The *Institutional Investor* Guide to

Investing in Alternative Asset Classes

Published in conjunction with

AIG Global Investment Group

Institutional Investor

An *Institutional Investor* Guide, Reprinted from July 2006

Primetime for Emerging Markets Private Equity

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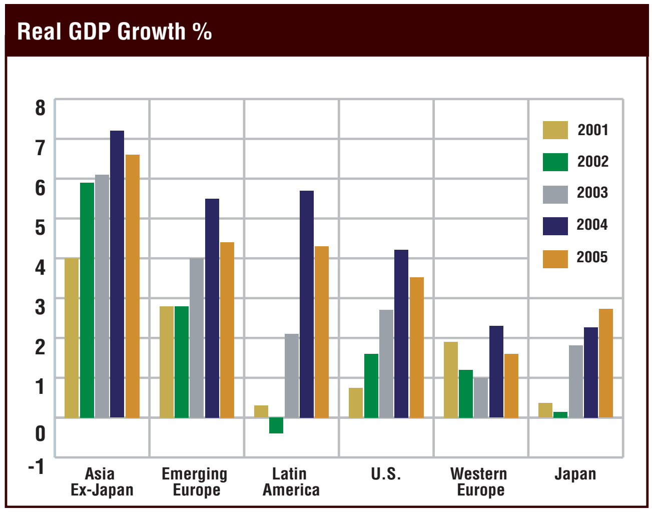
Imagine having the opportunity to invest on the ground floor with the young, innovative growth companies of the Industrial Revolution, or post-war Japan, or, more recently, China. One needn't imagine it, nor long for times past. This investment opportunity is available now in the form of Emerging Markets Private Equity (EMPE).

Why EMPE? Leaving aside for a moment the well known arguments related to rapid growth in GDP, trade, capital flows and so on, private equity provides investors with the unique opportunity to capture substantial market inefficiencies, where many high quality, successful growth companies are simply not listed…either by choice or circumstance…on public equity exchanges. PE allows one to work with these companies close to hand, structure the deals, create value and take them to the next level for an eventual exit, be it an IPO or a trade sale. Although there are substantial risks involved in emerging markets private equity investing, done right, exceptional returns over time are well within one's grasp.

Why EMPE now? Strong fundamentals and attractive valuations. As trade barriers have fallen, the inevitable result has been a flourishing trade environment (as seen in the rate of global growth over the past few years), one where the economics of imports/exports are being fully realized. Simply put, developed nations want lower cost manufactured and agricultural goods, along with cost efficient servicing and IT work. They also want new and expanding markets for their upstream products and services. Emerging nations are satisfying both needs, and in the process are creating wealth at a pace that few have experienced in years past.

Emerging markets are gifted with many fundamental strengths that are driving their rapid growth, among which are improved infrastructures, low cost/high quality work forces, low comparative tax burdens, rising per capita income and surging consumer demand for heretofore unavailable, or unaffordable, goods and services. There are others, to be sure. Naturally, this current economic vibrancy and future potential has attracted capital inflows originating from both developed and other emerging markets, a trend further reinforced by increasingly stable political systems and improved legal and economic environments via enforced government policy. Investors have benefited further from stronger corporate governance, improved shareholder and property rights, accounting standards, and greater operational transparency, to name but a few advancements in emerging regional fundamentals.

At the top of their respective pyramids, emerging economies are benefiting enormously from the engine that drives the economies of all nations: strong and growing consumer demand. More work, better paid work and ready markets for their goods and services are infusing local populations with



Source: Economist Intelligence Unit

disposable income on a scale previously unimagined. And they are spending it on everything from automobiles to washing machines to cell phones to Internet access and well beyond.

Many privately owned, local companies are and will be the primary beneficiaries of this economic boom. Like all businesses, they need capital—capital sorely lacking in most emerging markets—to maximize their potential. At present, forward thinking investors can obtain stakes in these emerging enterprises at quite compelling valuations. Those who invest private equity in these businesses and provide management expertise and other resources needed to grow and satisfy demand will benefit as their investments develop into market leaders that are either purchased at substantial premiums by strategic acquirers or make their way into the public investment arena.

Three emerging regions are particularly attractive.

