# Emerging Markets Funds: Not in Kansas Anymore

By John Daghlian, Partner, Akin Gump Strauss Hauer & Feld LLP

This article is not about the Abraaj Group, but as the Abraaj train wreck seems at last to be in the course of resolution it seemed a good moment to reflect on the current state of emerging markets funds, particularly those that are development institution backed. Before you read more of this article you should take note that what follows are my opinions, and not those of my partners.

When I first worked in private equity I particularly enjoyed the emerging markets work because it was so much less formulaic, more open to innovation, than regular venture capital (VC) or private equity (PE). The DFIs got exciting things done (I still admire one intrepid CDC executive who flew to Kabul in 2005 to diligence an Afghan fund). The funds and the deals were truly greenfield. Communism vanished from Eastern Europe, Africa, Asia, and Latin America were open for business and intrepid people were investing.

Now? On the fundraising side, it all feels rather hidebound and the legal processes run with the efficiency of the Tin Man after a rainstorm. Lawyers routinely warn general partners (GPs) about the pain of a DFI fundraising and how clients just have to grin and bear it, and survive to the second fund and start making money on the third. DFIs complain about GP lawyers producing unreasonable documents and failing to advise their clients properly. Both have a point. Certain GP side lawyers are remarkably tin eared.

It feels like economic alignment between emerging market GPs and limited partners (LPs), at least in the smaller funds, has been lost, while the limited partnership agreements that govern the funds are often unfit for purpose. The latter should be easy to fix, the former less so. Probably the best way to describe a typical limited partnership agreement for a new DFI backed GP is too little economic alignment and too many ill thought through governance provisions that do not provide the protection they should. (Abraaj provides a graphic illustration of this).

> "On the fundraising side, it all feels rather hidebound and the legal processes run with the efficiency of the Tin Man after a rainstorm."

This article focuses on economic alignment. Governance and Abraaj will be covered in another article. Thankfully, fraudulent general partners are rare. Economically disinterested ones and the resulting zombie funds are not.

## The Tyranny of Two and Twenty, the Lash of Eight Percent

It seems unthinkable to emerging market investors that a fund should have anything but a European fund as a whole waterfall, with a one hundred percent escrow account and worst case release provisions, all with a garnish of personal guarantees. Unfortunately, this combination back ends carried interest distributions from here to eternity in even the best performing fund.[1] These terms are imposed slavishly in the toughest markets in the world despite the fact that in developed markets well performing GPs have moved to very different economics. Add to that the 8 percent compounding preferred return, apparently mandated by divine ordinance (again often varied in developed world funds and sometimes dropped altogether), and the fact that most funds are exposed to local currency markets but denominated in dollars, and it is no wonder that so few managers succeed in generating carried interest.[2]

The plus side of this is that investors are not going to be embarrassed by losing money while GPs make off with carry. And that is fine if embarrassment is really that bad, but I have a strong suspicion that these terms do deter management teams from entering the market. I am certain I would not sign up ten years of my life to pioneer private equity in a tough market on those terms, and more to the point the terms surely do not make sense in today's market if it is the mission of international finance development institutions to encourage economic growth. One of the most persistent complaints of emerging market investors is the lack of homes for their cash.

Avoiding embarrassment is all very well, but if the aim is to attract smart teams into the market and to provide real alignment, new thinking is needed. When a compounding 8 per cent hurdle on dollar-denominated drawdowns is added to the local currency effects, and the long road to exit of most emerging or frontier market investments (not many exit opportunities in, say, Easter Island), then carried interest can rapidly become unreachable even in a profitable fund. Then investors may find themselves with a portfolio managed by a disinterested team with no incentive to stick around except the management fee, which is often a meagre fare at best. Alignment is lost, another zombie fund is spawned. If zombies spawn.

## Plan B; Click the Ruby Slippers

There are lots of ways to incentivize managers and maintain alignment without being embarrassed as an investor. The eight percent preferred return on dollar drawdowns is a particular problem. Alternatives?

Perhaps a fixed hurdle; return 1.25 times drawndown capital, (perhaps 1.33? Perhaps 1.33 for capital held over six years?). The fund will still be in profit, so no embarrassment, but GPs will not be chasing a vanishing bogey.

Or perhaps a hurdle—based on the local currency returns of, say, the rate of inflation plus four percent regardless of dollar exchange rates. Arguably true performance. Yes, the fund might make losses in dollar terms, but the GP will be rewarded for success.

Another possibility is stepped carry. At 2 percent preferred return, pay 5 per cent carry, at 4 percent, 10 percent carry, at 6 percent, 15 percent, at 8 percent, 20 percent. Actually, my preference for carried interest would be to start sharing once the fund is in profit, paying some carried interest with no preferred return, but tiering upwards thereafter.

