EMPEA Brief

Alternative Paths to Liquidity

May 2017

This EMPEA Brief investigates the shortfall in distributions from rapidly maturing EM PE funds raised in the run-up to the Global Financial Crisis and subsequent recovery years—with an eye to the challenges encountered by fund managers who made investments during the boom, the composition and changing dynamics of exit activity across EM regions and the potential for secondary transactions to help bridge the exit gap in years to come.

Unlocking "Stuck" Capital

Over the course of the past 15 years, emerging markets (EM) private equity (PE) has grown into a well-established segment of the global marketplace. From 2001 to 2008, capital raised annually for EM-focused private capital funds[1] climbed from US$6.6 billion to nearly US$65 billion, and annual fundraising for emerging markets has totaled US$44 billion or greater since 2011, averaging 14% of the global total over the last six years.

Yet the rapid development of the industry, particularly in the years before the Global Financial Crisis, has not come without significant growing pains. Perhaps the greatest, and one of paramount importance for limited partners in EM PE funds, is lagging exit activity. According to market observers and participants, due to a number of challenges—ranging from macroeconomic and political turns of events to general overexuberance and a lack of consideration for exit when putting capital to work on the part of some GPs—many investors in those vintages have yet to see capital returned in sufficient quantity to consider their experience in emerging markets a resounding success.

Resolving the challenge posed by locked-up commitments is vital to the future growth of the industry in emerging markets. Without an increase in distributions to investors, many emerging markets-focused private equity firms will find themselves unable to attain re-ups for new fund offerings. Moreover, the industry as a whole will face increasingly difficult questions regarding its track record of success and the ultimate viability of the PE model in geographies where it has only recently put down roots. LP sentiment on this front is clear: over half of the investors responding to EMPEA's 2017 *Global Limited Partners Survey* consider the lack of distributions from EM PE funds a top concern in managing their portfolios.

In order to help uncover a sustainable path forward, this *Brief* will explore EM PE's track record for distributions over the last decade, why some fund managers have struggled to find exits in the past and, finally, how secondary transactions may provide an alternate path to exit for fund managers who have traditionally looked to strategic buyers and public markets to return capital to their investors.

[1] Inclusive of private credit, infrastructure and real assets.

Key Findings

- **Distributions from EM private equity and venture capital funds raised in the lead-up to the Global Financial Crisis, as well as in the subsequent recovery years, have lagged behind their developed market peers.** The median ratio of distributed to paid-in capital (DPI) for EM-focused funds with 2006 through 2010 vintage years is 0.47, compared to 0.78 for U.S.-focused funds from the same vintage years. The lack of distributions from EM PE funds is a top portfolio management concern for institutional investors, according to EMPEA's 2017 *Global Limited Partners Survey.*
- **While the prevalence of public-market and strategic exits varies across EM regions, the number of disclosed sponsor-to-sponsor sales has increased in all geographies.** The sustained increase in these direct secondary deals, long the norm in the United States and Western Europe, has coincided with the emergence of firms in Emerging Asia specializing in the strategy—buying PE portfolio companies on either a single-asset or portfolio basis.
- **Secondary transactions, broadly defined, hold the prospect of delivering greater liquidity for investors and increasing the velocity of the PE cycle in emerging markets, but execution challenges are formidable.** While various segments of the EM secondaries market have grown, it is also still relatively underdeveloped in terms of buyer and seller pools, and bridging expectations gaps with regards to asset prices and other terms and conditions remains a challenge for practitioners.
- **Future prospects for direct secondary transactions and fund restructurings in emerging markets are likely to hinge on the amount of capital and number of fund managers pursuing these opportunities, as well as a change in perception on the part of GPs and investors regarding their attractiveness.** Industry professionals also point to deeper local capital markets and the maturation of local legal and regulatory frameworks as necessary precursors for greater secondaries activity.

A Look Back at the Boom Years

Fundraising for private investment opportunities in emerging markets grew precipitously in the lead up to the Global Financial Crisis, and as with any asset class that experiences a rapid influx of capital, changes in market conditions left many investors facing a sobering reality.

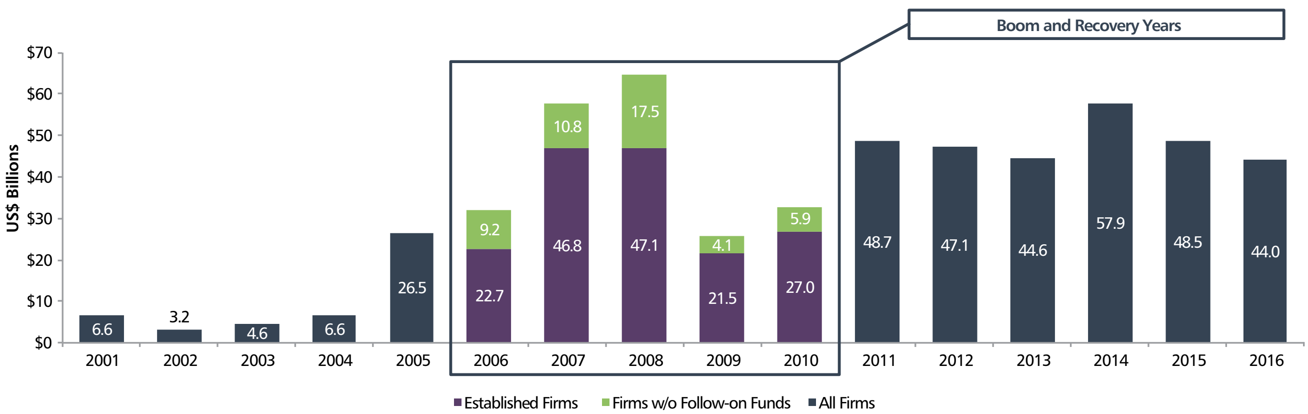
Stranded Assets

On one hand, many bets made during the boom years have not paid off. A sizeable fraction of firms that raised EM-focused vehicles around the time of the Global Financial Crisis have been unable to raise follow-on offerings and instead hold pools of legacy assets without a clear path to exit for investors. From 2006 through 2010, encompassing the pre-crisis and recovery years, US$48 billion was raised for emerging markets by firms that have since failed to launch a follow-on EM fund—representing 22% of total fundraising during this period. During 2008 alone, nearly US$18 billion was raised by firms that have not launched follow-on funds (see Exhibit 1).

