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PRIVATE EQUITY IN DEVELOPING WORLD: BANGLADESH PERSPECTIVE

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Abstract

Private equity can be described as the risk capital invested in the direct equity ownership of any non-listed private companies with a high growth potential. Modern private equity industry has passed several decades to reach its present level. By the end of 2014, freshly committed dry powder hit a global record of USD 1.2 trillion, including USD 452 billion earmarked for buyouts alone (Bain & Company, Inc, 2015). Emerging markets from Asia region also have a vibrant private equity market with large number of active funds while private equity market is almost absent in Bangladesh. By considering the growth potential and urgent need for capital to finance all kinds of infrastructure, communication, and specially the SMEs, now there exists a broad consensus that Bangladesh needs a strong private equity market. Recently the market has received a few private equity funds coming in. As a solid 'Greenfield' country, by removing some of its bottlenecks, Bangladesh may become an 'Investment Club' for private equity investors in near future. For a prospering private equity market to support investments, growth, competitiveness and entrepreneurial activities policymakers should focus on the creation of an adequate setting. This paper is just a foot step towards this vast field of study. More intensive theoretical modeling, law and regulatory reforms among others can be focused in future research work.

Keywords: Private Equity; Venture Capital; General Partners; Limited Partners.

Introduction

As of June 2015 private equity and venture capital assets under management (AUM) has reached to a new high of USD 3.8 trillion that is a 11.9 percent increase compared to the previous year (Preqin, 2015). Besides total volume of assets, dry powder i.e. grossly liquid asset of private equity industry hit a global record of USD 1.2 trillion by the end of 2014 demonstrating a strong presence in global financial market (Bain & Company, Inc., 2015). Between December 2008 and June 2014, total AUM has expanded by 66% mainly due to the unrealized portfolio value of private equity and venture capital assets from USD 1.2 trillion to 2.6 USD trillion (Figure 1). Modern private equity industry has passed several decades to reach its present level. The origin of the modern private equity industry trace back to 1946 when the first venture capital firm formed in United States. But the industry started to grow rapidly from 80's. The period of 1982-1993 has been termed as the first private equity boom. Private equity under management in the U.S. alone skyrocketed from about USD 4 billion in 1980 to about USD 300 billion in the late nineties (Leeds & Sunderland, 2003). Since then this industry has been continuously growing with various shaping and reshaping.

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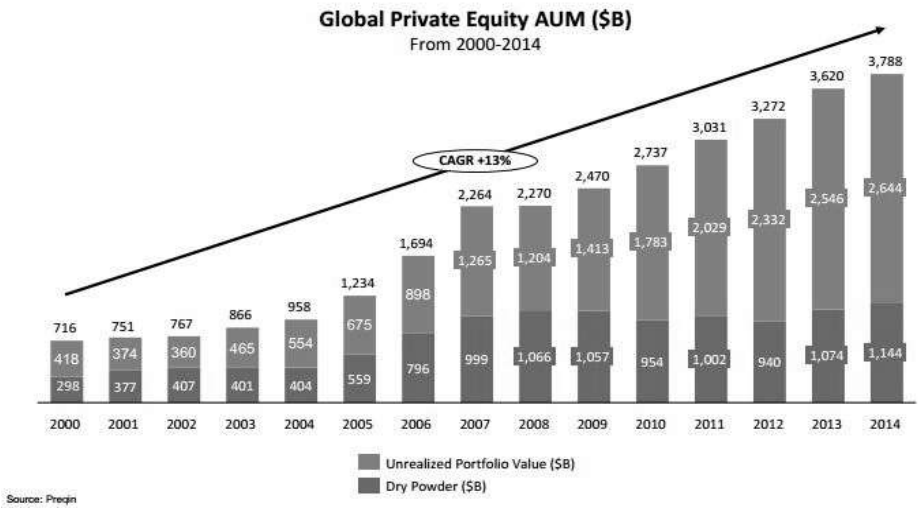
Figure 1: Size of Global Private Equity Market

