong operational expertise and deep, local networks becomes all the more important if they are to implement the necessary value creation initiatives. Today, Partners Group still believes most managers in emerging markets do not have the requisite skill set to capitalize on these opportunities. In such an environment, investors themselves need to navigate carefully between those firms that are skilled enough to succeed and the firms that are not.

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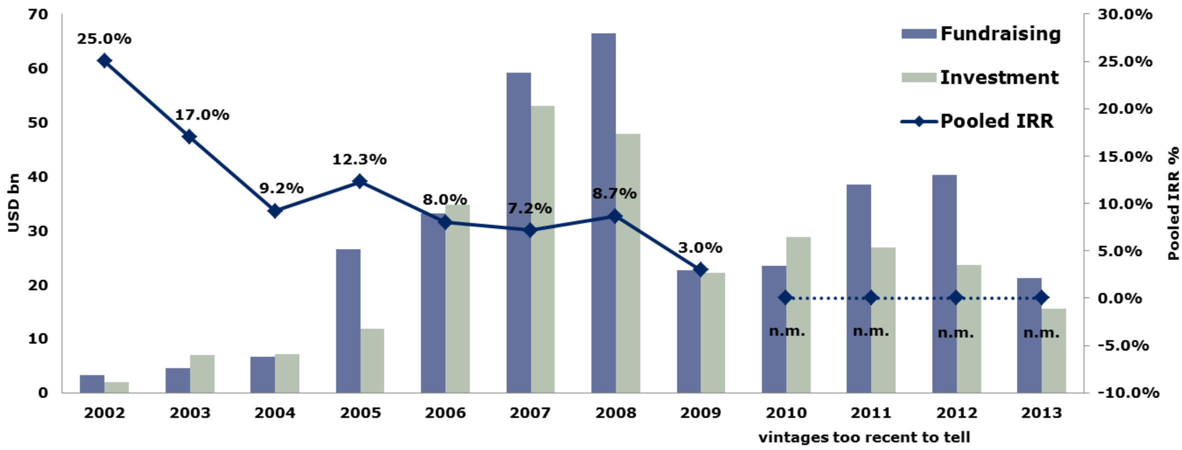
THE UNFULFILLED POTENTIAL OF EMERGING MARKETS PRIVATE EQUITY

An analysis of available data on private equity investment returns shows that despite strong performance in the early years of the last decade, investments in emerging markets have yielded mixed results in the last ten years. In fact, empirical data seems to demonstrate an inverse correlation between the quantum of capital raised in the market and the returns generated in corresponding vintages.

Exhibit 1: Returns impacted by too much capital supply and high valuations



Source: Cambridge Associates 30 Sep 2013, EMPEA Industry Statistics Q3 2013, Partners Group proprietary research

To a certain extent, emerging markets private equity became a victim of its own early success. Because private equity returns in emerging markets outperformed developed markets in the early 2000s, the market then saw a proliferation of emerging markets-focused private equity funds, raised by largely inexperienced fund managers. There were few transactions of scale and quality, leaving capital inflows to chase lower-quality, easy-to-access deal flow, driving prices up and returns down. At the same time, public equity markets experienced significant capital inflows and assets became more expensive, somewhat impacting entry valuations for private transactions as well.

However, it is noteworthy that GDP growth rates in emerging markets consistently outpaced those in the developed world during this period; hence the poor returns generated by the majority of the industry in emerging markets have not been due to a lack of macroeconomic growth.

Historically, the main investment strategy in emerging markets for private equity firms centered on one common theme: growth. While a few top-quartile investment firms were able to make outlier returns in this space, most minority investors with a passive, hands-off approach and solely relying on growth to deliver returns through co-investments and/or pre-IPO financing rounds, were in general ill-equipped to react to macro upheavals and executional and operational challenges. In our view, there was a common ground for almost all of these firms: lack of deep sector knowledge to define a successful corporate strategy for portfolio companies, shortage of qualified professionals, lack of requisite operational expertise to implement appropriate value-adding initiatives to improve efficiency and productivity and too small an industry network locally and globally to help these companies successfully expand into new markets and regions.

