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THE PRIVATE EQUITY INDUSTRIES IN LATIN AMERICA

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THE PRIVATE EQUITY INDUSTRIES
IN LATIN AMERICA (1)

Resumen:

The purpose of this paper is to provide the reader with an overview of the situation of the private equity industries in Latin America, focusing on the example of one Latin American economy, namely Brazil. It takes the view of a person who has no prior experience of private equity but who is interested in the industry and its situation in Latin America. Therefore it describes the general specifics of private equity, summarizes its evolution in Latin America and illustrates the regional framework within which this evolution has taken place. It also highlights specific features of the Brazilian private equity industry, all with the aim of drawing an illustrative picture of the industry in Latin America.

(1) This paper has been written under the supervision of Professor José Manuel Campa of IESE.

THE PRIVATE EQUITY INDUSTRIES IN LATIN AMERICA

Acknowledgments

First of all, I would like to thank very much Angela Gallifa, the director of CELA (Centro para la Empresa en Latino América) in Madrid, who invited me to do the project at IESE and therefore made this whole study possible. She was always very interested in the progress of the work and helped me whenever necessary. By introducing me to José Manuel Campa, my mentoring professor, and Ana Minguella, the person in charge of IESE's Latin American communication, she provided some very rewarding and helpful contacts at IESE in Barcelona and I would like to thank them all very much for the time they have spent with me and the effort they have put into the project.

Special thanks go to Professor Rob Johnson, who taught me all the key concepts of private equity in his lectures and gave me helpful hints in various after-class discussions.

A big thanks to all the Latin American MBAs on campus at IESE who invited me to their meetings and who gave me very valuable first-hand information about their countries. Thanks, and goodbye as well, to all the PhD students who shared the library with me and who supported me with their experience in writing longer theses.

THANK YOU!

Sources

The paper was written at IESE Business School in Barcelona where the author had access to all the facilities and so could use mainly three different types of sources:

- Literature of every kind obtained through various forms of research.
- Course material and class input gained through the MBA course on “Financing Entrepreneurial Activities”, given by Prof. Rob Johnson.
- Explanations and discussions with IESE faculty and first-hand information from Latin American MBA students.

Considering the data presented here, it is important to highlight one key characteristic of Private Equity: it is private. Transactions take place between two parties who have essentially no obligation and almost no incentive to disclose the terms of the investments. This characteristic makes a statistical analysis of private equity particularly problematic, especially in Latin America, where there are no institutions or associations that systematically collect the information. Therefore, the data presented here, gathered from sources like regional surveys of commercial service companies, is intended to serve as an indicator and is not necessarily complete.

Background

This paper is submitted as an elective report to the Centre for Enterprise in Latin America (CELA) at IESE Business School.

The elective report is a research project that has to be completed in order to successfully graduate from Witten/Herdecke University, a private university in Germany. At the Faculty of Economics and Management at Witten/Herdecke University the author is studying towards a master's degree in Economics and Business Administration.

IESE is a leading business school in the Spanish-speaking world, based in Barcelona and Madrid, where it runs various MBA programs and an array of executive training programs. Since its foundation, IESE has been known for its dense Latin American network and strong academic focus on this region. To bundle its Latin American activities, a special institute, the Centro para la Empresa en Latinoamerica (CELA), was created which holds dedicated conferences, runs special business training courses and undertakes regional research. The Centre is also designed to foster close links between IESE and the Latin American business and academic world (2). As CELA was the hosting institute for this project, Professor José Manuel Campa, Associate Professor of Finance at IESE, took on the mentoring role. His general interest in all aspects of Latin America, and especially Latin American financial markets, led him to participate, alongside his busy schedule, as mentoring professor in the project. For this the author would like to thank him very much.

