PORTICO ADVISERS

THE MID-MARKET SQUEEZE

Findings from the Portico Advisers EM Mid-Market Survey

JULY 2017

Introduction

In the six months since launching **Portico's first research piece**, I've enjoyed some great conversations with individuals who have welcomed a frank discussion of the industry's challenges, as well as firms that are on the leading edge of the evolution in emerging market ("EM") private markets. One recurring topic of conversation is the imbalance between supply and demand for capital for private equity ("PE") funds operating in the lower- and mid-market segments in EMs.

The hollowing out of mid-market funds animated my decision to found Portico, and it served as the impetus for our **EM Mid-Market Survey**. We had two objectives with this survey: first, to test our hypotheses for the supply-demand imbalance; and second, to illuminate potential paths toward solutions.

Most of our hypotheses were affirmed, in whole or in part, but **the overarching finding is that the mid-market squeeze in EMs is more than just a funding gap; it is a symptom of industry-wide problems.** This survey reveals **four drivers for the mid-market squeeze:**

1. **Nearly half of the survey's fund manager respondents believe the main reason institutional investors aren't committing to EM funds is the EM story / macro; however institutional investors' biggest pain point is poor performance.**

   The institutional quality (or lack thereof) of EM fund managers ("GPs") and currency risk are the second- and third-biggest pain points for institutional investors ("LPs"), respectively. This should give GPs a reason for optimism, as they have agency over the outcomes associated with LPs' top two pain points.

2. **LPs lament the lack of transparency in the industry and it inhibits their commitments to mid-market EM funds.**

   However, most LP (83%) and GP (57%) respondents are unwilling to pay a penny for independent, third-party due diligence and monitoring reports on fund managers. There is a disconnect between demand for quality information and industry participants' willingness to pay for it.

3. **There is an acute mismatch between LPs' preferred fund / ticket sizes and those of GPs within the sub-$100 million fund and sub-$5 million ticket segments.**

   There is very little appetite for funds below $100 million in size, even amongst development finance institutions ("DFIs"). LPs generally prefer EM funds between $100 million and $1 billion in size, with 60% of LP respondents indicating a preference for funds between $100 million and $499 million.

4. **Though DFIs should be supporting the development of funds in the lower- and mid-market segments, increasingly, they're not.**

   Portico's own analyses reveal that DFI commitments to funds smaller than $100 million in size have declined from an average of 31 between 2006-11, to an average of 19 between 2012-16. Meanwhile, our survey finds that DFIs' preferred fund and ticket sizes are in the sweet spot of where commercial LPs prefer to play. Moreover, commercial LP sentiment is overwhelmingly neutral toward DFI participation in a fund, with the balance of opinion tilting toward an unfavorable view.

What can be done to alleviate the mid-market squeeze? We would humbly propose the following:

- **Industry participants and stakeholders need to develop a cost-effective solution that addresses LPs' demands for greater transparency on the asset class.** Portico would welcome the opportunity to work with DFIs and other interested parties to solve this challenge. One idea could be to create a platform where DFIs could share due diligence and monitoring reports with vetted commercial LPs.
- **Credible third parties could expand the number of smaller institutions, family offices, and gatekeepers that would be open to lower- and mid-market EM PE strategies.** However, this requires better quality data on the investable market in EMs, a broader pool of academic and independent research, and a frank discussion about the performance of the asset class.
- **EM PE fund managers need to step up their game.** It's easier said than done, but GPs should take action to enhance their deal structuring, value creation, and portfolio construction capabilities, and invest in technology / back-office functions to improve their quality of reporting.

  More generally, LPs' demand for transparency creates opportunities for GPs that are willing to invest in identifying their differentiation, articulating their value proposition, and demonstrating their ability to deliver returns.

Candidly, with each conversation and investigation, my conviction grows that the traditional EM PE industry is in structural decline. Will EM-dedicated managers continue to raise capital? Of course. However, I believe that number will continue to consolidate, even though the absolute volume of capital targeted to EM private markets may very well increase in the next few years.

There are remarkable evolutions underway within EM private markets, leading to a richer, more diverse, and more fragmented investment landscape—one that may not fit within rigid asset allocation buckets, or even be accessible to institutionalized asset managers. I believe sophisticated investors are adapting their approach to EMs, and will increasingly embrace non-traditional fund and deal structures. In addition, some forward-thinking GPs will reassess their business models and identify new strategies that may be better aligned with the investable market, and duration of holds, in EMs. This is an area where we are spending a significant amount of our time.