Funds focused on Emerging Asia accounted for 52% of the 2006-2010 total, with China alone constituting 25% of this stranded capital, perhaps to be expected given the deeper fund pool in Emerging Asia than in other emerging markets (see Exhibit 2). However, the region that appears most disproportionately affected by the phenomenon is CEE and CIS. The region accounted for 17% of capital raised from 2006 to 2010 by firms that have since failed to raise a follow-on fund, while the region accounted for just 11% of total EM fundraising over the same period.

Not all of the firms in question are the dreaded "zombies" featured in the financial media, nominally active and collecting fees even though prospects for underlying assets are bleak. Many have changed strategies or been acquired, but the numbers begin to hint at the extent of the problem.

Exhibit 1: Emerging Markets Fundraising, 2001-2016



Source: EMPEA. Data as of 7 April 2017. Fundraising data prior to 2006 is obtained from third-party providers.

About EMPEA

EMPEA is the global industry association for private capital in emerging markets. We are an independent non-profit organization with over 300 member firms, comprising institutional investors, fund managers and industry advisors, who together manage more than US$1 trillion of assets and have offices in more than 100 countries across the globe. Our members share EMPEA's belief that private capital is a highly suited investment strategy in emerging markets, delivering attractive long-term investment returns and promoting the sustainable growth of companies and economies. We support our members through global authoritative intelligence, conferences, networking, education and advocacy.

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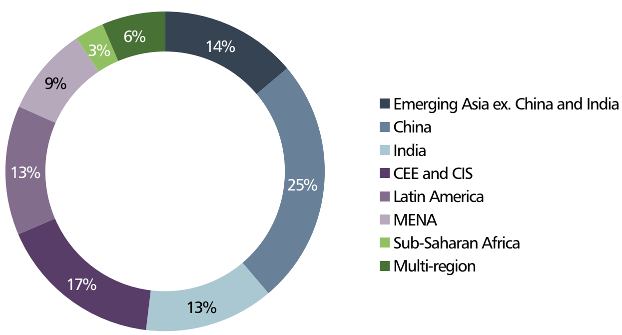
According to Ryan Wagner, Investment Director at U.K. development finance institution CDC Group, many PE investors who have decade-plus experience investing in emerging markets, especially in Emerging Asia, are familiar with the phenomenon: "Similar to other long-time investors, we have typical tail-end situations, many of which were raised in the pre-crisis first wave when it was easier for managers to raise money. Some of these managers didn't have the ability to create value and really drive exits; in other cases, management teams have been ineffective or fallen apart. In several situations, assets are impaired, the fund is in liquidation or the manager could not raise a subsequent fund and only a subset of the management team remains. In any case, there hasn't been a real push from some of these managers to get exits."

Quantifying the Distribution Shortfall

On the other hand, even relatively healthy funds from the vintage years immediately before and after the Global Financial Crisis (2006 to 2010) have experienced a shortfall in distributions compared to their developed market counterparts. Data from Cambridge Associates reveals that for vintages from the early years of the century (2001-2003), the track record of EM-focused funds is enviable, with both median distributed to paid-in capital (DPI) and total value to paid-in capital (TVPI) ratios exceeding those for U.S.-focused funds. Yet beginning with the 2006 vintage year, the distribution shortfall reverses, and a sustained gap between median DPI multiples for U.S. and EM funds opens up (see Exhibit 3).

Exhibit 2: Regional Breakdown of Fundraising by GPs Without a Follow-on Offering, 2006-2010 (% of Total Capital Raised)



Source: EMPEA. Data as of 7 April 2017.

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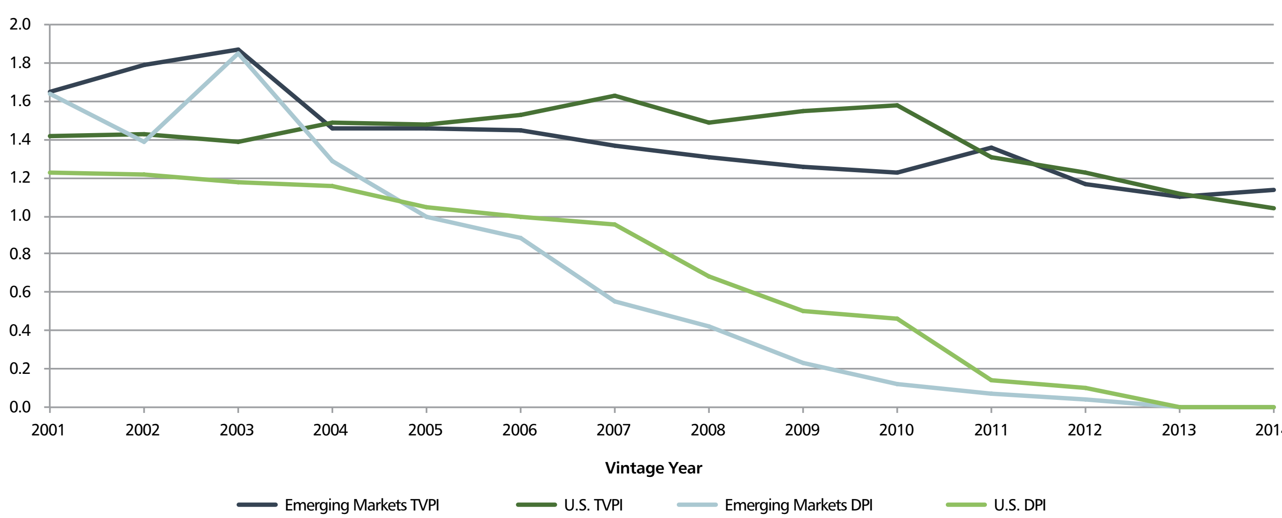
Exhibit 3: Median TVPI and DPI Multiples–Emerging Markets vs. U.S. PE/VC Funds, Vintage Years 2001-2014



Source: Cambridge Associates. Data as of 30 September 2016. Net to limited partners. Vintage year is equivalent to legal inception date.