The private equity industries in Latin America

Introduction

The purpose of this paper is to provide the reader with an overview of the situation of the private equity industries in Latin America, focusing on the example of one Latin American economy: Brazil. It takes the view of a reader who has no prior experience of private equity but who is interested in the industry and its situation in Latin America. Therefore, it describes the general specifics of private equity, summarizes its evolution in Latin America and illustrates the regional framework within which this evolution has taken place. It also highlights specific features of the Brazilian private equity industry, all with the aim of drawing an illustrative picture of this industry in Latin America.

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(2) For further information see: www.iese.edu/cela

The structure

The structure of this paper is intended to imitate the effect of a magnifying glass, narrowing the view from a broad perspective on the private equity market in general towards a detailed look at the market in an individual country, namely Brazil.

Chapter I

The paper starts, therefore, with a general introduction to the main characteristics of a private equity market, which are considered without any regional reference. In this first chapter, the three main players in any private equity market, the issuers, the investors and the intermediaries, are described, followed by an illustration of the three activities these players generally engage in, which are fundraising, investing and exiting.

Chapter II

The second chapter is intended to offer an overview of the Latin American region as a whole. This is needed because of the acknowledged close linkage between the different countries in the region, known as the "Latino Domino", which is a consequence of private equity having evolved in similar patterns and within a similar timeframe throughout the region. As the most important Latin American economies, as far as private equity investments are concerned, are currently Mexico, Chile and Brazil, these three countries will be looked at in some detail and assessed from the viewpoint of a potential investor. This means, on the one hand, getting to grips with the political and economic situation and background in each country and, on the other hand, gaining an impression of the specific country risk, which requires briefly considering some relevant indicators such as exchange rate, inflation and GDP growth. Aggregate data will be used to demonstrate the similarities in the evolution of private equity throughout the Latin American region, and common problems and difficulties will be pointed out.

Chapter III

To get a sound understanding of the private equity industry in Latin America, a closer look at one leading economy will be helpful. Therefore, an exemplary analysis of the Brazilian situation is offered as a means of working out the specific details and features that give the industry its Latin American character. By looking at the three phases of the private equity cycle –Fundraising, Investing and Exiting– this third chapter offers an illustration of the history and current situation of each distinctive activity and gives a comprehensive outlook for each phase of the cycle. Some of the features may also be observed in neighbouring countries, while others are specific to the Brazilian market.

Chapter I: Private Equity

Broadly speaking, the term "private equity" refers to any investment strategy that involves the purchase of equity in private companies. Such equity financing, which is not obtained through a public stock exchange, ranges from angel investing and venture capital to later-stage private equity financing and leveraged buyout capital. In Latin America the term *capital de risco* is commonly used, making no distinction between the stages of the companies that seek to raise private equity finance. The market for private equity has three major participants: the issuers of equity, the investors who invest in the equity, and the intermediaries between the issuers and the investors.

The issuers

Issuers in the private equity market vary widely in size and reasons for raising capital, but they share a common trait: private equity being one of the most expensive forms of finance, generally speaking they are firms that cannot obtain financing in the debt or public equity market.

Issuers of equity known as venture capital are young firms, most often firms that are developing innovative technologies and are expected to show very high growth rates in the future. They may be early-stage companies, those still in the research and development stage or in the earliest stages of commercialisation, or later-stage companies, those that have several years of sales but are still trying to grow rapidly.

Middle-market companies are roughly defined as companies with annual sales of US$ 25 million to US$ 500 million. Many of these companies are stable, profitable businesses in low-technology manufacturing, distribution, service and retail industries. They use the private equity market to finance expansion –through new capital expenditures and acquisitions– and to finance changes in capital structure and in ownership, the latter often the result of owners of private businesses reaching retirement age.

Public companies also are issuers in the private equity market. Public companies that go private issue a combination of debt and private equity to finance their management or leveraged buyout. Public companies also issue private equity to help them through periods of financial distress and to avoid the registration costs and public disclosures associated with public offerings.