Finally, I would like to thank the 76 industry professionals who participated in this survey, as well as the winner of our prize drawing—a representative from a sovereign wealth fund in the Asia-Pacific region—who selected the donation to UNICEF.

I hope that you enjoy our study. Do please drop a line and let us know what you think—we'd love to hear from you.

Best wishes,

Mike

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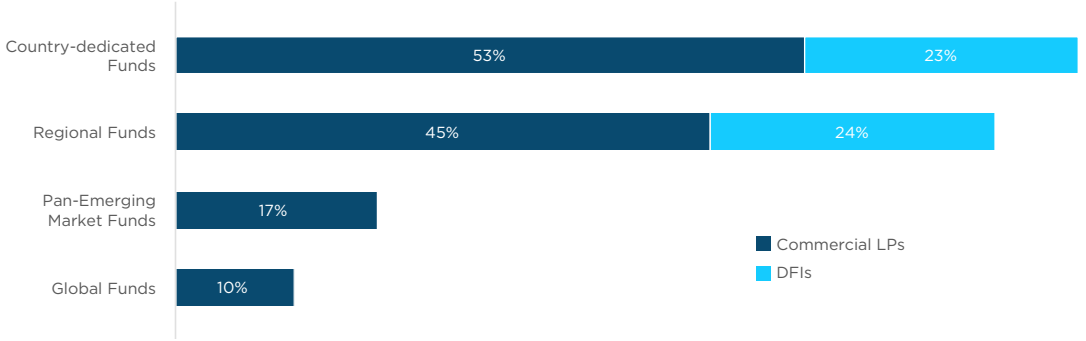
Question 1:
What Are LPs' Preferred Means of Accessing EM PE Opportunities?

We first asked LPs to share their preferred means of accessing EM PE opportunities across four categories: country-dedicated funds (e.g., Hony Capital Fund VIII); regional funds (e.g., KKR Asian II); pan-emerging market funds (e.g., Actis Global 4); and, global funds (e.g., Warburg Pincus Private Equity XII).

Investors evince a strong preference for country-dedicated and regional funds, which received 76% and 69% of total responses, respectively (see **Exhibit 1**). Only 17% of respondents indicate a preference for accessing EM PE opportunities via pan-emerging market funds, while 10% signal appetite for global funds.

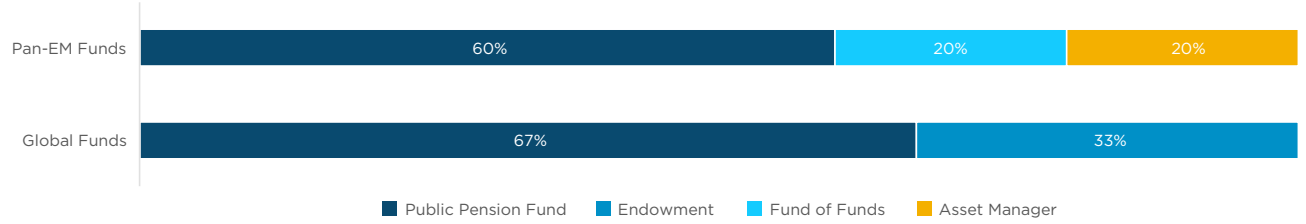
This finding hold across Commercial LP and DFI segments. Given their push to develop local capacity, it is not surprising to see DFI preferences clustered in country-dedicated and regional funds. However, we were surprised to see such a small number of investors selecting pan-EM and global funds. In part, this may be due to the survey's sample, which includes numerous funds of funds, as well as institutions that are more appropriately sized for country and regional strategies. Public pension funds constitute the bulk of the appetite for pan-EM and global funds (see **Exhibit 2**).

Exhibit 1: Investors evince a strong preference for country and regional funds, and this holds across commercial LP and DFI segments
(Preferred means of accessing EM PE opportunities, % of total LP respondents)



Note: Respondents were asked to select all that apply.