Across the 2006 through 2010 vintage years, EM-focused private equity and venture capital funds have attained a median DPI of 0.47, compared to 0.78 for U.S.-focused funds and 0.83 for those targeting Western Europe (see Exhibit 4). Median distributions have been higher for funds focused on Emerging Asia than for other EM regions, and they have also posted the highest TVPI multiples. Indeed, performance on a total value basis in U.S. dollars for Emerging Asia funds in the sample is comparable to U.S.-focused funds and dramatically exceeds it for the top 5% of the sample.[2] However, this also means that funds from the region hold, on average, the highest ratio of residual value to paid-in capital globally.

Diagnosing the Issues

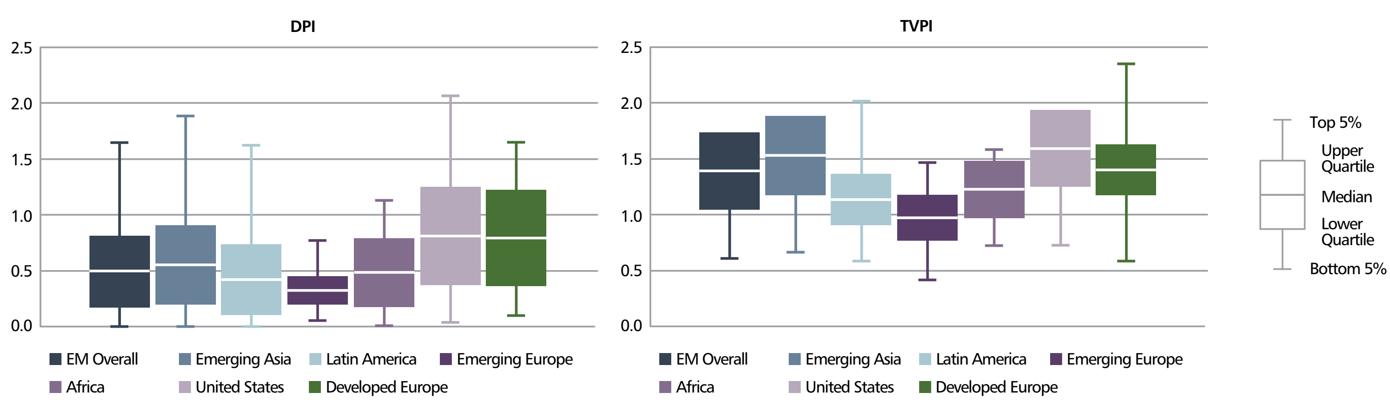
Though a range of factors contributing to the distributions gap from emerging markets-focused funds are at play, one of the most important is timing. In the heady years leading up to the Global Financial Crisis, having just raised record amounts of capital to deploy in emerging markets, GPs were wont to overpay for a limited pool of assets. This created challenges when the time came to exit—even when portfolio companies demonstrated healthy-but-not-stellar performance. As explained by Ralph Keitel, Principal Investment Officer for East Asia Pacific at International Finance Corporation (IFC), "If you pay too high a price on the way in and you have certain return expectations and things don't go according to plan, such as the company not performing as well as you had hoped or perhaps the economy unexpectedly turning, you don't have as much of a buffer to work with. From day one, you need the company to perform as well as you expect in order to justify the price."

A frothy market may have contributed to a lag in exits, but so did the deep freeze that set in with the advent of the Global Financial Crisis. The economic boom in the early years of the new millennium witnessed many GPs posting strong returns as emerging markets were swept along by strong global economic momentum, but was inevitably followed by a bust (and then, in some markets, the Arab Spring). While valuations fell in these times, economic uncertainty led GPs to deploy dry powder slowly and carefully. IFC's Global Portfolio Manager Nicholas Vickery notes, "Everybody who raised money got hit; any capital raised was just frozen for a year or two. GPs didn't make any investments—and then in MENA the Arab Spring prolonged the slowdown. For many of the fund commitments in these years, capital was being called long after the typical five-year investment period." Given the delay in putting capital to work caused by these economic and political disruptions, slower distributions are perhaps no surprise.

It is also important to emphasize that while many GPs active in emerging markets during the boom and recovery years were well-established institutions with partners boasting decades of experience, the conducive environment for raising capital meant a host of new entrants. CDC's Wagner observes that "there were a number of bankers and finance professionals that went into private equity in the first wave who lacked true operational and value creation skills." The fact that many of the transactions completed during this timeframe were minority growth capital investments may have added an extra degree of difficulty to the sort of value creation work at the operational level that would attract prospective buyers. Wagner adds, "Some minority investors got themselves into situations where business owners were never really going to really let them become influential in the companies."

While minority positions can arguably add an extra layer of difficulty to operational improvement, exit timing and, of course, enforcing claims when disputes arise, focusing entirely on the minority vs. control debate obscures a larger issue: the focus during these years seemed to be almost entirely on doing new deals at the expense of effectively managing the full life cycle of investments. Turnover at GPs, especially in Emerging Asia, has meant that "it's very rare that one investment professional sees an investment all the way from screening, to execution, to exit," according to NewQuest Capital Partners' Darren Massara. "Additionally, investment professionals who inherit investments from departed colleagues likely have more incentive to work on new deals rather than manage out older ones."

Exhibit 4: TVPI and DPI Multiples–Emerging vs. Developed Markets, Vintage Years 2006-2010



Source: Cambridge Associates. Data as of 30 September 2016. Net to limited partners. Vintage year is equivalent to legal inception date.

[2] TVPI at the top 5% breakpoint for 2006 to 2010-vintage Emerging Asia funds is 4.73, compared to 3.21 for equivalent U.S.-focused funds and 2.35 for those targeting Developed Europe. The equivalent figure for all EM-focused funds is 3.00.