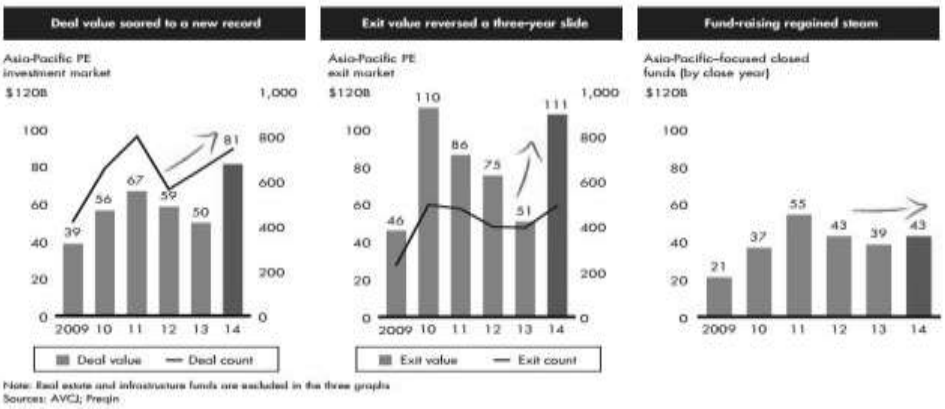


Source: Preqin Global Private Equity & Venture Capital Report, 2015

On the contrary of developed and heavily industrialized nations, private equity has gained popularity in developing world almost recently. By the early nineties, emerging markets seemed like fertile ground for this tested and successful paradigm. Institutional investors in US and other developed nations were on the look-out for new opportunities as the extraordinary returns generated from the surge in US equity markets. They also began to worry that the enormous increase of capital flowing into U.S. private equity would outpace the supply of high return investments (Leeds & Sunderland, 2003). Therefore, private equity has started to flow to emerging markets, especially, for those with the appetite for emerging market risk. Despite various differences between developed and emerging markets, analytical skills required are the same for both markets. In the emerging markets of Asia (excluding Japan) about 500 funds have raised more than USD 50 billion in new capitals between 1992 and 1999. Latin American markets also got momentous growth in private equity between 1992 and 1997, the value of new capital raised for private equity had increased by 114 percent annually, from just over USD 100 million to over USD 5 billion (Leeds & Sunderland, 2003).

Despite rapid growth in private equity industry, initial performance of this industry in emerging markets was not very convincing. One survey shows that out of 227 Latin American private equity investments only 15 (only 7 percent of the total) had been exited in the period of 1995 to mid 2000. Performance in Asia was slightly more encouraging. But the scenario has been changed in the new millennium. In 2014 private equity exit value was USD 111 billion in the Asia pacific region (Figure 2) where it was about USD 2.5 billion per year in 1998 and 1999. Besides USD 238 billion of funds have been raised in this region in between 2009 to 2014 (Bain & Company, Inc, 2015). The scenario of returns has improved over the years except some rough patches.

Figure 2: Asia-Pacific Private Equity Activity, 2014



Source: Asia-Pacific Private Equity Report, 2015, Bain & Company, Inc.

Unlike other emerging markets, especially those from Asia region, private equity market is almost absent in Bangladesh. Recently the market has received a few private equity funds coming in, setting up their offices here, and there are one-off investments that are done in conjunction with the International Finance Corporation (IFC). Bangladesh is severely lagging behind in this sector while India even has around 38 private equity firms and billions of dollars invested through this sector over the years. This lag in Bangladesh's private equity industry is the main focal point of this study. Moreover, the basics of private equity concept, benefits, prospects and impediments of this industry, and necessary policy actions for establishing strong private equity market is being discussed in this paper. Research on private equity is very rare in case of Bangladesh. This paper is just a foot step towards this vast field of study. More intensive theoretical modeling, law and regulatory reforms etc. can be focused in future research work.

Literature Review

There is a large body of literature exist on the private equity subject area. In this section some selected literature is being reviewed to come across the reasons behind emergence, inevitability, hindrance, and prospect of private equity market, especially in the developing world. The term 'developing' needs little clarification at this point. A country can be said developing from two aspects; the country with low to middle per capita income and/or the country with low level of industrialization. In this paper both of the aspects are considered to define the term 'developing'.

