INSEAD - PwC Study on Private Equity in Brazil

Brazilian Private Equity: A New Direction
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GPEI welcomes private equity investors interested in the center’s research efforts to reach out to us in Europe or Singapore. For further information on INSEAD’s Global Private Equity Initiative, please visit www.insead.edu/gpei.
Executive Summary

This report is a follow-up to INSEAD and PwC’s well-received 2011 publication *Brazilian Private Equity: Moving Centre Stage*. The original report detailed the evolution of the private equity (PE) asset class through 2011, drawing insight from major industry databases and a series of interviews surveying leading General Partners (GPs) and Limited Partners (LPs) investing in the country. The report – published at the peak of the country’s PE cycle – reflected the positive sentiment on the ground. This report extends that story and examines the changed world of PE in Brazil in 2014.

*Brazilian Private Equity: A New Direction* is an overview of the developments in Brazil’s PE industry over the last 3 years, highlighting the industry’s descent from the 2011 cyclical peak and industry participants’ expectations for the country’s near future. In the first section of the report, we revisit the macroeconomic context supporting the PE boom in 2011, and how trends since then have impacted the industry. The report’s second section is a close look at fundraising, investment and exits in today’s market. In the final section, we summarize the insights from over 20 interviews with GPs and LPs in an outlook for the PE industry in Brazil.

Throughout the report, we paint a picture of Brazilians PE industry at a crossroads. On one hand, most of current investing in the country still exhibits developing market characteristics. Most transactions are still in the form of growth capital, privately negotiated, relying on informal networks for deal sourcing and execution. Revenue growth drives performance of the investments in view of the limited amount of leverage available.

On the other hand, despite, or maybe because of the headwinds of the cyclical downturn, Brazil’s PE industry shows signs of evolving towards a more developed model. Arguments supporting this thesis are the increasing presence of international GPs, the raising of large domestic buy-out funds, the development of local LPs, an increasing segmentation of the market with increasing intermediation and competition in some segments, increasing focus on operational value creation, a diversification of exit routes including more sales to strategic and financial buyers and an increasing openness of business owners towards PE investments.

So while a foundation is in place for the PE market to evolve further and a revived fundraising and investment environment in 2014 provides tailwind, roadblocks to a wider adaption of the Private Equity model still remain. We look forward to continuing our coverage of the industry and plan to follow up with another report in due course to see in what direction Private Equity in Brazil will evolve.
I. The PE industry through 2011

Macro Drivers and PE Expectations

A decade of improved macroeconomic performance and stability in Brazilian policymaking, coupled with poor sentiment in developed markets following the Credit Crunch and sovereign debt crises, drove PE in Brazil to a cyclical peak.

A stable macro environment – both domestically and abroad – provided a benign backdrop for the Brazilian PE market to develop following the turn of the millennium. Externally, China’s rapid economic growth and its insatiable demand for resources provided broad stimulus to Brazil’s resources-centric economy. As industrial and agricultural commodities prices began their run to record highs, Brazil’s terms of trade (average price of its exports over its imports) significantly improved. The availability of foreign exchange not only contributed to a significant improvement in the country’s balance-of-payments and a strengthened Real, but also generated a positive domestic wealth effect and increased local purchasing power through lower tradable goods prices.

Internally, Luiz Inácio Lula da Silva Lula (Lula) continued many of the policies that contributed to the boom in Brazil’s economy. The market reforms enacted in 1995 – and continued under Lula – produced a sharp improvement in Brazilian productivity through 2007. In addition, government income-transfer policies, minimum wage increases above productivity growth, and an expansionist monetary policy reinforced a virtuous economic cycle that both decreased unemployment rates and drove consistent growth in domestic demand and household consumption.

Fears that Lula and the Partido Trabalhista (PT) party’s leftist ideology would risk the stabilization measures taken by Fernando Henrique Cardoso’s government fell away, as Lula’s government quickly showed a pragmatic streak. Lula nominated a conservative economic team, and his market friendly policies contributed significantly to reducing perceived risk in the Brazilian economy.

1 World Bank (2013)
This positive backdrop was reflected in the findings and outlook expressed in *Brazilian Private Equity: Moving Centre Stage*. International and domestic LPs and GPs alike expected a continuation of the bullish trends of 2011. Successful fundraising in 2010 when more than US$ 2.1 billion was raised for both large and mid-market funds, reflected investors’ optimism based on the macroeconomic stability exhibited in Brazil throughout the previous decade, and the potential for continued consumption-driven growth. Brazil’s regulatory framework and corporate governance standards made it more attractive compared to its emerging market peers.

On the back of the bullish sentiment, 2011 did not disappoint, as five billion-dollar funds targeting Brazilian investment closed. Total fundraising exceeded US$ 7 billion in 2011.

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2 EMPEA (2014)
II. Private Equity in Brazil: 2011-2014

Recent Macro developments

The booming macro environment that spurred the PE’s cyclical peak turned in 2011. Changes in many of the internal and external factors that made Brazil attractive to investors reversed, creating a challenging environment for the PE industry.