A Closer Look at Exit Activity in Emerging Markets

China and India have accounted for the vast majority of EM public market exits, owing both to their relative scale and unique country-level factors—the Chinese pre-IPO craze, on one hand, and the prevalence of PIPE investments in India, on the other. However, even where they are well-established, public markets can be fickle, and are by no means a silver bullet for liquidity. In China, for example, "last year was a particularly bad year for liquidity," notes NewQuest's Massara. "Take IPOs in China. The domestic market continued to be impacted by the regulator, and overseas markets remained unattractive from a valuation perspective. Even if you were lucky enough for your company to list, it didn't mean you received immediate distributions. There can be one- to three-year lock ups, and stock liquidity is generally always an issue. Ultimately, public markets are not a very reliable exit path in China or for most emerging markets."

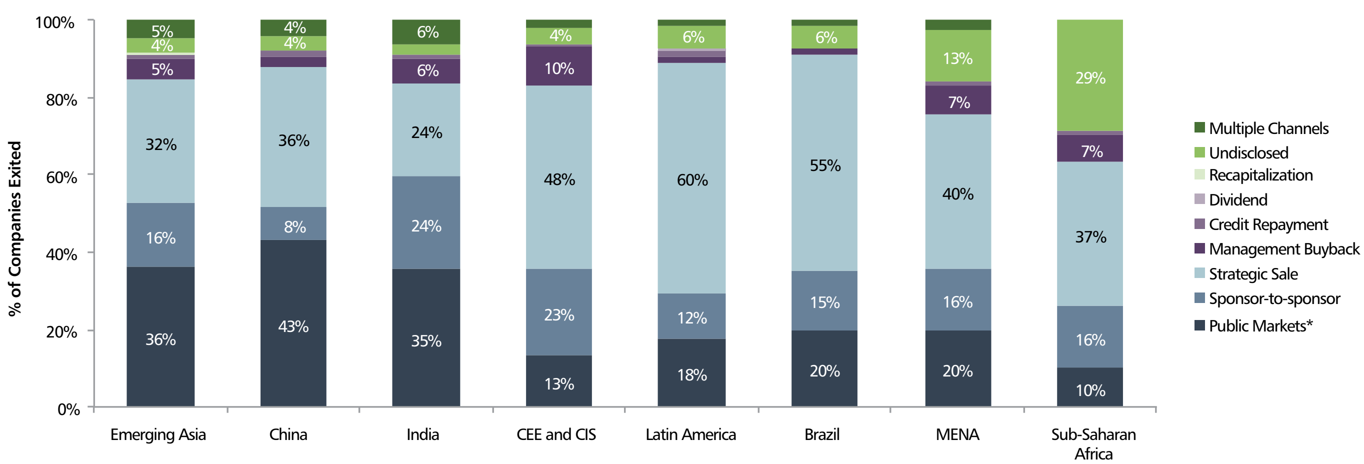
Strategic sales, while predominant in emerging markets beyond Asia, present their own challenges. According to Nicholas Rohatyn, CEO and CIO of pan-emerging markets alternatives fund manager The Rohatyn Group, "I think a lot of GPs have realized public markets aren't going to be their path to exit and have looked for strategic buyers, but in that case you need a real platform to drive operational change and create something attractive for a multinational." Indeed, building a company for a trade sale requires long-term strategic thinking. Ralph Keitel of the IFC noted, "At the outset, you need to identify your potential acquirer.

> "Last year was a particularly bad year for liquidity. Even if you were lucky enough for your company to list, it didn't mean you received immediate distributions. There can be one- to three-year lock ups, and stock liquidity is generally always an issue. Ultimately, public markets are not a very reliable exit path in China or for most emerging markets.

For example, if the target company is an online retailer, then from day one you need to build it to fit the buyer's specific needs."

The fact that most investments in emerging markets have tended to be minority growth equity deals can also complicate exit routes as, at exit, alignment between company promoters and GPs can be hard to create, and the promoter typically has leverage in the decision-making process. As noted by CDC Group's Ryan Wagner,

Exhibit 5: Distributions from Emerging Markers Private Capital Investments by Type, 2012-2016



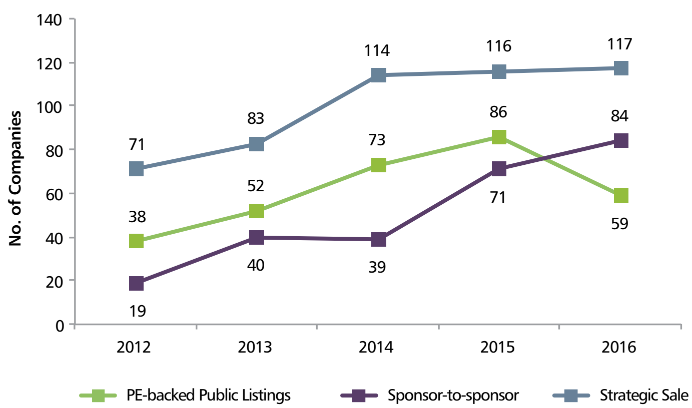
*Includes IPOs, as well as follow-on offerings and open-market transactions.
Source: EMPEA. Data as of 7 April 2017.

Methodology Note: For the purposes of this report, direct secondary (or sponsor-to-sponsor) transactions are defined as the sale of direct equity stakes in operating companies from one private equity fund manager to another private equity fund manager, institutional investor or investment holding company—on either a single-asset or portfolio basis. For more information on EMPEA's research methodology, please visit empea.org.

"Quite often, the GP will want to exit a minority stake in a family business, but the family isn't aligned and won't let go." Similarly, while selling back to the promoter is an option often written into the terms of original deals, GPs may not see it as the most attractive option, and at any rate, some may have trouble enforcing a put option back to a company promoter. "Such cases take years in court to sort out—rendering it an unviable path to exit," laments Wagner.

Other options common in developed markets are rarer in emerging markets. Leveraged recapitalizations are largely absent outside of Asia's most mature markets given limited bank leverage available for such transactions and the prevalence of minority positions. While it is unlikely that recaps will take hold in the near-term in emerging markets, other liquidity options prevalent in developed markets are gaining ground.

Exhibit 6: Disclosed Emerging Markets Exits and IPOs, 2012-2016



Source: EMPEA. Data as of 7 April 2017.

