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Private equity exits in emerging markets

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ABSTRACT

Using deal level data from 2733 private equity (PE) deals from 35 emerging markets, we find that PE fund managers have a higher probability of successful exits in countries with better business and legal environments. We also find that they are able to mitigate the potential costs associated with inefficient and corrupt business environments to increase the probability of exits by IPOs in countries with higher levels of corruption. Moreover, we find that market shocks in the developed markets result in a negative ripple effect as the probability of successful exits, especially by way of IPOs, decreases in emerging markets.

The development and importance of emerging markets within the global financial system can no longer be questioned. Emerging market economies contribute more than two-thirds of global growth and more so their growth is projected to increase. It is suggested by IMF (2014) that growth levels reached 4.7% in 2013, 4.9% in 2014 and potentially 5.3% in 2015. Brazil, Russia, India, China and South Africa (BRICS countries) currently

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rank within the top 10 largest economic entities. Without emerging markets, worldwide economic growth would be much lower than it currently is.

Financial institutions have for years sought to take advantage of this growth. As a result of the unprecedented growth in many emerging markets in the 1990's, increasing numbers of private equity (PE) investors have navigated these risky markets to profit from not only the economic growth but also the lowering of state intervention in those markets (Leeds and Sunderland, 2003). The opportunities for PE investments were thought to have developed significantly in both scale and quality in emerging markets over the past decades (Ahlstrom and Bruton, 2006). However, at the same time, the same investors were quick to come to the realization that there were challenges within the emerging markets that they were not prepared for resulting in unmet expectations. Not only were these emerging markets still relatively immature and, under-developed, but there were, and arguably are, insurmountable regulatory restrictions and corporate governance weaknesses (Bruton et al., 2002; Bruton and Ahlstrom, 2003). Also amid the expectation of emerging hot spot PE markets such as China and India achieving GDP growth rates in double-digits, it is possible that as a result of too much capital chasing too few good deals, PE investors may have rushed to invest without adequately preparing for the risks of a prolonged slowdown (Cumming and Macintosh, 2006; Ippolito, 2007; Aizenman and Kendall, 2012; Klonowski, 2013). Our study thus aims to explore the determinants of successful PE investments by measuring successful PE exits. We analyze the relationship between the development of business environments and legal protections and successful exit. We would be remiss in our analysis if we did not consider the role of corruption on the potential of success for PE investments in that previous researches have established the negative effect of corruption on the cost of doing business (Fisman and Wei, 2004; Fisman and Miguel, 2007; Fisman and Svensson, 2007; Fisman and Miguel, 2007; Fisman et al., 2008). With more studies documenting the impact of corruption on the cost of doing business at both the economic and firm-specific levels (Mauro, 1995; Rodriguez et al., 2005), very few of those studies focus on the PE investments in these corrupt jurisdictions. In a more recent study of Cumming et al. (2010a), they used 21 Asia-Pacific countries data to provide competing hypotheses regarding the impact of corruption on PE investments across markets. Our study aims to test similar competing hypotheses in emerging markets with wider range of countries (35 jurisdictions worldwide) using a longer sample period (1992–2012). Finally, we also seek to determine whether the dot com bubble and the recent financial crisis had any effect on PE investments in emerging economies.

We believe our research will shed light on relatively opaque PE activities in emerging markets. PE investors, as sophisticated financial intermediaries catering to equally if not more sophisticated institutional investors, primarily invest in relatively high risk, illiquid securities in private firms. Given that such investee firm characteristics are combined with high risk and volatile political environments in emerging markets, we can safely deduce that PE investments in emerging economies are riskier than that of developed countries. As such, the divestment or exit strategy which is the measure of success of an investment might be planned and executed by considering more critical factors. Our study is related to a growing body of research that establishes legal protection to be important factors to explain the size, structure and success of PE investments, results of course varying depending on the data analyzed (Lerner and Schoar, 2005; Cumming et al., 2006; Cressy et al., 2007; Cao and Lerner, 2009; Johan and Najar, 2011).

Our study benefits from the comprehensiveness of PitchBook's deal level database which provides us a unique opportunity to investigate the PE exit probabilities across emerging markets. The data documents the heterogeneities of investee firm-level characteristics together with business environments, legal conditions, security market structure and performance, macroeconomic and cultural dimensions as well as industry dispersions. We present our robust results based on 2733 PE deals of 1499 investee firms to investigate PE exits strategies and impact from multi-facet factors. Our findings suggest that better business and legal environments in emerging markets increase the probability of successful exits for PE investors. We also find that PE investors are better able to mitigate the potential costs associated with inefficient and corrupt business environments to increase the probability of exits by IPOs in countries with higher levels of corruption. Moreover, our findings suggest that market shocks arguably concentrated in the developed markets result in a negative ripple effect as the probability of successful exits, especially by way of IPOs, decreases for PE investors in emerging markets.

Our paper complements the growing literature on private equity, business ethics, corruption and IPO. We believe our findings not only support those of Cumming et al. (2006, 2010a, 2010b), but also augment both studies as our analysis comprises more jurisdictions and include the unique period of the recent financial crisis. Our analysis of PE investments in emerging markets also adds to the existing international comparative literature on PE and emerging markets to provide more updated information regarding PE divestment