The fallout from the Great Recession and government’s reaction to it negatively impacted the investment environment in Brazil. The sluggish global economy and a drop in demand for raw materials – particularly from China – weakened Brazil’s balance of payments position, bringing instability to the Real. The US Federal Reserve’s initial tapering of quantitative easing measures in 2013 introduced additional uncertainty in the investment climate, particularly for emerging markets. Moreover, improving economic conditions in developed economies reduced investors’ willingness to tolerate risky investment propositions in search of higher returns.

Domestically, several factors contributed to slower growth and lower risk appetite among investors. The optimism of the cyclical boom from 2005 to 2011 led to lax policies by the government, central and commercial banks, creating imbalances in the economy. The Brazilian government pursued an accommodative monetary policy and significantly expanded public expenditures in an environment of very low unemployment but a large persistent infrastructure gap. With the exhaustion of the consumer-led growth and a less supportive external environment, Brazil went into a period of slow growth and increasing inflation, which forced the central bank to raise interest rates.

In response to the deteriorating internal environment, Dilma Roussef’s government reacted with interventionist measures from 2010 to 2013, which tarnished the image of the country’s robust macroeconomic picture and safe legal framework that respondents to the 2011 survey hailed. In an effort to control inflation, Mrs. Roussef and her economic team implemented a micro-managed approach and interventionist policies in the energy, electricity, and financial sectors.3

All these factors had a strong effect on the Brazilian stock market, lowering investors’ expectations for companies’ future earnings and increasing the overall risk premium for investments in the country. Foreign investors, international organizations, and local companies became increasingly wary of government intervention in the economy, further dampening investment and sentiment. As a consequence, in March 2014 Standard & Poor’s downgraded Brazilian rating to BBB, the first downward movement in the country’s rating in the past decade.4

The turn in the economic environment and

3 In 2010, the government raised over US$ 70 billion for Petrobras to finance its pre-salt exploration and development plan. However, the state owned company then used part of its capital to subsidize gasoline prices, negatively impacting its share price and capacity for investment. In 2012, president Dilma initiated a public campaign on television demanding banks to lower spreads. In 2012, the government changed the system of electricity water dam concessions in order to lower electricity prices. The movement was seen as a breach of contract and shares of listed generators fell by over 20% in one month.

4 Bloomberg (2014)
investor’s risk appetite exposed the weakness of several companies listed during the cyclical boom. The subsequent underperformance of these companies contributed to an increase in risk aversion for Brazilian investments [see Box 1]. The pessimism reflected in the public securities market is also evident in PE market, as 100% of the firms interviewed for this study identified macroeconomic instability as a major challenge for both investing and raising money in Brazil.

Box 1: Investor complacency in Brazil (2007-2011)

From 2007 to 2011, investors’ risk appetite for Brazilian investments increased the availability of equity finance for companies operating in the country. From 2007 to 2010, 98 companies accessed capital markets through IPOs, and over US$ 130 billion in new equity were raised. However, the hype driving Brazil’s public equity market arguably led to lack of proper investment analysis, typical of bull markets. Substantial risks were overlooked, and while several success stories were created during that time, there were several large and public flameouts.

An example of investor’s over-exuberance leading to significant losses is evident in the fate of the companies belonging to Eike Batista’s EBX Group. Between 2006 and 2010, the entrepreneur floated five companies operating in the Mining, Energy, Logistics, Oil & Gas, and Shipbuilding sectors through the BOVESPA Stock Exchange. The companies had extremely ambitious projects, with a high degree of uncertainty and substantial capital requirements. With the hype of the Brazilian market and high risk appetite from investors, Eike was able to secure capital through equity and debt offerings, and in 2011 the total market capitalization of the five listed companies reached over US$ 40 billion. As a result of the successful listings, Eike Batista became the 8th richest man in the world.

Shortly after in 2013, Eike’s largest company, OGX Oil & Gas, filed for bankruptcy after failing to produce offshore oil. The insolvency at OGX triggered general uncertainty in the investor community about the health of all of EBX’s listed companies. The Group was later forced to sell stakes in its other companies at prices significantly below the IPO price.

Examples such as EBX contributed to negative sentiment about Brazil’s public markets, especially in relation to green field projects and unproven business models. The PE industry was also adversely affected, as projects that could potentially have been financed through an IPO before 2011 had to be further developed and de-risked before listing.

5 BMF&Bovespa
6 Bloomberg (2011)
7 Forbes (2012)
GP Perspectives

The positive macroeconomic trends and the development of a favorable regulatory framework evident in the 2011 survey brought significant attention to the Brazilian PE industry, leading to a significant expansion in the number of local funds. In addition, the country’s favorable growth outlook, demographics and low levels of competition attracted several global players to the country.