Exhibit 2: Public pension funds constitute the bulk of the appetite for pan-EM and global funds
(Preference for pan-EM and global funds, by LP type, % of respondents)

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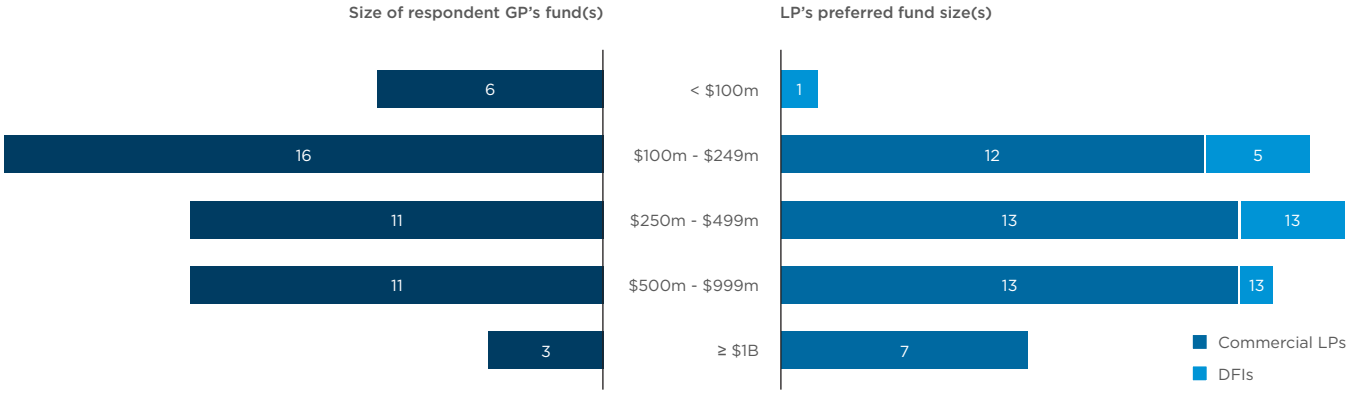
Question 2:
Are There Divergent Preferences for Fund and Ticket Sizes?

In our next series of questions, we sought to identify whether there are mismatches between market participants' preferred fund and ticket sizes.

With respect to fund size, there is general alignment between GPs' supply and LPs' demand, with the notable exception of funds below $100 million in size (see **Exhibit 3**). Even DFI respondents do not reveal much of an appetite for funds at this scale, which is a surprising finding given their developmental mandate and historic support for funds operating in this segment. To wit, Portico's own analyses reveal that upwards of 40% of DFI commitments between 2006-2016 were to funds less than $100 million in size. However, the number of commitments to these funds has declined from an average of 31 between 2006-11, to an average of 19 between 2012-16.

Exhibit 3: LPs' fund size preferences are generally aligned with GP offerings, though there is very little appetite for funds smaller than $100m—even amongst DFIs
(Fund size preference by firm type, # of respondents)



Note: Respondents were asked to select all that apply.

More generally, investors prefer EM funds between $100 million and $1 billion in size. One commercial LP explains, "Returns for sub-$200 million funds are not compelling. Funds above $200 million and below $800 million have shown better returns than smaller or larger funds." This observation conforms with performance data from Cambridge Associates, at least on an IRR basis (see **Exhibit 4**). The top-performing funds within this data set are likely to skew toward Asia and venture capital, though we note there has been a general lack of distributions across all fund size segments.

Portico's own analyses reveal that upwards of 40% of DFI commitments between 2006-2016 were to funds less than $100 million in size. However, the number of commitments to these funds has declined from an average of 31 between 2006-11, to an average of 19 between 2012-16.

Exhibit 4: Funds between $200m to $800m have generally outperformed other fund size segments, at least on an IRR basis
(Performance of 2007-2014-vintage EM Funds)

	IRR			DPI			TVPI		
Fund Size	Median	Top-Quartile	Top 5%	Median	Top-Quartile	Top 5%	Median	Top-Quartile	Top 5%
< $200m	5.36%	12.61%	36.60%	0.21x	0.50x	1.01x	1.20x	1.56x	2.80x
$200m - $800m	7.99%	15.96%	32.32%	0.17x	0.51x	0.99x	1.30x	1.70x	2.93x
> $800m	8.61%	13.53%	23.41%	0.22x	0.56x	1.10x	1.24x	1.45x	1.76%

