**Private equity explores more distant frontiers**  
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THE art of private equity, it might be said, is finding and polishing diamonds in the rough. No wonder, then, that more firms are venturing off the beaten path in search of uncut gems. With record sums pouring into the asset class in recent years—the biggest funds have topped $15 billion—more investors and fund managers are turning to the developing world. Just this week Citigroup unveiled plans for a new $200m fund dedicated to Africa.

Although America and Europe still attract the lion's share of private-equity investing, emerging markets—from Asia and Africa to Latin America—are rapidly growing. More than $22 billion was raised for these markets in 2006, according to the Emerging Markets Private Equity Association, up from $3.4 billion in 2003. The fastest growth last year was in Africa and the Middle East. A survey of big investors by the association found that 65% plan to increase their commitments to emerging markets in the next five years.

Several things explain their new appeal. Keener competition for deals in America and Europe is prompting funds to look further afield. Economic growth and greater stability have made some countries more attractive than they once were, as has the new maturity of their capital markets. A growing band of companies in the developing world have global ambitions of their own and want to tap into the expertise and networks that foreign investors can offer.

Finally, the rewards in these locales are often much richer than elsewhere. A private-equity index compiled by Cambridge Associates showed an annual return in emerging markets of about 23% over the three years to June 30th. That is more than double the return offered by the Standard & Poor's 500 stock index. Last year, the gap was even bigger: 25% versus 8.6%.

Such pickings are hard to resist and some of the world's biggest private-equity outfits are entering the fray. South Africa's financial circles are abuzz over reports that Blackstone Group, Bain Capital and Kohlberg Kravis Roberts are potential bidders for a retail chain called Edgars Consolidated Stores. Edcon, as it is known, has over 900 stores across southern Africa and a market value of about 19 billion rand ($2.6 billion), which would make it one of Africa's largest private-equity targets. Giants like Texas Pacific Group (TPG) have continued their march across Asia. TPG now has six offices in the region, stretching from China to India. Benchmark Capital, Apax Partners and 3i are among the global firms invested in Israel.

Of course one investor's frontier may be another's backyard. Countries like Israel and South Africa may seem fresh and far-flung to some, but in a private-equity sense they have already emerged. The stock of private-equity investment as a fraction of GDP amounted to 3.2% in Israel and 1.9% in South Africa at the end of 2005, putting them ahead of every region of the world except North America (see chart). These days the true
pioneers in the field--investors and fund managers such as CDC, Actis and Acap Partners--are putting money into countries from Afghanistan to Tanzania. In contrast to the mega-deals that have made private equity famous, they target modest investments in outfits ranging from dairies to banana growers.

Even veteran investors warn of the hassles of working in such markets. These can include decrepit infrastructure, poor corporate governance and a limited pool of skilled managers. Governments can turn hostile and currencies can turn against you. The cost of borrowing may also be dearer in emerging markets, making it too expensive for acquiring firms to load up on as much debt as they do elsewhere. It takes longer to turn a company around in emerging markets, veterans say, and at the same time exiting from a deal may be trickier. In particular, initial public offerings are less attractive in countries cursed with illiquid stockmarkets.

Private-equity investors are as demanding in their new stomping grounds as on their home turf. A survey last year by the Tuck School of Business at Dartmouth found that they want to see returns of at least 25% on their investments in emerging economies. The will to venture into frontier markets is strong, it seems, but only if the gems gleam brightly enough.