REVIEW OF THE PRIMARY PROFITABILITY INDICATORS

FOR VENTURE CAPITAL INVESTORS

IN EMERGING MARKETS

by

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ABSTRACT

This study highlights the macroeconomic financial and regulatory indicators that researchers and investors primarily focus on regarding venture capital (VC) investing in emerging markets. It will review several of the more impactful research studies done on the topic over the past several years. This study will also use data sourced from the Global Private Capital Association (GPCA) as well as The World Bank to draw conclusions on the relationships between certain variables and their impact on VC investment into emerging markets. This study aims to reveal several findings. First, that the globalization of the private capital industry increased funds invested into nations that VC Investors previously considered non-viable. Second, that non-economic factors, such as regulatory status and control of corruption, are also important aspects for VC investors when choosing a market to enter. Finally, from 2017-2022, VC investors used specific financial indicators to select emerging markets in which to invest. This study provides insights for researchers and industry professionals to draw upon when analyzing possible indicators and methods to employ as they choose which emerging market to invest venture capital funds.

Introduction

As the world becomes more interconnected, and more nations are moving towards developed economies, foreign businesses are becoming more attractive as viable investment vehicles. However, with such a vast array of options, including which nation, industry, business size, type of investment, etc., investors must know where and how to invest their money to increase profits. This review aims to pool findings from recent literature in tandem with the opinions of industry experts and fund managers, and quantitative analysis on industry data from the last 5 to 10 years to answer these questions.

Many economists have researched international investment into the general stock markets of other nations. The majority of which focuses on the risks involved, such as Ooi Kok Loang's (2023) work. Some focus on the potential returns and performance as well, such as Vladislav Kargin's (2002) research into the predicted returns of value investing in emerging markets. This paper will examine the economic status of different emerging markets/regions and examine what common metrics they display that indicate they will or will not be profitable specifically to venture capitalism (VC) investors. In the world's rapidly changing global economy, profitable investment opportunities are easily missed, or businesses can appear to be sound investments but not produce satisfying returns. For that reason, understanding the proper indicators of both risk and profitability is essential. Through a review of the most relevant and current literature, as well as insights gained from interviews of fund managers and analysts who focus on emerging markets, this thesis aims to reveal the primary economic metrics that signal profitability to venture capitalism investors.

The literature will cover how modern investors and industry experts view and approach venture capitalism investment strategies in emerging markets. First, by reviewing literature on various aspects surrounding the topic and an examination of the current economic state of the most popular emerging markets for this type of investing. Next, the paper will inspect the most pertinent economic indicators for profitability, which guides investors to the specific market and industry in which they should allocate their funds. As with any major investments, much due diligence must be done by analysts as well as a deep analysis of potential risks. Finally, the article the review will identify the major risks associated with VC investment as a whole, and specifically as it applies to investments in developing markets. This paper aims to give readers a wholistic understanding of private investment in emerging markets and the current state of the industry

Literature Review

Referenced Data Sources

The economic landscape of emerging markets is everchanging, which naturally makes them a riskier selection for private investors. Much of the literature regarding economic status and aptitude to investors for specific nations is partially or completely outdated since the data is no longer relevant. However, investors and researchers can still draw insights into the most important economic indicators from previous data, even those that are seemingly obsolete. The Lauder Institute at the University of Pennsylvania, "The Lauder Global Business Insight Report" (2022), highlights the struggles of Latin American private investment given the current economic and political landscapes, but also identifies some areas where private equity (PE) and VC firms have experienced major windfalls and the factors that supported their success (Barrett-Johnson, Rollins, de Ry and Jacobs, 2022). These insights draw mostly from easily accessible global economic data found on databases such as the World Bank or the Emerging Markets Information Service (EMIS), the OECD, and others. The venture capitalism data has proven to be more difficult to find. Primarily due to the privacy and non-disclosure policies of many VC funds. However, databases such as MSCI, previously Burgiss, collect this specific sort of data. The previous literature on this topic references either the industry as a whole or a handful of specific funds that allowed authors access to their more sensitive earnings reports and business models. Orbis is another database that keeps up to date with current private equity and venture capitalism deals and movements around the world. These sources combined with the large array of global economic metrics available to researchers allow inferences to be drawn on a macro scale about private investment into all emerging markets, as opposed to drilling down onto one specific market.

