

## GROUND FLOOR INVESTING

**Ralph Jaeger**  
**Siguler Guff**

Popular wisdom suggests emerging markets are no longer the force they once were. Siguler Guff's Ralph Jaeger argues otherwise.<sup>1</sup>

Investors in emerging market have endured a torrid time of late. Both the Morgan Stanley Capital International (MSCI) Emerging Market and MSCI Frontier Market indexes plummeted in 2015, falling 14.92% and 17.67% respectively.<sup>2</sup> Worse, net capital outflows (including unrecorded flows captured by net errors and omissions) totalled US\$735 billion in 2015, up from US\$111 billion the previous year, according to Washington-based Institute of International Finance.<sup>3</sup>

Even Goldman Sachs – once a trailblazer for investing in developing nations – closed its Brazil, Russia, India and China fund in November 2015, leading Bloomberg to declare the “BRICs” era of investing to be at an end.<sup>4</sup>

For Siguler Guff's Ralph Jaeger, however, rumours of the demise of emerging markets have been greatly exaggerated. On the question of demographics alone, he says, the arguments in favour of investing in emerging markets remain persuasive. According to United Nations forecasts, for example, the number of people on the planet is expected to rise from 7.3 billion today to 9.7 billion by 2050.

Most of that growth is forecast to come from countries in the emerging world, including India, Nigeria, Pakistan, the Democratic Republic of the Congo, Ethiopia, Tanzania, Indonesia and Uganda.<sup>5</sup>

Says Jaeger: “Emerging markets countries generally have young and growing populations – and this is instrumental in driving greater internal consumption and production. At the same time, we're seeing improvements in the fiscal outlook, the implementation of structural economic reform as well as massive infrastructure investments. We believe these factors provide a foundation for many emerging market countries to enter a new phase of development and sustainable growth.”

The IMF agrees: it expects the world's middle class (i.e. households that spend US\$10 to US\$100 a day) to increase to some five billion people by 2030. That growth in numbers, it says, will be driven almost exclusively by emerging markets.<sup>6</sup>

For all this potential, however, mainstream strategies for investing in emerging markets are not without their challenges, according to Jaeger. Take equity investing for example. Jaeger notes how emerging market indices tend to be heavily weighted towards just four sectors: energy, utilities, financial services and materials. By the same token, exposure to healthcare, consumer or tech is limited.

**1 Investment Managers are appointed by BNY Mellon Investment Management EMEA Limited (BNYMIM EMEA) or affiliated fund operating companies to undertake portfolio management activities in relation to contracts for products and services entered into by clients with BNYMIM EMEA or the BNY Mellon funds.**

**2** Source: Morgan Stanley, 31 December 2015.

**3** Citywire: 'Rush to exit: capital outflows from EMs soared in 2015', 21 January 2016.

**4** Bloomberg: 'Goldman's BRIC Era Ends as Fund Folds After Years of Losses', 8 November 2016.

**5** World Population Prospects. United Nations: July 2015.

**6** Kharas and Gertz: "The New Global Middle Class," 2010



This is less than ideal, says Jaeger, since those high-growth sectors are exactly the ones that benefit the most from emerging market demographics. “Even taking into account a levelling off of China’s growth trajectory, we’re looking at a situation where millions of people living in emerging markets are lifted out of poverty every year,” he says. “Upward mobility and the emergence of middle class consumers are clearly visible. But public markets don’t provide access to the companies and sectors that are the most obvious beneficiaries of that trend.”

This is not to say there are no listed emerging market companies in the tech sector or consumer discretionary space – but these are comparatively few and far between, meaning they have a “scarcity” value. As a result, says Jaeger, they are often overpriced.

At the same time, companies listed on emerging market exchanges also tend to be large, often state-controlled companies. While the large-cap mining and energy companies that make up the bulk of emerging market indices are not necessarily bad companies – their predominance does limit investors’ options if they do choose to access emerging markets through the traditional route of buying equities.

As Jaeger points out, this concentration of large companies in only a limited range of sectors also adds to volatility. “From a timing point of view, that concentration of emerging market equities in the extractive, energy and commodities sectors makes it very difficult to time your investment.

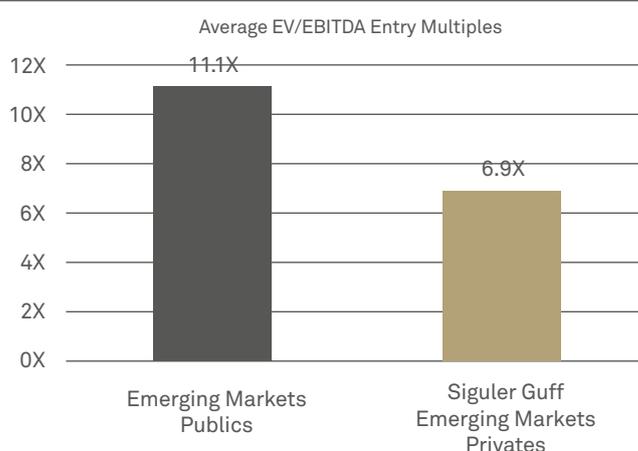
This is something we saw in 2015 where, one minute, emerging market equities were up; the next they were down. When they do well, they tend to do very well. When they do badly they tend to do very badly together.”