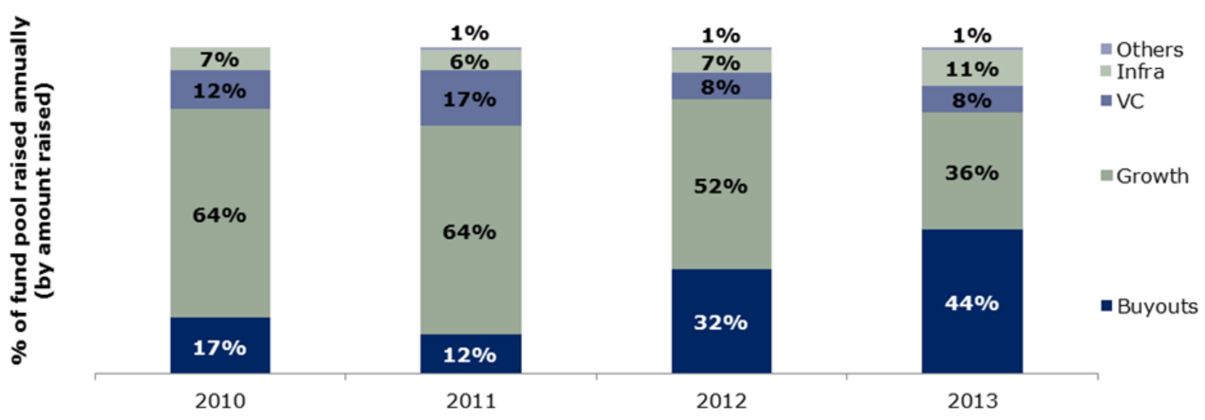
Most growth strategies were also hindered by corporate governance issues, which were difficult to overcome given the lack of control minority investors have over management and the business. There has been a lack of high quality private equity firms to partner with management teams and lead investments, resulting in an inability to bring businesses to their full potential and generate attractive returns for their investor base on exit. With such a mixed bag of results, institutional investors have been forced to focus on picking the right partner, with the right expertise and network to execute emerging markets private equity strategies successfully.

RESURGENCE OF EMERGING MARKETS BUYOUT FUNDS BACKS TREND TOWARDS CONTROL INVESTING

Recent fundraising trends show a resurgence of buyout funds for the first time in four years, though the reversal is fairly recent and has yet to fully materialize. Private equity firms are placing increased emphasis on active value creation at the company-level through a majority ownership, rather than passively riding on the coat-tails of the company's growth.

For the first time in recent years, buyout funds have occupied the majority spot in the pool of fresh capital raised in 2013, staging a recovery over the dominance of growth capital. The buyout fund pool has increased from 17% of all private equity capital raised in 2010 to 44% in 2013, overtaking growth that year as the dominant strategy in terms of available capital in Asia.

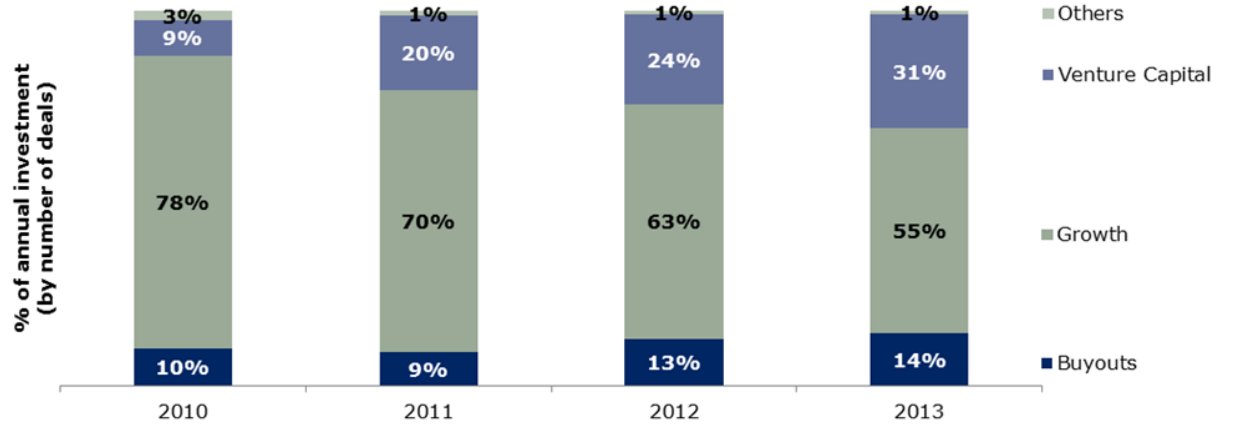
Exhibit 2: Buyout funds dominate Asian fundraising



