

Latin America PE Roundup

Latin America PE Roundup is a series from Ernst & Young focusing on private equity (PE) activity in this important developing economy.

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Private equity update

Overview

Interest in Latin America has continued to accelerate in recent months, driving increasing activity from local funds and global firms alike. Fund-raising prospects for Latam (Latin American)-targeted funds remain strong, with significant new funds being raised and even more in the pipeline providing the capital necessary for high-quality opportunities. Transaction activity is also robust, especially in the financial services space in Brazil, where global banks and investment managers have taken stakes in regional institutions with deep local experience and extensive networks of connections. Other global PE firms are cementing their commitment by setting up local offices for the first time.

In Brazil, continued strong GDP growth and high nominal interest rates means the specter of rising inflation continues to loom large in policy-makers' decisions, prompting measures to curb the influx of short-term capital into the country. Broader concern about rising valuations is leading some firms to expand their activities outside of Brazil to other Latam countries, notably Colombia, Peru, Chile and Mexico.

Despite macroeconomic anxieties, interest in the region continues to rise, as exemplified by sold-out conferences and growing attention from both general partners (GPs) and limited partners (LPs). Latam has moved from a niche "nice-to-have" portfolio holding to a critical pillar of LP's diversification models. LPs see in the emerging markets many of the characteristics that attracted them to the PE asset class in the first place – chiefly, the opportunity to earn returns that are better than public markets, especially in developed economies. As 2011 continues, we expect this wave of interest to translate into greater activity across the space, including fund-raising, transactions and exits.



Macroeconomic and policy update

Growth rates set to moderate after a strong 2010

Average GDP across the Latam region grew an estimated 5.7% in 2010, driven in large part by higher-than-expected private consumption fueled by a rapid recovery in job growth and wages and increased lending to the private sector. Domestic demand grew by 9.6% across the region, with many economies posting double-digit gains, including Brazil, Peru and Chile. Unemployment has continued to trend lower, dropping from 10.0% to 9.4% across the region.

With such tremendous growth in 2010, economists expect rates to moderate over the coming year, as the impacts of a sluggish recovery in developed markets, especially in Europe, and the necessity of monetary tightening across Latam's fastest-growing markets assert themselves.

Inflationary pressures are expected to see continued hawkishness from Latam's central banks. In Brazil, inflation closed out 2010 at 5.9%, more than 1.4% above the midpoint of the Brazil Central Bank's (BCB) target range, leading Brazil to raise the benchmark Selic rate by 50 basis points in January, to 11.25%. On 2 March, BCB raised the rate again by another 50 basis points to 11.75%. Colombia recently raised its target rate by 25 basis points, and Chile and Peru have taken similar steps.

PE welcomes clarification on Brazil's foreign capital rate increase

In Brazil in particular, global investors have continued to seek fixed-income investments as a remedy for depressed interest rates across the developed markets, prompting regulators to take steps to curb the influx of short-term capital in order to counter upward pressure on the real. In October, the Government raised the tax on foreign exchange transactions (IOF/FX) twice, from 2% to 6%. Originally intended to stem the flow of speculative investments into short-term bonds and other capital markets transactions, the policy specifically excluded investments in Brazil's stock markets and variable income securities but made no mention of PE funds.

For this reason, PE investors in Brazil breathed a sigh of relief in January when the Government issued Decree 7412, which effectively reverted the IOF rate back to the original 2% on Fundos de Investimento em Participacoes (FIP) vehicles and venture capital (VC) investments in emerging companies. Economists expect the Government to continue to take a tough anti-inflation stance in 2011, which could result in additional steps to curb speculative investments in real-denominated assets. However, by excluding PE funds from the recent increases in foreign exchange conversion taxes, regulators have telegraphed an understanding of the long-term and beneficial nature of PE investment.

Fund-raising

Encouraging signs from funds on the road

LP interest in Brazil and the rest of Latam is translating into new commitments for local, regional and global funds. Underscoring rising interest in the region, two Latam-targeted funds rounded out the top 10 largest buyout funds closed in 2010 – Southern Cross' Fund IV and Advent's Latin America Fund V – each with approximately US\$1.6b in commitments. According to EMPEA, Latam-targeted fund-raising closed out 2010 with US\$5.6b in new commitments, an increase of nearly 150% over 2009 levels.* Compared to a decrease of 26% in global PE fund-raising levels, Latam fund-raising is clearly recovering at a significantly faster rate than global averages.

The near-term outlook for 2011 is extremely positive, and there remains a strong pipeline of funds currently in the fund-raising stage. The largest of these is Gavea's targeted US\$1.5b Fund IV. Other funds currently raising assets include Patria's US\$1b infrastructure fund, P2Brasil, Angra Partners US\$500m growth capital fund and The Carlyle Group's US\$500m buyout fund.

* Includes Caribbean-targeted fund-raising



Transactions

2010 marks second-best year in a decade

According to EMPEA, 2010 saw US\$6.6b in aggregate PE deals by Latam-targeted firms, a remarkable 404% increase over 2009 levels. Brazil received the majority of this investment, accounting for 70%, with US\$4.6b in new deals.