The Rise of Sponsor-to-Sponsor Sales

Beyond strategic acquirers, public markets and company promoters, fund managers are increasingly looking to their peers as buyers when it comes time to exit. From 2012 to 2016, the number of disclosed sponsor-to-sponsor or "direct secondary"[3] sales captured in EMPEA's dataset quadrupled (see Exhibit 6). The trend is not confined to one region or country. From Latin America to Sub-Saharan Africa to Emerging Asia, GPs increasingly consider secondary sales an attractive prospect in lieu of other options.

Such deals are not without their detractors. Some industry observers deride this "passing the parcel" approach to exiting investments, but the reality is that sponsor-to-sponsor deals are the rule, rather than the exception, in developed markets. NewQuest's Darren Massara notes that in any given year in the United States and Europe, GP-to-GP sales can represent anywhere from 40% to 60% of exits, and "the percentage tends to creep higher in years when IPO markets are more challenging or trade buyers are not flush with cash."

> "I think a lot of GPs have realized public markets aren't going to be their path to exit and have looked for strategic buyers, but in that case you need a real platform to drive operational change and create something attractive for a multinational.

[3] Hereafter, sponsor-to-sponsor or direct secondary transactions both refer to a private equity firm or institutional investor buying a direct position in a portfolio company—or a portfolio of direct positions—from another private equity firm.

Secondaries: Assessing the Landscape

What does the rise of direct secondary transactions mean for investors? The glut of PE dry powder targeting investments in emerging markets, not to mention the precedent set by developed markets, suggests that these transactions will become a mainstay.

To date, most direct secondary deals have been completed by generalist GPs on a single-asset basis, rather than by secondaries-dedicated investors acquiring whole portfolios. It's important to recognize that such deals exist at one end of a broader spectrum of specialized secondary transactions, for which the global market has grown substantially in recent years. According to data from industry advisor Greenhill, global secondary volume grew from US$25 billion in 2011 to US$42 billion in 2014 before dropping slightly in subsequent years (see Exhibit 7).

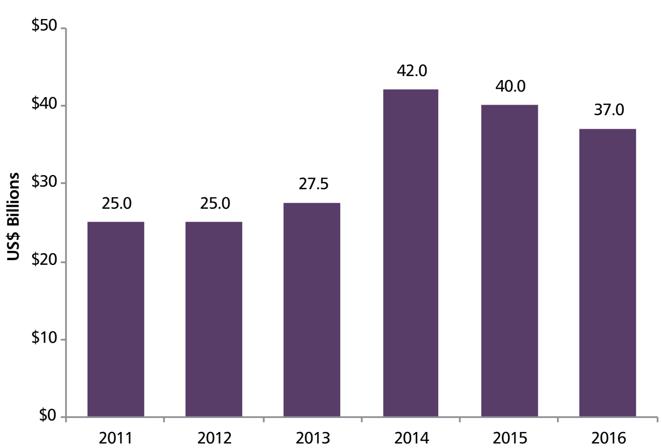
All of the segments of the secondaries market hold the potential to deliver additional liquidity to EM investors. However, the remainder of this *Brief* will explore the extent to which GP-led restructurings and direct secondaries may be better suited than traditional secondaries to resolve the lingering overhang in un-exited private assets in emerging markets.

> "In developed markets, 15 years ago the traditional secondary market was still small. Today it's grown to become very large where LPs can regularly cycle through their portfolios and reconstruct them to match the vintage years they desire to hold. Those LPs active in the secondary market can be buyers in some years, sellers in the next and then buyers again the year after.

The Traditional Market

Why direct secondaries in particular? It is perhaps most instructive to start with the traditional secondary market—which involves the sale of fund interests on the part of LPs—given that it's what most people think of when it comes to secondaries.

Exhibit 7: Global Secondary Market Volume, 2011-2016



Source: Greenhill, "Secondary Market Trends & Outlook, January 2017." Inclusive of fund interest sales, GP-led restructurings and direct secondary portfolios.

The bulk of the activity of large secondaries specialists like Coller Capital, Lexington Partners and Ardian is in this market segment. Traditional secondaries are both an important way for new PE market entrants to gain exposure to previous vintages and a way for LPs to gain liquidity or rebalance their portfolios—though such deals do require GP consent and often require transacting at a discount to a fund's net asset value (NAV).

In developed markets, where the secondaries market is older and has matured significantly, investors are able to use traditional secondaries to shape their portfolios in ways that were not possible just a few decades ago. As NewQuest's Darren Massara recounts, "In developed markets, 15 years ago the traditional secondary market was still small. Today it's grown to become very large where LPs can regularly cycle through their portfolios and reconstruct them to match the vintage years they desire to hold. Those LPs active in the secondary market can be buyers in some years, sellers in the next and then buyers again the year after."

Secondaries for Asian funds have gained some traction, totaling US$2.3 billion, or 6% of the global total, in 2016.[4] However, deal activity in other EM regions appears negligible, and findings from EMPEA's 2017 *Global Limited Partners Survey* suggest most EM PE investors are unlikely to be active market participants, at least in the short term. Just 14% of survey respondents plan to sell EM PE fund interests in the secondaries market in the next 12 months, and only 10% have sold EM PE fund interests in the past. Even

[4] Source: Greenhill, "Asia Secondary Market Review 2016."

when investors with EM-only mandates are excluded from the sample, just 16% plan to sell fund interests. Meanwhile, 26% of respondents plan to buy EM PE fund interests, with 15% indicating that they had done so previously, revealing a potential mismatch between supply and demand.

Pricing challenges may be at play, with a bifurcation in the market between established name brands and lesser-known entities, at least in Emerging Asia. "Larger, well-known managers tend to command the highest prices for their assets," notes one Asia-based advisor. "These firms generally invest in larger-cap companies that are diversified in their operations, which mitigates currency and local risk, and the companies are probably majority owned by the fund, which means better information and transparency. So for those kinds of assets, we actually see pricing being very strong—even ahead of pricing in developed markets at the moment, by the simple virtue of the fact there's a lot of money chasing those deals to justify the existence of big teams in Hong Kong and Singapore and Beijing, and not a lot of deals to do."