International GPs’ interest in the Brazilian PE market persisted after 2011. This activity included both setting up offices by KKR, Apax, HIG and EIG, buy-outs executed by Advent International, Riverstone Holdings and 3i Group. The influx of global players is also reflected in the significant increase in assets under management (AUM) by PE funds in Brazil, which reached approximately US$ 43 billion at year-end 2013, representing a 58% increase compared to 2011.8

International GPs also access the Brazilian market through partnerships with strong performing local firms and co-investments. These partnerships – for example between Patria and Blackstone – provide local firms with access to a larger pool of capital and foreign firms with a local partners’ network and expertise. Co-investments typically take place in capital-intensive industries, such as oil & gas and infrastructure, and for specific investments. An example is Mare and Mantiq’s investment in flexible pipes company DeepFlex.

The influx of foreign firms is expected to slow as a result of the countries’ challenging macroeconomic environment and increased competition. It may lead to some sponsors’ exits from the country. Roughly 40% of respondents to the 2014 INSEAD-PwC Survey identified a consolidation of GPs as a potential development. The recent departure of the British mid-market fund 3i feeds the speculation, although the fund’s departure may have been driven by an internal restructuring.

LP Perspectives

Brazilian GPs have not had the same support from LPs since the last study. Following the 2009 Global Economic Crisis, LPs looked beyond developed economies to large emerging economies as a source of return. Brazil, along with Russia, India and China (collectively the “BRIC” countries), was a noted beneficiary of this trend. However, improving conditions in developed market economies in recent years reversed the trend, as LP allocations to developed markets recovered at the expense of allocations to emerging markets. This downturn was compounded in Brazil as LP allocations flowed to its emerging market and Latin American counterparts.

The improvement in allocations to developed market GPs since the last survey was driven by several factors, particularly low interest rates, which enabled GPs to increase distribution to LPs through dividend recapitalizations. Equity markets in developed countries reached new highs which supported attractive exit opportunities. As a result, LP flows to developed market GPs increased at the expense of emerging market managers. In 2013, emerging markets PE fundraising fell 19% compared to 2012, representing only 12% of global PE fundraising, compared with 21% in 2012.8 The United States and Western Europe reached their highest fundraising levels since the 2008 global financial crisis.

In Brazil, the reduction of LP allocations to emerging markets was exacerbated by the large amount of capital raised during the country cyclical peak. The hype over Brazilian PE markets

8 ABVCAP (2014)
9 EMPEA (2014)
brought a significant number of new players and capital to the market, increasing competition over deals. According to the 2014 Emerging Markets Private Equity Association (EMPEA) Emerging Markets Private Equity Survey, the factor likely to deter investments in the country over the next two years is an oversupply of funds and excessive competition, cited by 33% of survey respondents. In addition, lower growth expectations, higher interest rates, inflation, a more volatile exchange rate, and recent government intervention have contributed to LPs' reduced interest in Brazilian PE.

Brazil also lost ground to countries in Latin America, Sub-Saharan Africa, and Southeast Asia. In the 2014 EMPEA Emerging Markets Private Equity Survey, Latin America (excluding Brazil) is cited by LPs as the most attractive block among emerging economies. While Brazil topped the list of most attractive country to invest in EMPEA and Coller Capital's similar survey in 2011, it held the 5th position in a similar survey in 2014. Among the reasons mentioned for this drop was an oversupply of funds resulting in too much competition for investment in Brazil.

Despite the LP trends several factors provide Brazil with a structural advantage for PE investment relative to its Latin American peers. First, Brazil has a significant size advantage; for example, the country's population is roughly equal to the population of the Pacific Alliance combined. Its GDP is US$ 2.4 trillion compared to US$ 2.0 trillion for the alliance. Brazil's PE market is also at a more advanced stage of development. Its investors and entrepreneurs are much more familiar and open to the asset class, and the public equity market is broader, facilitating potential exits. Finally, the number of investment opportunities in Brazil far outweighs its regional counterparts, representing 73% of Latam's deal activity in the period from 2009 to 2013.11

10 EMPEA (2014)
III. Private Equity in Brazil: On the Ground

This chapter describes the main aspects of the Brazilian PE industry along the PE industry’s value chain. Starting with the fundraising, it continues with a description of the investment environment, before concluding with a look at exits.

Fundraising

After the cyclical peak in 2011, the Brazilian PE industry experienced a sharp drop in fundraising in 2012 and 2013. This was driven not only by excessive dry powder raised by the major funds investing in the country in 2011, but also by the perception of a deteriorating macroeconomic and political environment among major LPs. According to EMPEA, US$ 7.1 billion was raised in 2011 versus only US$ 1 billion in 2013.

The fundraising environment looks increasingly better in 2014. As pointed out by several survey respondents, the relative cool down of the Brazilian market, reflected in the low valuations on Brazil’s public equity markets, may reduce entry multiples for PE firms in the medium term. Moreover, although the depreciation of the Real hurt returns for existing foreign funds, the lower exchange rate provides a good entry opportunity for LPs seeking exposure to the country’s positive long-term growth trends.

