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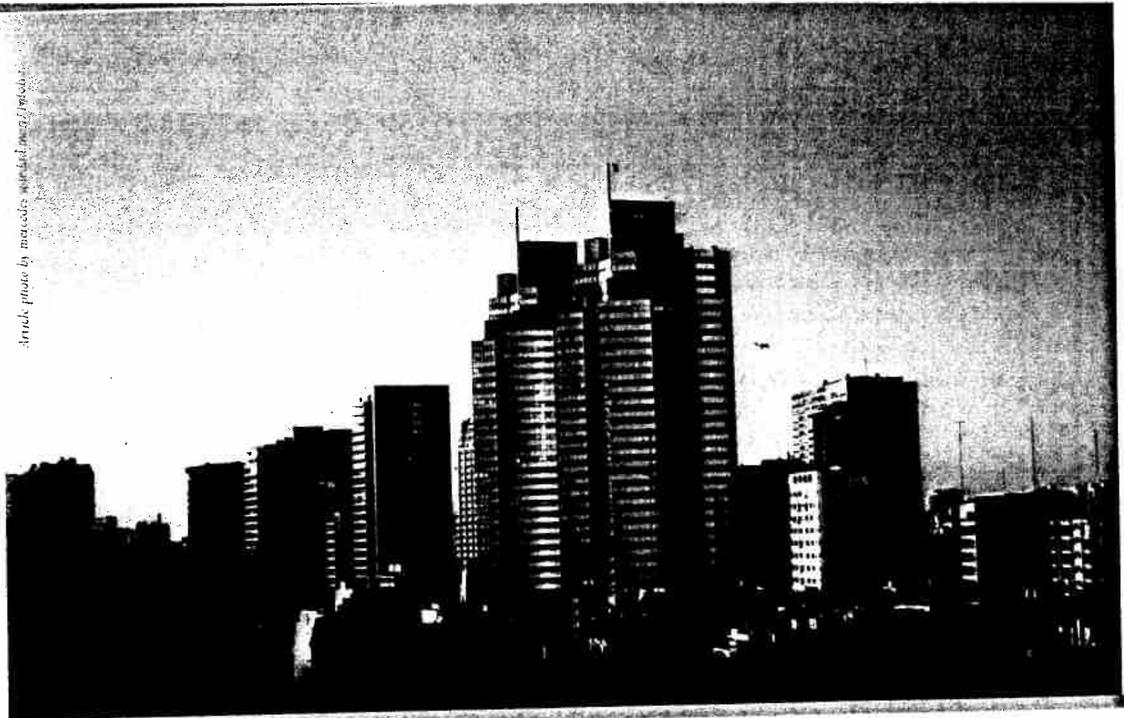
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Private equity in Latin America

Orlando Fernández of PLCCross-border examines recent developments in private equity investment in Latin America, outlines some key common characteristics of the Latin American private equity market and analyses legal and market developments in Brazil, Chile and Colombia.

With a couple of notable exceptions, private equity investors have traditionally been less active in Latin America than in Europe, the US and the major Asian economies. According to the Emerging Markets Private Equity Association (EMPEA), in 2009, Latin America accounted for:

- 10% of the US$22 billion (about EUR17 billion) raised by private equity firms for investing in emerging markets.
- 14.5% of the US$48 billion (about EUR37 billion) invested by private equity funds in emerging markets.
- 2% of the US$345.5 billion (about EUR270 billion) invested by private equity sponsors worldwide (*see EMPEA, EM PE Industry Statistics: Fundraising and Investment available at the EMPEA website* (*www.empea.net*)).

In addition, private equity investments in Latin America are heavily concentrated in a few jurisdictions. Based on data by the Latin America Venture Capital Association (LAVCA), an organisation representing the region's private equity community, 45% and 14% of all private equity transactions in Latin America during 2009 took place in Brazil and Mexico respectively (*see LAVCA, Press Release, Latin American Investment Activity Strong in 2009 with Positive Outlook for 2010* (*www.lavca.org*)).

There are, however, signs that private equity activity could surge in Latin America in the near future. 58% of private equity houses surveyed for a KPMG report published in April 2009 stated their intention to increase their presence in the region between 2010 and 2012 (*see KPMG, Insight Latin America: A guide to the future of Private Equity for investment professionals*) (*KPMG Report, available at www.kpmg.com*).