**ANOTHER WAY?**

Faced with these challenges, investors do have other options. One route, according to Jaeger, is to invest in emerging markets via private equity – a strategy, he says, that has a range of possible benefits.

First, emerging market private equity funds tend to have their investments spread across a far wider spectrum of sectors than public indices. Crucially, this means areas such as healthcare and technology – among the key beneficiaries of rising prosperity in developing countries – can be well represented. It also makes for a less volatile experience for investors as portfolios tend not to be focused in a concentrated sub-set of sectors that rise and fall in lockstep with each other. The difference can be significant: data provider Cambridge Associates says volatility on its Emerging Markets Private Equity & Venture Capital Index is approximately half that of the MSCI EM Index.<sup>7</sup>

FIGURE 1: CONSISTENTLY LOWER ENTRY VALUATIONS VS. EMERGING MARKETS PUBLIC COMPARABLES



Sources: Bloomberg, Capital IQ, Siguler Guff database Average Emerging Markets Publics: Represents the average annual multiple for the RTS, BSE Sensex, Bovespa, and Chinese (average of Shanghai, Hang Seng, and Shenzhen) exchanges between 2003 and 2014, weighted by the aggregate exposure of BRIC I, II, and III to each respective country on an invested capital basis. Average Siguler Guff Emerging Markets Privates: Entry multiples are calculated based on Siguler Guff’s propriety database of BRIC I, II, and III companies from April 2003 – December 2014. Not all companies are included in this analysis; companies where the trailing P/E or EV/EBITDA multiple at entry were not available were excluded. The sample for Siguler Guff Emerging Markets Privates entry multiples represents approximately 26% of the aggregative underlying invested capital of the BRIC portfolio.

Second, private equity funds seek to identify and invest in opportunities early in the life cycle of companies and this may equate to better entry and exit multiples. Between 2003 and 2014, for example, Siguler Guff's emerging market entry multiples for private companies were 25%-40% below those for public companies (see Figure 1). "By definition, a lot of private equity investing is about getting in on the ground floor," says Jaeger. "Often the aim is to transform the company with a view to unlocking future value through either an IPO or M&A – and, in turn, that means valuations at the point of investing and at exit tend to be more attractive."

A third argument in favour of emerging market private equity investing is performance. To illustrate this point, Jaeger turns once more to research by Cambridge Associates. As Figure 2 demonstrates, returns from emerging market private equity funds have been broadly comparable to – or marginally better than – developed and emerging market equities as well as US private equity and venture capital funds, depending on the time period.

FIGURE 2: EM PE & VC VS. BENCHMARK. ANNUALISED TIME-WEIGHTED RETURNS

	EM PM & VC	Perf. vs. US PE and VC (bps)	Perf. vs. R3000* (bps)	Perf. vs. MSCI EM** (bps)
Three-year	11.60	-552	-617	749
Five-year	10.00	-641	-749	601
10-year	12.80	-2	461	430

Sources: Cambridge Associates, Russell Investments and Capital IQ. Data as of 30 September 2015. \* Russell 3000 Index. \*\* MSCI Emerging Markets Index.

On closer examination, though, a far more compelling picture emerges (see Figure 3). Says Jaeger: "If we consider returns from funds in just the first- and second-quartile you see spectacular outperformance against equities." Over a 10-year period, for example, returns for first- and second-quartile funds outpace those of US private equity & venture capital (US PE & VC) funds, the Russell 3000 Index, and the MSCI EM Index by over 875 bps, 1,338 bps, and 1,308 bps, respectively.

FIGURE 3: 1ST AND 2ND QUARTILE EM PE & VC VS. BENCHMARK. ANNUALISED TIME-WEIGHTED RETURNS

	EM PM & VC	Perf. vs. US PE and VC (bps)	Perf. vs. R3000* (bps)	Perf. vs. MSCI EM** (bps)
Three-year	22.80	575	481	1846
Five-year	20.40	394	286	1637
10-year	20.10	875	1338	1308

Sources: Cambridge Associates, Russell Investments and Capital IQ. Data as of 30 September 2015. \* Russell 3000 Index. \*\* MSCI Emerging Markets Index.

