

Brazilians have a saying: “Brazil is the country of the future—and always will be.” To what extent is this adage true of the country’s private capital industry? In light of a tumultuous few years defined by economic volatility and political scandal, are fund managers in Brazil in a position to fully realize the market’s potential? With Brazil now on a clear trajectory of economic recovery and improving capital market conditions, this EMPEA Brief examines how key developments in Latin America’s largest market are contributing to the evolution of its private investment landscape. Fund managers and institutional investors considering Brazil’s prospects may find that the recent crisis has begun to promote positive changes in the country’s private capital industry and that current conditions provide ample opportunity for investment.

Moving in Cycles

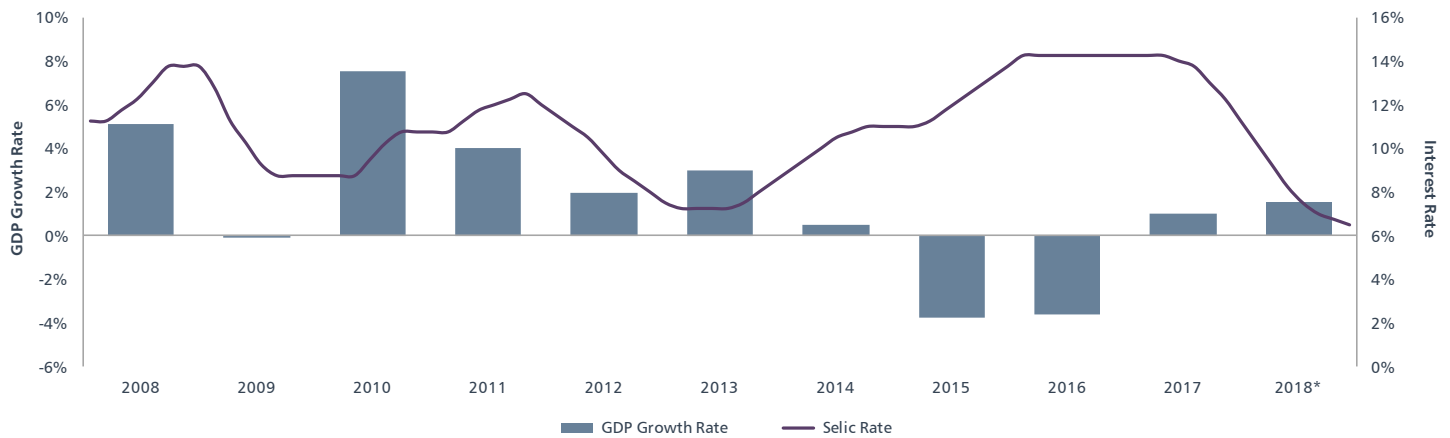
Brazil is a significant market in the global economy. With a population of over 200 million and a GDP of US\$2.1 trillion, it is by far the largest consumer market in Latin America, often serving as a gateway for corporations looking to access the region. While investors in private capital discouraged by Brazil’s recent painful economic recession cannot be blamed for holding back on new commitments to the country given the rollercoaster ride of the past several years, the abrupt downturn Brazil experienced in 2015 points to the shortcomings of piling into a market *only* when indicators of economic health are at their peak.

Brazil’s economy grew at an average pace of 3.4% between 2000 and 2014, in large part driven by the dual pillars of the global commodity super cycle and rising domestic consumption fueled by credit. The country was also relatively insulated from the Global Financial Crisis, with GDP falling by just 0.1% in 2009, compared to more than 2% in the United States (see Exhibit 1).

In Summary

- In spite of its recent economic recession and the *Lava Jato* scandal, Brazil remains an attractive strategic market that is too large for investors with global mandates to ignore. A country like Brazil that has historically been prone to economic peaks and troughs demands sustained commitment on the part of both local and international investors in order to capture value in down periods.
- Capital raised for Brazil-focused private capital vehicles bloomed early in the decade, but has fallen off at a time when deal pricing looks attractive by global standards. While some local managers who raised capital during the last boom will not raise new funds, those who remain report ample opportunities in the country, in part stemming from the prevalence of family-owned businesses, high industry fragmentation and relatively low productivity. Recent deal activity has been concentrated in recession-resilient sectors such as health care and education, as well as new verticals in technology and consumer services.
- While Brazilian pensions have proven less active in private capital since the recession as they shore up their balance sheets, the current low-interest rate environment will likely draw greater amounts of local capital to alternative investments in the coming years. Moreover, lessons learned during the crisis will encourage local institutional investors to align with international LP standards by moving away from involvement in investment committees and improving their fund selection processes. These changes can help promote a more sustainable industry moving forward.
- Equity capital markets in Brazil experienced a revival in 2017, and GPs took advantage through listings that have generated much-needed liquidity for their investors. However, the fickle nature of these windows suggests that fund managers must be able to execute their value creation plans quickly in order to be ready to exit at the right moment. As a result, GPs investing at the larger end of the market may increasingly favor investment targets that need less transformation.
- Despite continued political uncertainty, the *Lava Jato* investigations and the fallout for Brazil’s political classes and leading corporations have led to a realignment toward more pragmatic policy initiatives in the country. While many proposed reforms will face an uphill battle, local observers doubt that there will be any substantial shift away from this new orientation following the October 2018 elections.

Exhibit 1: Key Macroeconomic Indicators for Brazil, 2008-2018



*Estimated GDP growth rate.

Source: Brazilian Central Bank; IBGE; IMF World Economic Outlook Database, October 2017. Accessed 15 March 2018.

With developed markets in turbulence in the aftermath of the crisis and global benchmark interest rates falling, capital flooded into emerging markets like Brazil. Much of this influx was in the form of portfolio flows into publicly-traded debt and equity securities, but foreign direct investment (FDI) also increased, peaking at US\$101 billion in 2011, up from US\$31 billion in 2009.¹ The former investment total also coincided with the high-water mark for Brazil-specific private capital fundraising, as fund managers raised US\$7.3 billion in 2011.