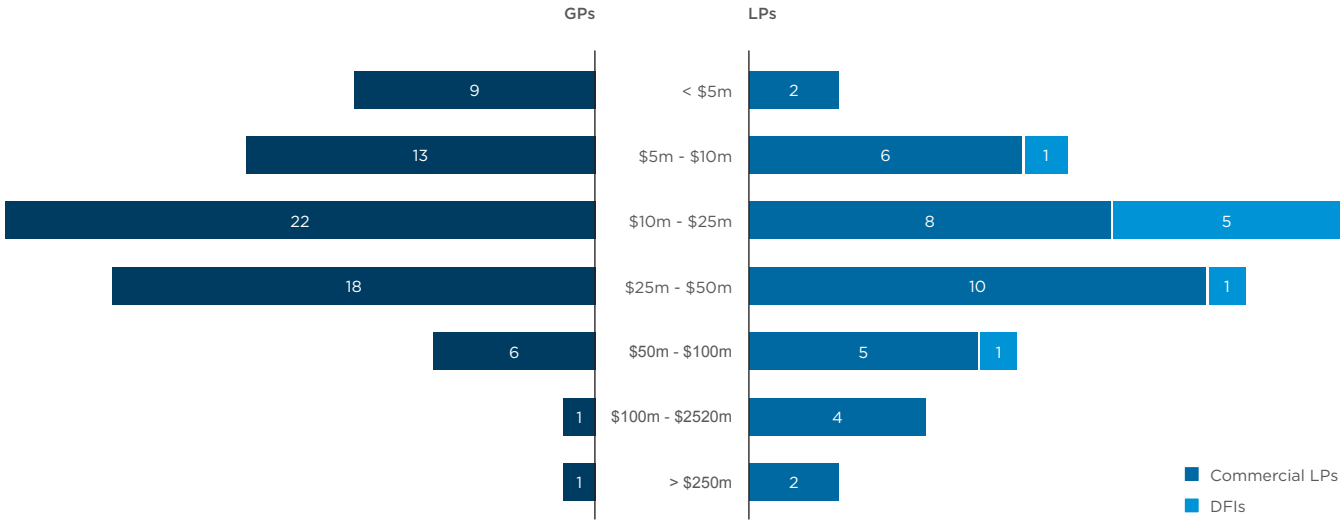
Source: Cambridge Associates, Thomson Reuters Datastream, Portico Advisers.
Note: Includes 2007-2014 vintage buyout, growth equity, mezzanine, private equity energy, and venture capital funds investing in Emerging Markets.

Ticket Sizes

On the issue of ticket sizes, GP respondents are much more open to checks of less than $5 million in size than LP respondents. This lower end of the market simply appears to be a place where DFIs don't seem keen to play (see **Exhibit 5**). Two commercial institutional investors indicate a willingness to take smaller bites of a fund—surprisingly, one is a public pension fund representative, while the other is from an endowment. We would expect family offices to be more active in this segment.

DFIs appear to be migrating up the fund size scale as a conscious decision, with a revealed preference for checks between $10 million and $25 million. One DFI participant indicates appetite for a commitment size between $50 million to $100 million, which all but guarantees deployment into large-cap funds. Regardless, the distribution of DFI preferences leads us to ponder the age-old question: are they crowding in or crowding out commercial capital?

Exhibit 5: Are DFIs catalyzing private capital if their preferred ticket size is in the sweet spot of commercial investors?
(Preferred ticket size by firm type, # of respondents)



Note: Respondents were asked to select all that apply.

Question 3:
Are DFIs Catalyzing Capital to Mid-Market Funds?