Emerging Markets Economic Status

The Q3 2023 Emerging Markets Monitor reports that the current economic status of emerging markets is somewhat reflective of that of the current status of the United States. Rates and currency values continue to show large volatility and many fear recessions. However, the report also states that "growth, inflation and policy are quite divergent across the heterogeneous universe of countries we refer to collectively as 'emerging markets'. As such, we continue to expect markets to place an emphasis on differentiation amongst countries and credits" (Morgan Stanley Investment Management, 2023, p. 18). Even though flows have turned negative recently amid the Federal Reserve (Fed) tightening, it appears that a level of divergence among the emerging markets analyzed remains. This indicates that selectivity and differentiation will be key for any investors, particularly those dealing in venture investments. Global inflation has been a major concern following the pandemic. Supply chain disruptions and disorganization have caused prices to surge internationally, greatly affecting the emerging markets that already had somewhat unstable monetary policies. In Asia for example, economists expected recovery from the pandemic in 2023 for the ASEAN-5 economies (Indonesia, Malaysia, Philippines, Thailand, Vietnam) to be second in the region only to India in terms of expected real GDP growth of 4.9% (Butters and Rice, 2022). This expectation is somewhat misleading however, as investment and export growth drove growth and recovery in 2021 and rather than domestic consumption. Naturally, this was expected these nations that were so strongly hit by the COVID-19 pandemic. But it is an area to be mindful of for investors as they identify which industries they select within these nations. Lastly, the current state of the Chinese economy plays a major role in the analysis. As the second largest global economy that is still expanding, China offers significant potential upside to foreign investors. However, their GDP growth of just 3.2% in 2022 was the lowest for the nation in 40 years, excluding the 2020 COVID-19 shutdown. A decline in consumer confidence partnered with large loan loss and a 7% contraction in the real estate sector during 2022 have slowed the Chinese economy greatly over the past 2 years (Butters and Rice, 2022). The global emerging market economy is currently in a place of worse than preferred performance as nations fully move out of the pandemic. However, certain markets still offer great potential returns for private, foreign investment.

Regulatory Status in Emerging Markets with Regards to Venture Capitalism

Freedom to invest, trade, and grow business is essential for VC investors and can lead to certain markets becoming more lucrative than others. Research has shown that public policy that is favorable to foreign direct investment spurs innovation and business creation in emerging markets. Which primarily impacts nations classified as a “frontier emerging market”, a term coined by the “The Financial Times and the London Stock Exchange, FTSE Index” to describe markets that are still underdeveloped and have recently been identified as possible emerging markets. These frontier markets have fewer restrictions on businesses acquiring international funds. The foreign direct investment correlation with the number of quality entrepreneurial ventures was highest in frontier emerging markets according to a 2013 study that uses 35 different emerging markets (Herrera-Echeverri, H., Haar, J., & Estévez-Bretón, J. B., 2014). Implying that the increase in government interference into the ease and availability of securing foreign venture investment is most often a disincentive to entrepreneurs and innovative efforts.

However, the opposite of frontier emerging market theory can be true in the sense that many investors want to see stability in a nation before pledging a large amount of their funds to a business in that market. Favorable governance is a two-sided issue for venture capitalists. The frontier emerging markets allow investors to move funds relatively freely in and out of the market with the likelihood of larger returns over longer periods, if the timing of the entrance and exit is correct. On the flip side, these frontier markets increase the risk factor for foreign investors since the governments can be much more unstable and the economy is usually less developed. This risk adds to an already uncertain and unpredictable investment vehicle.

Current Risks Involved with Investing in Emerging Markets

As with any investment, it is required to understand all possible risks that investors are undertaking. Beyond the traditional risks of VC domestically, emerging markets present unique risks of their own. The five main risks identified by Samuel Enow in his research titled *Investing in Emerging Markets: An Empirical Comparative Analysis* are: economic and political conditions, currency risk, regulation, corporate governance risk, and liquidity (Enow, 2023). Though these risks may affect any business in any market, it appears that in emerging markets they are more likely to negatively affect investor returns. These five risk factors all correlated in the sense that each is a direct result of volatile governmental and economic atmospheres. Another example of why due diligence is incredibly important for VC investors when selecting a market and specific business. However, some specific characteristics about emerging market investment remain constant across the world. A comparative analysis done on the stock markets of emerging markets from 1990 to 2020 showed that emerging markets on average have had lower realized returns than those of developed nations over three decades (OECD, 2020). However, this study focuses only on stock market returns and is not necessarily indicative of the returns from private investment into specific businesses. Investors continue to allocate funds into emerging markets despite these risks, because they also offer a possibility of high returns over certain time horizons compared to those of developed nations (Cole, Melecky, Mölders & Reed, 2020). Persistence of returns has long been the target for venture capitalism fund managers, and if properly diversified, no indication exists that emerging market VC investing cannot overcome the aforementioned risk factors and produce persistent returns.