By 2015, however, economic conditions in Brazil had deteriorated. Inflation had remained persistently high, peaking at more than 9% in 2015 and prompting the Brazilian Central Bank to raise interest rates. The benchmark federal overnight rate nearly doubled from 7.25% in October 2012 to 14.25% in July 2015, with commercial rates far higher. With global demand for raw materials abating as the commodity boom drew to a close, Brazil's economy flagged and GDP

contracted by 3.8% in 2015 and 3.6% in 2016. At the same time, the U.S. dollar-to-Brazilian real exchange rate sharply depreciated, falling from approximately 2.38 in January 2014 to over 4.00 two years later (see Exhibit 2).

Exhibit 2: Brazilian Real to U.S. Dollar Exchange Rate, March 2008-March 2018



Source: Investing.com. Accessed 1 March 2018.

1. Source: World Bank, World Development Indicators (updated 22 February 2018).

About EMPEA

EMPEA is the global industry association for private capital in emerging markets. An independent, non-profit organization, the association brings together 300+ firms—including institutional investors, fund managers and industry advisors—who manage more than US\$5 trillion in assets across 130 countries. EMPEA members share the organization's belief that private capital can deliver attractive long-term investment returns and promote the sustainable growth of companies and economies. EMPEA supports its members globally through authoritative research and intelligence, conferences, networking, education and advocacy.

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Private capital fundraising numbers for Brazil during this time reflect a wariness on the part of foreign institutional investors. Fund managers raised just US\$672 million for the country in 2016—the lowest total since EMPEA began tracking funds in 2006. The abruptness of the economic downturn after years of growth may have been especially alarming. As Ettore Biagioni, Managing Partner of Brazil-focused middle-market private equity firm Alathon Group, notes, “Prior to 2014-2015, Brazil had almost a decade of relative stability and positive GDP growth. These last three years shook everybody up quite a bit.”

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The increase in interest rates that accompanied the economic downturn also had a profound influence on local institutions, whose incentives had suddenly changed. Luiz Francisco Novelli Viana, the President & CEO of Brazilian fund manager TMG Capital, explains: “Local investors didn’t see the need to take equity risk or a long-term perspective. Furthermore, the types of instruments available with those levels of domestic interest rates did not create an environment for acquisition financing. In terms of private investors’ portfolios, there was no significant incentive for investors to get out of the cozy high-real-interest-rate instruments and allocate funds to private equity.”

The country returned to modest growth in 2017, as GDP increased 1%. Public markets also surged, with the MSCI Brazil Index climbing 25% in 2017 alone. With inflation contained to under 4%, the central bank has aggressively cut interest rates since late 2016, gradually bringing the Selic benchmark down to 6.5% by March 2018. This economic improvement has notably taken place even as the country’s political arena has faced continued scrutiny and corruption allegations, as well as legislative reform that has proven only partially successful. As Gabrielle Trebat, Regional Director of strategic advisory and advocacy group McLarty Associates, points out, “What we’ve seen in the past 18 months is a broader trend of the economic situation decoupling from the political.” With 2018 well underway, the outlook for the Brazilian economy is broadly positive. GDP is predicted to continue growing at a stable pace, interest rates may come down even further and the Brazilian government is expected to continue shifting its policy mix in favor of structural reform, albeit slowly.

Brazil’s recent economic troubles lay bare the difficulties that can arise for institutional investors when committing to emerging markets like Brazil that are prone to volatility. But given the long-term nature of private capital as an asset class, they also highlight the benefits of sustained commitment.

Carlos Carneiro, Portfolio Manager for Venture Capital and Private Equity at Brazilian development bank BNDES, explains, “You have to invest across vintages. Sometimes the economy is better, sometimes it gets worse. This happens everywhere. You can say Brazil’s economy is a little more volatile compared to developed markets. But if you are an investor, you might take advantage of this volatility as a very good time to invest because asset prices are at lower levels than the average for the last few years.”

25%

The year-on-year gain in the MSCI Brazil Index in 2017

Coming Clean?

Beyond the economy, politics and government administration have also been a deterrent for investors in Brazil. One of the principal causes of Brazil’s economic recession of 2015-2016 was the chronic mismanagement of public funds and bureaucratic bloat at all institutional levels. Under the auspices of the Workers’ Party (Partido dos Trabalhadores, or PT), which had led the country since 2003, the government failed to address structural deficiencies of the Brazilian economy, such as the massive regulatory compliance and tax burden for companies and the lack of investment in its industrial sector. The Carlyle Group’s Fernando Borges, Managing Partner and Co-Head of the South America Buyout Group, notes that during this period, “Nobody was discussing reforms. Nobody was discussing modernization.”

The twilight of PT’s presidential tenure was defined in many ways by the corruption scandal known as the *Lava Jato* (‘Car Wash’) Operation. The investigations into this sprawling web of illicit payments, padded contracts and political patronage have garnered international attention, resulting in more than one hundred politicians and several major businessmen and billionaires—in the past rarely brought to justice—being convicted. Crucially, the *Lava Jato* investigations, in the context of the recession, contributed to the impeachment of former president Dilma Rousseff in late 2016, ostensibly for budget manipulation. She was succeeded by Michel Temer, who has shifted the government toward more market-oriented policies. Since then, critical labor and regulatory reforms have been passed and others—most notably the much-needed reform of Brazil’s generous pension system—have been working their way through congress, though not without difficulty.