Greene (1998) emphasized on the availability of debt financing as the key factor for new venture entering in the market, therefore this debt availability is prerequisite for a vibrant local private equity market. Moreover, number of players in the market, supporting institutions like law firms, investment banks, auditors, M&A boutiques, and consultants are also very important for creating deal flow and exit transactions. Some other researchers found IPOs as the strongest driving force for private equity investment while, surprisingly, GDP growth and market capitalization are not significant (Black & Gilson, 1998; Jeng & Wells, 2000). On the contrary, Gompers

& Lerner (2000) emphasized that risk capital flourishes in countries with deep and liquid stock markets. Chemla (2005) argues that attractiveness of any region to the investors depend on large enough deal flow and higher than expected payoffs to cover the cost of private equity fund management. Therefore, there is a simple relationship prevails between the size of an economy and PE activity. If an economy is too small, it is simply not on the scope of internationally acting institutional investors.

Apart from these economic and market related factors there are some other key determinants take part in the emergence of private equity market in any country or region. Quality of a country's legal system has a direct connection with private equity backed exits rather than the size of a country's stock market (Cumming, Flemming, & Schwienbacher, Legality and Venture Capital Exits, 2006). In an extended research, Cumming et al (2008) showed that cross-country differences in legality, including legal origin and accounting standards, have a significant impact on the governance of investments in the private equity industry. By analyzing private equity transaction structures of developing countries Lerner & Schoar (2004) found that the choice of securities is driven by the legal and economic circumstances of the nation and of the investing private equity group. La-Porta et al (1998) proved that the size and extent of a country's capital market and local firm's abilities to receive outside funding is predominantly depends on the legal environment of that country.

Along with positive economic, market and legal condition, access to viable investments is another important factor for the emergence of a regional PE market. Megginson (2004) argued that for healthy growth of risk capital industry R&D culture, especially in universities or national laboratories, is quite important. Moreover, private equity activity is significantly correlated with R&D expenditure. Schertler (2003) emphasized that human capital endowment has significant positive influence on private equity activity. The author took number of employees in R&D field and patents number as the determinants of human capital endowment.

From the above discussion it is clear that emergence of active and efficient private equity market depends on a range of factors. It is important to make an environment favorable for private equity market by making fundamental change to those factors since it has some unique features over other forms of investment. Hellmann & Puri (2000) showed that private equity backed companies are more efficient innovators. Moreover, this kind of firm able to generate more employment and growth than their peer firms (Belke, Fehn, & Foster, 2003). Levine (1997) also found that private equity funds foster innovative and competitive firms, even many people believe that a strong private equity market is a cornerstone for commercialization and innovation in modern economies. These proofs of validity of private equity revealed that this market is more important in emerging markets. These markets need huge capital to invest in infrastructure, communication and new innovative projects to foster economic growth. Policymakers should focus on the creation of an adequate setting for a prospering private equity market to support investments, growth, competitiveness, and entrepreneurial activities.

Besides the absence of key factors discussed earlier, there is some other issues those may hinder the private equity activity in any particular market. There are

considerable numbers of paper focuses on the factors creating hindrance for private equity market. Rigid labor market policy usually negatively affects the attractiveness of private equity market. Lazear (1990) showed the effect of employee protection in reducing employment and economic growth. While Black & Gilson (1998) showed the variations in labor market restrictions correlate with private equity activity. Capital gain tax rate also influence the private equity activity of any market. Cullen & Gordon (2002) documented that taxes has an effect over the entry and exit of businesses. In another survey focusing on Hungary, The Czech Republic, Poland and Germany, Farag et al (2004) found that lack of talented people to manage the private equity backed enterprises, as the quality of management ranks highly as a reason for investment failure. Furthermore, Johnson et al (1999) emphasized the protection of property rights in emerging regions for higher private equity activity while they find access to bank financing does not a big problem.

This literature review shows various factors affecting the emergence and success of private equity investment in different kinds of markets. However, reviewed literature does not provide any rank of importance of those factors. Scholars found mixed reasons behind the success of private equity market while everyone grossly agrees about the importance and benefits of the private equity, especially for emerging markets.