According to Chris Bonfield, Managing Director at industry advisor Greenhill, when it comes to the Emerging Asia-focused funds LPs are looking to sell, most skew towards the growth and venture capital end of the market. These earlier-stage assets are inherently more difficult to price given uncertainty over the projected hold period and potentially inflated valuations: "There are a lot of funds that are trading at par or even a premium in Asia, but these are primarily newer vintage funds, which are not primarily what LPs are looking to sell. A lot of the secondary volume we have been seeing in Asia are China-focused funds that in many cases have a high degree of "unicorn" exposure: companies that are good, but carry a premium valuation. Meanwhile, some funds contain illiquid public securities that may be trading at inflated valuations to what the fund would ultimately be able to realize if it sold its position. Asian funds, especially China-focused funds, tend to have higher exposure to illiquid public securities than other geographies." These factors have contributed to a discount applied to Asia-focused funds as a whole compared to their global peers (see Exhibit 8).

Nearly half (46%) of LPs likely to sell EM PE fund interests in the next 12 months are motivated by poor performance, and 31% indicate that the funds in question are unlikely to produce needed liquidity over their projected hold period.[5] It is precisely these positions which may prove hard to sell without a significant discount to net asset value. While the traditional secondaries market will continue to grow as more and more motivated sellers look to rebalance their portfolios, LPs looking to wring the most value from their locked-up commitments may thus look to other parts of the secondaries market for alternative solutions.

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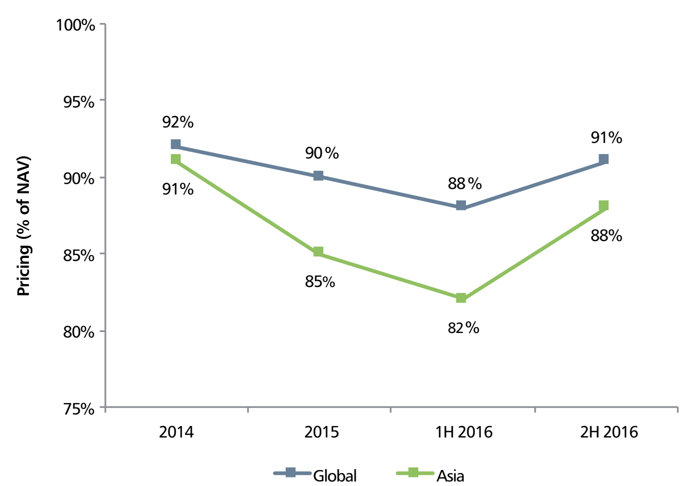
Exhibit 8: Secondary Market Pricing, 2014-2016 (% of NAV)



Source: Greenhill, "Asia Secondary Market Review 2016". Pricing data derived from Greenhill transactions, weighted by net asset value.

[5] Source: EMPEA 2017 *Global Limited Partners Survey.*

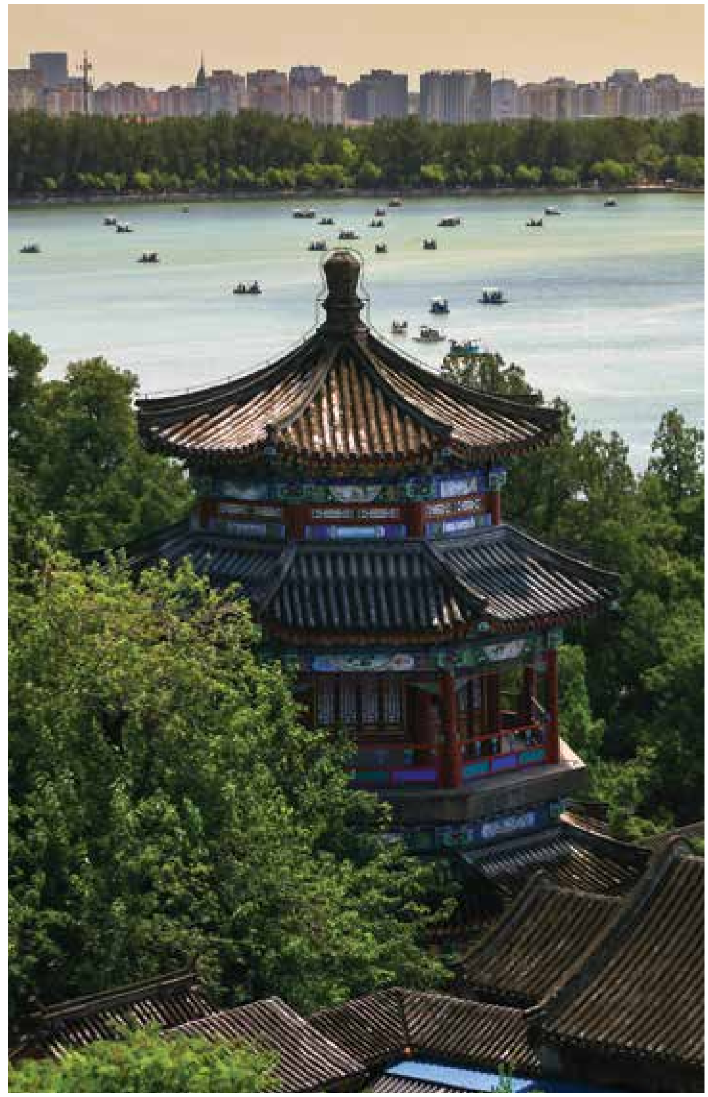
A New Lease on Life

GP-led liquidity solutions may be part of the solution. Such transactions have the advantage of providing all of a fund's investors the option to exit or roll over their commitments, while also giving fund managers an extended timeframe in which to create value and exit—offering potential upside to both those who stay the course, as well as the GP's new backers. The trend in GP-led restructurings began in the U.S. with established buyout funds and is spreading to Asian growth markets at the behest of commercial LPs. Greenhill's Bonfield observes, "In general, GPs are hearing more from their LPs, and as a result we're starting to see more GPs exploring liquidity options for their LPs as each fund nears the end of its contracted life. The breadth in the types of transactions, the types of GPs involved and the geographic footprint of GPs pursuing these deals is expanding." GP-led transactions accounted for 25% of global secondary volume in 2016, with the trend even more pronounced in Asia, where GP-led secondaries accounted for 39% of deals by count and over 50% of transaction volume.[6]

However, such transactions are not without their challenges. GP-led restructurings, while growing in popularity, are perhaps the most difficult secondary deal type to execute. To start, according to Geoffrey Kittredge, Partner at Debevoise & Plimpton, "The GP and its investors have to agree that even though a fund may be out of time, the portfolio still holds promise and is dependent on the GP staying on to exit within a reasonable timeframe. When you're at the end of the fund life, the GP can then live to fight another day instead of exploring a direct secondary or other form of liquidation." Coordination between investors and the GP—as well as between the investors themselves—can prove tricky, however, as new terms and occasionally new capital are introduced as part of the restructuring.