Intermediaries

The Intermediaries are, in general, management companies to whom the investors delegate the labour-intensive responsibilities of selecting, structuring, managing and liquidating their private equity investments. They structure their relationship with the investors in a partnership agreement, which usually lasts about ten years. Under this partnership agreement the investors are limited partners, and the professional private equity managers, working as a team, serve as the general partners. In most cases the general partners are associated with a partnership management firm or work as affiliates of a financial institution, such affiliates being structured and managed in the same way as the independent partnership management firms. Because of their good insight and local presence in the relevant private equity market, the general partners are expected to be better equipped to act on a daily basis with the portfolio companies than the limited partners.

Through this arrangement the investors commit their money for a specific period of time to the funds raised by the general partners and in so doing forgo virtually all control over their investments. Two factors ensure that the goals of the limited and the general partners are aligned: First, partnerships have finite lives, so in order to remain in business, private equity managers must regularly raise new funds, and fund-raising is less costly for more reputable firms, which makes establishing a favourable track record key for these companies' future. Second, the general partners' compensation is closely linked to the partnership's performance. Besides a relatively small management fee, which is calculated as a fixed percentage of committed capital and is designed to cover day-to-day expenditures, the general partner's main compensation is a share of the partnership's profit, known as "carried interest". This arrangement –providing limited compensation for making and managing investments and significant compensation in the form of profit sharing– lies at the heart of the partnership's incentive structure. The relationship between the two parties is documented in a partnership agreement, in which issues such as management fee, carried interest and covenants are negotiated.

Investors

A variety of groups invest in the private equity market. Public and corporate pension funds are the largest investor groups, followed by bank holding companies, wealthy families and individuals. Most institutional investors invest in private equity for strictly financial reasons, specifically because they expect the risk-adjusted returns on private equity to be higher than the risk-adjusted returns on other investments and because of the potential benefits of diversification. Bank holding companies, investment banks and non financial corporations may also choose to invest in the private equity market to take advantage of economies of scope between private equity investing and their other activities.

Market activities

The activities in this market can be divided into three main stages: i. Fundraising, ii. Investing, and iii. Exiting.

Fundraising

This is the process through which a management firm solicits financial commitments from limited partners for a private equity fund. Firms typically set a target when they begin raising the fund, and ultimately announce that the fund has closed at a specific amount, meaning that no additional capital will be accepted. Sometimes funds are raised in several stages, referred to as "closings", which appears to be primarily a device for communicating to the investment community that a fund is being successfully raised, implying a favourable evaluation of the fund by those that have already committed. Targeting all different types of potential investors, successful fundraising strongly depends on the management company's having a favourable track record and announcing appropriate strategies for the fund in question. Setting up new partnerships is considered to be very time-consuming and costly, generally starting with a road show involving presentations to institutional investors and their advisers. Because partnerships have finite lives, the private equity manager must regularly raise new funds in order to stay in business. In fact, in order to invest in portfolio companies on a regular basis, managers must set up another new partnership as soon as the fund from the existing partnership has been fully invested.

Investing

After the investors have committed their money to a certain fund, their interests are illiquid over the agreed lifetime of the partnership and they have in general little control over the way the fund is managed. It is now the general partners' responsibility to manage the partnership's investments and normally they contribute a very small proportion of the partnership's capital (most often, 1 percent) in order to prove they have an interest aligned with the needs of those who have provided the balance of the investment fund, the investors. A partnership's investment activities are divided into four stages. The first is selecting the investments, which includes obtaining access to high-quality deals and evaluating potential investments during various due diligences. The second stage is structuring the investments. "Investment structure" refers to the type and number of securities issued as equity by the portfolio company and to other substantive provisions of investment agreements. These provisions affect both managerial incentives in portfolio companies and a partnership's ability to influence companies' operations. The third stage, monitoring the investments, involves active participation in the management of portfolio companies. Through membership on boards of directors and less formal channels, general partners exercise control and furnish the portfolio companies with financial, operational and marketing expertise as needed. The fourth stage is exiting the investments. Because partnerships have finite lives and investors expect repayment in cash or marketable securities, an exit strategy is an integral part of the investment process.