Private Equity: A Solid Financing Option

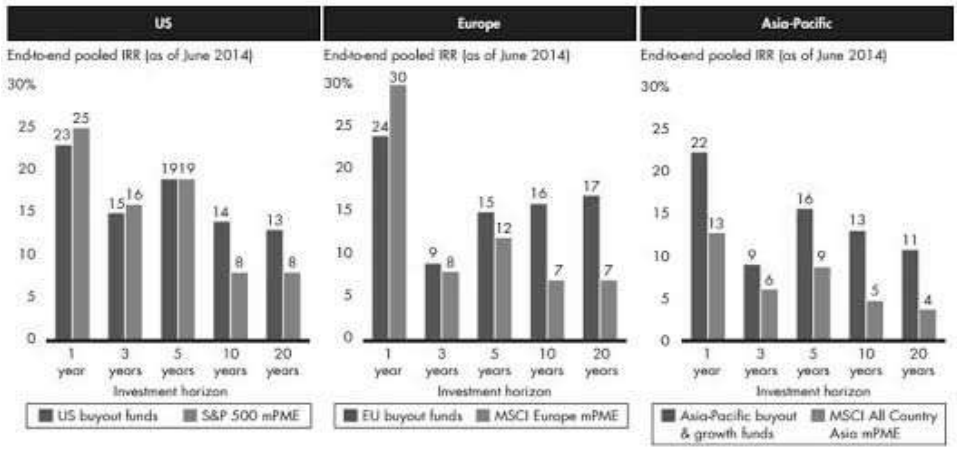
Private equity can be described as the capital invested in the direct equity ownership of any non-listed private companies with a high growth potential. The basic idea of private equity is to privately invest in a company and make it more valuable over several years in order to sell it to a buyer who recognizes the lasting value what is added (Butler, 2010). Gilligan & Wright (2008) defined private equity as risk capital provided in a wide variety of situations ranging from finance provided to business start-ups to purchase of large, matured quoted companies. As per European Venture Capital Association (EVCA), extended definition, the goal of private equity and venture capital is to help more businesses achieve their ambitions for growth by providing with finance, strategic advice, and information at critical stages of their development. It can be considered as an umbrella of alternative investments. Private equity covers not only the financing required to create a business, but also includes financing in the subsequent developments stages of its life cycle.

Private equity can be divided into three broad categories, such as venture capital (VC), leveraged buyouts (LBOs), and mezzanine capital. Venture capital typically finances into a firm at start up (seed capital) or early stage or at later stage of the growth life cycle of its business. LBOs funds generally acquire controlling stakes, either alone or in partnership with other private equity firms, of mature, cash-flow-stable companies. Mezzanine financing is the combination of debt and equity financing. Generally, the investors in private equity funds are both family offices/individuals with high net worth and the institutional investors like corporations, pension funds, endowment funds, insurance companies, and banks because of their complex nature, limited regulations and relative lack of liquidity.

During past several years, private equity investments have seen a boom and grown exponentially, both globally and in emerging markets, making private equity firms and funds increasingly important actors in emerging markets. Here private equity is termed as a solid financing option due to its attractive risk-return characteristics, its ability to generate long term values for the investors, portfolio diversification, and as it offers valuable resilience against market cycle (Pictet Alternative Advisors SA, 2014).

Firstly, the primary motivation to invest in private equity is to achieve returns above what the traditional asset classes of stocks and bonds have provided (Phillips, Hager & North Investment Management Ltd. (PH&NIM), 2008). It is generally associated with high returns on investment compared to other types of investment such as bonds, equity, and mutual funds. Private equity has continuously outperformed the Public Market Equivalents (PME) over 5, 10, and 20 year period (Figure 3). According to Global Private Equity Report of Bain & company Inc. 2015, US-focused buyout funds outperformed the S&P 500 mPME (modified PME) over 10, and 20- year investment horizon. In the Asia-Pacific region, the combined returns for buyout and growth funds surpassed public market gains over all investment periods. In European market buyout-fund returns exceeded the benchmark by widening margins over a five-, a 10- and a 20-year investment horizon.

Figure 3: Return from Private Equity Buyout-funds and Public Markets, 2014



Source: Global Private Equity Report 2015, Bain & Company Inc.

Secondly, private equity offers value creation over the long term (Pictet Alternative Advisors SA, 2014) and patient capital with control features and alignment of interests (Pries & Berla, 2012). Generally, the investors of private equity fund have medium to long term investment holding period of time and they invest with an intention to add valued capital as well as to make strategic and operational improvements of the firm.