Venture Capitalism Trends/Focuses

For years, venture capitalist funds have attempted to identify the upcoming trends in industries and find markets that are about to make a large jump as far as economic growth. Recently one of these trends, especially as it pertains to emerging markets, has been sustainable investing with a goal of total economic development in the region. Sustainability is becoming increasingly important to consumers and investors not just in advanced economies but in all nations. According to an article published in *Sustainable and Responsible Investment in Developing Markets*, "sustainable investments reduce the long-run risk of a firm, improve its brand image and reduces contracting costs with various stakeholders" (Abor, 2023, p. 223). Venture capitalism investors constantly chase the next trend so that their investments produce long term returns. Sustainability will continue to be one of the more important and profitable factors to firms in the foreseeable future. Sustainability, so long as the firm still shows consistent financial returns, only adds to the positive reputation, and further diversifies a firm's customer base. Dedication to sustainable practices is an indicator of long-term potential upside for private investors as these investments "increasingly offer financial returns consistent for their asset class" (Emerson, 2011, p.8). Recent trends in VC have also greatly focused on innovation and technology. Fintech and crowdfunding ideas have been a newer focus for investors both domestically and abroad. In fact, behind sustainability they are the second largest frontier at the moment for venture capitalists according to the “Mapping the venture capitalism and private equity research: a bibliometric review and future research agenda” published by Douglas Cumming, et al., (2022). According to this research paper and review of the current literature on the topic “it is expected that the financing of business too will change and therefore the topics of fintech and internet-based funding such as crowd- funding seem to have emerged to transplant, in some part at least, the traditional sources of financing” (Cumming et al., 2022, p. 199). Recently, private equity research has followed similar topics of alternative financing and equity crowdfunding. The most commonly analyzed PE frontier by the research mapped in this article is private equity and strategy, specifically strategic management. The trends referenced above are merely some of the many trends observed in this space, however, they seem to be the most prevalent in the emerging market investment groups.

Summary of the Key Economic Indicators for Investors in Emerging Markets

Upon reviewing the literature available for this research, an abundance of findings exists on how foreign investment, including venture capitalism, effects the nation’s economy, with empirical evidence to support the findings. To the contrary, little is written on how investors originally chose in which emerging market to invest or on which industry to select and when. One report by Technavio (2023) focuses on markets around the world, both advanced and developing, and their outlook for private investment through 2027. This report aims to draw connections between specific economic indicators that venture capitalism investors can identify that generally indicate a market will be profitable. The report only gives small snapshots of each market, but it uses Porter’s Five Force Analysis to give a prediction on the global investment market, with an in-depth breakdown of each factor. The report claims that "the market dynamics for vendors were moderately challenging in 2022. They will remain unchanged during the forecast period" (Technavio, 2023, p. 43). The statistics used in this prediction are very broad, since the data is an aggregated analysis of the entire global market. However, the methodology is useful in this thesis to drill down on specific economic indicators for VC and their potential profitability in emerging markets.

In a study of the economic and bank factors' relationship to investor risk aversion in emerging markets, the IMF growth rate (Year-on-year per cent changes in constant price GDP projected by IMF) and GDP growth rate proved to be highly correlated with investor risk aversion (Loang, 2023). The markets used in that research were in southern and eastern Asia, but GDP movement was the main indicator looked at by investors across most emerging markets. Real interest rates were also a major indicator in India and Malaysia, this is especially important to VC investors as they have to consider the cost of funds needed to increase the profitability of the businesses in which they invest.

Size of the specific venture capital market for that region as well as emerging markets as a whole is another important factor when selecting a nation to invest. The market growth indicates interest in the region from foreign investors. Consistently increasing growth rates signify that the market is receptive to foreign private investment. From 2000 to 2013, the percent of total VC investment in emerging versus developed markets grew from 2.4% to 20.8%. The share of all funds grew 18.4% in just 13 years, reaching USD 9.8 billion in 2013 (Groh, A. P., & Wallmeroth, J., 2016). This growth was an initial indication to many investors and researchers of the potential for venture capital in emerging markets. It also allowed many fund and business managers to better time their entrance and exit events. The small window of opportunity for large windfalls is another reason why careful watch over market growth rates is crucial for VC investors.