The sentiment is evidenced by the July 2014 final close of Patria’s US$ 1.75 billion Patria Brazilian Private Equity Fund V after roughly six months in the market.12 There was a dearth of large funds closed in 2012 and 2013 following 5 billion-dollar fund closings in 2011. This successful closing provides a tailwind for two other large-sized funds in the market, Patria (infrastructure) and Gavea (balanced).

<table>
<thead>
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<th>Brazil Dedicated Billion-dollar Funds</th>
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<td><strong>Closed</strong></td>
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Source: EMPEA, Preqin

A noted trend among recent PE fundraising in Brazil is the increased number of large infrastructure funds. Several GPs have raised dedicated funds to invest in Brazilian infrastructure, namely P2Brasil, Darby Investment Overseas in association with Stratus, and

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12 Preqin
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BTG Pactual’s successful US$ 1.38 billion fundraising last year. For background on the growing demand for infrastructure see Box 2.

While the fundraising outlook for this year is generally positive and many players are tapping the market, there remains significant uncertainty for small players and first time funds. Although 70% of the GPs that responded to the 2014 INSEAD-PwC GPs Survey expect to raise fresh funds in the next 18 months, they highlighted several major challenges to a successful fundraising. The majority of the respondents to the Survey underscored Brazil’s macroeconomic situation as the main challenge to raising capital. The volatility of the exchange rate is another major concern, since many dollar-denominated funds experienced a significant reduction in returns with the depreciation of the Real.

Existing dry powder is another factor frequently mentioned in the survey. The record fundraising of 2010 and 2011 significantly increased assets under management and was cited as a prime driver of higher valuations in the country. However, data from EMPEA suggest that the capital overhang has not been a major issue for the industry as a whole, as Brazilian GPs deployed significantly more capital than raised in 2012 and 2013.

As competition for funding increases, LPs are becoming more demanding, requiring more detailed due diligence and increased investment from GPs in their own funds. The ratio of GPs’ total equity commitment to the industry’s total committed capital increased from an already high 13% to 18% between 2011 and 2013.

GP Question: What do you consider to be major challenges to fundraising for Brazilian investments?

<table>
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<tr>
<th>Challenge</th>
<th>Percentage</th>
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<td>More Demanding LPs</td>
<td>33%</td>
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<tr>
<td>Dry Powder to Deploy</td>
<td>33%</td>
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<tr>
<td>Brazil lost ground to other EMs</td>
<td>56%</td>
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</tbody>
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Source: INSEAD-PwC study on Private Equity in Brazil (2014)

13 A partnership between Patria and project maker Promon.
14 ABVCAP (2014)
Box 2: Brazilian Infrastructure Fundraising

You cannot just arrive with a backpack and start walking, there are no trains and you cannot drive [from one venue to another]. Don’t just turn up thinking it is in Germany, that it’s easy to move around the country. – Jerome Valcke, FIFA Secretary General, 40 days before the 1st World Cup Match

When Brazil was chosen in 2003 to host 2014 Football World Cup, great expectations were raised in the country. However, Brazil’s crippling infrastructure posed a significant challenge to the country’s selection. The country would need not only stadiums, but world class roads, trains and airports to support the influx of players and fans. The economic boom from 2003 to 2010 further strained an already taxed system. Significant delays were holding back infrastructure project development. A mix of ideology, government bureaucracy, and complacency led to massive delays and cancelations of many infrastructure projects in the country in preparation for the World Cup. By 2013, Brazilian infrastructure ranked 114th out of 148 countries according to the World Economic Forum, a scary statistic for a country on the verge of receiving the world’s two largest sporting events.

Faced with slowing growth and falling investment rates in 2011, Mrs. Roussef’s government finally accepted the viability of private investment in infrastructure, overturning a long-standing policy of her political party. A large government initiative was launched to open investments in airports, roads, railways, ports, and energy infrastructure to private companies. The plan set a target of roughly US$ 240 billion public infrastructure concessions in the coming decade.

Infrastructure investments expected for the next 5 years

- **Ports Program**
  - Investments in 16 States, covering public port concessions, private port authorizations, and the dredging plan

- **High-Speed Train**
  - Rio de Janeiro to Campinas (through São Paulo)

- **Oil and Gas**
  - 3 Concessions

- **Railroads Program**
  - 10 railroads, covering over 12,000 km

- **Highway Program**
  - 9 Federal highways, covering over 7,800 km

- **Airports Program**
  - Galeão Airport
  - Confins Airport

- **Energy**
  - 32,971 MW
  - 28,200 KM

- **Urban Mobility**
  - Urban Mobility Growth Acceleration Program (federal investments)
  - São Paulo Subway Program
  - Urban Mobility in Rio de Janeiro

Source: Credit Suisse and Ministry of Finance
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Investment

Deal activity in Brazil during 2013 was the lowest since 2009, according to EMPEA, reaching only US$ 2.8 billion. The drop came as a result of the country’s economic slowdown, as well as the devaluation of risky assets and the resulting valuation gap between buyers and sellers. However, the fall in deal activity might reverse as sellers adjust to new valuation levels and new deals come to market. According to the 2014 INSEAD-PwC Survey, GP’s opinion about investment activity levels is evenly split, with 55% expressing a positive view on the deal pipeline over the coming years.