Thirdly, private equity fills the gap between self-financing and the traditional way of financing. Conventional ways of raising finance, such as borrowing from banks, are often difficult for companies already burdened with debt, or those which

are not sufficiently well-known to inspire confidence at an early stage (Kapoor & Smith, 2012). Likewise, international capital markets are not accessible to the great majority of companies. Private Equity investment is attractive to developing economies because it can fill the gap between a company self-financing and obtaining funds from banks or through issuing debt securities or shares to investors.

Fourthly, private equity offers valuable resilience against market cycle (Pictet Alternative Advisors SA, 2014). One of the reasons why private equity in emerging market appears to have been more resilient to the financial crisis 2008 is that it is comparatively less dependent on the leverage than in developed markets. Moreover, private equity offers portfolio diversification.

Road to Private Equity: A New Market for Bangladesh

Over a long enough period of time private equity has considered a respected investment strategy in the developed economies, even in some developing countries like China, India etc. It has gained significant recognition as a profitable and worthwhile investment vehicle in the emerging markets during late 1990s. However, private equity industry in emerging markets has increased sharply over the year from 2005 to 2009, mainly driven by a number of factors such as superior GDP growth, urgent need for capital, greater resilience to the developed world's financial crisis, and an increasingly improving socioeconomic environment (Meerkatt & Liechtenstein, 2010). With the exception of global financial crisis in 2008 when the attractiveness of emerging markets to private equity investors has slowed down as expected returns were not achieved (Kapoor & Smith, 2012). Since then, situations have recovered gradually.

In Bangladesh, private equity is relatively a new concept. Fundamentally, Bangladesh remains in a capital constrained economy. Inadequate funding remains a key constraint for the local companies operating in Bangladesh. As a result, firms in Bangladesh need to use internal savings to finance investments. In this scenario, private equity can be an alternative source of investment to meet this financing gap and Bangladesh has potentially large opportunity, which is yet to be explored in a substantial way in the private equity market.

As the alternative investment vehicles, private equity and the venture capital are seem to possess higher risk-return characteristics and in a booming market investors are less risk sensitive while in a bearish market private equity and venture capital are always attractive. During last few years, Bangladesh capital market is facing a bearish sentiment. However, irrespective the bullish/bearish sentiment, investment in private equity and venture capital is increasing in the country. There are 12 active funds in Bangladesh - seven of these funds are only making investments in Bangladesh, while the remaining five are the regional with capital deployed in other countries. Among these 12 funds 10 are private equity funds and two are venture capital funds (GIIN Advisory Team, Dalberg Editorial Team, 2015).

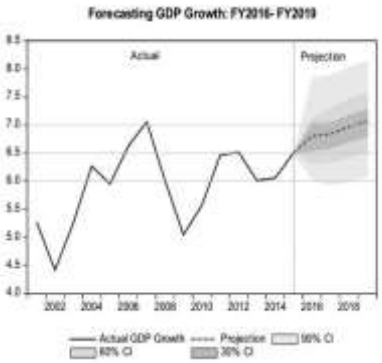
Bangladesh has the third most active impact investing (investment made in companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return) market in South Asia after India

and Pakistan (GIIN Advisory Team, Dalberg Editorial Team, 2015). Encouraged by high economic growth, a large potential market, an addressable social needs a large number of impact investors have been entering into the South Asia's third large economy. Given the country's strong, growing, and diversifying economy and appealing demographics, investors have exhibited strong optimism about the prospect in Bangladesh and increased interest in private equity investment.

Recent sound macroeconomic developments of Bangladesh have experienced a stable GDP growth, declining inflation, rising reserves, contained fiscal deficit, and stable public debt. Despite the policy divergence between US and Europe, tensions in Middle East resulting uncertainties in the movement of fuel prices, China's slowdown and India's contrasting invigoration, weaknesses in Latin America and Africa; Bangladesh sets a different tone of optimism in the sound ambiance of macro stability (Monetary Policy Statement, January-June 2016, Bangladesh Bank).