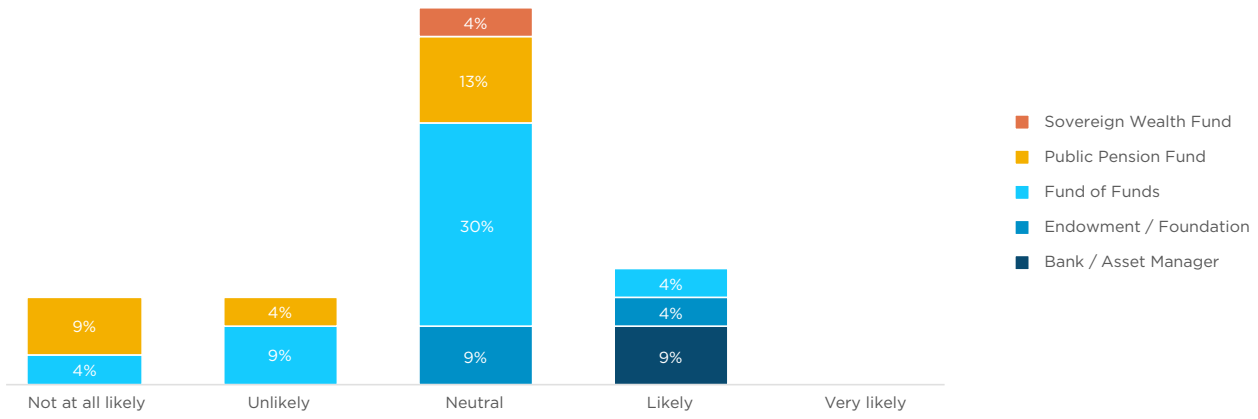
With increasing frequency, we observe DFIs committing more capital to larger, established managers that ostensibly should have graduated from DFI funding, leaving less capital available for smaller, newer funds. Depending upon the depths of one's cynicism, one might detect a whiff of corporate welfare.

In any event, given that one of the DFIs' missions is to catalyze private capital into EMs, we sought to identify whether commercial investors would be more likely to commit to a fund less than $250 million in size if DFIs were participating in the vehicle. The answer surprised us: commercial LP sentiment is overwhelmingly neutral toward DFI participation in a fund (see **Exhibit 6**). In fact, the balance tilts toward more investors adopting a negative view than a positive one.

Plainly, these responses may be less of a comment on the DFIs, as such, than a tacit acknowledgment of the challenges with investing in smaller funds. So, we sought to explore this issue in greater detail with our next question.

> Commercial LP sentiment is overwhelmingly neutral toward DFI participation in a fund. In fact, the balance tilts toward more investors adopting a negative view than a positive one.

Exhibit 6: How much more likely is your institution to commit to a fund < $250m in size if its investors include DFIs?
(% of total LP respondents, by institution type)



Question 4:
What Are the Constraints to Investing in Small / Mid-Size Funds?

We asked LPs to share the biggest constraints to investing in sub-$250 million EM PE funds, and we received 27 responses to our open-ended question. The responses largely fall into four buckets: size constraints; lack of verifiable track record; institutional quality of the GP; and, the resources required for due diligence and monitoring (see **Exhibit 7**).

Notably, DFI participation in a fund would not ameliorate three of the four key constraints. In theory, commercial LPs could piggyback off DFI's due diligence by tracking the funds that receive their support, but we note that even DFI respondents cite the intensity of resources required for manager due diligence as a key challenge.

Dealing with the Size Constraint

Admittedly, there is not terribly much that GPs can do to solve the size constraints issue, apart from: (1) scaling up the size of their fund(s); or (2), expanding the number of smaller institutions, family offices, and gatekeepers that would be open to EM PE strategies. With respect to the latter, candid conversations and better quality data would be more useful over the long run than cheerleading the growth prospects of emerging markets, or demonstrating alpha over the (poorly performing) MSCI EM benchmark. Credible industry associations can play a role, but a broader pool of academic and independent, third-party research would be a helpful start.

Exhibit 7: LPs' biggest constraints to investing in sub-$250m funds largely fall into four main buckets
(Open-ended responses to the question: What are your biggest constraints to investing in a small / mid-size EM PE fund (i.e., < $250m in size)?)

Size Constraints (e.g., minimum check size)	Too much work for a small amount—we invest $5B-$6B per year with a small staff. Regardless of the amount of investment, we still have the same rigorous due diligence done by staff. — *Public Pension Fund* It's difficult to get enough exposure per relationship if we target funds below $250m. —*Public Pension Fund*
Lack of Verifiable Track Record	Track record, lack of investment history, and more importantly a lack of exits. — *DFI* Proven team and track record. — *Fund of Funds*
Institutional Quality of GP (e.g., compliance, reporting)	Lack of bench strength (susceptible to key man risk) and operational expertise. Lack of transparency to investee company records, as well as GP's own budget vs. actuals. Lack of a solid reporting standard and often a lack of an investor relations person. — *DFI* Compliance, transparency, and corporate governance. — *Fund of Funds*
Resources for Due Diligence and Monitoring	Need to perform extensive due diligence on less institutionalized firms; investment committee risk tolerance. — *Foundation* Manager selection and monitoring (i.e., handholding). — *DFI* Resource intensive to make the investment and then to monitor it. — *DFI*