A survey of institutional investors, published by Coller Capital and the EMPEA in April 2010, ranked Brazil as the world's second most attractive emerging market after China. The same survey ranked the rest of Latin America in fifth place, ahead of central and eastern Europe, Africa, the Middle East and the CIS (*see Coller Capital/EMPEA, Emerging Markets Private Equity Survey 2010, available at www.collercapital.com*) (EMPEA survey).

International private equity sponsors are also beginning to look beyond Brazil and Mexico and into countries like Chile, Colombia and Peru, which have experienced steady economic growth, improved political stability

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and enacted investor-friendly legislation in recent years. 23% of general partners (GPs) interviewed for a Deloitte survey published in July 2009 said they expected Colombia to see the most deal activity out of all Latin American countries during 2010. 14% predicted that either Chile or Peru would be the region's dealmaking hotbed (*see Deloitte, Latin American Private Equity Confidence Survey, available at www.deloitte.com*).

Against this background, this article examines the Latin American private equity landscape. In particular, the article:

- Overviews recent developments in private equity investment in Latin America.
- Outlines some key common characteristics of the Latin American private equity market and highlights current regional trends.
- Analyses legal and market developments in Brazil and the increasingly popular investment destinations of Chile and Colombia.

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Recent developments

Although international private equity houses are currently showing increasing interest in Latin America, this is not their first incursion into the region. As Richard Cooper, a partner at *Cleary Gottlieb Steen & Hamilton* recalls, "we were already advising private equity firms in Latin America back in the mid-1990s. For instance, in 1995, we acted for TPG Capital (then called Texas Pacific Group (TPG)) on the establishment of the US$300 million (about EUR233 million) Newbridge Capital's Latin America Fund (TPG was an original co-founder and co-owner of Newbridge)".

"By the mid-90s", Cooper continues, "there were several big private equity sponsors active in Latin America, including Carlyle, KKR, CVC International, HM Capital Partners (then called Hicks Muse Tate and Furst (Hicks Muse)) and Advent International (Advent). However, due to economic turmoil in the region in the late 1990s and early 2000s, the returns on many of these sponsors' Latin America funds were unsatisfactory, which caused some of them to leave". For instance, Argentina's economic meltdown in 2001 led to bankruptcies and defaults in several of Hicks Muse's portfolio companies in that country, which undermined investor confidence. As a result, Hicks Muse's second Latin America fund raised US$150 million (about EUR120 million) out of an initial target of US$1.5 billion (about EUR1.2 billion) at its first closing. These setbacks caused Hicks Muse to partially retreat from the region in August 2001.

As Cooper explains, between late 2001 and 2008, private equity activity in Latin America was sporadic and mostly confined to a couple of players such as Advent. However, in the past two years, sponsors have rekindled their interest in the region.

Key characteristics of market and regional trends

Although some jurisdictions have a larger and more developed market than others, Latin American private equity has some key common characteristics. These include:

- The way funds are structured and the jurisdictions where they tend to be domiciled.
- The kind of transactions taking place.

Fund structures

The Cayman Islands limited partnership is the most popular structure among foreign private equity firms looking to invest in more than one Latin American jurisdiction. Examples of funds that have been set up as Caymans limited partnerships include:

- All five of Advent's Latin American private equity funds (LAPEFs).
- A US$1.3 billion (about EUR1 billion) fund raised by GP Investments in 2007.

According to Martin Litwak, head of investment funds and wealth structuring at *Ferrére Internacional* in Uruguay, private equity sponsors sometimes structure their Latin American funds as British Virgin Islands (BVI) limited partnerships, which can be more suitable for funds that have more than 15 investors, have a minimum subscription requirement of less than US$100,000 (about EUR79,000) and do not plan to list on an approved stock exchange (see *LAVCA, Domiciling Latin American PE Funds*).

Litwak further notes that private equity sponsors investing in Latin America occasionally domicile their funds in Bermuda, the Bahamas and the Channel Islands. They have also recently started looking into Ireland and Luxembourg but generally regard these jurisdictions as too expensive and heavily regulated.

In addition to the more "typical" offshore structures highlighted above, there are other alternatives, such as the Ontario limited partnership, which was used by both Aureos Capital for its US$140 million (about EUR109 million) Latin America Fund, and vSpring Capital for its recently raised US$150 million (about EUR114 million) Alta Ventures Mexico Fund I.