The Capital Shortfall

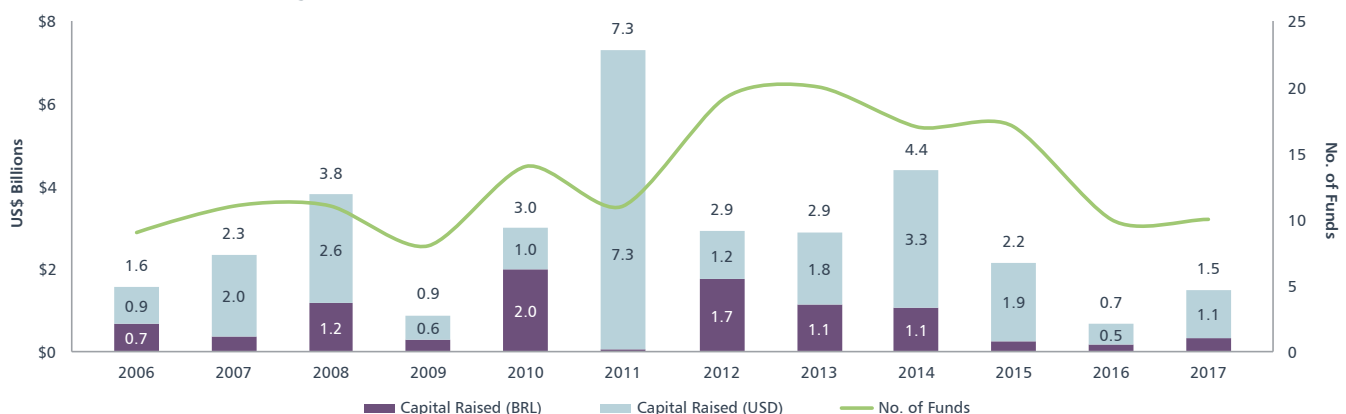
Private capital as an asset class in Brazil has grown gradually since the start of the millennium, but the flood of capital into the country following the Global Financial Crisis, as well as the subsequent economic and political turmoil, accelerated this process. In 2011 alone, fund managers raised US\$7.3 billion across buyout, growth, venture capital (VC) and infrastructure strategies, as large GPs such as Gávea Investimentos, Patria Investments, Vinci Partners and BTG Pactual closed funds of over US\$1 billion (see Exhibit 3). João Busin, Partner at Brazilian law firm TozziniFreire, recalls, “Especially during the credit crunch, Brazil was in the spotlight for some time, with many international investors wanting to invest in the country.”

However, as Brazil’s economic crisis took hold and excitement waned in 2015, most investors quickly pulled back from the country. While fund managers had raised an average of US\$4.1 billion per year from 2010 to 2014, Brazil-focused funds raised only US\$2.8 billion during all of 2015 and 2016. On a relative basis, the decline was even more severe for local real-denominated funds than for offshore vehicles. Similarly, although depressed asset values during the crisis years would seemingly be attractive to long-term private capital investors, disclosed capital invested declined considerably. GPs had deployed an average of US\$3.6 billion per year from 2010 through 2014, which declined to under US\$2 billion in the following two years (see Exhibit 4). Most of the decline came at the top end of the market, and capital invested through large buyouts dropped sharply: GPs invested US\$2 billion through 15 buyouts in 2013 but just US\$373 million through seven deals in 2015.

It is tempting to look at this political scenario and see only the volatility and uncovered corruption. In particular, international LPs, who have increasingly been subject to stringent compliance regimes under legislation such as the U.S. Foreign Corrupt Practices Act and the U.K. Bribery Act, have been understandably wary. However, while the issues of corruption can never be ignored, the turmoil of recent years is in many ways a sign that Brazil’s institutions are working as intended. As McLarty Associates’ Trebat adds, “There is a wide expectation that this culture of corruption and impunity for officials will end.” Ingrained cultural factors will take time to overcome, but those who can peer through the political fog may be able to capitalize on what has been an underpenetrated market for private capital.

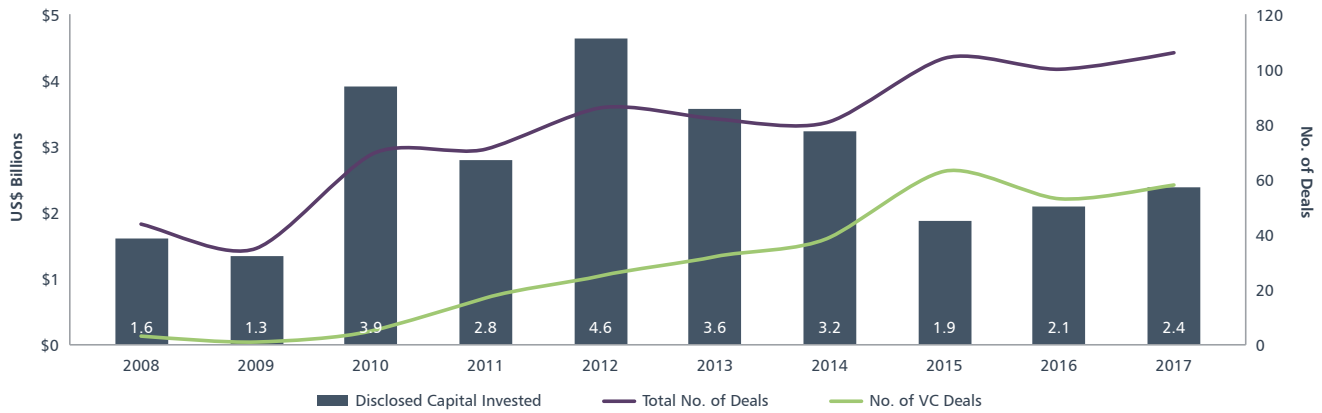
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Exhibit 3: Brazil Fundraising, 2006-2017



Source: EMPEA. Data as of 31 December 2017. Unless otherwise indicated, all EMPEA data include private equity, private credit and private infrastructure and real assets.

Exhibit 4: Brazil Investment, 2008-2017



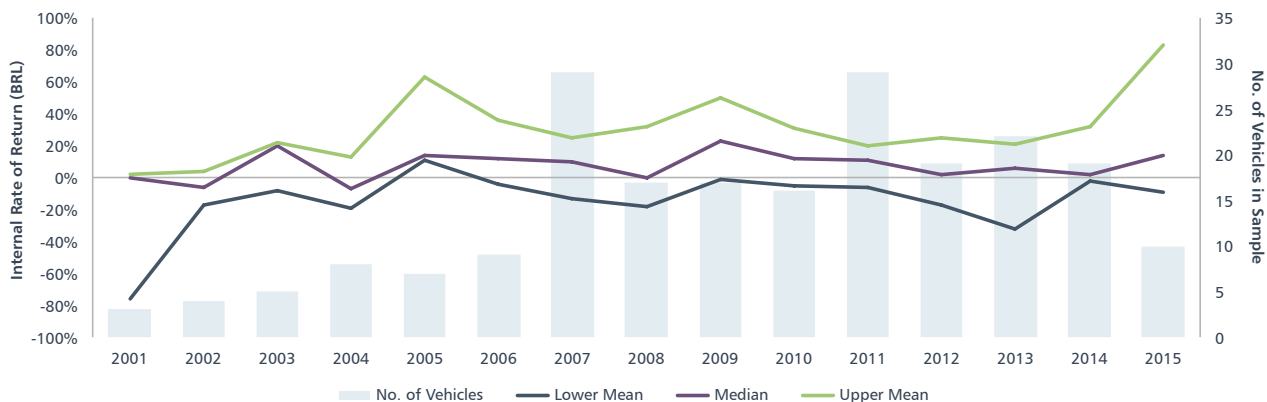
Source: EMPEA. Data as of 31 December 2017.