Despite the significant growth of Brazil’s PE market and the increasing number of large foreign buy-out firms, deal-making continues to be concentrated in small and mid-sized investments, often in family-owned business. Of the 46 deals that disclosed values in Preqin’s data base from January 2011 to April 2014, 8 were above US$ 200 million and 18 were above US$ 100 million.15 Reflecting Preqin’s data, 64% of the respondents to the 2014 INSEAD-PwC survey showed preference for growth capital deals. This is partly due to the current structure of Brazil’s industrial economy, where fragmented industries have historically enabled growth equity funds to perform successful roll-up strategies. In time, these industry consolidations may provide deal flow for the larger buy-out funds.

The lack of a developed market for private debt continues to be a barrier for big leveraged buy-outs. Ninety percent of the funds surveyed said that on average deals are done with 25% debt or less.

In the meantime, deal size might be pushed up by demand for capital for big infrastructure projects and in particular oil infrastructure to support Petrobras offshore development plans. This trend should be strengthened by the availability of cheaper debt for these types of investments provided, in large part, by The Brazilian Development Bank. The bank often subsidizes financing for infrastructure projects, for oil & gas exploration, and production units’ acquisition or construction. Yet overall these transactions will appeal most to funds with lower risk/return profile, either through infrastructure funds or energy dedicated funds. Sizable deals following this trend were the US$ 567 million acquisition of LLX Logística, a port operator, done in 2013 by EIG Global Energy Partners, a large US Energy fund, and several Drillships sold by Sete Brasil to major financial players (BTG, EIG, Santander, etc).16

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15 Preqin
16 Up to 29 Drillships sold by Sete for US$ 0.8 million each
**Sector Activity**

In terms of deal count, goods and service-related businesses continue to dominate, along with consumer goods & retail, business services, TMT (technology, media & telecommunications), and education, representing over 57% of deals since 2011. The high degree of activity in the consumer goods & retail sector suggests that the consumption-driven growth theme continues to provide attractive investment opportunities. As the middle class grows, consumer spending in non-food goods, such as clothing and cellphones, and services, such as private education and health care, should continue to provide opportunities for investment.

These trends are reflected in recent PE investment in Brazil, with a large number of deals in apparel, telecommunications, and education. Last year, apparel deals included Warburg Pincus’ co-investment with Advent to acquire 72% of shirt manufacturer Dudalina, and Gávea’s investment in menswear retailer Camisaria Colombo. In TMT, one of the highlights of last year was BTG’s acquisition of Brasil Telecom Cabos Submarinos. In education, PE investors are now looking into sub-sectors in education, such as language education, edtech, vocational training, and k-12, as illustrated in Box 3.

While not as material in terms of deal count, the energy & utilities sector is responsible for a large share of total dollars invested in Brazil. Investment in oil & gas was a significant contributor to this trend and was the second most active sector in terms of value invested in 2012 and 2013 combined. Oil & gas transactions are mainly focused in related-service businesses, but also include investment in exploration and production (E&P) companies. In the services segment, transactions included Modal’s US$ 42 million investment in Georadar, and Mare and Mantiq’s co-investment in flexible pipes company DeepFlex. In the E&P segment, one of the main transactions of 2013 was the sale of OGX Maranhao to the investment group Cambuhy.

Many of the respondents expect PE investments in capital-intensive industries – such as infrastructure, agribusiness and oil & gas – to increase in the coming years. This trend is supported by an increasing number of dedicated funds and government incentives, such as attractive concessions and subsidized financing. Financial services and consumption-driven sectors, such as education and health care, are also expected to thrive.

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17 LAVCA (2014)
Box 3: PE in Education – beyond post-secondary Education

Since the first PE investments in education in the middle of the last decade, several funds were attracted to the sector, mainly in the post-secondary segment. Brazil’s growing middle class and the growth of beyond “basic needs” education prompted a 6.7% CAGR in enrollment from 2003 to 2012. This increase was fostered by governmental policies such as Prouni and FIES, and by a substantial increase in distance learning enrollment, which represented 15% of total enrollments in post-secondary education in 2012. These incentives and an extremely fragmented market helped put the education sector center stage in Brazilian PE, as large PE funds – including Patria, GP Investments, and Advent – realized significant returns on investments in post-secondary private institutions through operational improvements and consolidation.

While there is still room for investment in this segment, growth investments aiming at market consolidation is now more challenging, since larger players formed through PE’s initial investment in the industry now possess significant advantage over smaller institutions when competing for new assets. Large buy-outs firms are still looking into secondary investments in large institutions, however most GPs are now exploring various sub-segments within the sector.