Over the past two decades, jurisdictions such as Brazil, Chile and Colombia have introduced legislation authorising and governing the establishment of domestic private equity and venture capital funds. These structures are popular among local private equity firms, but can also serve as pass-through entities for offshore-domiciled funds investing in a specific jurisdiction.

Institutional investors. Foreign private equity houses active in Latin America raise their capital from institutional investors in North America, Europe and, increasingly, Asia and the Middle East. Advent International's US$1.65 billion (about EUR1.28 billion) fifth Latin America fund (LAPEF V), the biggest fund ever raised for the region, provides a useful insight into the complexion of a Latin American fund managed by an international sponsor. Out of LAPEF V's reported 51 investors:

- 56% were North American, including the Pennsylvania State Employees' Retirement System and Washington State Investment Board.
- 25% were European.
- 19% were Middle Eastern, Asian and African.

FROM THE OUTSET, SPONSORS OPERATING IN LATIN AMERICA NEED TO THINK ABOUT HOW TO STRUCTURE THEIR INVESTMENTS IN A WAY THAT MINIMISES THE TAX IMPACT OF AN EXIT FOUR OR FIVE YEARS DOWN THE LINE, WHICH REQUIRES CONSULTATION WITH LOCAL LAWYERS AND TAX SPECIALISTS.

Notably, LAPEF V was also the first ever LAPEF fund to receive a commitment from a South American pension fund, which suggests that recent regulatory changes allowing Latin American institutional investors greater flexibility to invest in private equity are beginning to have an impact (*see below*).

Current trends. The effect of the financial crisis on private equity fundraising was less acute in Latin America than in other parts of the world. According to LAVCA, fundraising in the region fell by 43% to US$3.6 billion (about EUR2.71 billion) in 2009, compared to a fall of 61% worldwide.

Commentators believe that Latin America is poised to benefit from the current wave of interest in emerging economies. According to the EMPEA, private equity firms raised US$11 billion (about EUR8.4 billion) to invest in emerging and frontier markets in the first half of 2010 (H12010), US$2 billion (about EUR1.6 billion) more than in the equivalent period in 2009.

Private equity transactions

Latin American private equity transactions tend to consist of growth capital investments and mid-market buyouts of companies seeking expansion or facing liquidity or succession issues. According to LAVCA, in 2009:

- Early-stage investments accounted for 17% of all transactions.
- Expansion stage and development capital transactions made up 38% of investments.
- Buyouts comprised 12% of deals.

The number of development capital transactions is partly due to the prevalence of family-owned businesses in Latin America's corporate landscape. For instance, over half of the 200 largest companies on the São Paulo Stock Exchange (BM&FBOVESPA) are family-owned (*see box, Investing in family-owned companies: structuring considerations*).

The average value of a Latin American private equity transaction ranges from US$23 million (about EUR18 million) in Chile, to US$75 million (about EUR59 million) in Brazil (although buyouts in the billion dollar range have taken place in the latter (*see below, Brazil*)). In comparison, the value of the average UK private equity-backed buyout in the first half of 2010 was around US$141 million (about EUR111 million) according to Barclays Private Equity (BPE) (*see BPE press release, UK Buyout Value Overtakes 2009 by 45% in First Half of 2010 (www.bpe.com)*).

Low leverage. According to Cooper, the lack of highly leveraged buyouts (LBOs) is a feature of Latin American private equity: "Even in the current climate, it is not unusual for an LBO in Europe or the US to have a 70:30 gearing ratio. This is certainly not the case in Latin America where deals are leveraged very conservatively, if at all". There are a number of reasons for the inability of private equity sponsors to raise large amounts of debt finance for their Latin American acquisitions: these include smaller deal sizes, regulatory and tax obstacles making it harder to raise debt finance in certain markets and, most importantly, greater risk perceptions among lenders (without a commensurate benefit in terms of pricing, commitment and other fees).

Cooper further notes that, when debt is raised in Latin American deals, "it is often in the form of vendor finance as opposed to third-party bank loans, which tend to be subject to shorter maturities and higher amortisation than high yield deals in Europe or the US, either in the Term B loan syndication market or high yield bond market, and are therefore far less prevalent. Likewise, bonds are hardly used in Latin American acquisition finance".

The relative lack of leverage has an impact on both risk and returns. Latin American private equity funds have to put more of their own equity capital at risk, usually in exchange for lower internal rates of return (IRRs) than their European and US counterparts. Conversely, notes Cooper, "the lack of high gearing gives investors greater flexibility to withstand volatility, which is always greater in emerging markets, and to cope with sudden economic fluctuations or changes to the law".