Exiting

This is the point at which the investors realise their investment. General managers may, depending on their business and their own situation, look to achieve an exit in anything from a few months to 10 years. The contractual agreement to end the partnership and to repay the limited partners within a specified period of time forces the general partners to think about a clear route to exit their portfolio companies. Exits generally occur via trade sales, secondary management buy-outs and flotation on the stock market or by write-off if the investment ends in receivership.

Chapter II: Private equity in Latin America

A study of the Latin American private equity industry needs to begin with a familiarization with the macroeconomic environment. Private equity activity represents a long-term commitment for the investors, potentially as long as ten years between a limited partner's contribution and the liquidation of the fund. Accordingly, private equity investors and managers need to adopt a long-term view and monitor closely the macroeconomic conditions and trends of the targeted regions. As the economies of the Latin American countries are strongly interdependent and cannot be surveyed independently, it is necessary to look first at some of the major countries in order then to take a closer look at a single nation like Brazil. The following section will therefore describe the economic situation of the three countries which are, according to PriceWaterhousecoopers (i), currently the most popular private equity destinations for U.S. private equity investors: Brazil, Mexico and Chile.

The countries

Mexico

The site of advanced Amerindian civilizations, Mexico came under Spanish rule for three centuries before achieving independence early in the 19th century. A devaluation of the peso in late 1994 threw Mexico into economic turmoil, triggering the worst recession in over half a century. The nation continues to make an impressive recovery. Ongoing economic and social concerns include low real wages, underemployment of a large segment of the population, inequitable income distribution, and few advancement opportunities for the largely Amerindian population in the impoverished southern states.

Mexico has a free market economy with a mixture of modern and outmoded industry and agriculture, increasingly dominated by the private sector. The number of state-owned enterprises in Mexico has fallen from more than 1,000 in 1982 to fewer than 200 in 2000. The administration under Zedillo privatised and expanded competition in seaports, railroads, telecommunications, electricity, natural gas distribution, and airports. A strong export sector helped to cushion the economy's decline in 1995 and led the recovery in 1996-2000. Private consumption became the leading driver of growth in 2000, accompanied by increased employment and higher real wages. Mexico still needs to overcome many structural problems as it strives to modernize its economy and raise living standards. Income distribution is very unequal, with the top 20% of income earners accounting for 55% of income. Trade with the US and Canada has tripled since NAFTA was implemented in 1994. Mexico completed free trade agreements with the EU, Israel, El Salvador, Honduras, and Guatemala in 2000, and is pursuing additional trade agreements with countries in Latin America and Asia to lessen its dependence on the US.

Chile

A three-year-old Marxist government was overthrown in 1973 by a dictatorial military regime led by Augusto Pinochet, which ruled until a freely elected president was installed in 1990. Sound economic policies, first implemented by the Pinochet dictatorship, led to unprecedented growth in 1991-1997 and have helped secure the country's commitment to democratic and representative government. Growth slowed in 1998-99, but recovered strongly in 2000.

Chile has a market-oriented economy characterized by a high level of foreign trade. During the early 1990s, Chile's reputation as a role model for economic reform was strengthened when the democratic government of Patricio Aylwin –which took over from the military in 1990– deepened the economic reform initiated by the military government. Growth in real GDP averaged 8% during 1991-97, but fell to half that level in 1998 because of tight monetary policies implemented to keep the current account deficit in check and to lower export earnings –the latter a product of the global financial crisis. A severe drought exacerbated the recession in 1999, reducing crop yields and causing hydroelectric shortfalls and electricity rationing, and Chile experienced negative economic growth for the first time in more than 15 years. Despite the effects of the recession, Chile maintained its reputation for strong financial institutions and sound policy that have given it the strongest sovereign bond rating in Latin America. By the end of 1999, exports and economic activity had begun to recover, and growth rebounded to 5.5% in 2000. Meanwhile, Chile has launched free trade negotiations with the US.