Three such sub-segments include K-12 education, language courses, and edtech. In the K-12 space, a low penetration of private schools (only 15% on average) opens space for players with an affordable solution. The high degree of fragmentation of the market provides consolidation opportunities in estates with high penetration. Abril Educacao, a company that was initially funded by BR Educacional, made three significant investments in the K-12 space between 2010 and 2013. In the languages space, the increased integration of Brazil in the global market-place, coupled with the growth of tourism-related jobs for the World Cup and Olympics, dramatically increased the need for professionals who speak at least one foreign language. As of today, only 2% of the population speaks English at a professional proficiency. This market’s potential and depth was evidenced by the sale of Kinea’s Grupo Multi to Pearson for US$ 826 million in December 2013. Within edtech, the distance learning market, which encompasses a variety of different tools, and administrative solutions to increase efficiency in educational institutions, offers opportunities for investment. Bozano Investimentos recently raised a venture capital fund with the German media group Bertelsmann focusing exclusively in edtech.

Another sub-segment that has been closely watched by PE funds is vocational training. Popular in parts of Europe, such as Switzerland and Germany, this type of education is still incipient in Brazil. However, there is a strong focus from the Government to develop such offerings. According to the National Education Plan (PNE), the government plans to triple the number of vocational course offerings in the country by 2020 through incentives such as PRONATEC and Fies Tecnico, the technical training versions of Prouni and FIES. This will likely open material opportunities in another fragmented education sub-segment.

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18 Credit Suisse
19 “Universities to Everyone” (Prouni) was created by the government in 2004 in order to provide scholarships to undergraduate students who attended secondary public or private schools with full scholarships. Institutions participating in the program enjoy full federal tax exemption (income tax, social contribution, PIS/COFINS) by providing one scholarship for every 10.7 regular-paying students.
20 Created in 1999 and reformulated with important changes in 2010, the post-secondary student financing fund (FIES) provides students with subsidized financing at extremely attractive terms. Students enjoy a 3.4% interest rate (compared to 38% in average retail loans), 18 months grace period (for amortizations), and an amortization period of 3 times the duration of the course.
21 Censo da Educacao Superior (2012)
22 Company website
23 Credit Suisse
24 Project of law that establishes 10 directives and 20 goals for the education sector in Brazil to be achieved by 2020.
**15**

**Brazilian Private Equity: A New Direction**

*Competition and the Path to Differentiation*

Competition in the Brazilian PE market is increasing. Although competition for different deal sizes is perceived differently by 2014 INSEAD-PwC Survey participants, there is a general sense of a more competitive environment for deals compared to 3 years ago. With new players in the market and a large amount of dry powder, GPs will have to leverage a differentiated network, and offer additional value to find and attract potential portfolio companies.

Respondents to the 2014 INSEAD-PwC Survey perceive increased competition for large deals (>US$ 100 million) increasing from already high levels in the last study. This is a result of the increasing number of large international buy-out funds entering this space and large amount of funds raised for deals of this size. Of the PE capital raised in 2010-11 in Brazil, over 90 per cent poured in to only six funds. At the same time, the range of companies that these funds are looking at (with revenues above US$ 200 million) is quite limited (estimated at 3,000). The respondents’ perception of competition for medium-sized deals (US$ 50 – US$ 100 million) has decreased. The underfunded middle market sector, with fewer than 15% of the total capital PE money available in the country, has over 14,000 companies, which makes competition much less intense. For this reason, Brazil has attracted large international middle market funds, such as HIG. Competition for small sized deals remained stable at neutral levels.

The general perception among the respondents is that Brazil’s PE market is more competitive than in 2011. In such a competitive environment, access to deals becomes an essential differentiating factor. This is particularly true in a country with the dimensions of Brazil, where many family businesses are in places distant from the main business hubs. Accordingly, 73% of the respondents to the 2014 INSEAD PwC-Survey see the industry moving towards more proprietary deals, unlike the more mature and intermediated PE markets.

Established local players have developed large networks over the years. Institutional-backed local funds, for example, leverage multiple client relationships held by the parent banks to source deals, which would be extremely difficult to access otherwise. This access is a larger challenge for international funds. They try to increase proprietary deal sourcing through local offices with native people or through partnerships with established local funds. This was the option pursued by Blackstone, which in 2010 established a partnership with Patria Investments, one of Brazil’s largest GPs.

Another source of differentiation is sector expertise. Of the GPs interviewed, 73% of the GPs interviewed identified higher specialization as an important trend. GPs that have sector
knowledge can bring additional value to portfolio companies, which can be an advantage in competitive auctions, especially when dealing with family business owners, who often stay on as partners to participate in the growth of their company. In these cases, sector expertise and track record help GPs to gain credibility with business owners. Additionally, sector specialists have a differentiated network, which also helps in the deal sourcing process. An interesting example of an international fund that leverages on both strategies is the Emerging Market fund Actis. It utilizes a mix of sector expertise, through global sector teams, and has local presence in Brazil in Sao Paulo.