Beyond affecting investors' perceptions of Brazil, the economic crisis of 2015 and 2016 also had a deep impact on the composition of fund managers active in the country. The recession years and exchange rate volatility caused a severe compression of many funds' returns, particularly for the vintages directly preceding the recession, forcing GPs to critically evaluate their selection, due diligence and management processes (see Exhibit 5). Cesar Collier, Brazil-based Managing Director of global multi-strategy private equity firm Siguler Guff, notes, "The fund managers that survived the crisis or have capital to deploy will be much more careful with the sectors they invest in, much more careful with the types of deals. They may also structure their deals a little bit more, given the fact that they have more leverage now; there is less credit available in the market and less competition from other private equity firms." Fund managers active in the country continue to attest to the importance of organic growth in driving returns over the long run, but for some, the volatility of the last several years has meant narrowing their focus to companies with more stable, predictable cash flows in which they can execute value creation plans more rapidly.

SPOTLIGHT: Venture Capital

In contrast to the decline in buyouts experienced in Brazil since 2015, the recession years appeared to have little effect on the burgeoning venture capital market in the country. Fund managers invested US\$299 million via 53 deals in 2016, compared to just US\$5 million via five deals in 2010. Venture capital activity in Brazil has been concentrated in technology verticals that target the relatively low productivity of Brazilian companies in key sectors of the economy, such as financial services, agriculture and retail. Guilherme Mantovan, Analyst in the Investment Funds division at Brazilian innovation and research agency FINEP, explains, "For venture capital funds, a difficult macroeconomic scenario like Brazil's recession can be an opportunity because early-stage companies still need access to capital." Financing new ventures through traditional loans is often still prohibitively expensive, serving as a roadblock for innovative and energized entrepreneurs. While Brazil's VC ecosystem is still relatively young, as more successful entrepreneurs switch sides from investee to investor over time, venture capital activity will likely continue to grow.

Exhibit 5: Brazil Private Capital Performance by Fund Vintage - Internal Rate of Return (BRL), 2001-2015



Source: Private Equity Bay (Pebay). Figures based on local currency cash flows and valuations (BRL). Includes only funds marked at fair market value or with distribution to total value ratio above 80%. Vintage based on date of first contribution to the fund. Upper and lower means refer to the geometric mean of the upper and lower halves of the sample. Accessed 22 March 2018.

While many firms have weathered the storm of recent years, others have not fared so well, which has already begun to have a knock-on effect on the local landscape. TozziniFreire's Busin notes: "There is going to be consolidation in the private equity industry in Brazil over the coming years. We may also see larger financial institutions buying private equity houses in order to get stronger captive private equity arms, since they need to turn to alternative assets in order to keep their position in the market." With large local and international LPs pulling back from the asset class, the fundraising environment has been exceptionally difficult. Fund managers who are not top performers have often been unable to raise follow-on funds, reducing the number of firms hunting for new deals.

Carlyle's Borges explains, "It's a natural selection of GPs. In order to raise money, you need good performance. In the middle of an economic crisis, it's very difficult to have good performance. Now the crisis is over, and we see companies performing much better. That will impact the performance of GPs and will attract capital. You need one thing to happen for the other to happen, and in the middle of this cycle, the weakest ones will disappear." Ultimately, this process of consolidation should work to the benefit of the industry over the long term, but the current capital 'underhang' in Brazil means that even GPs with solid track records and strong deal pipelines risk being short of capital at an opportune time to invest.

Room to Grow

The opportunity for private capital in Brazil ultimately rests on a simple idea: a more sophisticated, battle-hardened group of GPs looking to partner with private businesses that are underserved by traditional financing options and increasingly receptive to outside capital and expertise. TMG Capital's Viana describes, "In the last ten years, we saw a consolidation of the concept of a financial sponsor and the concept of growth capital because, frankly, at the early stages, most businessmen were not very

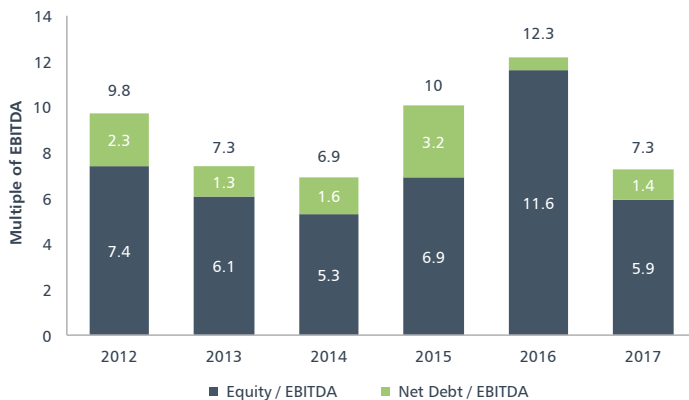
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Brazilian businesses increasingly see private capital funds as a credible and reliable source of financing and operational support—not only because of the acute difficulties brought on by the recent economic downturn, but also because of the structural inefficiencies inherent to the country. Capitalizing on these factors—a large productivity gap compared to developed markets and highly fragmented industries—increasingly means seeking outside partners that are well placed to offer a fresh look. Patrice Etlin, Managing Partner at global private equity fund manager Advent International in São Paulo, adds, "Low productivity and industry bottlenecks are still prevalent across Brazil, and this provides opportunities for investors who have deep sector expertise and operational capabilities. Particularly with the recent recession, there are opportunities to invest in companies that have been undermanaged and undercapitalized and provide resources to help them improve and grow."



