Private equity funds in Brazil: perspectives and opportunities

Felipe Souto

Despite the current economic and political turmoil in Brazil, when the pains of adjustment of public accounts and fall of economic activity level are now being felt by the population, entrepreneurs and investors, there still remains good opportunities for business development. Private equity funds have, to some extent, ignored the general pessimism, and have taken advantaged of specific market opportunities to execute 275 merger and acquisitions, amounting USD 22.1 billion, in the first 5 months of 2015, for example.

Private equity and venture capital (PE/VC) funds are legal entities privately placed, usually as limited partnerships between professional investors and a fund manager, through which large sums of capital are pooled so as to, in its purest form, either acquire control of companies or fund start-up ventures. Yet, private equity funds are commonly linked interchangeably with leverage-buyouts firms.

Despite the involvement of a restricted number of participants, when compared to public listed companies, PE/VC funds still presents a complex chain of legal relations, rights and liabilities; and brings together a heterogenic classes of players. The regulatory constraints (as well as the complexity of its structure) limits the universe of parties allowed to invest in private equity and venture capital funds to a short group of individuals – capable themselves to evaluate market trends, product risks and opportunities and read management and financial reports. All the relation between managers and investors is mainly established by contractual arrangements, despite the growing amount of regulation worldwide; that is, the amount of capital sought by the fund managers, the investment period, the lifetime of the funds, the manager's duties and responsibilities, performance incentives and preferential treatments are, *inter alia*, part of the investment partnership contract.

PE/VC funds generally seek private companies (mature or startups) with excellent market prospects as their targets. The lifetime of a PE/VC fund is between seven and ten years: from marketing, and multiple capital raising rounds, to the divestment stage – and return of results to investors. We are not talking, therefore, by any means, of any kind of speculative type of investment. On the contrary, PE/VC funds are highly regarded due to the improvements in managements and corporate governance of their portfolio companies, high amount of investment in research and development, qualification of human capital and increase in productivity.

Although the global industry of private equity and venture capital (PE/VC), as we currently see, started investing in private companies in the mid-1950s, only in late 1970s it gained financial relevance worldwide, with the setting up of KKR & Co LLP by Jerome Kohlberg Jr., Henry Kravis and George R. Roberts. In Brazil, this practice only got some relevance in late 1990s. Between 1999 and 2006, despite the lack of experience by the local PE fund managers in Brazil, there were some fund raising

with significant sizes, all aiming at taking advantaged of the revival of the Brazilian local capital market, strong currency (and stable exchange rate), growth of a massive consumer market and economic and political stability. This momentum boosted the entry of international management and experienced funds in the country. In general, Brazilian funds started a period of better performance compared to US funds. From 2006 onward, the Brazilian PE/VC industry started a process of maturation when the management consolidated its practices, allowing Brazilian funds to raise a record USD 7.1 billion in 2011 (versus only USD 2.9 billion in 2009 and USD 1 billion in 2013).

The Brazilian industry is still far from the reality of PE/VC in developed industries, such as United Stated e United Kingdom. According to audit carried out by the Brazilian Venture Capital and Private Equity – ABVCAP – and KPMG in 2014, there are USD 100 billion of capital for investment by PE/VC in Brazil, whereas in the US the amount is approximately USD 1 trillion. In addition to that, the ratio between the amount invested and the GDP illustrates the difference: whereas in Brazil the amount invested by PE/VC is 0.3% of the 2014 Gross Domestic Product, in the US it is approximately 1.0% of their GDP.

Among the key stakeholders in Brazilian assets are foreign investors. In Q1 2015, for example, they were responsible for 51% of the total capital invested through PE acquisition of minority interest in companies in the banking, telecommunication, oil and gas, energy, healthcare and education sectors. In previous years, however, the difference between foreign and internal capital were larger than this year – a clear reflection of the cautiousness that investor are having with the current political and economic scenario.

The rapid growth of private equity fund-backed transactions worldwide to an unprecedented level in the last thirty years has provoked calls for regulation – and raised a heated discussion as to whether policy interference is really necessary. The regulatory proposals have insistently tried to handle financial services generally (without further distinctions among distinct products) with proposals that ranged from enhancing disclosure requirements and limiting contractual and governance methods to limiting the leverage ratio of private equity funds and their portfolio companies. In Brazil, for example, the market authority, Comissao de Valores Mobiliarios (CVM), edited the first set of norms ("Instrução Normativas – IN") about the incorporation, operation and management of private equity funds in 2003 (ICVM 391/2003); but it has been amended seven times since 2011, and CVM published a new Instruction in December 2014: the ICVM 555, which rules incorporation, management, operation and disclosure of investment funds generally.

In order to boost the industry, the Brazilian government is also taking some few important steps. Early in 2015, for example, the Brazilian legislative authorized foreign capital in Brazilian privately owned hospitals. In May, Carlyle announced the acquisition of 8% stake of the largest private hospital operator in Brazil, Rede D'Or São Luiz, for USD 600 million. Another regulatory adjustment was the loosening of

restrictions imposed by the government on pension funds. That is, the government recently increased the limits of these funds on non-fixed-income investment from 50% to 70%. This adjustment is estimated to released USD 53 billion in capital that can now be invested in PE.

Despite these positive adjustments in its legal framework, Brazil still faces two old legal challenges. First of all, Brazil has to simplify its legal system and tax framework, both extremely bureaucratic. This combination inevitably leads to higher transaction costs for investors in PE/VC. Secondly, the Brazilian judiciary and procedural laws need urgently a reform in order to accelerate the progress of cases in its courts and tribunals. For example, specialists estimate that, on average, lawsuits of competition and conflicts of patents go unsolved four to seven years – unacceptable when the lifetime of a PE/VC fund is between seven to ten years only.

Additionally, foreign investors are reasonably pessimists with the current moment of the Brazilian economy. According to 100% of the firms interviewed for the 2014 INSEAD-PwC Survey, Brazilian macroeconomic instability is the major issue for investors in raising money for projects in Brazil at this moment in time. With a major corruption case involving the top executives and politicians, lower growth or GDP contraction expectation, higher interest rates, inflation, weak currency (and volatile exchange rate) and government intervention, investors are very cautious in bringing their capital to Brazil – despite a great interest in the market potential and gaps in Brazilian economy.

It is almost unanimous among PE/VC professionals that its undeveloped market for private debt is one of the greatest barriers for big leveraged buyouts in Brazil. PE managers believe, therefore, that the sector in Brazil will finally boom when Brazil's capital debt market takes off, as it will reinforce long-term financing – what will back PE/VC funds in getting higher returns on investments.

Despite all the above said, there is now a positive outlook for investment in PE in Brazil. Investors are seeing a maturity of Brazilian institutions (Public Attorney, Federal Police and Judiciary) never seen before, an exchange rate strongly beneficial for cross-border investment, voluntary measures (independent of external pressure) to adjust public expenditure, balanced current account and a robust foreign currency reserve. Not only this, Brazil needs investment across all the sectors, particularly in education, healthcare, infrastructure, energy, oil and gas, telecommunication, media and technology.