Brazil

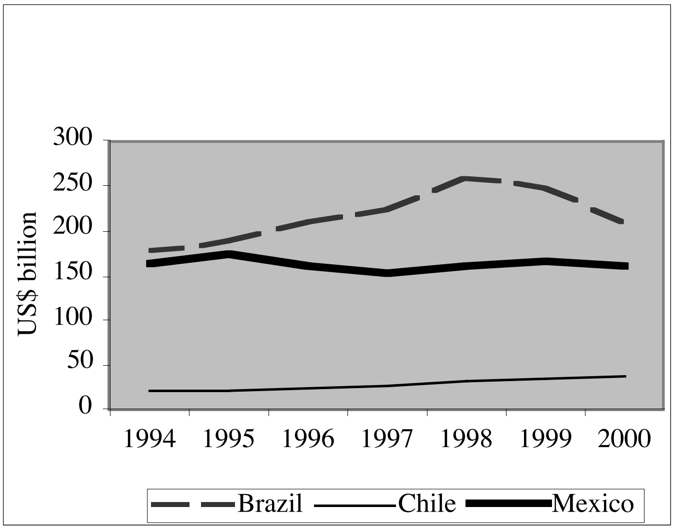
To take a closer look at the situation of private equity in Brazil, this country will be discussed in detail in chapter III.

Assessment of macroeconomic environment

Risk Rating and Interest Rates

Country risk, which is widely used in Latin America, is generally measured as the spread of the yield on local government bonds over comparable U.S. bonds. This measure indicates the excess return that a country has to pay for the higher risk according to the risk-return principles. Several institutions report country risk; the most frequently cited source is the JP Morgan EMBI+ Indicator. Specifically, country risk has important implications for the refinancing of the government and the whole financial community.

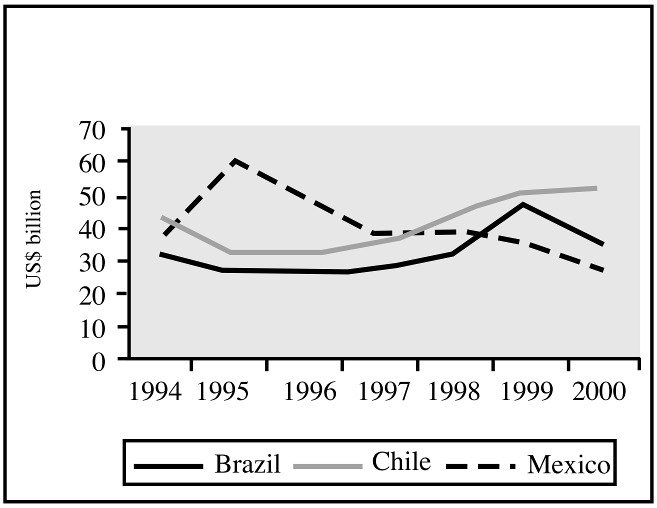
Figure 1. External Debt 1994 – 2000



Higher country risk implies that refinancing deficit spending becomes more expensive. Brazil (2000: US$ 207.2 billion) and Mexico (2000: US$ 160.4 billion) have both accumulated a large deficit, which results in big debt-interest payments. In 2000, Brazil's debt amounted to 34.8% of GDP while the Chilean and Mexican debt adds up to 52.2% and 38% of GDP, respectively.

In all three countries, the trade balance is still, or was until recently, negative and therefore did not improve the deficit situation significantly. Consequently, all three countries have to refinance their amount of debt by issuing new bonds, which leads to increasing interest rates for all financial instruments. Exhibits 1 and 2 demonstrate the interest levels for short-term financing in Brazil, Mexico and Chile.