The opportunity for specialized funds will remain limited to specific sectors that have the necessary size of opportunity, such as Energy and Agribusiness.
Exit Strategy

PE exits in Brazil have historically been dependent on trade sales and IPO’s. However, the declining performance of Brazil’s public equity markets since the last study has made tapping public markets less appealing. Taking out the government-backed deal for the capitalization of Petrobras for US$ 60 billion, IPOs and follow-on transactions accounted for only US$ 37 billion worth of transactions between 2010 and 2013. In addition, as detailed in Box 1, recent failures of companies that went public before 2011 caused public market investors to be more cautious with IPOs, especially for projects with unproven business models. Growth and buy-out funds still see public markets as a possible exit strategy, but are relying less on them. Last year, for example, only 4 private equity investments were exited through IPOs, including Carlyle Group’s travel agency CVC and Bozano Investments Anima Educação.

Reflecting this sentiment, respondents to the 2014 INSEAD-PwC Survey reported that they expect 66% of their investments to be exited through trade sales and only 22% through IPO on average. A recent successful example of this strategy was Itaú’s US$ 826 million sale of Grupo Multi, an English-training company to Pearson PLC. Another exit path that funds are increasingly exploring is sale to another PE firm through the secondary market. With the increasing number of large buy-out funds in the country and as growth investments mature, this type of strategy could become more relevant, as is the case in more developed markets. A recent example of a secondary market transaction is Actis’ US$ 170 million sale of financial services provider XP to General Atlantic in 2012.

The exit mix and low reliance on IPOs is not necessarily expected to adversely impact exit multiples and returns, as sufficient alternative exit strategies exist. In fact, 63% of the respondents to the 2014 INSEAD-PWC Survey were either positive or neutral about the impact of exit opportunities on returns.
**Performance**

PE investment in Brazil has historically provided healthy returns. Median Brazilian PE funds’ IRR from 1990-2008 was 26%, with mean multiples of money invested of 2.5x over the period. The historic return profile for PE in Brazil was reflected in the 2014 INSEAD-PwC Survey, as only one firm among those providing historical performance reported returns below 20%.25

A comparison of the attribution of returns between the 2011 and 2014 INSEAD-PwC Surveys highlights the changing industry dynamics from the cyclical peak. Historically, EBITDA growth drove returns in Brazilian PE, predominantly via top-line revenue growth. Multiple expansion has also been a consistent driver of performance, with leverage playing a smaller role. Tempered growth expectations and increased risk aversion have driven Brazilian public equity markets lower in recent years. As a result, the contribution from capital market-sensitive drivers (i.e. multiple expansion and leverage) fell 14% between the survey of 2011 and 2014. Operational improvements as a generator of returns increased by 8% between the surveys. The shift exemplifies the PE industry’s recent focus on operational value creation in an increasingly competitive market.

A similar comparison between the 2014 INSEAD PwC Survey participants and developed market PE fund performance highlights the stage of development of Brazil’s PE industry. As opposed to the high share of performance attributed to cash flow growth – particularly revenue growth – in Brazil, developed market PE funds generate returns from a more balanced mix of the four observed drivers and a high contribution from leverage.26 This difference is mainly due to the higher proportion of buy-out investments, as well as the customary usage and ready availability of debt capital to fund transactions.

GP and LP participants in the 2014 INSEAD-PwC survey expressed a general sense of optimism in regard to the future performance of PE investment in Brazil. Of the GPs that provided expected returns, all anticipate returns between 20% and 30% IRR over the next five years. An expected driver of performance includes the current downturn in equity markets, which represents good opportunities for funds with local knowledge and networks to enter investment at lower valuations, and benefit from multiple expansion at exit. LPs, while optimistic, are more cautious regarding future returns given the increasingly competitive environment.

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25 Spectra (2013)
26 GP performance and performance attribution from the INSEAD-PwC study on Private Equity in Brazil (2014) are self-reported and unverified. Future-looking predictions are also biased and often overly optimistic.
27 For an example see : Capital Dynamics (2009)
IV. Outlook

With a consistent track record of political stability, positive long-term economic dynamics in place and a cyclical upturn in fundraising Brazilian PE professionals are guardedly optimistic about the prospects for the industry.

Although macroeconomic policy has been unstable over the past few years and investor confidence is not at the level of the last study, the long-term trends that make Brazil a compelling investment case are still in place. Brazilian demographics remain positive and the country has a decade of positive demographic development left, including a working age population growth rate faster than non-working age population growth. Additionally, Brazil’s middle class continues to grow, although at a slower pace, unemployment is expected to remain low, and salaries increase above inflation rates.