Exhibit 6: Brazil Entry Valuations – EV/EBITDA (BRL), 2012-2017



Source: Private Equity Bay (Pebay). Figures based on EBITDA and net debt in BRL of the same year of the transaction, except where 2017 information was not yet available and 2016 figures were used instead. Includes 56 deals across buyout, growth, venture capital, infrastructure and real estate (developers or shopping malls only). Transactions with EV/EBITDA above 30x or below zero were removed from analysis. Accessed 30 March 2018.

Especially for family-owned businesses, which are prevalent in Brazil, GPs can provide both growth capital and improvements in operational efficiency and corporate best practices. BNDES's Carneiro elaborates, "Most of the medium-sized companies are family-owned businesses that have a lot to improve in terms of productivity and governance. The huge gap in productivity that you see in Brazil, especially in mid-sized companies, is an area in which professional GPs can add tremendous value."

Fund managers competing for these opportunities may find themselves in an advantageous position for negotiation, especially compared to peers in other geographies. According to Brazil-focused data provider Private Equity Bay (Pebay), the average EV/EBITDA multiple for Brazilian PE investments in 2017 was 7.3x (see Exhibit 6). In contrast, U.S. M&A multiples (including PE buyouts) reached 10.5x over the same time period, higher than during the lead-up to the Global Financial Crisis, and Asia PE multiples averaged 14.1x.² Forming clear-cut conclusions from disparate data sources can be a fraught exercise, but the general pattern is clear: absent a jump in valuations in 2015 and 2016—the result of a denominator effect due to the drop-off in corporate earnings during the recession—relatively attractive deal pricing in Brazil has actually held since 2013. Still, Brazil remains relatively underpenetrated in terms of private capital investment. Over the last five years, the ratio of disclosed capital invested to GDP has averaged 0.12%—equal to the rate for China but still an order of magnitude lower than the 1.55% rate for the United States.

“These are sectors with a high level of fragmentation, making them ripe for consolidation in order to scale up the business, benefit from margin improvement and tap into the increasing demand for higher-quality services.”

Beyond attractive pricing and a relatively shallow pool of competing GPs, key characteristics of the Brazilian economy have made sectors like health care and education particularly attractive for private capital investors. As the purchasing power of middle-class consumers expands, they have tended to switch from public health care and education to private providers. Moreover, as Priscila Rodrigues, Partner at Brazil-focused alternative asset manager Bozano Investimentos, points out, “These are sectors with a high level of fragmentation, making them ripe for consolidation in order to scale up the business, benefit from margin improvement and tap into the increasing demand for higher-quality services.” They also have the added benefit of being quite recession-resistant, as spending on health care and education is still necessary even during economic downturns.

Brazil’s burgeoning early-stage technology space also exemplifies the potential for investors to address many of Brazil’s structural constraints. Early-stage companies providing solutions to

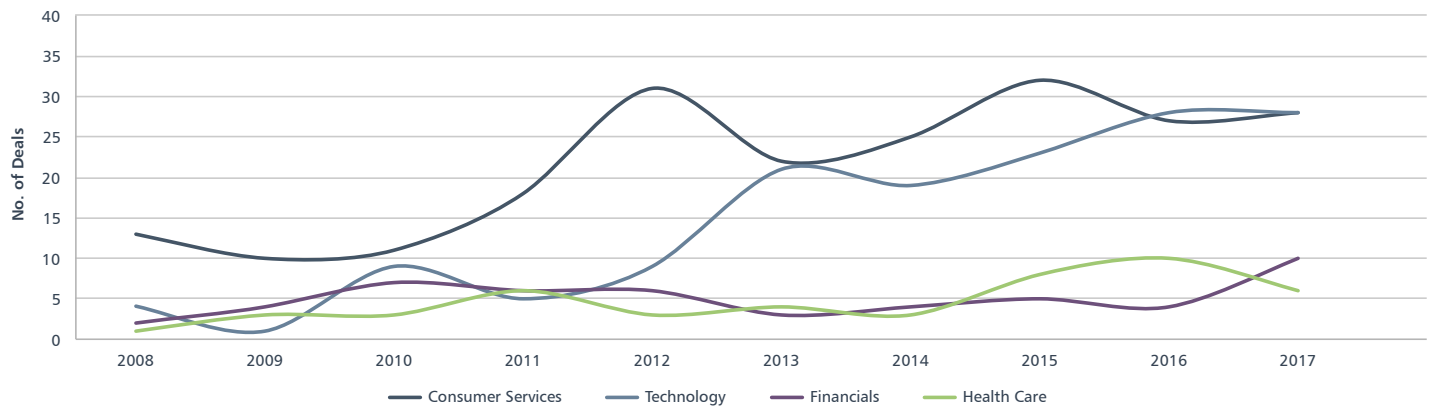
improve productivity, management and information access have the potential to significantly change the dynamics of the Brazilian economy, as well as reward investors getting in on the ground floor of these companies’ development. Productivity issues are pervasive across the Brazilian economy, which has encouraged entrepreneurs to invest in potential solutions both in Brazil’s well-developed sectors, such as financial services and agribusiness, as well as in its less-developed ones, such as health care and online retail (see Exhibit 7).

0.12%

Disclosed private capital investment as a percentage of GDP in Brazil over the last five years

2. Sources: United States – PitchBook, 2017 Annual US PE Breakdown (published 15 January 2018); Asia – Bain & Company, Asia-Pacific Private Equity Report 2018 (published 15 March 2018).

Exhibit 7: Brazil Investment in Select ICB† Industries, 2008-2017



† The Industry Classification Benchmark (“ICB”) is owned by FTSE International Limited (“FTSE”). “FTSE®” is a trademark of the London Stock Exchange Group companies and is used by FTSE under license. FTSE does not accept any liability to any person for any loss or damage arising out of any error or omission in the ICB.

Source: EMPEA. Data as of 31 December 2017.

FINEP’s Mantovan surmises, “Despite Brazil not being a traditional country for technology creation, some verticals like fintech and agtech are very well-developed. Companies need to improve efficiency and productivity, so we see opportunities for companies that offer digital marketing, sales growth, cost reduction and modernization services.” Early-stage investments addressing this crucial need in the Brazilian economy will likely continue to grow as the need to be competitive in the global market increases the adoption of new technology. The transformative power of technology is currently front and center in other leading emerging markets like China and India, and market participants can already see its growing impact on Brazil.