Indicator Breakdown

The economic metrics explored in this thesis appear below. Each are some of the most commonly explored and referenced metrics used to signal a market's profitability possibilities for VC. *Note: Many of these economic indicators are referenced in multiple of the source materials of this article.*

INDEPENDENT VARIABLES

GDP Growth Rate: (Year over year growth rate of GDP in the value-added approach)

GDP growth rate is possibly the most commonly referenced and used economic indicator throughout the review of literature. GDP growth rate is a measure of the yearly increasing output of a nation. Analysts calculate this number by taking the most recent year's GDP, subtracting the previous year's GDP, and dividing the difference by the previous year's GDP. The formula is as follows: $(GDP_t – GDP_{t-1}) / GDP_{t-1}$. The GDP for each year comes from the World Bank.

Sources: Butters and Rice, (2022); Loang, (2023); Groh, A. P., & Wallmeroth, J. (2016); World Bank. (2024)

Inflation Rates: (yearly inflation rates of local currency)

Inflation rates are a strong indicator of current economic status, possible currency risks, and projection for potential economic growth. Analysts calculate inflation rates using pricing indexes, such as the consumer price index. The inflation rates for each nation were derived from the World Bank data base.

Sources: Raghutla, C., & Chittedi, K. R. (2021); World Bank. (2024)

R&D Expenditure: (amount spent on real sector devoted to research and development as % of GDP)

Authors findings indicated that R&D expenditure has a substantial positive impact on economic growth. R&D expenditure, as a percent of total GDP, allows analysts to better understand the level of sophistication and interest in VC within a certain market. The R&D expenditure data used in this study comes from the World Bank.

Sources: Raghutla, C., & Chittedi, K. R. (2021); Choi, C., & Yi, M. H. (2018); World Bank. (2024)

Control of Corruption Index: (perceived level of public sector corruption, percentile rank)

The corruption index is a measure of the regulatory climate in a nation based on expert assessments and opinion surveys. The corruption index ranks nations from 0-100, using an assortment of data points and tests. The result reflects how weak or strong a nation's control is over corruption within their government and economic system. This statistic helps investors better understand the climate of the markets they are debating entering. The control of corruption data is sourced from the World Bank.

Sources: Groh, A. P., & Wallmeroth, J. (2016); World Bank. (2024)

DEPENDENT VARIABLES

Venture Capital (% of GDP): (level of domestic output derived from VC investments)

This metric signifies the impact that VC investing has on a nation's annual economic production. Analysts calculate this number by dividing the venture capital expenditure for a certain year by the GDP of the nation that year. The simple statistic allows researchers to better grasp the current status of VC in the markets and analyze trends over previous years. The formula is as follows:

VC_t / GDP_t (Note: Variable "VC" stands for amount invested in VC activities for a given nation each year). This statistic comes from the GPCA for emerging markets and the OECD for developed nations.

Sources: Groh, A. P., & Wallmeroth, J. (2016); Global Private Capital Association, (GPCA). (2021 & 2023); Organization for Economic Co-Operation and Development, (OECD). (2022)

Market Growth Rate: (yearly growth of venture capital investments)

Market growth rate signifies growing trend in the industry and market receptiveness to venture capital investments focusing on emerging markets. This statistic is most helpful for identifying trends in VC and can show how changes in the previously mentioned independent variables effect the growth of the VC market in each nation. The formula to calculate is as follows: (VC_t – VC_{t-1}) / VC_{t-1} (Note: Variable "VC" stands for amount invested in VC activities for a given nation each year). The VC expenditure data comes from GPCA for developing nations and OECD for developed nations.

Sources: Groh, A. P., & Wallmeroth, J. (2016); Cumming, D., Kumar, S., Lim, W.M., Pandey, N. (2022); Global Private Capital Association, (GPCA). (2021 & 2023); Organization for Economic Co-Operation and Development, (OECD). (2022).

Methodology

This study aims to answer the question: What are the primary economic indicators in emerging markets that signal profitability to venture capitalism investors? This paper will aggregate findings from many research projects and the experiences of fund managers to find a viable and useful answer to this question. To achieve an appropriate and sound conclusion, many different approaches will be taken to answer the question.

This thesis begins with an extensive review of the literature surrounding the topic. This includes both literature that directly addresses this exact topic, as well as ones that include some aspect or unique combination of the topics addressed by the research question. For instance, a deep understanding of current trends in VC, no matter the market, is necessary to understand why investors employs certain strategies in emerging markets. Finding the most current information ensures that the findings are relevant to the modern investor landscape. However, this study will reference some older research that explores more fundamental aspects of private investment or foreign investing.

Finally, using the information found in the review of literature and the industry expertise, the research will analyze the economic metrics of several emerging markets to identify trends that have indicated profitability in the past through VC investment. An exploration of economic data from the World Bank and OECD will give current statistical, empirical backing to the conclusions drawn from the preceding review. Many economic metrics will be observed to inform the conclusion, but primarily focused on GDP growth as influenced by the research of Butters and Rice (2022), inflation rates from Morgan Stanley Investment Management (2023) and Raghutla, C., & Chittedi, K. R. (2021), Bribery & Corruption Index, Global Innovation Index (WIPO, 2023), Venture Capital (% of GDP) from Groh, A. P., & Wallmeroth, J. (2016).