A recapitalized or restructured fund may or may not have new capital available for follow-on commitments and can involve reduced management fees or a change in carry terms for the GP. An inability on the part of the GP to get comfortable with these terms can itself kill a deal. One Asia-based advisor recalled a deal in which "even though the LPs may have actually endorsed the price, the GPs couldn't agree with the reset to the fund's economics and didn't see any reason to go and do it."

In addition to negotiating updated fund terms and conditions, such transactions face similar challenges to those found in direct secondary deals. According to Asia Growth Capital Advisors' Executive Chairman Harjit Bhatia, GP-led restructurings tend to fail for three primary reasons. "First, there are often unbridgeable pricing gaps between fair values assessed by the new potential buyer versus the NAV for those assets reflected in the books of the fund; second, there is frequently disagreement between the GP and LPs backing the fund—with LPs wanting to liquidate while GP drag their feet; and third, deals are often dropped after the underlying portfolio is not found to be attractive after due diligence."



Agreeing on price can be even more complicated than for sales of fund interests, given that the GP, existing investors and new backers all have to agree and may possess different levels of visibility onto the underlying portfolio. A central challenge, then, becomes assessing the quality of the underlying portfolio. Indeed, many of these portfolios are challenged for more fundamental reasons than simple dearth of liquidity. As Chris Bonfield of Greenhill notes, "GP-led deals involving 10- to 12-year old funds tend to have relatively few companies remaining in the portfolio. At that point in the lifecycle, many of the best assets likely have been sold, and the companies that remain in the fund are likely challenging to sell for a reason."

The Direct Approach

Direct secondary transactions, inclusive of both opportunistic generalist GPs and specialists buying portfolio companies on a single-asset or portfolio basis, may thus hold the greatest promise for ameliorating the EM exit gap due to their relative simplicity. As EMPEA's exit data demonstrate, GPs are increasingly utilizing

[6] Source: Greenhill, "Secondary Market Trends & Outlook, January 2017," "Asia Secondary Market Review 2016."

the option of selling to another fund sponsor. However, given the sheer number of unexited investments in emerging markets, it's not likely nor desirable that generalist GPs can absorb all of the last cycle's investments. Luckily, specialist direct secondary GPs—with an explicit focus on working through thorny portfolio issues, adding value and exiting companies—are emerging, albeit thus far only in Emerging Asia, and many of these GPs were born of direct portfolio sales from larger institutions (see Exhibits 9 and 10).

While the largest global secondaries funds will likely continue to focus on only the largest portfolios of fund interests or direct holdings, regional or thematic funds can look deeper into the small and mid-cap market. NewQuest's Darren Massara echoes the sentiment: "The biggest need for liquidity is in the minority growth mid-cap space, because that's where a bulk of the capital has been invested." Moreover, a focus on direct secondaries can work symbiotically with GP-led restructurings, with the latter pursued in advantageous settings. While NewQuest tends to buy and manage assets and portfolios themselves, as Massara notes, "When the GP is a good steward of its portfolio and can continue to be a good steward going forward, we are happy to support them with proper alignment."

Even in markets with large amounts of stuck capital, not all portfolios will be attractive targets for secondary buyers—and like primary market investors, direct secondary specialists must exercise discretion when deploying capital. As noted by TRG's Nicholas Rohatyn, "There's a huge drive toward consolidation in the industry, but direct secondaries are perhaps not appropriate for all portfolios. You have to pick and choose the right spots to invest."

Across all segments of the secondaries market, cultural factors and perception issues can limit deal flow. According to one Asia-based industry advisor, the transformation in thinking needed to unlock these assets will not be easy: "There's a cultural factor here, which may be the unknown question. Will a local Chinese GP ever fully embrace the concept of people selling in and out of their funds, or recapitalizing one of their vehicles?" Even for direct secondaries, the norms of transparency and global best practices for valuing companies and reporting to investors mean that even if GPs were to consider a deal, they may face skepticism on the part of buyers. In some emerging markets, the advisor adds, "the buy side finds it very hard to digest the direct secondaries, which are concentrated in companies which are very hard to price due to poor information. So the risk-return profile of doing a direct secondary in Asia is quite different than in the West."

The Way Forward

For the secondaries market, and direct secondaries in particular, to provide the jolt needed to increase the velocity of the PE cycle in emerging markets, overcoming the stigma attached to finding another private equity firm to buy a company on the part of both investors and fund managers is thus a prerequisite. LPs should take heart in the fact that academic research suggests that so long as secondary buyers are not under undue pressure to put capital to work at the end of their investment periods, such transactions can perform as well as any primary private equity investment.[7] For GPs, the industry's track record on distributions points to the need for more exits, even if they are not blockbuster IPOs or sales to blue-chip multinationals.