Source: APER Dec 2013. Others include non-relevant strategies such as mezzanine and secondary tracked by APER.

At the same time, the proportion of growth capital deals has shrunk in tandem with the slowdown in growth and deal activity of the two giants, China and India, while in the buyout space the gap (by amount invested) with the more developed markets of Japan, Australasia and South Korea is narrowing[1].

Exhibit 3: Asian buyouts are increasing as proportion of PE deals, although growth still dominates



Source: APER Dec 2013. Others include non-relevant strategies such as mezzanine and secondary tracked by APER

This gives us strong reason to believe that buyout funds are not only here to stay in emerging markets, but can be expected to continue to increase as a proportion of private equity investors' active total fund pool in the market over the next few years.

TODAY, DESPITE A SLOWDOWN, THE POTENTIAL IN EMERGING MARKETS IS CLOSER TO BEING REALIZED

The current investment environment in emerging markets is tempered by a degree of political uncertainty around upcoming elections, resulting in capital outflows and a downward adjustment in currencies and valuations. Brazil, Indonesia, and India all face elections in the near term. At the same time, GDP growth rates this year in China, India, and Russia are expected to be below their ten-year average.

As a result, foreign direct investment (FDI) flows into emerging markets as a whole have only grown at about 2% CAGR over the past two years, and Asia, which accounts for >50% of such flows is actually on a declining trend.[2] FDI into East Asia and South Asia (of which China and India account for two-thirds) declined by 10% and 30% respectively in 2012, while 2013 estimates are flat. Total capital inflows to emerging markets dropped a total of USD 100 billion from 2012 to 2013 and are forecast to remain at current levels until 2015.[3] Due to this reduced capital supply, public market valuations and currencies have adjusted downwards substantially; but we still feel the fundamental growth drivers are intact despite adjusted growth rates and potential market volatility, marking an attractive entry point for private equity investments.

[1] APER 2013 Year-End Review
[2] United Nations Conference on Trade and Development (UNCTAD)
[3] IIF Research Note, January 2014

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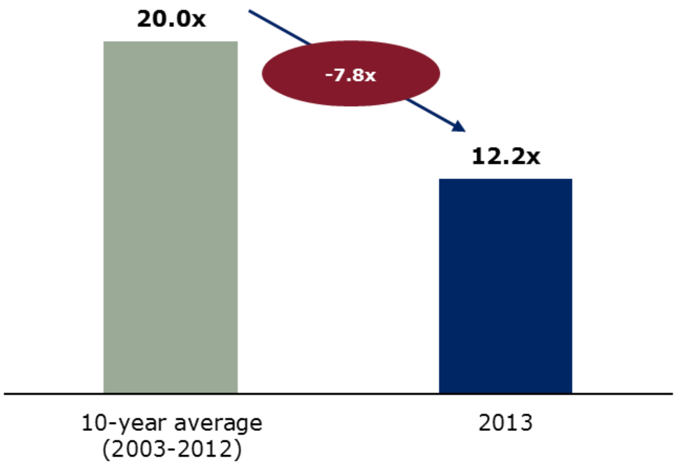
Exhibit 4: Substantial valuation adjustments in BRIC markets P/E multiples



Source: APER 2013 YE report, Partners Group, IIF (January and February 2014)

In this environment, Partners Group's platform is focused on finding companies with stable growth prospects. By identifying structural shifts in a rapidly changing market environment, growth can be identified without a great degree of volatility. We believe investors active in the middle market are often the best-positioned to pull operating levers within their underlying portfolio companies, provided they have the necessary in-house industry expertise to do this.