Tax considerations. As Cooper explains, funds investing in Latin America need to devise tax-efficient ways of repatriating their future profits as early as possible in the transaction, especially if there is a possibility that capital gains tax (CGT) might be levied locally.

He notes: "From the outset, sponsors operating in Latin America need to think about how to structure their investments in a way that minimises the tax impact of an exit four or five years down the line, which requires consultation with local lawyers and tax specialists".

Current trends. The global economic downturn's impact on Latin American M&A was less dramatic than in Europe or the US, partly due to the region's conservative approach to leverage (*see above*). While worldwide private equity deal values dropped by 55% in 2009, Latin American transactions fell by 29% to US$3.3 billion (about EUR2.4 billion).

As in the case of fundraising, commentators believe that Latin America stands to benefit from the emerging market M&A rally that has been taking place during 2010. According to Dealogic, as at September 2010, there had been US$575.7 billion (about EUR441 billion) worth of emerging market M&A transactions accounting for 30% of global deal volumes (and, for the first time, surpassing Europe, whose share fell to 29%). LAVCA president Cate Ambrose predicts that Latin America private equity-backed M&A could reach a three-year high by the end of 2010.

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According to Cooper, "most deal activity continues to take place in Brazil. However, jurisdictions like Peru and Colombia, which are on an upward trajectory in terms of opening up to private investment and GDP growth, are also attracting increasing interest". In addition, regulatory initiatives in Mexico such as the introduction of SAPIS (*Sociedades Anónimas Promotoras de Inversion*) and CKDs (*Certifcados de Capital de Desarollo*) may, over time, hasten the development of a more active private equity market, as international investors seek to raise capital from Mexico's pension funds (AFORES) (*see box, Recent reforms to the Mexican pension system*). Conversely, there has been a decrease in activity in Argentina lately, partly as a result of various interventionist initiatives by the current government. Cooper believes that, depending on the outcome of the October 2011 presidential election, Argentina could, once again, attract overseas private equity money in the near future.

Latin American private equity-backed businesses span a wide array of sectors including agribusiness, retail and real estate. But as Cooper explains, with

the exception of some sector-specific investors like Ashmore's AEI and First Reserve, private equity sponsors tend to stay away from heavily regulated industries such as utilities, where there are often additional layers of complexity and risk to be considered, such as the possibility of political intervention or a sudden shift in tariffs, which can make it complicated to time an exit.

Brazil, Chile and Colombia: legal and market developments

The remainder of this article examines market and regulatory developments in the following jurisdictions:

- Brazil, which combines the region's most dynamic private equity market with a favourable legal and tax regime.
- Chile, which, according to LAVCA, has the best business environment in the region.
- Colombia, where recent reforms have stimulated the emergence of a domestic private equity market and attracted increasing interest from overseas investors.

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Brazil: a vibrant market

Brazil has the most active and mature private equity market in Latin America. As Francisco Müssnich, senior partner at *BM&A - Barbosa Müssnich & Aragão*, notes: "Due to economic growth and unexpected performance during the crisis, Brazil has received substantial private equity capital from non-resident investors over the past few years. In addition, the prospective infrastructure boom arising from the sports events that Brazil will host over the next six years (the 2014 World Cup and 2016 Olympic Games), which JP Morgan Brazil's Investment Trust estimates could reach US$50 billion (about EUR39 billion) by 2014, has further increased the potential for new private equity investment". *BM&A - Barbosa Müssnich & Aragão* recently acted as Brazilian counsel for Carlyle in the Qualicorp buyout and Apax in its Tivit investments.

Based on data by the Brazilian Venture Capital Association (*Associação Brasileira de Private Equity & Venture Capital*) (ABVCAP), as at late 2008, there were 132 active private equity funds in Brazil. Although many are managed by foreign entities, domestic firms such as GP Investments and Gávea Investimentos are as active as overseas players.

In terms of recent private equity-backed M&A activity, in 2009, Brazil accounted for:

- 79 of the 176 private equity transactions that took place in the region.
- US$2 billion (about EUR1.6 billion) of the US$3.27 billion (about EUR2.6 billion) invested by private equity funds in the region.