Already, many investors, including those with a mandate to support the development of the industry, are encouraging this reality check on the part of their investees: "For us, we want to reward the fund managers who have the most discipline in terms of managing their exits, and the ones who do are the ones who really strategically think through their portfolio construction," explains IFC's Nicholas Vickery. This maturation, in terms of understanding all available exit options and the need to prioritize

Exhibit 9: Sampling of Disclosed Secondary Transactions in Emerging Markets, 2011-2016

Selling Firm(s)	Buying Firm(s)	Vintage Year(s)	Transaction Year(s)	Transaction Detail
Standard Chartered Private Equity (SCPE)	Goldman Sachs, Coller Capital, GIC, Abu Dhabi Investment Authority, LGT Capital Partners, Partners Group, Blackstone Strategic Partners, Rothschild, Unigestion and Standard Chartered	N/A	2013-2015	Standard Chartered closed its principal investment business, splitting its assets into four vehicles, which it sold between 2013 and 2015; while initially planned as a spinout of SCPE, Standard Chartered instead decided to wind down the assets without the spinout
Draper Fisher Jurvetson	NewQuest Capital Partners	2006-2015	2016	DFJ closed its India operations, selling its India portfolio to NewQuest
Bank of America Merrill Lynch (BAML)	NewQuest Capital Partners	2007-2008	2011	Backed by Paul Capital, HarbourVest Partners, LGT Capital Partners and Axiom Asia Private Capital, NewQuest raised NewQuest Asia Fund I to buy BAML's Asian private equity assets
Credit Suisse	Asia Growth Capital Advisors	N/A	2013	Backed by HarbourVest Partners and Axiom Asia, AGCA spun out from Credit Suisse, acquiring its Asian private equity assets
Citi Venture Capital International (CVCI)	The Rohatyn Group	2005-2007	2013	TRG acquired CVCI, taking over management of its funds portfolio
Canaan Partners	JP Morgan Asset Management	2006-2014	2015	When Canaan Partners chose to cease its India operations, JP Morgan—seeking exposure to Indian VC—purchased its India assets for an estimated US$200m
Kleiner Perkins Caufield & Byers (KPCB), Sherpalo Ventures	Lightbox Ventures	2006-2010	2014	When KPCB and Sherpalo chose to shift their focus to the U.S. venture market, Sandeep Murthy, a GP at Sherpalo, launched Lightbox; Lightbox Ventures I acquired six remaining portfolio companies from KPCB and Sherpalo; Lightbox's following funds and investments, however, have targeted primary deals

Source: EMPEA. Data as of 7 April 2017.

7 "On Secondary Buyouts", Journal of Financial Economics (JFE), Francois Degeorge, Jens Martin, and Ludovic Phalippou. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2329202

> First, the market needs more secondaries-dedicated GPs backed by substantial capital; while there are a few already active, the scale of assets warrants much more capital. Second, the prospect of new investors entering the EM private capital markets could bode well—secondaries can provide quick cash flow, moving investors up the J-curve quickly. Finally, DFIs, given their outsize presence in these markets, need to become proactive as sellers.

life cycle management, will go a long way towards avoiding the pitfalls experienced during the boom years of EM PE and lead to an increased willingness to pursue direct secondary exit channels.

Going forward, Debevoise & Plimpton's Kittredge suggests that three additional factors could contribute to more vibrant secondaries markets in emerging economies. "First, the market needs more secondaries-dedicated GPs backed by substantial capital; while there are a few already active, the scale of assets warrants much more capital. Second, the prospect of new investors entering the EM private capital markets could bode well—secondaries can provide quick cash flow, moving investors up the J-curve quickly. Finally, DFIs, given their outsize presence in these markets, need to become proactive as sellers."

While more capital is needed, particularly for managers investing in direct secondaries in the middle market, price discipline among the buying community will be crucial. According to one Asia-based advisor, the Asian market for LP interests is already frothy. The heady pre-GFC years, where assets were bid up to prices that created many of today's challenges at exit, are instructive: "The buying community needs to exercise a lot of discipline in Asia. There's a need for transactions to feed the massive overhang of capital among traditional secondaries buyers, so I think things will happen, but not necessarily for the right reasons."

A lingering challenge will be the role of development finance institutions. While mandated to bolster emerging markets private equity, they may not be able to apply the right pressure with GPs, especially for those they will not support in the future. According to CDC Group's Ryan Wagner, "DFIs—which account for a large share of LP capital in these funds—might not have seriously considered selling into the secondary market whether because the requirements of their mandate, or the duty to see investments out naturally rather than get involved in GP restructurings or finding alternative paths to create liquidity." Nonetheless, the tension between their underlying goals and the reality is clear. "Commercial LPs are hesitant to invest in markets where capital hasn't been fully returned from the last cycle. A number of managers have performed very well and global LPs are happy with those select relationships, but average returns in some markets have been lackluster for a whole host of reasons."

Nicholas Vickery of IFC agrees that, thus far, liquidity has been largely driven by commercial investors. "In terms of exits, where there's been improvement, a lot of it has been at the insistence of institutional investors and funds of funds that don't have any leeway in terms of extending the life of a fund. There's a time when they need money returned, and they've applied the right pressure to get capital returned."

Only time will tell whether the right balance can be struck between providing GPs and their investors with an acceptable and appropriately timed exit and ensuring that a secondary buyer is able to deliver value during the next turn. Undoubtedly, there will be bumps in the road. However, the alternative—a decade-long trail of stranded assets with little to no prospects for exit—is untenable for the asset class.

Exhibit 10: Sampling of Firms Active in Direct Secondaries in Emerging Asia

Firm	Fund(s) (Final Close Year, Amount Raised)	Geographic Focus	Website
AB Value Capital Partners	AB Value Bridge VI (Fundraising, US$65m), Ant Bridge Asia V (2014, US$70m)	Greater China	http://www.abvaluecapital.com/
Asia Growth Capital Advisors	Unity 1–Credit Suisse Private Equity Asia Portfolio (2012)	Asia	http://www.asiagrowthcap.com/
K2 Investment Partners	K2 Liquidity Solution Fund (2014, US$76m), Shinhan K2 Secondary Fund (2012, US$43m)	South Korea	http://www.k2investment.co.kr/
The Rohatyn Group	TRG Asia Direct Secondary Fund (Fundraising)	Asia	https://www.rohatyngroup.com/
NewQuest Capital Partners	NewQuest Asia Fund III (2016, US$540m), NewQuest Asia Fund II (2014, US$316m), NewQuest Asia Fund I (2011, US$390m)	Asia	http://www.nqcap.com/
STIC Investments	STIC Special Situation Private Equity Fund (2016, US$526m)	Asia	http://www.stic.co.kr/
TR Capital	TR Capital III (Fundraising), TR Capital II (2012, US$129m)	Asia	http://www.tr-capital.com/

Source: EMPEA. Data as of 7 April 2017.