Figure 2. External Debt as % GDP

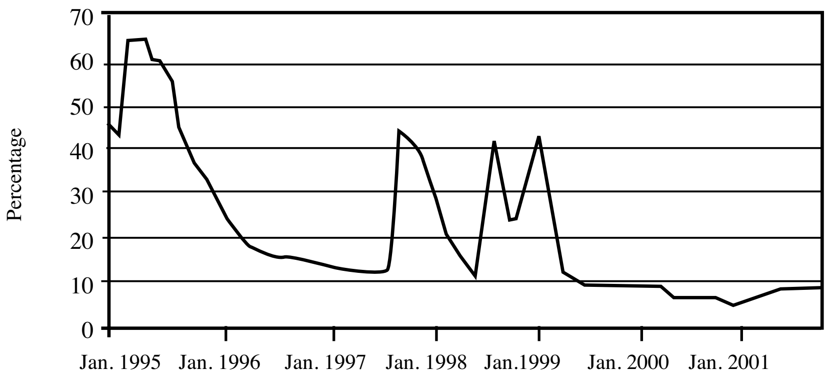


Source: www.dbresearch.de

Brazil. Interest Rate

After experiencing a trade deficit of US$748 million in 2000, Brazil reported for 2001 its first realized trade surplus since seven years (US$ 2.6 billion) while the high level of interest rates of up to 50% only recently dropped slightly under 20%, which therefore still represents a high barrier to access to capital.

Exhibit 3. Brazil - Interest Rate (3)



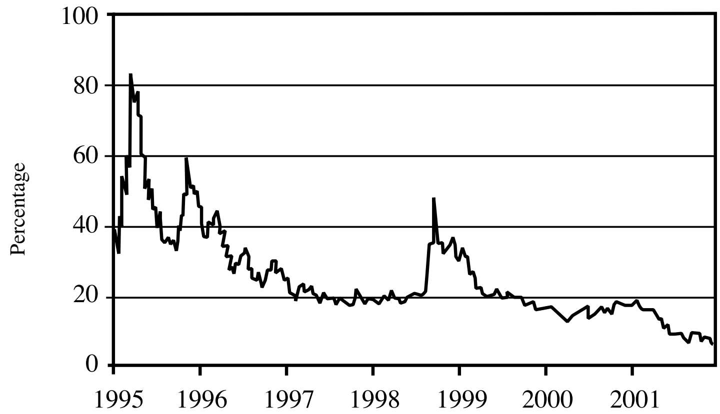
Source: Banco Central do Brasil

Mexico. Interest Rate

With a trade deficit of US$ 536 million in July 2001, Mexico's interest rate averaged roughly around 20% and just recently decreased to an amount below 10%.

(3) Note: Interest rate represents annualised Serviço Especial de Liquidaçao e Custódia—SELIC.

Figure 4. Mexico – Interest Rate (4)



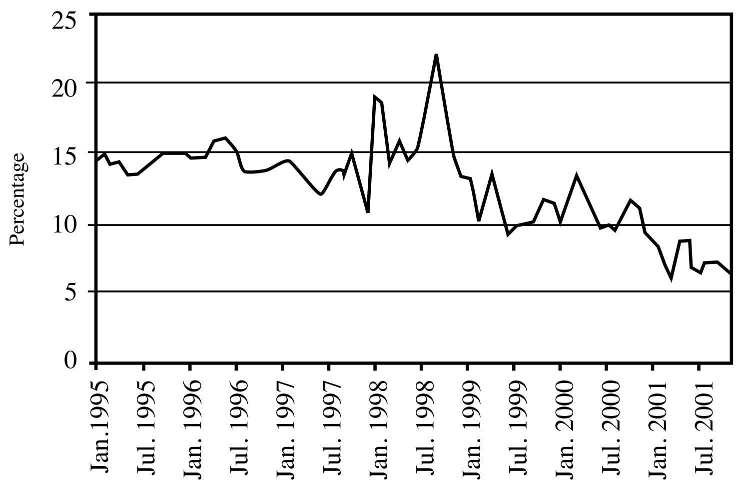
Source: Banco de México

Chile

Interest Rate

Even Chile has been faced with an interest rate above 10%, but figures higher than 20% have been only a temporary phenomenon in its history. This result is accompanied by a trade surplus which in June 2001 amounted to $48 million.