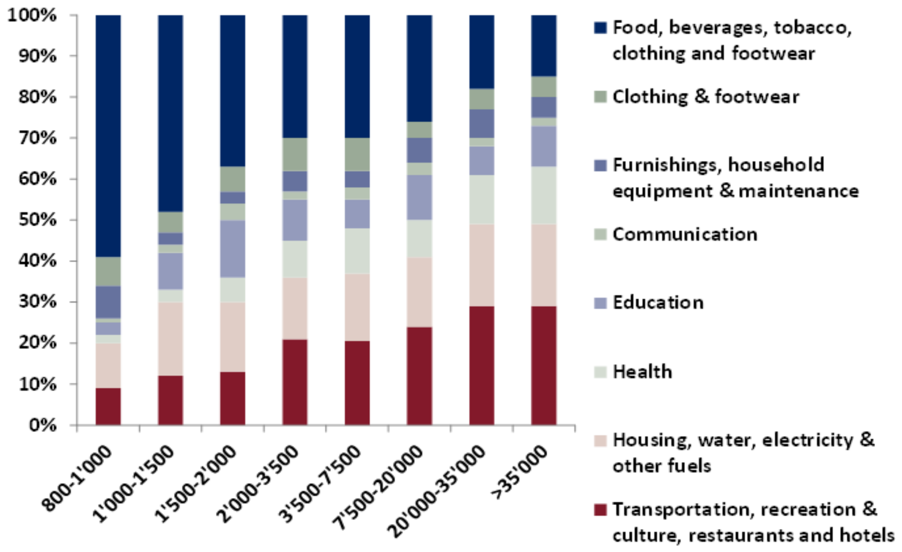
A good example from Partners Group's portfolio is CSS Corp, a business process outsourcing company which we acquired in June 2013 on behalf of our clients. CSS provides a range of services, including mobility solutions, cloud enablement, technical support and remote infrastructure management to a blue-chip client base that includes some of the largest global technology companies. The company serves a client base in the US and Europe and has a large delivery presence in India, the US, the Philippines, Poland, Mauritius, Costa Rica and China, with service delivery centers in 13 locations worldwide and a team of over 5'400 professionals.

Through Partners Group's global platform, we are currently helping CSS to build a stronger sales presence in Europe and the US, and have so far made over 30 meaningful business introductions to other companies in the Partners Group portfolio and network. The company has also been further developing its delivery footprint in lower cost locations that are nearer to clients, such as Costa Rica, in order to streamline operational costs. For an export-oriented company like CSS, the challenging macroeconomic environment in India and the depreciation of the Indian rupee serve as a tailwind to the business.

At the same time, there are many factors which continue to support the emerging markets growth story. An active investor in emerging markets is required to have broad sector coverage to take advantage of all opportunities. Some of these themes are not new but remain relevant today, namely the domestic consumption drivers coming from the emerging middle class and urbanization. Discretionary spending patterns will continue to evolve and drive the domestic consumption story: with greater disposable incomes, expenditure on healthcare, education, and recreation will continue to increase. For example, China, with around USD 3.3

trillion in private consumption or 8% of the world's total and still growing, is projected to overtake the US as the world's largest consumer market over the next five years.[4]

Exhibit 5: Consumption diversifies as income climbs



Source: Goldman Sachs Global Research

Many sophisticated private equity investors have positioned themselves with dedicated sector teams to capitalize on these trends and continued economic development in emerging markets. Partners Group expects consumer-oriented sectors, such as education and healthcare, where there continues to be an acute demand-supply imbalance, as well as sectors such as business and financial services to offer the most compelling investment opportunities in the medium term, especially against the background of continued urbanisation, which projects that consumption in large emerging markets cities will increase by around USD 14 trillion to 2025[5].