Emerging Asia

In Emerging Asia, many PE opportunities are available owing to rapid export growth and the accompanying expansion of domestic consumption. Expansion or growth capital is amongst the most attractive situational genres in the region. This is because many of Emerging Asia's fastest-growing companies are owned and managed by first and second generation entrepreneurs who seek partners to grow their businesses to the next level and are less willing to sell control.

The manufacturing leadership model predominates in China, where quota constricted manufacturers have had to learn to be super efficient in order to survive. Among several advantages, China possesses a large, low cost manufacturing workforce that plays into an expanded trading range care of its recent acceptance into the World Trade Organization.

In India, the labor arbitrage model applies. Much of India's large, highly educated, low cost workforce is also proficient in English, making it a magnet for IT services and contract research. Other nations in Emerging Asia offer variations of both of these themes, with many also benefiting from abundant natural resources, growth in global tourism, and increasingly stable leadership.

Common strengths throughout the region include entrepreneurial cultures, a historical inclination to save, improvements in technology and productivity and modern infrastructures. Leading their advance is the ever important emergence of strong growth in local consumer income and related demand for goods and services.

Emerging Central and Eastern Europe

Emerging Central and Eastern Europe are following a different path to growth in the form of convergence with the European Union, with the attendant benefits of higher visibility within their respective legal, economic and political systems, and greater macroeconomic discipline imposed by the EU integration process. Countries there are major beneficiaries of a shift in manufacturing from Western to Eastern Europe, one facilitated by a low cost, educated workforce and major investments in improving the region's infrastructure. These changes are driving strong, long-term growth in GDP, in consumer demand and in the related production and distribution of products and services.

Here, the intense interest of multinationals seeking to enter Central and Eastern Europe through acquisitions promises many reliable exit strategies.

Emerging Latin America

Latin America offers close proximity to the U.S. market, along with large local markets, an improving economic and legal infrastructure, relative economic stability and declining interest rates. Many of the region's economies are beginning to flower as a result of its growing export trade with China, along with the rapid development and potential consolidation of its agribusiness and commodity sectors and, as in most emerging markets, growth in consumer income and demand.

A notable example is Brazil, the region's largest economy and one with a GDP per capita that is 3-4 times that of China. Brazil has a large and diverse consumer base (approx. 180 million), and strong competitive advantages derived from rich natural resources, low production costs, increasing domestic demand, improved access to credit, and others.

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Importantly, as with other promising emerging economies, Brazil is presently underserved by the private equity market, making it an opportune time for such investments.

Challenges

As with any high potential investment opportunity, Emerging Markets Private Equity investing involves risks best assumed by sophisticated investors well versed in emerging markets.

One is simply identifying opportunities. Although conditions have improved markedly in recent years, there remains in many cases a general lack of access to business networks, Western-style operational transparency and information about markets and companies. This can lead to mismatched expectations in the negotiation process and the outcomes of same. As such, local, on-the-ground experience, established relationships and close communications are keys to eventual success.

Another challenge is creating value in environments where corporate governance may be weak, legal networks may be less developed, and where financial and risk reporting may fall below Western standards.

There is also the risk of ultimately realizing value. Although improvements are occurring, realizations through IPOs are less predictable options at this time. One also has to take into account a general lack of liquidity in local capital markets, along with the effects of currency fluctuations and market volatility.

International institutional private equity investors with a strong local presence and an associated business network have an advantage in dealing with these challenges in that they have the local expertise needed to help these companies grow, the credibility to help attract suitable management talent and the international reputation required to support their ultimate listings, either domestically or overseas, for eventual exits.

Conclusion

We believe that the next five to ten years will witness explosive growth in Emerging Markets Private Equity, growth that will accrue to the benefit of "early adopters" in the investment community. Economic upheavals of this magnitude do not come without risk, but these are risks that can be managed through diligent, ongoing research, hands-on management assistance and commitment by all parties to the ultimate success of their respective ventures. To be sure, Emerging Markets Private Equity investing can be a difficult business, requiring substantial resources—both capital, experience and time; however, it can also be exceptionally rewarding business, one that can create superior returns over time. As such, it should be favorably considered within the framework of institutional portfolio construction and asset allocation decisions. For our part, we believe the best is yet to come. ■

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