Taking Action on Track Records and Institutional Quality

GPs could take several steps toward enhancing their track record and institutional quality, from the fund level down to the portfolio company level. These measures include:

- **Improving portfolio construction,** with a view toward building a portfolio of companies that deliver consistently high returns, rather than pursuing the venture capital approach that leads to a few big winners and a lot of duds.
- **Attaining international standards** of compliance, transparency, and reporting, including through investments in software and back-office functions.
- **Building operational expertise** to drive value in portfolio companies.
- **Structuring deals** to mitigate the J-curve and alleviate exit risk.

Due Diligence and Monitoring

Going into this survey, we held a hypothesis that a lack of information on EM managers, and the resource requirements for diligence and monitoring, were key inhibitors to LP commitments to small / mid-market funds. Accordingly, we asked a question to gauge whether there is demand for independent, third-party due diligence reports on EM fund managers, as well as ongoing monitoring services / synopses of AGMs.

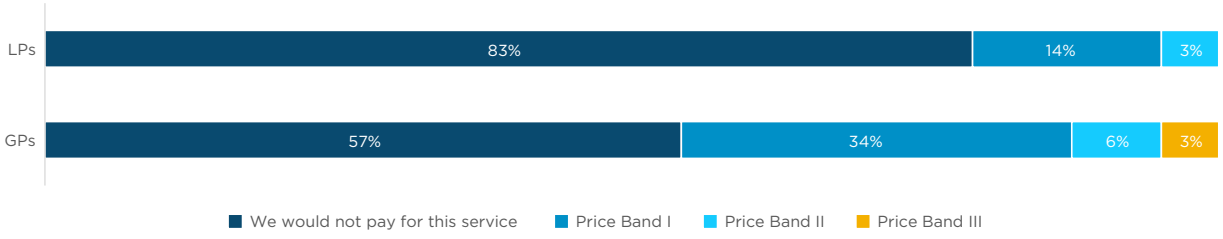
To our surprise, 83% of LP respondents and 57% of GP respondents say they would not be willing to pay for these services (see **Exhibit 8**). Though we collected data on pricing sentiment, we are keeping them confidential. Perhaps this is an area where DFIs could add value, by creating a platform to share due diligence and monitoring reports with vetted institutional investors. Portico is happy to help.

The Role of Investment Consultants

Given the important role that gatekeepers play in "picking winners" on the fundraising trail, we sought to identify whether survey respondents rely on investment consultants or outsourced CIOs for their EM PE commitment decisions. Only 16% of commercial LP respondents to our survey rely on consultants, and one of these respondents adds, "We do our due diligence ourselves; however, we have a consultant that conducts due diligence in parallel, and then we discuss the findings."

We also sought to identify LP satisfaction with investment consultants. Sentiment was generally middling, with an exception or two. Respondents indicate that they are clients of Altius Associates (Pavilion), Cliffwater LLC, Franklin Park, Hamilton Lane, Meketa, Pension Consulting Alliance, and Torrey Cove.

Exhibit 8: Though due diligence and monitoring are a key hurdle for commitments to sub-$250m funds, most people wouldn't pay to overcome it
(Responses to the question: How much would you pay for independent third-party due diligence and monitoring reports on small / mid-size EM GPs)



Question 5:
What Are the Biggest Pain Points in EM PE?

Finally, we sought to understand the biggest pain points that LPs have with EM PE, and that GPs have in securing an LP commitment. We asked open-ended questions of each segment, and bucketed the responses. Comparing the top three hurdles across GP and LP segments reveals a profound misreading of the market on the part of GPs (see **Exhibit 9**).

Nearly half of GP respondents believe the reason why they have difficulty in securing LP commitments is that investors aren't convinced of the EM story, or for other macro reasons (i.e., FX risk). While 16% of LPs report FX is their biggest pain point with EM PE, the clear issue is the poor performance of funds, a factor that only 13% of GPs report as being a hurdle to a commitment to their fund. GPs' perceptions are off-target; EM macro isn't the problem, it's the ability of EM fund managers to deliver returns.