Partners Group has eight dedicated in-house industry teams specializing in value creation activities; these teams work alongside the deal teams to provide industry intelligence as well as strategic resources for portfolio companies. For example, in early 2014, Partners Group invested in Fermaca, a midstream gas pipeline operator in Mexico, on behalf of its clients; planned value creation initiatives include increasing sales through cross-border expansion, implementing an efficiency program including enhanced KPI tracking, and reorganization of the corporate structure.

NONETHELESS, RISKS AND CHALLENGES REMAIN

Investors also need to keep in mind the challenges inherent to investing in emerging markets, despite strong underlying growth. A key concern in developing economies is corporate governance and the inadequate regulatory frameworks in several of these markets which leave

[4] The Economist, 25 Jan 2014
[5] McKinsey Global Institute, June 2012.

investors with limited recourse when dealing with corruption and fraud risks. One needs to be well-entrenched locally to understand the intricacies of doing business in these markets.

Partners Group maintains high corporate governance guidelines for its portfolio companies and declines a vast number of transactions in emerging markets due to corporate governance issues. Even when companies are well-positioned in their market in attractive growth sectors, we can often develop concerns around transparency and integrity during the due diligence process. For example, Partners Group’s majority ownership in CSS Corp and majority representation on the company's board allow us to maintain strong corporate governance standards as part of the overall IT services sector in India.

The challenges above underscore not only the need for rigorous due diligence and active ownership but also the need to enforce strong corporate governance structures, rather than taking an opportunistic, passive approach to investment which relies solely on growth to deliver strong returns. The latter has to-date been the modus operandi for the majority of private equity firms in emerging markets.

Another example of active ownership from Partners Group’s portfolio is Trimco International, which we acquired in April 2012 on behalf of our clients and which has shown strong development since. Trimco is a leading Asia-headquartered supplier of a full range of garment labels, tags and trimming products to blue chip global apparel companies. Trimco's products include care labels, woven labels, hang tags and trimming products used for brand identification and information management. Trimco's complex, high-volume, low unit cost and error-free production are crucial components used by blue chip global apparel brands to reflect brand differentiation, premium quality and design elements.

Post-investment, Partners Group has helped to execute on key strategic value creation opportunities identified during due diligence, such as strengthening the management team, new customer introductions, and expanding in Asia and Latin America, as well as an add-on acquisition in Europe. In addition, we launched a firm-wide upgrade and integration of IT, CRM and ERP systems at Trimco, and also initiated production insourcing and revamped pricing internally. Since Partners Group’s investment, revenues have doubled as a result of a larger global footprint and the European add-on acquisition. The insourcing initiative and pricing reviews of key customer accounts have also led to a 10% margin improvement year-on-year since investment.

TREND TOWARDS ACTIVE OWNERSHIP IN EMERGING MARKETS PRIVATE EQUITY

As highlighted above, Partners Group has seen a resurgence of buyouts and a stronger focus on active ownership in recent years, especially in the aftermath of the global financial crisis, which exposed the limitations of a passive approach towards private equity investment. Further key developments in large emerging economies, such as China and India, have resulted in a gradual evolution of the investment landscape towards more control-type investments requiring a significant level of operational and strategic involvement.

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The key drivers of this emerging trend include:

1. Increasing acceptance of private equity firms as a value-adding partner

The global financial crisis has separated true value-adding investors from more opportunistic, arbitrage-driven investors and has resulted in many founder-led businesses becoming more open to ceding control to an investment partner who can truly add value.