Finding the Nearest Exit

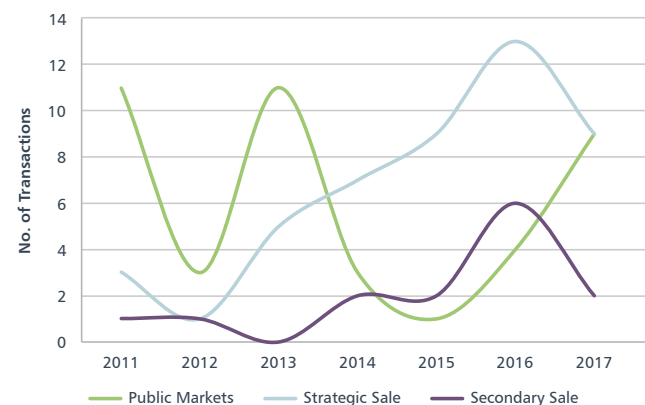
Even if managers active in Brazil can capitalize on the current opportunity set and commit capital to promising companies, the ultimate measure of their success will be the distributions they generate for their investors. On this front, investors can find reasons for both optimism and continued vigilance. Brazil’s exit environment improved dramatically beginning in 2016, with disclosed transactions jumping 69% from 2015 levels. However, EMPEA’s exit data also suggest that options for liquidity can be inconsistent over time—highlighting the need for fund managers to consider liquidity strategies well in advance of deploying capital in the country in order to capitalize on selling opportunities.

The fickle nature of exit windows in Brazil is most evident in the country’s public markets. Following 18 months of dormancy, initial public offerings (IPOs) in Brazil surged in 2017, and fund managers took advantage of soaring public markets to achieve some of the much-needed liquidity for investors that was restricted during the recession (see Exhibit 8). The majority of companies that held an IPO in Brazil over

the last two years was backed by private capital sponsors—including the five offerings in 2017 that raised more than US\$800 million for investors.

Indeed, public markets have been the primary exit path for GPs in Brazil over the last decade, accounting for just over a third of exit transactions, followed closely by strategic sales. However, given the volatility of the Brazilian economy, liquidity through public markets has not been reliably available to GPs, with strategic and secondary sales instead predominating during the recession years. Carlyle’s Borges explains, “You don’t IPO when you want. You IPO when you can, when there’s a window. Say you have a company that requires a lot of transformation, and after two years there’s a big window of opportunity to sell. The stock market is in a good moment but you cannot sell because you still need more time to improve the company, and you miss the window. Then, when the company is ready, if the market has cooled you might not have a window to do it. We tend to

Exhibit 8: Disclosed Exits in Brazil – Select Transaction Types, 2011-2017



Source: EMPEA. Data as of 31 December 2017.

Note: ‘Public markets’ includes all IPOs, back-door listings and follow-on sales.

assume that the IPO market is always there as a consistent exit option, but in Brazil you cannot take this for granted. It's very selective." In order to avoid missing the exit window, managers like Carlyle at the larger end of the market are favoring targets that need less 'heavy lifting' and can be ready for an offering sooner. Shortened holding periods may have the additional benefit of boosting fund internal rates of return (IRRs).

Size has proven to be a crucial factor when it comes to new offerings in the country. Bozano's Rodrigues explains, "In the past, you had offering sizes which were on average about BRL450 million (US\$136 million). Now that is no longer the case. What the market demands currently is an offering size which is on average about BRL1 billion (US\$301 million). This is largely because existing investors are requiring more immediate liquidity in order to participate in an IPO." While this may not pose a problem for large companies, middle-market companies will have a tougher time accessing the public market if they cannot achieve sufficient growth to satisfy these requirements. GPs investing in small and mid-sized companies may in turn look to different exit avenues, including secondary sales, which increased three-fold in 2016, albeit from a low base. Just as persevering through Brazil's economic cycles is imperative for fund managers to succeed in the country, so is understanding the inconsistent liquidity options at hand and not being caught flat-footed when exit windows close.

Local Lessons

An improved economic climate, attractive deal-making conditions and the revival of public markets all combine to cast the Brazilian market in a new light. Nevertheless, perhaps the most promising potential development in the country's private investment space will be a change in the way local investors approach private capital. The painful consequences of entrenched practices that hindered investors' returns over the past decade have prompted a reconsideration of how local LPs commit capital to private funds. As a result, investors are increasingly bringing practices into alignment with international standards.

\$2.2B

Total proceeds in U.S. dollars from the five largest private capital-backed IPOs in Brazil in 2017

Brazil's largest pension funds, along with development finance institutions (DFIs) and government agencies such as BNDES and FINEP, have historically served as anchors for the private capital industry in the country. However, the local pension funds' approach to the asset class differed from that of international LPs in a few crucial ways, including a prioritization of lower fees and more favorable terms over backing better-performing GPs. Cesar Collier of Siguler Guff explains, "The pension funds employed a negative selection process. They selected managers solely based on

those that offered the most attractive fee structures, which we feel is far too narrow an approach to the manager selection process. We would recommend first evaluating managers based on their past performance, track record, level of expertise and experience in their space, and once the most competent managers are identified, then a discussion on fees will ensue."



Moreover, many of the pension funds invested in capital-intensive sectors such as oil and gas, infrastructure and power via FIP (Fundo de Investimento em Participações) structures. Although local GPs commonly use FIPs to independently manage third-party capital, similar to how they utilize offshore limited partnerships, the pension funds also employed these vehicles to invest without an independent fund manager. As a result, institutional investors were directly liable for the performance of the value of investments. As Brazil's economy slid into recession, the value of many LPs' portfolios—which were often strongly or directly linked to commodities and invested at the height of the market—sharply declined.

The weak macroeconomic environment also made it far more difficult to exit these loss-making investments. As Siguler Guff's Collier explains, "On the one hand, pension funds have this pressure to invest in alternatives now that interest rates have come down. On the other hand, they are stuck with bad investments that they cannot liquidate unless they take a haircut, which they don't want to do because they will be audited by regulators and could be held personally liable. So it is a catch-22 situation." Extending the term length of these funds in the hope of a better exit environment in the future would also have a negative impact on IRRs. As a result, local pension funds have reduced allocations to private capital funds as they work to free up this stuck capital, preventing new commitments. Smaller local managers heavily reliant on the support of Brazilian pensions and development banks have been severely affected.