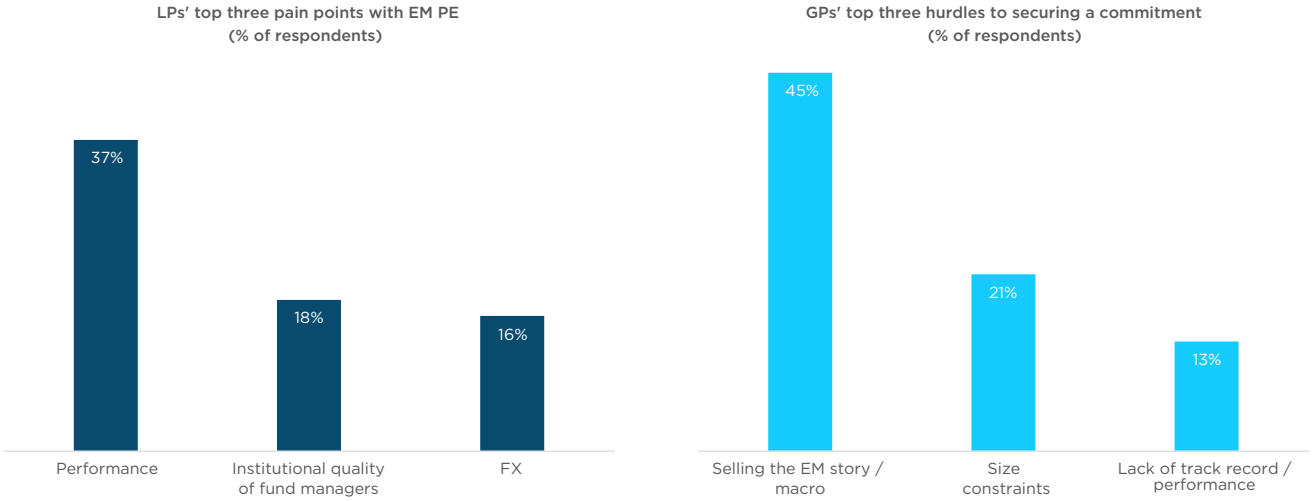
> As with most things in life, the source of the problem lies not outside, and the solutions are found within.

Some might argue that this outcome is a function of our survey's sample. We acknowledge that GP respondents may be pitching their funds to the unconverted—the "smaller institutions, family offices, and gatekeepers" that we alluded to in the previous section—and that our survey's sample includes LPs that are already sold on the EM story. However, even if we assume this is true, then it is all the more reason for GPs to focus on improving their own businesses before these existing EM PE investors walk away from the asset class altogether.

Indeed, data from EMPEA's 2017 *Global Limited Partners Survey* suggests this is already happening: 25% of LPs plan to decrease the proportion of their PE allocation targeted to EMs over the next two years, and this figure jumps to 36% for LPs that have been active in EM PE for more than 15 years.

As with most things in life, the source of the problem lies not outside, and the solutions are found within.

Exhibit 9: GPs' perceptions are off-target; EM macro isn't the problem, it's the ability of fund managers to deliver returns



LPs: What is your biggest pain point with EM PE?

- The returns on a portfolio basis are simply not there to compensate for the risk. Inexperienced managers and / or very few managers are able to demonstrate returns matching expectations over the cycle, and repeated from first vintage to second vintage. — *DFI*
- It is a struggle to find managers with strong and deep enough track records to overcome the risks of investing in EM. — *Endowment*
- Huge landscape to cover and the markets are becoming more fragmented. — *Asset Manager*
- Low quality of managers; lack of track record; size of investable universe. — *Fund of Funds*
- Pooled EM PE has generally not outperformed relative to developed markets. — *Public Pension Fund*
- Not a better risk-return profile than public equities. — *Foundation*
- High valuations, few exits, and low reporting standards. — *DFI*
- As in all PE, badly behaved / un-transparent GPs, though I would argue that there are fewer of these in EM than in developed markets. — *DFI*