The first nine months of 2010 have witnessed several buyouts of Brazilian companies by foreign sponsors. These include:

- The Carlyle Group's acquisitions of Qualicorp, a Brazilian health services provider, for US$1.2 billion (about EUR912 million) and Scalina, Brazil's largest manufacturer of women's lingerie, for US$160 million (about EUR125 million).
- Apax Partners's US$921 million (about EUR720 million) acquisition of a 54.25% stake in Tivit, a Novo Mercado-listed IT and outsourcing company, the first Brazilian deal by a UK-based private equity firm since 1995.
- Actis's acquisition of a minority stake in Companhia Sulamericana de Distribuição (CSD), a supermarket chain operator, for US$58 million (about EUR45 million).

In September 2010, the US$4 billion (about EUR3 billion) acquisition of Burger King by 3G Special Situations Fund II (a vehicle controlled by New York-based private equity fund 3G Capital) was announced. Although not a Brazilian acquisition as such, 3G is backed by several Brazilian investors.

Some market participants predict that an influx of foreign capital over the coming years will give further impetus to Brazil's private equity industry. For instance:

- Respondents to the EMPEA survey expect Brazil to experience the largest increase in new investors of all emerging markets over the next two years.
- ABVCAP president Sidney Chameh believes that Brazil-based private equity funds could raise up to US$15 billion (about EUR12 billion) by mid-2011 (see *Reuters, Private equity sees Brazil fund raising at $15 bln* (*uk.reuters.com*)).
- The Private Equity Research Center at the Getúlio Vargas foundation (GVF-CEPE) estimates that private equity could account for 3.5% of Brazilian GDP in six years' time (compared to 1.7% as at 30 June 2008).
- Smith & Williamson, a UK financial services advisory company noted in a recent report commissioned by UK Trade & Investment (UKTI)

that, despite the recent surge in Brazilian deal activity, the country's potential for private equity investment remains relatively untapped (*see UKTI press release, Brazil private equity reaches critical mass, but many opportunities untapped* (*www.ukti.gov.uk*)).

Legal and regulatory landscape

The 2010 edition of the LAVCA Scorecard, an annual ranking of the business environment in 12 Latin American jurisdictions from a private equity perspective, ranked Brazil in second place, one point behind Chile (*see below, Chile*) (*see LAVCA Scorecard 2010*).

Some of the most appealing aspects of the Brazilian legal landscape include:

- A number of tax-efficient domestic fund structures.
- Access to domestic institutional investors.
- A wide range of exit options, including initial public offerings (IPOs).
- Increased commitment to transparency and international best standards.

Domestic fund structures. As Luís Loria Flaks, a lawyer at *BM&A - Barbosa Müssnich & Aragão* notes, non-resident private equity investors can either acquire the shares of a Brazilian company directly or invest in units in a Brazilian private equity fund, the most common of which are:

- Venture capital funds, known as *fundos mútuos de investimento em empresas emergentes* (FMIEEs).
- Private equity funds, known as *fundos de investimento em participações* (FIPs).

FMIEEs are governed by Normative Instruction 209 (*Instrução Normativa 209/94*), which was issued by the *Comissão de Valores Mobiliários* (CVM), Brazil's financial markets regulator in 1994. FMIEEs are generally used for seed capital to second-stage expansion investments and have the following key characteristics:

- They are closed-ended partnerships.
- They are limited to 35 investors and subject to a ten-year term, renewable once for a further five years.
- They can be managed by authorised individuals or legal entities.
- They can only invest in companies (public or private), which cannot:
  - have an annual net revenue above BRL150 million (about US$75 million) on the date of the first investment; or
  - be part of an economic group whose consolidated net worth exceeds BRL300 million (about US$150 million).

Investing in family-owned companies: structuring considerations

Investing in businesses with an unbroken tradition of family ownership, which are common in Latin America, can create difficulties for private equity houses, such as initial opposition by the company's majority shareholders. For instance, according to media reports, the buyout of *Frango Assado* (a chain of Brazilian restaurants) by the International Meal Company (IMC) (an investment vehicle controlled by Advent) took 18 months of negotiations, partly as a result of initial reluctance by the Mamprim family, *Frango Assado*'s previous majority shareholders, to cede control of the business.

In addition, the ownership structure of most Latin American companies means that private equity investors need to ensure that the acquisition documentation clarifies the relationship between them and the original shareholder(s) regarding issues such as:

- Governance and board composition.
- Financial decision making.
- Day-to-day management.
- Dispute resolution mechanisms.
- Minority shareholder protection.
- Exit strategies.