And if investors are serious about alignment and incentivization, why not get rid of the retention account. Clawback on European waterfall funds is rarer than polar bears will soon be. The added protection to investors from a retention account is minimal. Or if investors feel naked without an escrow account, be a bit daring and drop the amount retained to 25 percent. Clawback could be backstopped with a management company guarantee, if the manager has substance, or personal guarantees if not, but not joint and several and net of tax. (Although personal guarantees always seem a step too far.)

How about going truly daring, and for really tough emerging markets include an element of true deal by deal carried interest, say five percent with no clawback? This is not a frivolous suggestion. Many years ago a United Kingdom (UK) government quango was trying to get VC expertise into investing in recycling. The relevant body was made up of sophisticated people, and they knew the market was very tough and the fund very small. Even if it performed well, the absolute amount of carried interest would not be huge. With eyes wide open they agreed a substantial true deal by deal carried interest. As another example, UK GPs have occasionally offered investors the choice between funds with a standard fund as a whole 80/20 carried interest, and a pure deal by deal with a 10 percent carried interest (pure meaning no clawback or true up).

1. A worst case escrow release provision only allows money to be paid to the management team if they would still be entitled to it if all remaining investments had zero value and all undrawn commitments were drawn and lost.
2. A recent survey, the accuracy of which seems doubtful to me, claims over 20 per cent of funds have no preferred return. Whether or not that number is accurate, there is no doubt that successful managers have for a number of years been adding extra layers of carried interest, reducing or eliminating retention accounts and reducing or removing the preferred return.

> First time GPs need proper advice with realistic expectations, or the lawyers are just setting the client's expectations too high and starting their relations with their investors on a truly sour note."

## Skin in the Game

Obviously alignment has two components. Carried interest and the team's commitment of capital. All too often new teams are unable to invest significant amounts of capital, and one result of this is that if the carry proves unreachable and their co-investment is small, then there is nothing except perhaps pride (and the management fee, which may not be generous) keeping them on board. Perhaps a possible solution is for the investors to lend the team an element of the co-investment, with interest. A portfolio can still be profitable without hitting the hurdle and this could give some upside. (Of course there are issues that need thinking through, but they are not rocket science).

## Sweat or Sweet Equity

Another way to keep the team engaged might be a small strip of equity, at least in funds that have leverage available (although leverage is rare to nonexistent in many emerging markets). For those unfamiliar with sweet or sweat equity being used as a carried interest alternative it works by the GP team buying a strip of the equity in every deal, but none of the preference shares or shareholder debt put in by the fund, and benefitting from any external leverage. In other words economically they are typically in the same position as the investee company's team.

With leverage the equity strip will be valuable in a well performing deal, and wiped out in a poorly performing one. The advantage of this if combined with a regular carried interest is that if the fund cannot hit fund as a whole carried interest then the team can be incentivized to stick around by the carrot of a return on the sweet equity.

## When in Doubt Blame the Lawyers

If investors resemble the inflexible Tin Man then a lot of lawyers come closer to the brainless Straw Man, but without the charm. Or the heart. Although with better suits. Seriously, legal brethren and sisthren you are doing your client a disservice if you roll out your standard format "LPs are the unworthy serfs of the manager who need to be exploited for their own good" limited partnership agreement.

These agreements are often full of egregious provisions, pre clearing more conflicts than I ever imagined could exist and with assumed tax rates for tax distributions based on the highest marginal rate in any known or imagined galaxy, regardless of where the team are based. (Income tax on Tatooine is eye watering, apparently.) Etc. ad infinitum.

This is just not good lawyering and over the years it has produced a substantial backlash from any LP lawyers who actually read the documents, and also their clients, and rightly so. First time GPs need proper advice with realistic expectations, or the lawyers are just setting the client's expectations too high and starting their relations with their investors on a truly sour note.

On further thought, perhaps the lawyers resemble the Cowardly Lion. Full of bluster about market practice and how they always get these provisions, but eventually (after many chargeable hours) retreating once rapped on the nose by investors.

## Not in Kansas anymore

A great deal has happened in emerging markets which would not have occurred without DFIs being bold innovative investors, but now there definitely needs to be a recalibration of approach on the legal terms, both in economics and governance. A more thoughtful approach is desirable in both cases. Governance will be left for the next article.

The private equity model is not broken in the emerging markets, but it works much less well than in North America or Europe. Improving it requires only some thought and imagination, not the Wizard of Oz.

## About the Author

**John Daghlian** is Partner, Akin Gump Strauss Hauer & Feld LLP