Innovations in Private Equity Investing

Introduction

The universe of international blended value private equity investments is enormous, ranging from informal micro-capital investments by individuals all the way to professional private equity funds investing hundreds of millions of dollars in developing economies. Investment strategies range from social-value maximizing approaches to blended-value investment methodologies to strictly profit-maximizing investing. Given the broad range of investors, funds and deals in this realm, this section cannot be exhaustively comprehensive. Instead, it examines a range of methods deployed in the United States, followed by three very different international investment approaches, each deliberately adapting standard private equity practices to generate blended value returns.

The Crucial Role of Private Equity Investment in Developing Economies

Private equity investment is essential to building robust private sectors that create employment, improve living standards and produce tax revenues. Equity investors are usually more risk-tolerant than debt investors. They commit their capital for an uncertain term and have a residual claim on earnings only after all debt obligations have been satisfied. Equity investors face a host of other risks, several of which are explored below.

Equity investments are particularly suitable for early stage companies that will have unpredictable cash flows and accordingly are not suitable for debt investments. Unlike lenders, who maintain an arm's-length relationship with their borrowers in most circumstances, private equity investors can mitigate some of their risks by exercising a large measure of influence or control over the investments, and such investor engagement often encourages transfers of best practices and organizational capacity building. That involvement can help businesses build better, more efficient business processes, improve their corporate governance, forge partnerships with other businesses, and work more productively with other local institutions. The investors can also advocate for and/or support the entrepreneur's efforts to create, social and environmental value that, in turn, often builds enhanced economic value.

A Survey of Risks and Challenges

Private equity investors in developing economies face a variety of formidable risks that tend to be more severe than similar investments in developed economies. Savvy investors can deploy tactics to minimize some of these potential hazards, but many of them cannot be eliminated; all of them can challenge the likelihood of fully risk-adjusted market returns.

Corporate governance: Many cultures and economies lack a tradition and expectation of corporate governance that protects all stakeholders. Small enterprises particularly are often not subject to regulations that would encourage optimal governing practices. Remote investors not steeped in local culture may find it difficult to implement prudent governance.

Management competence: Frequently, entrepreneurs do not have the opportunities to work in well-run companies before starting their own businesses. Without widely available management training or relevant previous experience, enterprises in developing economies often lack well-trained managers.

Multiple ways of extracting value: Developed economies have established (and narrowly defined) means of extracting value from specific companies through interest, dividends or a sale of business. In many cultures, returns are generated in other ways. Examples include directing business to other companies controlled by a business's principals or hiring family and friends (in the developed world, such practices would be decried as self-dealing or cronyism). Such practices are by no means confined to developing economies, but in many cultures, these practices are considered legitimate ways of distributing value.

Corruption and graft: Certain countries and economic sectors face this obstacle more severely than others. Operating a business that does not engage in such practices can engender a very real competitive disadvantage when competing against business that do.[36]

Bureaucracy: In many parts of the world, businesses face great bureaucratic regulatory hurdles when founding and operating businesses. Particularly when bureaucracy and corruption interact, the effect can dramatically chill a country's investment climate.[37]

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Rule of law and enforcement of contracts: Many investors take a well-developed code of corporate law and a relatively functional judiciary for granted. Such conditions make contracts enforceable and give recourse to entities that have been wronged. Without them, an enterprise must carefully attempt to do business only with entities that will honour their contracts and obligations. In many emerging economies, the law and judiciary are not dependable, which increases transaction costs and risks.

Exits: Realizing a return either through a sale or public offering can be especially difficult when such strategies are rarely practiced or supported by a robust financial sector. Sales and ownership transfers depend not only on the presence of buyers and sellers (which may be relatively thin in emerging economic environments), but also require supporting professional services and infrastructure, including banking, accounting and legal services. Such support may also be in short supply in less developed economies.

Country risk - political and macroeconomic volatility: With less political and economic stability in developing countries, private enterprises face a grave range of hazards from coups d'etat to currency devaluations. The duration of equity investments and the extraordinary difficulty in building currency hedges make currency exchange fluctuations a significant risk.