Take for instance the pre-IPO strategy in China, which was a prominent investment strategy for several local private equity firms. These investors capitalized on the multiple arbitrage upon going public and did not focus on longer term value creation initiatives. Exits have become a key issue for several pre-IPO focused private equity firms since China's IPO window was suspended in October 2012, with more than 700 companies reportedly in the queue. Partners Group invests in long-term propositions where there is tangible upside to be made from value creation and tends to avoid non-control situations due to limited governance rights and influence over portfolio companies. Today, a more discerning entrepreneur is looking for a private equity investor who can actually maximize returns due to long-term and sustainable value creation initiatives, rather than just providing capital, and is more open-minded towards ceding control.

2. More countries and sectors are opening up

More emerging economies are recognizing the importance of liberalizing their domestic market and allowing a more open trade environment. For instance, India recently eased its restrictions to allow 100% foreign ownership in key sectors including telecommunications and single-brand retail, as part of its overall strategy in attracting FDI to boost a flagging growth rate. The Vietnamese government has also recently increased the foreign ownership limit of certain listed entities from the blanket exchange-wide cap of 49% to 60%. Indonesia modified its investment restriction policy to allow greater foreign participation in the power, advertising and pharmaceutical sectors. Brazil is implementing trade reforms, lowering tariffs and rolling out a massive, state-led privatization program in key sectors of the economy such as steel, telecommunications and electricity.[6] The opening up of these key sectors will allow good access to control-oriented investment opportunities to those private equity firms which have the requisite network on the ground, the respective sector know-how and the skill set to drive a firm's operations forward successfully. It is important to be active across disparate regions; Partners Group tracks the development of individual countries closely with on-the-ground deal teams in China, India, Latin America and Southeast Asia, connected with an established European base and US operations.

3. Entrepreneur succession offers opportunities

Succession has emerged as a critical corporate issue in the larger, more developed emerging economies. China provides a good example – one study estimates over 3 million Chinese businesses will come under new leadership in the next five to ten years.[7] Many of these businesses were founded by young entrepreneurs during the 1970s and 1980s. As more and more of these first-generation entrepreneurs are due to hit retirement age over the next few

[6] WTO report on Brazil, 1996
[7] Beijing Huashang Institute of Management

years, many are expected to turn to private equity to provide investment capital and secure the future of the company, given the lack of viable heirs or alternative professional managers.[8]

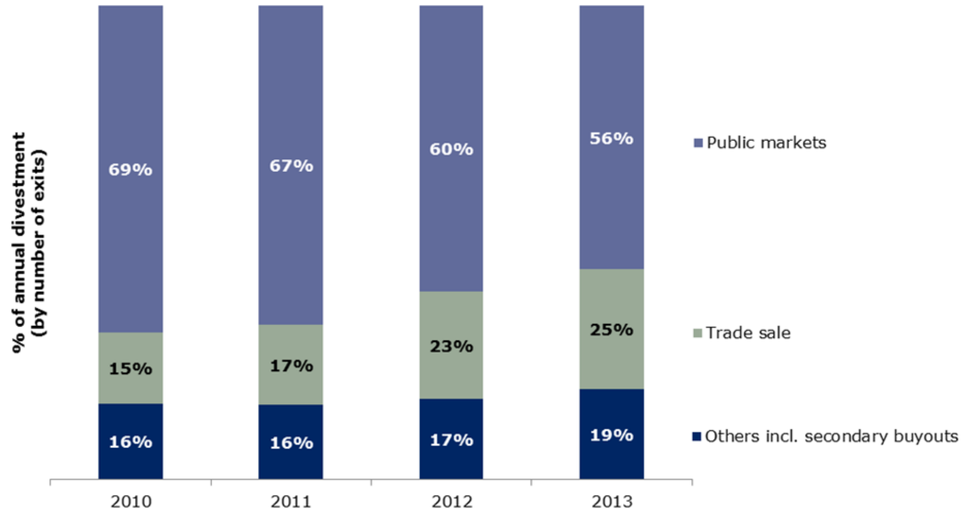
4. Increasing cross-border activity

Accessing global markets, companies and consumers is a key strategic growth driver for businesses of scale; most companies want to internationalize through acquisitions and increasingly look for attractive targets to improve their footprint and build geographical scale. According to a survey of 3’500 senior executives in listed and private companies globally, 39% of all respondents expect their acquisitive growth to be cross-border; this number increases to 47% for Mainland Chinese and 46% for Indian business owners.[9] While historically, cross-border M&A activity consisted primarily of companies in developed markets investing in emerging markets to access the higher growth available in these markets, today the picture is changing.