The Carlyle Group's acquisition of a 63.6% stake in *CVC Brasil Operadora e Agencia de Viagens* (CVC), Latin America's largest tour operator, shows the kind of compromise arrangements that sponsors can enter into when making this type of acquisition. Carlyle acquired its stake in CVC from the company's founder and chairman Guilherme Paulus. The resulting deal carved up the different companies in the CVC group, enabling Paulus to retain control of an airline, hotel management business and advertising agency. Paulus also retained his position as group chairman and kept a minority stake in the holding company.

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FIPs, which are regulated by Normative Instruction 391 (*Instrução Normativa 391/03*), have the following features, according to Müssnich and Flaks:

- They are closed-ended investment funds.
- They can only be managed by legal entities.
- They can invest in any company, regardless of its revenue or net worth, but must participate in its decision-making.

To be eligible for investment by an FIP, companies must abide by certain governance standards (for example, referring all corporate disputes to arbitration).

As Fabiana Gouveia, a tax lawyer at *BM&A - Barbosa Müssnich & Aragão* notes, "investing in an FIP can give rise to several tax benefits. For instance, FIPs are exempt from tax on acquisitions and disposal of Brazilian assets".

In addition, Law 11312 (*Lei 11312/06*) reduced the rate of withholding tax on "income distributions" by an FIP (which includes both distributions and capital gains earned on the sale of an interest in the FIP) to non-resident investors to zero. To benefit from this exemption, non-resident investors and the FIP must comply with certain requirements. For example, 67% of the FIP's portfolio must be in shares, convertible debt instruments or subscription bonuses. Non-convertible debt instruments cannot make up more than 5% of the portfolio.

"The popularity of FIPs among non-residents has grown in recent years due to their tax advantages", note Müssnich and Flaks. FIPs and FMIEEs account for 39% of private equity and venture capital funds in Brazil by committed capital. Limited partnerships account for 34%. Other types of fund and corporate entity make up the remaining 27%.

Access to local institutional investors. Brazilian pension funds play a major role in Brazilian private equity fundraising, accounting for nearly a quarter of the capital raised by such funds.

In September 2009, the National Monetary Council (*Conselho Monetário Nacional* (CMN)) adopted Resolution 3792 (*Resolução 3792*), which allows closed pension funds (*Entidades Fechadas de Previdência Complementa* (EFPCs)) to invest up to 20% of their assets in structured CMN-approved investment funds, such as private equity and venture capital funds (if they are investing in either real estate or overseas-based funds, the cap is set at 10%).

Range of exit options. According to Fabíola Augusta de Oliveira Bello Cavalcanti, a finance and capital markets partner at *BM&A - Barbosa Müssnich & Aragão*, the fact that the BM&FBOVESPA is the world's tenth largest stock exchange by market capitalisation gives Brazil a competitive advantage, as it gives investors an exit route that is not commercially feasible in other Latin American jurisdictions (14% of respondents to the EMPEA survey identified "weak exit environments" as one of the reasons deterring them from investing in Latin America). The existence of the *Novo Mercado*, a listing segment in the BM&FBOVESPA where companies must adhere to strict corporate governance standards, can be particularly appealing to venture-backed companies.

Proposed code of best practice. At the time of publication, ABVCAP and the Brazilian Association of Financial and Capital Market Entities (*Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais* (ANBIMA)), a national association representing financial services businesses, were developing a code of best practice for private equity funds (*Código de Regulação* e *Melhores Práticas de FIP e FIEE (Fundos de Investimento em Empresas Emergentes)*) (Code). The Code will establish guidelines and transparency rules to be observed by Brazilian private equity players in line with internationally recognised best practice. As Müssnich and Flaks explain, "the Code's key purpose is to facilitate oversight of private equity funds, which will strengthen investor protection". They hope that adherence to the Code, which will be mandatory for ABVCAP and ANBIMA members carrying out private equity-like activities, will further boost the industry's reputation in Brazil and attract further investment.

Chile: strong business environment

According to the 2010 LAVCA Scorecard, Chile has the best business landscape for private equity investment in the region. However, despite Chile's regulatory and judicial probity, its private equity market remains modest. Chile accounted for just 8% of the region's investment in 2009. Practitioners attribute these relatively low levels of activity to several factors, and in particular to:

- Smaller average deal sizes and, correspondingly, exit options.
- A smaller population (16 million) than Brazil (191 million), Colombia (45 million) or Mexico (111 million).
- High taxes levied on non-resident investors.