So much for performance – but is there a way for investors to improve their chances of picking those high-return private equity funds in the first and second quartile? For Jaeger, one strategy might be to focus on smaller and newer emerging market private equity funds since they appear to consistently outperform their larger and older counterparts (see Figure 4). According to Cambridge Associates data, this is the case on a five-year, 10-year and 15-year view where the internal rate of return for small/mid cap funds was higher than that of their large/mega cap counterparts by 5.8%, 8.0% and 5.0% respectively. The same holds true of the performance of younger funds versus older funds where first-generation investment vehicles enjoyed an uplift of 16.9% against the performance of their later iteration peers (see Figure 5).

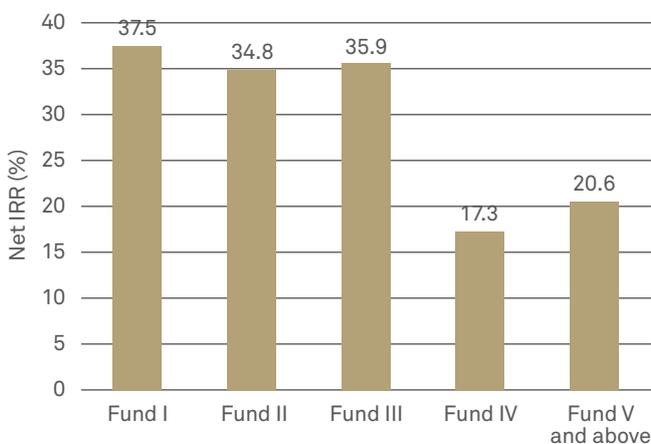
FIGURE 4: SMALLER AND NEWER IS MORE BEAUTIFUL

	5-year IRR	10-year IRR	15-year IRR
EM PE & VC – All sizes	10.1%	11.2%	9.4%
EM PE & VC – Small/Mid (<\$750 million)	13.1%	15.1%	11.3%
EM PE & VC – Large/Mega (>\$750 million)	7.3%	7.1%	6.3%
Outperformance:			
Small/Mid vs Large/Mega	587 bps	797 bps	501 bps

Sources: MSCI, Cambridge Associates as of September 30, 2015.



FIGURE 5: YOUNGER GENERATION FUNDS OUTPERFORM



Source: Cambridge Associates as of December 31, 2014. The graph represents the return for the top 5% of funds, by fund generation, for funds in vintage years 2000-2009.

According to Jaeger, this outperformance could be due to a couple of key factors. First, he says, private equity general partners often commit significant personal net worth to first-generation funds which are often smaller than their later generation peers. Committing their own capital creates a strong alignment of interests with limited partners, says Jaeger, while also creating a greater sense of fiduciary duty and obligation.

Meanwhile, smaller companies – which tend to be the focus of smaller funds – usually benefit from lower levels of deal flow competition and a wider range of exit options than their larger counterparts. Ultimately this works in favour of more attractive entry and exit multiples, says Jaeger.

Finally, the close ownership structures of smaller companies can provide additional strategic insights and support from management teams as well as a stronger alignment between managers and shareholders. All of this can provide a boost to performance and can perhaps help explain the higher returns of smaller and newer emerging market funds, says Jaeger.

He concludes: “To us, if investors are looking to tap into the potential of emerging markets, private equity investing does seem to make sense – not just from a performance point of view but also taking into account factors such as volatility. In addition, investors might consider focusing on the smaller and younger funds in the EM private equity universe since these do appear to offer the possibility of outperformance versus their larger and older peers.”

BNY Mellon Investment Management is an investment management organization, encompassing BNY Mellon's affiliated investment management firms, wealth management organization and global distribution companies. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation and may also be used as a generic term to reference the Corporation as a whole or its various subsidiaries generally.

This information is not investment advice, though may be deemed a financial promotion in non-U.S. jurisdictions. Accordingly, where used or distributed in any non-U.S. jurisdiction, the information provided is for Professional Clients only. This information is not for onward distribution to, or to be relied upon by Retail Clients.

For marketing purposes only. Any statements and opinions expressed are as at the date of publication, are subject to change as economic and market conditions dictate, and do not necessarily represent the views of BNY Mellon or any of its affiliates. The information has been provided as a general market commentary only and does not constitute legal, tax, accounting, other professional counsel or investment advice, is not predictive of future performance, and should not be construed as an offer to sell or a solicitation to buy any security or make an offer where otherwise unlawful. The information has been provided without taking into account the investment objective, financial situation or needs of any particular person. BNY Mellon and its affiliates are not responsible for any subsequent investment advice given based on the information supplied. This is not investment research or a research recommendation for regulatory purposes as it does not constitute substantive research or analysis. To the extent that these materials contain statements about future performance, such statements are forward looking and are subject to a number of risks and uncertainties. Information and opinions presented have been obtained or derived from sources which BNY Mellon believed to be reliable, but BNY Mellon makes no representation to its accuracy and completeness. BNY Mellon accepts no liability for loss arising from use of this material. If nothing is indicated to the contrary, all figures are unaudited.