China’s Outbound Direct Investments (ODI) in 2011 were USD 65 billion[10], while information from the Chinese government showed that by the end of 2011, 13’500 Chinese enterprises had established over 18’000 overseas enterprises in 177 countries across the world.[11] As a global organization, Partners Group has a key role to play in the internationalization of portfolio companies. In the case of Trimco for example, we were able to actively source and complete a European add-on transaction, as well as explore expanding the company's operations to Brazil and Vietnam.

5. Secondary buyouts serving as source of private equity exits

Exhibit 6: Decrease in private equity exits in Asia through public markets



Source: APER 2010-2013

[8] Ernst & Young Asia-Pacific private equity outlook 2014
[9] Grant Thornton International business Report 2013
[10] UNCTAD stat, extracted 14th November 2012
[11] Ministry of Commerce, 30th August 2012, MOFCOM, the National Bureau of Statistics and SAFE jointly announce the 2011 Annual Statistical Bulletin of China’s foreign direct investment

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Secondary buyout transactions have also been on the rise since mid-2011, with difficult public market conditions limiting IPOs as an exit option and pressure mounting on private equity firms to return capital to investors due to maturing portfolios. As of December 2013, the average holding period for private equity-backed investments across Asia was slightly over five years, reflecting the tough liquidity environment[12] compared to an average of four years in 2009-10. Given the typical fund term of ten years, this exerts pressure on private equity managers to monetize their stakes in portfolio companies. This has also been driven by buyout firms increasingly taking out several minority investors to create control opportunities in situations which previously involved only minority investors, which has contributed to the increased trend of secondary control buyouts among Asian private equity firms.

DIFFERENT SKILL SET REQUIRED FOR CONTROL INVESTING

The need to create value beyond top line growth in emerging markets has resulted in growing demand for an active, hands-on approach when managing investments. Controlling investment stakes allow for this active ownership and enable private equity firms to set strategic targets and directly oversee the implementation of their respective initiatives. Private equity owners can also align, remove and replace management and have strong board oversight over company operations. Such corporate governance structures facilitate prompt decision-making in challenging times, when private equity owners can act quickly and decisively to put corrective measures in place.

Although the overall pace of growth in emerging markets may have slowed, it still remains compelling from a relative value standpoint. The more challenging emerging market macroeconomic landscape requires a tailored investment approach, allowing the investor to under- and over-weight certain sectors and regions according to their relative value. Countries with a strong regulatory framework in place and sound fundamentals offer compelling investment opportunities on the terms described above and provide for an attractive country risk premium.

STRONG DEAL FLOW AS A PRE-REQUISITE OF SUCCESSFUL INVESTING

Strong deal flow is a pre-requisite for a successful pan-regional investment approach. Partners Group's platform serves to generate both strong deal flow and compelling return profiles for our investment partners. Between 2010 and 2013, Partners Group sourced over 550 direct private equity opportunities and invested in 17 transactions across sectors and regions in emerging markets. Furthermore, the firm screened and evaluated over USD 31 billion in private equity secondary opportunities and selectively invested in about 1% of our deal flow. Selectivity remains key in preserving superior investment returns.

