

# Private Equity Update

An informational newsletter from Goodwin Procter's Private Equity Group

## Private Equity Interest in Latin America Increasing Despite the Risks

By all accounts, the recent seizure of foreign-owned oil fields in Bolivia and Hugo Chávez's persistent attempts to extend his influence and policies beyond Venezuela's borders have not dampened private equity interest in Latin America and for good reason. With very few exceptions, most Latin American countries are better places to invest than they were only a few years ago, with more stable economies and in many cases, even recent legal reforms specifically formulated to attract foreign investment. A recent survey by KPMG of fund representatives and other active participants in the field found that respondents expected foreign investment into Latin America to increase by 25% or more this year, with 90% expecting fundraising for Latin America to increase as well.<sup>1</sup> Foreign investment in Latin America is no longer only the purview of strategic players and private equity funds either. Venture capitalists and hedge funds are also entering the fray.<sup>2</sup>

While Asia still receives the vast bulk of private equity dollars earmarked for investment in emerging markets, many funds are discovering or rediscovering Latin America as a way of diversifying their holdings or steering clear of the auction scene that is so common in the United States and Europe and becoming more prevalent in Asia. Deals, fundraising and exits are all up significantly, with total equity invested in 2005 reaching \$1.05 billion, up 67% from the prior year. Likewise, fundraising doubled on a year over year basis, resulting in the second-best year Latin America has ever had in terms of number of fund closings. Finally, exits were up 121%, with many exits taking place on local stock exchanges, which in turn is generating greater liquidity in those capital markets and creating a more predictable market for future IPOs.<sup>3</sup>

<sup>1</sup> KPMG Survey, presented at the Economist's Eighth Annual Conference on Latin America, Miami, Florida, February 8, 2006.

<sup>2</sup> One indication of the burgeoning hedge fund interest in emerging markets is the number of new funds being formed to invest in them – 153 new funds last year, according to Hedge Fund Research, as quoted in "The Fever for Exotic Stocks: Unfazed by Risk, Investors Pour Money Into Faraway Markets," *New York Times* (May 18, 2006) at C1. See also "Hedging Toward Private Equity: Will the Territories of Hedge Funds and Private Equity Funds Cross Paths in Latin America?" *Venture Equity Latin America* Vol. V No. 7 (April 28, 2006) at 2 (estimating that dedicated Latin American hedge funds have assets under management of more than \$25 billion).

<sup>3</sup> "Back on the Charts: Increased Activity Levels Across the Board Demonstrate a New Confidence in Latin America's Private Equity Markets," *Venture Equity Latin America* ("VELA") 2005 Year-End Report, at 1. See also "Latin America M&A Activity May Rise," *Wall Street Journal* (February 15, 2006) at B3C; "Fundraising Continues to Roar Back," *VELA 2005 Year-End Report* at 20; and "Improving Capital Markets Aid Strong Exit Performance in Brazil and Mexico," *VELA 2005 Year-End Report* at 26.

Many private equity investors making their first foray into emerging markets are focused on the so-called BRICs (Brazil, Russia, India and China), with the result that Brazil is attracting by far the most private equity attention in the region. However, other investors are bullish about the prospects of Mexico and/or Argentina, and still others are consciously bypassing these relatively mainstream countries in order to make investments in smaller but neglected and stable economies such as Colombia, Peru and Uruguay, among others. Some have even begun to focus on Central America, which is well-poised to increase exports to the United States with the passage of DR-CAFTA. Many new sector-specific funds are also being formed, with 11 of the 25 new funds raised in 2005 focusing on energy or real estate.<sup>4</sup>

Most Latin American countries are working hard to attract foreign capital by enacting legal reforms. Mexico recently adopted a new securities law.<sup>5</sup> Colombia established an entity to facilitate private equity investments that is successfully being used by investors to structure some of the country's first private equity funds.<sup>6</sup> Brazil has been working on minority protections, and the *Novo Mercado* (New Market) portion of the Bovespa stock exchange is rewarding better governance with a trading premium.<sup>7</sup> The examples are many of Latin American countries learning that the market for foreign investment is a global one and that meaningful reforms will help them attract their share of foreign investment.

Risks persist, but savvy private equity investors have learned from the mistakes of the early 1990s, when investors poured money into the region, typically betting on the same strategies that had been successful in the United States and often with little planning for multiple exit strategies or the quirks of investing in family-owned businesses. Investors have learned several lessons since then, and the new flow of capital to the region appears to be based on better information, better analysis and a better sense of the risks.<sup>8</sup>

One major lesson learned from the last downturn in the region is the importance of exit planning. IPOs accelerated last year and this year, particularly in Brazil, but the capital

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<sup>4</sup> "Back on the Charts," *VELA 2005 Year-End Report* at 8.