Global firms acquire local stakes in Brazil

Among the most interesting news in the Brazilian PE space in recent months is the acquisition by global firms of stakes in some of Brazil's most respected asset managers. In September, The Blackstone Group announced that it had acquired a 40% stake in Patria Investimentos. In October, Highbridge Capital, the hedge fund owned by JP Morgan Chase, acquired a majority stake in Gavea Investimentos. Gavea, which has approximately US\$6b under management, was founded by former central bank Governor Arminio Fraga. And in December, a consortium led by JC Flowers and including sovereign wealth funds GIC, China Investment Corporation and Temasek, acquired a 19% stake in BTG Pactual for US\$1.8b in the largest Brazilian deal of its kind.

In an era of accelerating globalization, especially in the asset management space, the acquisitions give global managers like Blackstone and JP Morgan an immediate and significant footprint

Figure 1: Top announced transactions over the last six months

Company	Date	Deal size (US\$m)	Sponsor	Country
Banco BTG Pactual	6 Dec 10	1,800	JC Flowers	Brazil
Gavea Investimentos	27 Oct 10	440	JP Morgan	Brazil
Transportadora de Gas del Interior	17 Dec 10	400	Citigroup Private Equity	Colombia
Odebrecht	19 Oct 10	400	Temasek	Brazil
Omega Energia Renovavel	22 Sep 10	202	Warburg Pincus	Brazil
Patria Investimentos	29 Sep 10	200	Blackstone Group	Brazil

Source: Dealogic; excludes add-ons

in one of the fastest growing markets in the world, as well as access to the robust networks of local connections, critical for sourcing and completing transactions. For Patria and Gavea, partnering with global firms brings access to significant financial and operational resources, as well as closer relationships with institutional investors and greater access to capital.

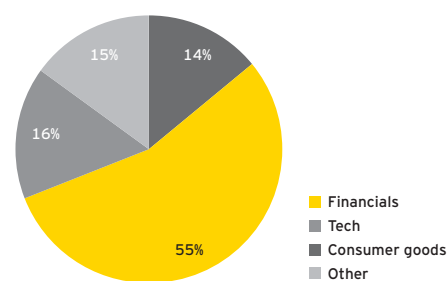
Marquee investments push financials to leading 2010 sector for Latin American

The December BTG Pactual investment by JC Flowers and a June investment by The Carlyle Group in Qualicorp pushed financial services to the top sector for PE investment in 2010 on a value basis, representing over 50% of PE investment by value during the period. Investments in the sector could continue through 2011. The business opportunities for financial services firms in Brazil are expected to grow on the back of sustained economic growth, increase in foreign

direct investment, cross-border deals and increase in requirement of capital for infrastructure projects and emerging companies in Brazil.

Technology and consumer goods, representing 16% and 14% of PE investment last year respectively, were the next two largest sectors.

Figure 2: Sector breakdown of 2010 PE deals



Source: Dealogic; breakdown by value

Exits

As Petrobras overhang recedes, IPOs poised to resume – one-third could be PE-backed

On the exits side, IPOs in Brazil are poised to rebound after a subdued second half of 2010 as investors waited out the overhang from the colossal Petrobras offering in September. The secondary offering raised more than US\$70b. In doing so, it put an exclamation point on the robustness of the country's capital markets – at the same time, it suppressed many IPOs that delayed or withdrew their offerings in order to avoid competing with the offering. International Meal Corp., a Brazilian restaurant chain controlled by Advent International, re-filed for an IPO in January after cancelling an earlier IPO attempt last year. The company received a reported US\$100m private placement from investors in June 2010 to fund expansion plans. Another potential IPO is expected by retailer Magazine Luiza, backed by Capital International. As issuers once again queue themselves up, PE-backed companies should account for at least one-third of new issuance.

Investors increasingly look beyond Brazil

Colombia, Chile and Peru top investors' lists

Concerns about elevated valuations in Brazil have many investors increasing their activity in countries such as Colombia, Peru, Chile, Argentina and Mexico. These economies share many of the same secular trends present in Brazil, including a rising consumer class, favorable demographics and a political environment that is favorable toward PE investment.

According to EMPEA, Latam investment, excluding Brazil, totaled more than US\$2b in 2010.

One recently announced investment was US-based Riverwood Capital's investment in Chilean IT services provider Synapsis for US\$52m in December. The company has customers across South America, and the growth capital investment by Riverwood is expected to reach US\$100m over the next several years and will be used to fund an aggressive plan of geographic and business-line expansion. The Synapsis investment dovetails with Chilean President Pinero's focus on fostering innovation and attracting growth-oriented companies to Chile.

Other investments across the region include Aureos Capital's acquisition of a 40% stake in Peruvian tourism company Condor Travel. The deal is the firm's 2nd investment in Peru and its 10th in Latam, and it comes on the heels of a similar investment in the sector by Carlyle, when it acquired CVC Brasil a year prior. In the energy space, Citi Venture Capital International made a US\$400m investment in exchange for a 31.9% stake in Colombia's Transportadora de Gas de Interior (TGI). The gas distributor is owned by Empresa de Energia de Bogota, the country's second largest electricity transporter.

While we continue to see Brazil as a major focus for PE funds over the near term, we also expect that attention will translate into increasing activity across Latin America. The primary beneficiaries will include countries with limited structural challenges that demonstrate to investors an understanding of how PE firms can deploy both capital and operational expertise to impart profound benefits upon these rapidly developing economies.

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