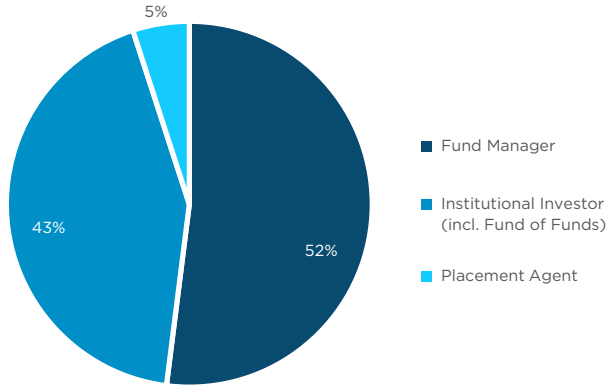
GPs: What is your biggest hurdle to securing a commitment?

- Assurance of top-quartile returns compared to the U.S. PE market; managing currency volatility; deal flow; deal execution capability.
- First-time LP relationships are always tough to secure; currency volatility in EM is a turn-off; EM returns don't offer a sufficient premium over developed markets; LPs increasingly like to make larger commitments to fewer GPs.
- Resistance to country risk.
- Demand for reduced management fees.
- Our fund size is too small; track record needs more consistency rather than a few big winners.
- Knowledge of EM and corresponding willingness to invest.
- Size. LPs investing internationally tend to favor large funds in order to commit and deploy more capital per relationship.
- Macroeconomic risks.
- Risk aversion toward EMs.
- Africa story.
- India story.
- Brazil macro.

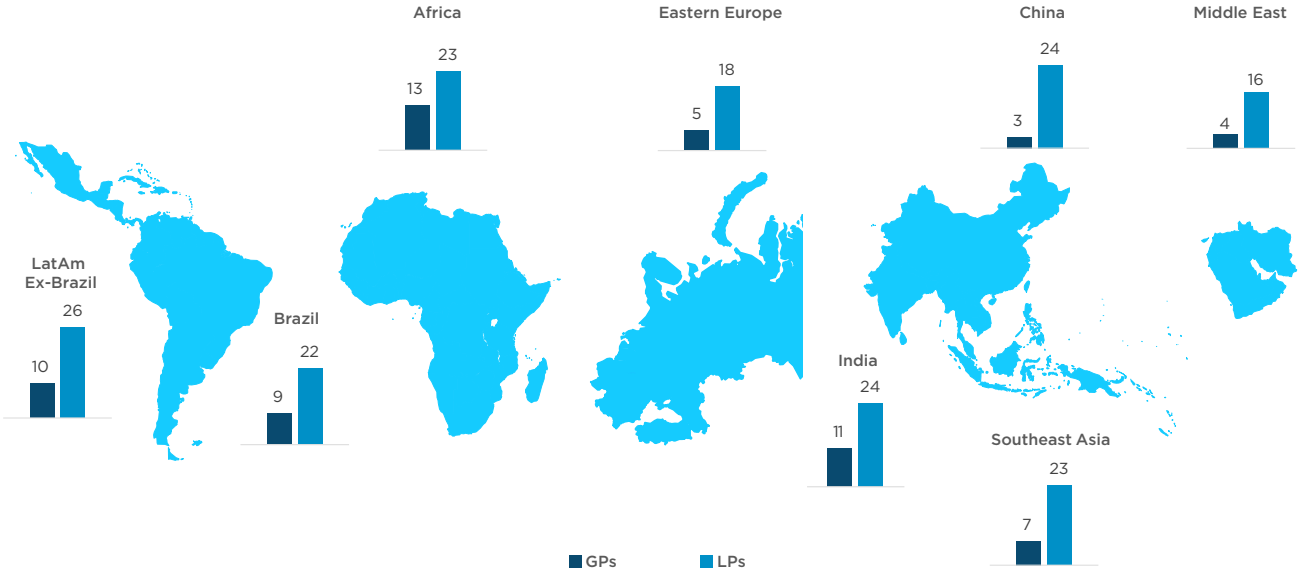
Methodology

Portico's EM Mid-Market Survey includes responses from 76 private equity practitioners, which were collected in May 2017. The breakdown of respondents was 52% GPs, 43% LPs (including funds of funds), and 5% placement agents. Note: In some exhibits, numbers may not foot due to rounding.

Survey respondents by institution type



EM geographies in which respondents invest
(by institution type)



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