Many local pension funds also ran into liability and operational issues when committing to GP-managed funds, as they included participation in the investment committee as a necessary condition for committing capital. Consequently, underperforming funds left these LPs with painful deficits to square. Furthermore, this arrangement created substantial difficulties for fund managers. Mounir Guen, CEO of global placement agent MVision Private Equity Advisers, notes, "LPs deciding on entry and exit is extremely difficult. If a pension fund is having trouble meeting its liabilities and doesn't want to have a capital call, for example, it can block the GP from making an investment. This kind of situation greatly disrupts the decision-making processes and the cycle of a fund."

Despite these past experiences, lower interest rates may eventually incentivize local pensions to commit to alternatives again. While it may still take some time for Brazilian pension funds to be able to make significant commitments to new funds, local observers believe that the recession and resulting poor performance of some investments have precipitated a change in thinking, especially around LP participation on investment committees. BNDES' Carneiro adds, "Sometimes you need a crisis to move on. External disruption forces you to look at what went wrong and evaluate your own process: How do you select and monitor funds and conduct your due diligence? How do you assess fund performance, not only in terms of financial returns? In the next few years we will see a major change in the industry in Brazil." This shift in perspective has been aided by institutions like BNDES and FINEP, as well as experienced foreign LPs that have established a significant presence in Brazil and worked to move the process along (see Exhibit 9).

Exhibit 9: Sampling of LPs with Disclosed Past Commitments to Brazil-specific Funds

DFIs and Government Agencies	Private Pensions	Public and Government Pensions	Funds of Funds
AGERio	Fundação Chesf de Assistência e Seguridade Social (FACHESF)	Kentucky Teachers' Retirement System	Hamilton Lane
Banco Nacional de Desenvolvimento Econômico e Social (BNDES)	Fundação dos Economistas Federais (FUNCEF)	Missouri State Employees' Retirement System	Siguler Guff & Company
CDC Group	Fundação Itaú Unibanco	New York State Common Retirement Fund	Spectra Investments
Corporacion Andina de Fomento (CAF)	Industriens Pensionforsikring	Ohio Police and Fire Pension Fund	SVB Capital (Silicon Valley Bank)
Desenvolve SP	Intel Corporation Pension Plan	Oregon State Treasury (Oregon Investment Council)	
FINEP	Petros	Teachers' Retirement Systems of Louisiana (TRSL)	
IDB Invest	PGGM	Texas County & District Retirement System	
International Finance Corporation (IFC)	PREVI		
Overseas Private Investment Corporation (OPIC)	Real Grandeza		
	Valia		

Source: EMPEA. Data as of 31 December 2017.

“The families and the high-net worth individuals are really the preeminent source of capital at the moment.”

At the same time, the recent pullback in allocations from large Brazilian institutional investors has coincided with fund managers increasingly tapping into the large pool of family and high-net worth individual wealth in the country. Particularly as interest rates have declined, family offices have piled into the asset class at unprecedented levels. Bozano Investimentos' Partner Jaime Cardoso sums this trend up succinctly: “The families and the high-net worth individuals are really the preeminent source of capital at the moment.” As long as interest rates remain low, it is likely that family wealth will continue to flow into private capital even as allocations from large institutional investors increase in the coming years.

Traditional allocators to private capital funds are beginning to undergo a shift in thinking, and new sources of local capital are joining the fray at an opportune juncture. Both developments bode well for the future of private capital in the country.

Ready for Takeoff

International institutional investors have been faced with an altogether different set of issues in committing capital to Brazil and have had a checkered relationship with the country. One source of concern is the upcoming October 2018 elections, which will determine the next president of Brazil, as well as governors and local officials. Naturally, any election has the potential to change the political landscape of a country and for most institutional investors, waiting another few months for the election's outcome to be determined is not a significant burden. However, in spite of the turbulence surrounding some of the potential candidates, continuity in economic policy is most likely to prevail in Brazil's case. No major contender for public office has espoused radical economic views, and as this *Brief* has explored, negative headlines can distract from an important idea: unlocking the fundamental opportunities in Brazil and other emerging markets requires steady commitment based on more than superficial perception.

Private capital in Brazil has undergone dramatic changes over the past decade. While the country's ascendancy to star performer status among emerging markets in 2011 brought an inflow of investors, its abrupt descent into recession in the last few years quickly starved it of much-needed capital. Yet, despite the negative perceptions, not only have the fundamental opportunities for private capital remained intact in the country, but the recession has begun to bring about key changes to the economic environment and to the private capital industry.

“Brazil is a country of innovation; it's a country with energy; it's a country with resources; it's a country with skills. Brazil has a high-quality private capital community that is very switched on and able to manage portfolios in a very positive manner.”

The country's large and vibrant economy, driven by a young and urbanized middle-class consumer base, continues to provide ample opportunity for fund managers and investors able to address the country's productivity gap and bring value to private businesses. As MVision's Guen describes, “Brazil is a country of innovation; it's a country with energy; it's a country with resources; it's a country with skills. Brazil has a high-quality private capital community that is very switched on and able to manage portfolios in a very positive manner.” Local LPs are undergoing vital transformations in their operational standards, helping to ensure a more sustainable and better-quality industry in the coming years. Greater amounts of capital may flow into private funds as interest rates are lowered, allowing a broad range of fund managers active in the country (see Exhibit 10) to chase promising assets at lower valuations and with less competition. In light of these conditions, investors who may have written Brazil off in the past few years would do well to reassess the opportunities on offer. ●