Table 1: Overview of the World Economic Outlook and Forecasted GDP of Bangladesh

GDP at constant prices	% change			Projections	
	2012	2013	2014	2015	2016
World	**3.4**	**3.3**	**3.4**	**3.1**	**3.6**
Advanced Economies	1.2	1.1	1.8	2	2.2
USA	2.2	1.5	2.4	2.6	2.8
Euro Area	-0.8	-0.3	0.9	1.5	1.6
Other Advanced Economies	1.7	2.1	2.8	2.2	2.4
Emerging Market and Developing Economies	5.2	5.0	4.6	4.0	4.5
China	7.7	7.7	7.3	6.8	6.3
India	5.1	6.9	7.3	7.3	7.5
Bangladesh	**6.3**	**6.0**	**6.3**	**6.5**	**6.8**



Source: Monetary Policy Statements, January-June 2015, Bangladesh Bank

A strong service sector and growing industry sector have outpaced the growth in the agricultural sector, with the expansion and the diversification of the sub-sectors within each sector. Most notably, manufacturing, which is captured in the industry sector, is a booming segment, due to a large and expanding textile and garment industry. However, manufacturing is estimated to have achieved a significantly high growth of 10.31 percent despite the severe disruption of the supply chain due to political turmoil in FY2015 (CPD IRBD 2015 Team, 2015). The service sector's estimated growth rate of 5.83 percent in FY2015 is a surprise.

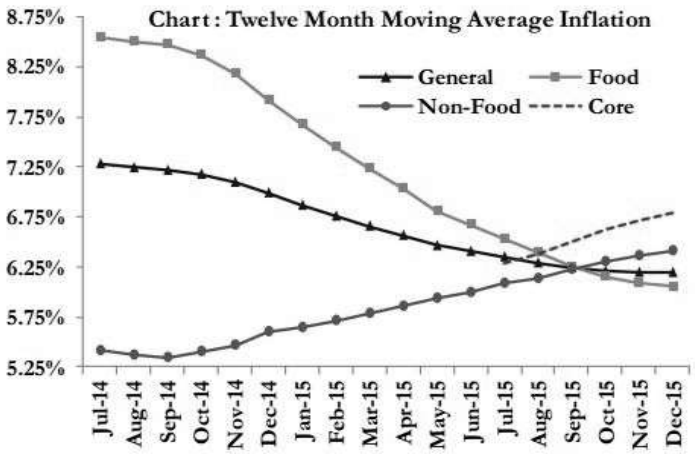
Table 2: Sector-wise GDP Growth (%) in Bangladesh

Sectors	FY2011	FY2012	FY2013	FY2014	FY2015
Agriculture	4.46	3.01	2.46	4.37	3.33
Industry	9.02	9.44	9.64	8.16	9.67
Manufacturing	10.01	9.96	10.31	8.77	10.31
Service	6.22	6.58	5.51	5.62	5.80
GDP	6.46	6.52	6.01	6.06	6.55

Source: GDP of Bangladesh 2014-2015, Bangladesh Bureau of Statistics

Inflation in Bangladesh has shown a slowly declining trend for the last couple of years. Inflation has declined to 6.19 percent in December 2015 from 7.28 percent in July 2014 (Figure 4). Current account surplus stood at USD 2.0 billion at the end of fiscal year 2015.

Figure 4: Inflation Trend of Bangladesh



Source: Monetary Policy Statements, January-June 2015, Bangladesh Bank

Bangladesh's capital market is growing moderately, primarily driven by a developing domestic investment trends. Market capitalization has grown about 74.69 percent, from USD 23.94 billion in 2009 to USD 41.82 billion in 2014 (Bangladesh Investment and Policy Summit, 2016). Furthermore, country's stock market has experienced a moderate level of market P/E ratio. Throughout 2009 to 2010 market P/E has remained high due to bull market and then became almost half in the following years as a result of malpractice in the market, causing public protests and sit-ins by small investors. The market has since recovered but domestic investors report considerably increased wariness (GIIN, 2015). Investors express a preference for IPO exit while secondary sales, trade sales, and owner buyback are also viewed as feasible exit options.