Any indication of past performance is not a guide to future performance. The value of investments can fall as well as rise, so investors may get back less than originally invested.

Not for distribution to, or use by, any person or entity in any jurisdiction or country in which such distribution or use would be contrary to local law or regulation. This information may not be distributed or used for the purpose of offers or solicitations in any jurisdiction or in any circumstances in which such offers or solicitations are unlawful or not authorized, or where there would be, by virtue of such distribution, new or additional registration requirements. Persons into whose possession this information comes are required to inform themselves about and to observe any restrictions that apply to the distribution of this information in their jurisdiction. **The investment products and services mentioned here are not insured by the FDIC (or any other state or federal agency), are not deposits of or guaranteed by any bank, and may lose value.**

This information should not be published in hard copy, electronic form, via the web or in any other medium accessible to the public, unless authorized by BNY Mellon Investment Management.

#### Issuing entities

This information is approved for Global distribution and is issued in the following jurisdictions by the named local entities or divisions: Europe, Middle East, Africa and Latin America (excl. Switzerland, Brazil, Dubai): BNY Mellon Investment Management EMEA Limited, BNY Mellon Centre, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorised and regulated by the Financial Conduct Authority. • Switzerland: Issued by BNY Mellon Investments Switzerland GmbH, Talacker 29, CH-8001 Zürich, Switzerland. Authorised and regulated by the FINMA. • Dubai, United Arab Emirates: Dubai branch of The Bank of New York Mellon, which is regulated by the Dubai Financial Services Authority. This material is intended for Professional Clients only and no other person should act upon it. • Singapore: BNY Mellon Investment Management Singapore Pte. Limited Co. Reg. 201230427E. Regulated by the Monetary Authority of Singapore. • Hong Kong: BNY Mellon Investment Management Hong Kong Limited. Regulated by the Hong Kong Securities and Futures Commission. • Japan: BNY Mellon Asset Management Japan Limited. BNY Mellon Asset Management Japan Limited is a Financial Instruments Business Operator with license no 406 (Kinsho) at the Commissioner of Kanto Local Finance Bureau and is a Member of the Investment Trusts Association, Japan and Japan Securities Investment Advisers Association. • Australia: BNY Mellon Investment Management Australia Ltd (ABN 56 102 482 815, AFS License No. 227865). Authorized and regulated by the Australian Securities & Investments Commission. • United States: BNY Mellon Investment Management. Securities are offered through MBSC Securities Corporation, distributor, member FINRA and a broker-dealer within BNY Mellon Investment Management. • Canada: Securities are offered through BNY Mellon Asset Management Canada Ltd., registered as a Portfolio Manager and Exempt Market Dealer in all provinces and territories of Canada, and as an Investment Fund Manager and Commodity Trading Manager in Ontario. • Brazil: this document is issued by ARX Investimentos Ltda., Av. Borges de Medeiros, 633, 4th floor, Rio de Janeiro, RJ, Brazil, CEP 22430-041. Authorized and regulated by the Brazilian Securities and Exchange Commission (CVM).

The issuing entities above are BNY Mellon entities ultimately owned by The Bank of New York Mellon Corporation

#### BNY Mellon Company information

Investment Managers are appointed by BNY Mellon Investment Management EMEA Limited (BNYMIM EMEA) or affiliated fund operating companies to undertake portfolio management activities in relation to contracts for products and services entered into by clients with BNYMIM EMEA or the BNY Mellon funds.

BNY Mellon Cash Investment Strategies is a division of The Dreyfus Corporation. • Investment advisory services in North America are provided through four different SEC-registered investment advisers using the brand Insight Investment: Cutwater Asset Management Corp, Cutwater Investor Services Corp, Pareto New York LLC and Pareto Investment Management Limited. The Insight Investment Group includes Insight Investment Management (Global) Limited, Pareto Investment Management Limited, Insight Investment Funds Management Limited, Cutwater Asset Management Corp and Cutwater Investor Services Corp. This information does not constitute an offer to sell, or a solicitation of an offer to purchase, any of the firms' services or funds to any U.S. investor, or where otherwise unlawful. • BNY Mellon owns 90% of The Boston Company Asset Management, LLC and the remainder is owned by employees of the firm. • The Newton Group ("Newton") is comprised of the following affiliated companies: Newton Investment Management Limited, Newton Capital Management Limited (NCM Ltd), Newton Capital Management LLC (NCM LLC), NCM LLC personnel are supervised persons of NCM Ltd and NCM LLC does not provide investment advice, all of which is conducted by NCM Ltd. Only NCM LLC and NCM Ltd offer services in the U.S. • BNY Mellon owns a 20% interest in Siguler Guff & Company, LP and certain related entities (including Siguler Guff Advisers LLC).