Exhibit 10: Sampling of Fund Managers Active in Brazil

Fund Manager	Strategy	Geographic Focus	Most Recent Funds (Most Recent Close Year, Amount Raised)	Website
2bCapital	Growth	Brazil	Brazil Mid-Market Growth Fund (2013, US\$197m)	2bcapital.com.br
ACON Investments	Buyout	Latin America, North America	ACON Latin America Opportunities Fund IV (2014, US\$515m)	aconinvestments.com
Actis	Buyout, Growth, Infrastructure, Real Estate	Pan-Emerging Markets	Actis Energy 3 (2013, US\$1.15B), Actis Energy 4 (2017, US\$2.75B)	act.is
Advent International	Buyout, Growth	Global	Latin America Private Equity Fund VI (2014, US\$2.1B)	adventinternational.com
AGBI Real Assets	Real Assets	Brazil	Agribusiness Brazil Partners I (Fundraising), Brasil Agro II FIP (2017, Fundraising)	agbi.com.br
Alothon Group	Buyout	Brazil	Alothon Fund III (2014, US\$200m)	alothon.com
Aqua Capital	Buyout, Growth	South America	Agribusiness Fund II (2017, US\$370m), Agribusiness Fund I (2013, US\$173m)	aquacapital.net
Bozano Investimentos	Growth, Venture Capital	Brazil	Bozano Growth Capital Fund (2017, Fundraising), BR Education Ventures (2015, US\$27m), Bozano Educacional II (2015, US\$324m), Criatec II (2013, US\$83m)	bozanoinvestimentos.com.br
Brookfield Asset Management	Buyout, Growth, Direct Lending, Infrastructure, Real Assets, Real Estate	Global	Brookfield Agricultural Fund II (2016, US\$800m)	brookfield.com
BTG Pactual	Buyout, Growth, Infrastructure, Real Assets, Real Estate	Latin America	BTG Pactual Latin America Infrastructure Fund (Fundraising), BTG Pactual Brazil Timberland Fund I (2015, US\$860m)	btgpactual.com.br
Canary	Venture Capital	Brazil	Canary Fund I (Fundraising)	canary.vc
Darby Private Equity	Growth, Mezzanine, Infrastructure	Pan-Emerging Markets	Darby Servtec Energia FIP, Darby Latin American Private Debt Fund III	darbyoverseas.com
Denham Capital Management	Infrastructure, Real Assets	Global	Denham International Power (Fundraising), Denham Commodity Partners Fund VI (2012, US\$3.05B)	denhamcapital.com
DGF Investimentos	Growth, Venture Capital	Brazil	DGF Ventures 2 (2017, Fundraising), DGF Fund 3 (2013, US\$155m)	dgf.com.br
DOMO Invest	Venture Capital	Brazil	DOMO Invest Fund I (2017, Fundraising)	domoinvest.com.br
DXA Investments	Growth, Direct Lending, Real Estate	Brazil	DXA Excelsior II (Fundraising), DXA Excelsior I (2015, US\$50m)	dxainvestments.com.br
e.Bricks Ventures	Venture Capital	Brazil	e.Bricks Ventures Fund II (2017, Fundraising)	ebricksventures.com
Gavea Investimentos	Growth, Hedge, Real Estate	Brazil	GIF V (2014, US\$1.1B)	gaveainvest.com.br
General Atlantic	Growth	Global	General Atlantic Investment Partners 2017 (2018, US\$3.3B)	generalatlantic.com
Inseed Investimentos	Venture Capital	Brazil	Criatec III (2016, US\$55m), Inseed FIMA Fund (2012, US\$77m)	inseedinvestimentos.com.br
Invest Tech	Growth, Venture Capital	Brazil	Capital Tech VC (Fundraising), Capital Tech II (2014, US\$88m)	investtech.com.br
Jaguar Growth Partners	Real Estate	Latin America	Jaguar Real Estate Partners II (Fundraising), Jaguar Real Estate Partners (2017, US\$350m)	jaguargrowth.com
Kaszek Ventures	Venture Capital	Latin America	Kaszek Ventures III (2017, US\$200m), Kaszek Ventures II (2014, US\$135m)	kaszek.com
Kinea Private Equity	Growth	Brazil	Kinea IV Private Equity (Fundraising)	kinea.com.br
L Catterton	Growth	Global	L Catterton Latin America II (2017)	lcatterton.com
Monashees Capital	Venture Capital	Brazil	Monashees Capital VII (2015, US\$120m)	monashees.com.br
Neo Investimentos	Growth	Brazil	Neo Capital III (2015, US\$135m)	neoinvestimentos.com.br
NXTP Labs	Venture Capital	Latin America	NXTP Fund 2 (Fundraising), NXTP Fund 1 (2013, US\$36m)	nxtplabs.com
Oria Capital	Growth	Brazil	Oria Tech II (Fundraising), Oria Tech I (2014, US\$86m)	oriacapital.com.br
Patria Investments	Buyout, Infrastructure, Real Estate	Brazil	Patria Private Equity Fund VI (2017, Fundraising), P2 Brasil Private Infrastructure Fund III (2013, US\$1.7B)	patria.com
Redpoint eVentures	Venture Capital	Brazil	Redpoint e.Ventures Brasil (2012, US\$130m)	rpev.com.br
SP Ventures	Venture Capital	Brazil	Sao Paulo Innovation Fund (2014, US\$46m)	spventures.com.br
Stratus Group	Growth	Brazil	Stratus Capital Partners III (Fundraising), Stratus Capital Partners II (2015, US\$122m)	stratusbr.com
The Carlyle Group	Buyout, Growth, Direct Lending, Real Estate	Global	Carlyle South America Buyout Fund II (Fundraising), Fundo Brasil de Internacionalizacao de Empresas II (2014, US\$276m)	carlyle.com
Tiger Global Management	Venture Capital, Hedge	Global	Tiger Global Private Investment Partners X (2015, US\$2.5B)	-
TMG Capital	Growth	Brazil	TMG Co-Investment Fund III (2010, US\$100m)	tmg.com.br
Victoria Capital Partners	Buyout, Growth	South America	Victoria South American Partners II (2012, US\$850m)	victoriacp.com
Vinci Partners	Buyout, Growth	Brazil	Vinci Capital Partners III (2017, Fundraising)	vincipartners.com
Vox Capital	Venture Capital	Brazil	Vox Capital Fund II (2016, Fundraising), Vox Capital Impact Investing Fund I (2014, US\$36m)	voxcapital.com.br
Warburg Pincus	Buyout, Growth	Global	Warburg Pincus Financial Services Fund (2017, US\$2.3B), Warburg Pincus Private Equity XII (2015, US\$13.4B)	warburgpincus.com

Source: EMPEA. Data as of 31 December 2017.