Table 3: Bangladesh Capital Market: Exit Route for PE and Venture Capital

Particulars	FY2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Index	4535.5	8290.4	5257.6	4291.3	4266.6	4865
Return (%)	61.5%	82.8%	-36.6%	-18.4%	5.2%	14%
Market Cap (USD Bn)	23.94	44.12	32.91	30.23	34.05	41.82
Market P/E	25.65	29.16	13.68	12.07	15.07	17.77
Companies Listed	236	218	232	242	256	274
New IPO	18	13	14	20	14	17

Source: Bangladesh Investment and Policy Summit, 2016

Moreover, large population of Bangladesh and shifting demographics is one of the main drivers for its attractiveness as a destination for private equity investment. Low cost labor force and the spirit for free enterprise make the country appealing to investors as both a sizable labor market and a large potential consumer market. Bangladesh is the eighth most populous country in the world with a total population of around 157 million (World Economic Indicators, The World Bank). The population is relatively young- 89 percent of the people are under the age of 54 years, and 45 percent are under the age of 24 years (CIA World Fact Book). For investors, Bangladesh's large young population translates into a potential labor market. There were more than 76 million economically active people as of 2012 and nearly 50 million more will be added in the next decade (ILO Key Indicators of the Labor Market Database).

As a private sector led growth economy, Bangladesh offers a strong local market, easier global market access and proven export competitiveness. Its middle class consumers are larger in numbers than the total population of Malaysia, Singapore and Thailand (D-8 Organization, 2014). According to the Boston Consultancy Group, the tech-savy middle income group in Bangladesh is increasing. As per a recent survey, economic units doubled during the last decade. Over the last five years, around 2.95 million SME entrepreneurs have drawn SME loans from banks; 21.7 percent of these in manufacturing, 4.6 percent in services, and 73.7% in trade (Bangladesh Investment and Policy Summit, 2016).

Some Challenges

Weak corporate governance and legal structure, lack of financial and operational credibility, inadequacy of regulations and policy assistance for quasi equity and government focus, non-compliance with laws and regulations by investee, lack of high technical professional ‘venture capital’ team, tax exemption and incentives, access to report of Credit Information Bureau, political instability, unethical and greed driven bad corporate culture are some of the challenging factors that Bangladesh have to overcome in order to establish a vibrant private industry. In this regard, a sound and coordinated initiative should be taken on behalf of the regulatory authorities like Ministry of Finance, Bangladesh Bank, Board of Investment, and National Board of Revenue to attract foreign investment in various forms including private equity and venture capital. Likewise, barriers to international trade and capital flows have to be lowered so that companies are put under pressure to compete internationally and to specialize where they have competitive advantage. The impact of lowering barriers to trade and capital flows has had an impressive outcome on deal flow in South Africa, Morocco, East Africa, and Colombo. In case of Bangladesh, similar steps are necessary to facilitate the flow of private equity and venture capital investment. Greater degree of transparency along with more efficient legal systems has to be ensured to develop the confidence level of the prospective investors.

Recently, an initiative has been taken by the Bangladesh Securities and Exchange Commission (BSEC), the regulator of the capital market of Bangladesh, to facilitate alternative funding arrangements for prospective private firms. BSEC has approved the private equity and venture capital financing rules as the Bangladesh Securities and Exchange Commission (Alternative Investment) Rules, 2015.

Recommendations and Conclusion

There is no set guideline to forecast the success of private equity market in Bangladesh. Even though it is not evidently explicable which factors might play crucial role in developing this industry; investor protection, corporate governance and protection of property rights, strong legal system might be the dominant criteria to affect or to attract private equity funding. Still lots of success stories of private equity investment are common in various countries (India, China) like Bangladesh. Developing countries are commonly in the shortage of funds to finance their development projects, both in private and public sector. Due to public borrowing and inefficiency, cost of debt capital becomes very high. While private equity can be a best strategy to combine financial returns as well as to achieve long term financial independence. As the private equity and venture capital are negatively correlated with the traditional investment tools, we can make very good use of these if we can successfully implement the alternative investment mechanisms. In this reality, policy makers should attract and bring international private equity flow to the country to spur the growth.

In Bangladesh, private equity can become a vehicle of change with real influence and real growth potential and it can be a lucrative destination for the investors to enjoy the first mover advantage as India and China are both extremely crowded with a lot of private equity funds competing with one another. With over 6 percent annual growth rate sustained over last 20 years, consistent export growth, a large remittance base, and vibrant private sector, Bangladesh has a great opportunity to attract private equity investment in energy, power, pharmaceuticals, telecommunication, and infrastructure sectors as well as in labor-intensive ready-made garments, household textiles, and leather processing sectors. As a solid 'Greenfield' country, by removing some of its bottlenecks, Bangladesh may become an 'Investment Club' for private equity investors in near future.

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