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[12] APER Year-End Review 2013

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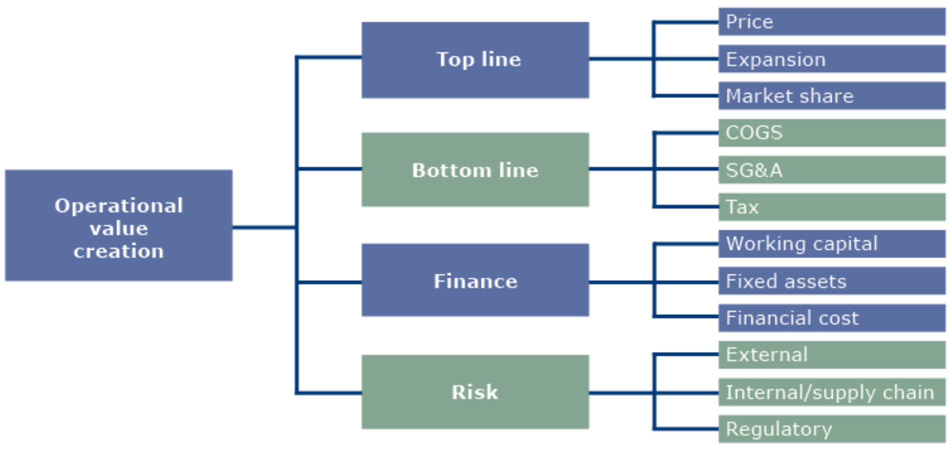
ACTIVE VALUE CREATION

Creating value is easier said than done. Investors must have the necessary resources and processes in place to systematically work with each portfolio company to develop joint goals. With 17 offices globally (of which seven are in emerging markets) and over 480 investment professionals on the ground, Partners Group is able to maintain broad yet in-depth regional coverage, position portfolio companies effectively within their target markets, as well as formulate clear plans for future expansion and development on a global scale.

The process of active value creation begins with the correct sourcing and identification of opportunities that fit into a specific industry theme, and continues on through the life of an investment through the formulation of an "action plan" all the way through to implementing initiatives as a company moves toward exit.

Exhibit 7: Partners Group targets all levels in the value creation spectrum



COGS: cost of goods sold; SG&A: selling, general and administrative expenses
Source: Partners Group

Value creation initiatives vary but typically focus on strategic objectives such as revenue growth, cost reduction, acquisitions, divestitures, new financing or other major corporate developments. Partners Group systematically identifies those strategic objectives within its portfolio companies and executes on those which provide the most value creation opportunities. For example, strategic and operational measures formed the blueprint for the Trimco investment, which, as mentioned, has culminated in a doubling of revenues since entry and a 10% EBITDA margin improvement.

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CONCLUSION

The market opportunity in emerging markets remains compelling, as long-term fundamentals continue to be attractive, and governments continue to liberalize their economies and put in place proper regulatory frameworks to attract investments into the private sector. However, as a result of the evolving investment landscape in emerging markets, the investment opportunities we see today no longer consist solely of providing passive capital to fast-growing founder-led companies for expansion. While this is still true for some of the younger emerging economies, we are starting to see more complex, control-oriented investment opportunities in larger and more developed emerging markets such as China, Brazil and India. This is a result of an ageing generation of entrepreneurs with succession issues, increasing cross-border activity and maturing private equity portfolios of existing local private equity managers.

Buyout investments require active ownership and hence a much different skill set when compared to minority growth investing. Creating value is easier said than done. Not only must investors have the necessary resources and processes in place to systematically work with each portfolio company to develop joint goals, they must also be in close enough contact to influence the ongoing development of each company. Private equity firms need to have the requisite platform and resources to spearhead strategic and operational initiatives for their investments in order to maximize value creation at exit. The disappointing returns generated in emerging markets over the past decade exposed the limitations of passive minority investing, but also suggest that several private equity firms lacked the requisite skill set to actively manage their investments during this period, especially during the financial crisis.

We expect more private equity firms to turn their focus towards control-oriented investments as buyout opportunities continue to gain prominence in emerging markets. However, the mismatch between the investment opportunities available and the skill set of firms in the market is likely to persist, if not increase. Investors will need to be able to distinguish between those firms ill-equipped for the new control-oriented investment environment and the truly differentiated private equity firms that possess the requisite skill set and platform to capitalize on and add value to future investment opportunities.

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