<sup>5</sup> The New Securities Market Law was adopted on December 30, 2005 and will take effect on June 28, 2006. It will create new corporate entities designed to attract venture capital financing, which will be required to comply with stricter governance and transparency standards.

<sup>6</sup> Resolution 470 was adopted in June 2005 and sets up a framework specifically tailored for private equity investments into Colombia and opening up private equity investment to pension funds and insurance companies. The Latin American Venture Capital Association recently noted that "with government initiatives to boost access to local equity capital, public sector support and a surge in country-specific fundraising, Colombia seems set to lose its status as a well-kept secret for venture capital and private equity investors." "In the Pipeline: Venture Capital & Private Equity in Colombia" (February 1, 2006) available at <http://www.lavca.org/lavca/web.nsf/0ab802518c7915ef86256f2e006a0ddb/933d24b78edb65838625710b000e8ecf?OpenDocument>.

<sup>7</sup> See [http://www.bovespa.com.br/Companies/NovoMercadoSpecial/cias\\_niveisdif\\_intro\\_i.htm](http://www.bovespa.com.br/Companies/NovoMercadoSpecial/cias_niveisdif_intro_i.htm) for a description of the corporate governance standards required for listing on the New Market, which are stricter than those required by Brazilian law.

<sup>8</sup> For a more detailed analysis of lessons learned and strategies for successful private equity investing in Latin America, see Alyssa A. Grikscheit, "Private Equity Investing in Latin America: Strategies for Success," *Latin American Law & Business Report* (May 31, 2005) at 3, available at [http://www.goodwinprocter.com/getfile.aspx?filepath=/Files/publications/grikscheit\\_a\\_6\\_05.pdf](http://www.goodwinprocter.com/getfile.aspx?filepath=/Files/publications/grikscheit_a_6_05.pdf).

markets in many Latin American countries remain underdeveloped and the vast majority of exits will not be on the public markets. Investments, particularly non-control positions in family businesses, must be made after careful evaluation as to whether the family's exit horizon will coincide with (or hinder) the ideal private equity exit.

Another key is to mitigate risk through control. Many seasoned investors in Latin America, such as Advent International, only invest in control positions. Others aim for de facto control through minority rights, but the protections that are sufficient in other markets may be inadequate in countries with a weak track record on judicial enforcement or where the average duration of a court case can be longer than the investment time horizon. Minority investors in particular must ensure that their incentives are properly aligned with those of the majority stakeholder and should endeavor to be active in managing their Latin American investments. Very few investors have been successful in Latin America on pure timing plays, except for those with the stomach to invest in the midst of a financial crisis.

Companies in Latin America are slowly learning that the benefits of good governance do not solely accrue to their investors. Private equity investors can accelerate this learning process by insisting on good governance and enforcing it, but also by showing their portfolio companies how good governance can have tangible benefits such as a lower cost of capital and an increase in the exit premium for all concerned.

Preparing for the downside case as well as the upside case is another important strategy. Private equity investors have to undertake comprehensive risk planning. Some are insisting on a "risk premium" in the case of investments in Latin America, but other investors are finding such a premium to be arbitrary and unnecessary if the risks are already addressed in the business plan.<sup>9</sup>

Many investors are skipping equity and investing through debt instruments to take advantage of a lower risk profile and better liquidity. Private equity investors no longer feel confined to using equity and are tailoring deals more carefully to local risk profiles.

Finally, investors need to tailor strategies that have worked elsewhere to the local market. It is particularly helpful to combine broad-based deal experience with local market experience, both on the deal team and as a matter of ongoing portfolio management.

The risks of investing in Latin America are many. But savvy private equity investors have learned that higher returns are often found where there is less competition for deals and greater need for access to capital. Moreover, certain sectors in Latin America, such as energy and commodities, seem poised to perform well for the foreseeable future given the high oil prices on the one hand and sustained demand from China and other countries on the other hand. Private equity investors are also starting to better distinguish the individual countries, which will hopefully decrease the risk of a withdrawal of capital from Brazil in response to saber rattling in Venezuela.

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<sup>9</sup> A recent survey by the Emerging Markets Private Equity Association (EMPEA) found that the investors surveyed required a 7.8% premium for Latin America above an expected return of 17% for U.S. buyout investments. "EMPEA LP Survey: Emerging Markets Private Equity is Going Mainstream," *Emerging Markets Private Equity Quarterly Review* Vol. II, No. 1 (Q1 2006) at 4.

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We believe this update will be useful in helping to understand the recent uptick in private equity investing in Latin America as well as some of the strategies private equity funds are employing to ensure that their investments are successful.

If you have any questions about the foregoing, please do not hesitate to contact

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