Some of the interviewees cited that Brazil’s middle class is entering a new phase of development, where consumers that gained access to basic consumption goods over the past decade now demand more complex goods and services, such as computers, private healthcare, and travel packages. In addition, the slowdown of Brazil’s consumer-driven growth boom is leading the government to take measures to foster sectors instrumental to creating sustainable long-term growth, such as education and infrastructure. This support should provide a more robust base for economic growth and open up investment opportunities for private capital.

Local Capital

While the attention of foreign institutional investors has shifted from Brazil to other emerging and developed economies, investment interest from local LPs has increased significantly compared to three years ago from both institutional investors and high net-worth individuals. A higher willingness to invest in Brazil by local institutional investors was cited by 78% of GPs in our survey, while an increased willingness among local high net-worth individuals was cited by 67% of respondents.

Respondents mentioned that as the PE market develops and a larger number of firms deliver strong and consistent track record, local LPs have become more comfortable and familiar with the asset class. Steps towards a clearer regulatory framework for PE have also contributed to the increased interest from local investors, including the Code for regulation and best practices of Fundos de Investimentos e Participações (FIPs) by ANBIMA and ABVCAP. This Code was a result of research and dialog between regulators and industry participants.

LPs exhibiting this trend include Brazilian pension funds Previ and Funcef, who recently announced the intention to increase the share of PE investments in their portfolios.\(^\text{26}\) Previ is

\(^{26}\) Estado de São Paulo (2014)
expected to increase the allocation to PE from its US$ 71 billion Plano I fund from 0.6% to 2-3% in 2020, and the allocation from its US$ 2 billion Previ Futuro fund from 1.8% to 4-5%. Funcef announced its intention to increase its current 12% PE commitment to 15%.29

Yet while this supply of domestic capital will help the industry, it is unlikely to replace foreign institutional investment as the dominant investor category for the asset class in the foreseeable future.

**GP & LP Outlook**

Despite the macro environment and general perception of Brazil among investors is not as bright as in 2011, LPs and GPs are relatively optimistic for the coming years. Premier GPs’ fundraising efforts – including Patria’s successful US$ 1.75 billion buy-out fund raise in Q3 2014 – are expected to keep LPs’ focus on the market. Patria’s fundraising also signifies an expected uptick in buy-out activity, supported by a swath of smaller companies achieving desirable size to be acquired in buy-out transactions.

This sentiment was reflected by GPs and LPs in the 2014 INSEAD-PWC Survey. When asked about their outlook on ten main factors affecting the PE environment in Brazil compared to three years ago, many were considered either stable or better. The most positively perceived factors were quality of management and GP teams, the pipeline of opportunities, and currency levels. Expectations about regulation, exit opportunities, entry prices and competition are mixed, while the macroeconomic environment and competition are the factors causing the most concern.

![GP and LP Question: How do you see the following factors affecting returns compared to recent past?](image)

Source: INSEAD-PwC study on Private Equity in Brazil (2014)

29 Estado de São Paulo (2014)
V. Conclusion

The extremely positive outlook pictured by industry practitioners in the last INSEAD-PwC study in 2011 did not fully materialize. Fundraising decreased dramatically after 2011, partly due to a shifting perception of Brazil, and partly due to a substantial capital overhang from record fundraising in 2011 when most major funds present in Brazil raised money. However, many of the long-term secular growth trends that helped to bring Brazil to the top of the list of most attractive emerging markets for PE investors in 2011 are still in place, albeit somewhat diminished. The PE industry has matured significantly over the past years. In 2014, several billion-dollar funds are in the market and expectations for deal activity and returns are positive.

The majority of highly successful deals continue to be executed in capital-light areas, such as consumer goods & retail, business services and TMT; however, dedicated funds and government incentive programs indicate GPs’ interest in more capital-intensive industries – including infrastructure and agribusiness – moving forward. Competition for attractive large deals is expected to intensify, with an increase in the number of players and capital pursuing deals of this type. Competition in the mid-market is less intense, although several large players have entered the space.

The Brazilian PE industry has evolved and consolidated but still shares many features with other emerging PE markets. Growth capital is still predominant and most deals are still done with minimal leverage. Looking ahead, GPs expect continued strong performance, and the general sentiment is that the pipeline for deals is improving, currency is favorable, and prices are reaching attractive levels. Despite macro concerns, GPs believe that the Brazilian market is too large to be ignored and that the recent market cool-down represents a good buying opportunity for investors with the right network and who are familiar with the country’s environment for doing business.

International LP’s perception of the market is split, as the attractiveness of opportunities in Brazil have fallen relative to other geographies, particularly developed markets. Local LPs, on the other hand, are increasing allocations to PE, as they become more familiar with the asset class and industry regulation improves. Although these investors still represent a small share of the industry’s investor base, they have size and potential to be a significant source of industry capital in the long run.

The PE market has undergone dramatic changes between the 2011 and 2014 INSEAD-PwC studies on the industry. As the industry experiences an uptick in fundraising and sentiment, GPs and LPs are guardedly optimistic about the country’s prospects moving forward. We look forward to returning to the market in a few years to assess the market’s further development.
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