These metrics seem to be the most relevant and provide a wholistic look at how other economic and regulatory factors of a nation affect VC investment.

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The most recent possible data was collected and used to search for correlation between favorable economic metrics and high profitability/interest among VC Investors.

Summary Statistics

Table 1:

Variable	Mean	Median	StdDev	25th Percentile	75th Percentile
Emerging Market Data 2017 - 2022					
GDP (current USDb$)	$682.42	$253.95	$2,197.42	$59.07	$412.26
GDP % Change YoY	5.42%	5.32%	7.47%	1.31%	9.48%
Inflation, consumer prices (annual %)	5.20%	4.06%	5.03%	2.39%	6.22%
Research and Development Expenditure (% of GDP)	0.90%	0.74%	0.60%	0.51%	1.42%
Control of Corruption: Percentile Rank	49.48	48.34	21.61	34.00	62.95
Emerging VC % Change (YoY)	29.34%	40.97%	54.17%		
Emerging VC (% of GDP)	0.24%	0.22%	0.09%		
Developed Market Data 2017 - 2022					
GDP (current USDb$)	$2,112.89	$660.70	$4,304.92	$395.35	$1,865.55
GDP % Change YoY	3.65%	3.26%	4.63%	0.80%	5.69%
Inflation, consumer prices (annual %)	2.33%	2.48%	0.92%	1.78%	2.95%
Research and Development Expenditure (% of GDP)	2.53%	2.62%	1.07%	1.48%	3.18%
Control of Corruption: Percentile Rank	88.09	92.11	11.69	83.38	96.71
Developed VC % Change	27.26%	9.45%	43.57%		
Developed VC (% of GDP)	0.34%	0.30%	0.12%		

Table 2 is an aggregate of the summary statistics and gives a snapshot of the economic and regulatory status of both emerging and developed markets from 2017 to 2022. Each statistical variable, mean, median, etc. was calculated from the yearly averages of each variable point from the market over the six years analyzed.

Results and Conclusion

Table 2:

	Emerging VC % Change	*Change in GDP (YoY%)*	*Inflation, CPI (annual*	*R&D expenditure*	*Control of Corruption:*
Emerging VC % Change	1.000				
Change in GDP (YoY%)	-0.686	1.000			
Inflation, CPI (annual %)	-0.068	0.126	1.000		
R&D expenditure	-0.055	0.227	-0.549	1.000	
Control of Corruption:	0.027	0.077	-0.570	0.407	1.000

Table 2 is a correlation matrix of the dependent variable VC % change with all independent variables, using a year fixed effect.

Table 3:

	EM VC (% of GDP)	*Change in GDP (YoY%)*	*Inflation, CPI (annual*	*R&D expenditure*	*Control of Corruption:*
EM VC (% of GDP)	1.000				
Change in GDP (YoY%)	-0.161	1.000			
Inflation, CPI (annual %)	0.345	0.126	1.000		
R&D expenditure	0.013	0.227	-0.549	1.000	
Control of Corruption:	-0.199	0.077	-0.570	0.407	1.000

Table 3 is a correlation matrix of the dependent variable VC % of GDP with all independent variables, using a year fixed effect as well.

This study also utilizes a panel regression with time fixed effect for each variable and all possible combinations of variables. Inflation was consistently the most significant variable, returning P-Values well under .1. These results were especially significant when inflation was analyzed using VC investment as a percent of GDP as the dependent variable.

These results signify the importance of all indicators when investors look into specific emerging markets in which to invest. Inflation was the most statistically significant in the regressions. Practically and theoretically this result makes sense as investors, though they may not care as much about R&D or GDP growth, certainly want to see stability in the economy to protect their investments. Currency stability is also a key in creating sustainable, profitable businesses, no matter the market. While more research on the topic certainly could and should be done by investment professionals and economist, several conclusions can be drawn from this study. First, that inflation rates play a major role in VC investor's decisions on which markets to enter and how much capital to invest. Also, that markets once thought of as "risky" or "dangerous" for investors have seen large amounts of new funds invested since they have created more stable and reliable economies, with upgraded technology. Venture capital investors see these markets for their large potential upside and recognize the untapped potential of many developing nations.

Further research in this area will certainly continue to pull back the curtain on what makes a market desirable to and most profitable for venture capital investors.

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