Figure 5. Chile - Interest Rate (5)



Source: Banco Central de Chile and LatinFocus calculations

In 1998, the emerging market crisis in Asia finally reached Latin America, which led to a massive outflow of capital from the region. To increase the inflow of capital, Latin

(4) Note: CETES 28 days (Certificados de la Tesorería de la Federación a 28 días).
(5) Note: Benchmark interest rate, PDBC (Pagarés Descontables del Banco Central). On 26 July (effective: 9 August 2001), the Chilean Central Bank decided to define its monetary policy interest rate in relation to Chilean pesos rather than the inflation-adjusted UF (Unidad de Fomento), a widely used indexing unit. From July 1997, the data in the chart refer to the nominal 90-day PDBC. Prior to that date, the chart reflects the 90-day PRBC (Pagarés Reajustables del Banco Central), adjusted for inflation.

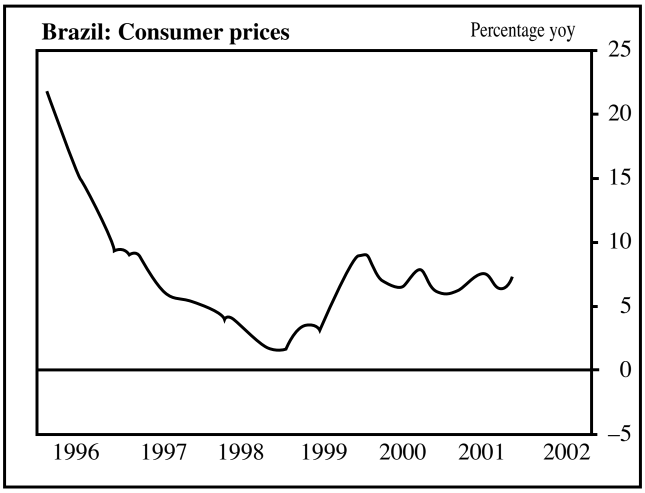
American central banks had to raise interest rates significantly. Still, the comparatively high level of interest and the continuing demand for capital from the Mexican and Brazilian governments made access to capital in the region very difficult. In an effort to finance their debt, the governments were raising interest rates to draw foreign capital into the region, thus completely drying up the local markets for debt. Big local suppliers of capital such as pension funds, insurance companies and local banks presently hold a major part of their assets in government bonds. Some multinational companies are still able to refinance on the international capital markets, but for the huge number of medium-sized companies this capital source is too expensive and effectively unavailable. This lack of debt instruments affects companies at every stage of their development. Debt capital is not available for starting up a company; in their day-to-day business companies are unable to refinance their working capital; and American-style leveraged buyouts are also out of the question.

Inflation

After a period of hyperinflation during the 1980s and early 1990s, all three countries show reasonably low inflation rates. The Brazilian Extended Consumer Price Index-Special (IPCA-E), calculated by IBGE (6), closed the year 2001 at 7.51%, presenting a change of 1.92% in the last quarter.

Mexican consumer prices increased by 5.39% (7) and Chile reported a change in its consumer price index of 2.6% (8).

Figure 5. Brazil – Consumer Price Index



Source: DBR

A history of hyperinflation has an effect on the behaviour of the market participants. Savings are historically low because consumers do not trust long-term vehicles. Additionally, people are not used to long-term planning, which was never fully possible in the past. This lack of long-term vision is also reflected in investment behaviour.

(6) See: National Statistical Institute IBGE, Brazil: www.ibge.gov.br
(7) See: Ministry of Finance, Mexico: www.shcp.gob.mx
(8) See: National Statistical Institute INE, Chile: www.ine.cl

Exchange Rate

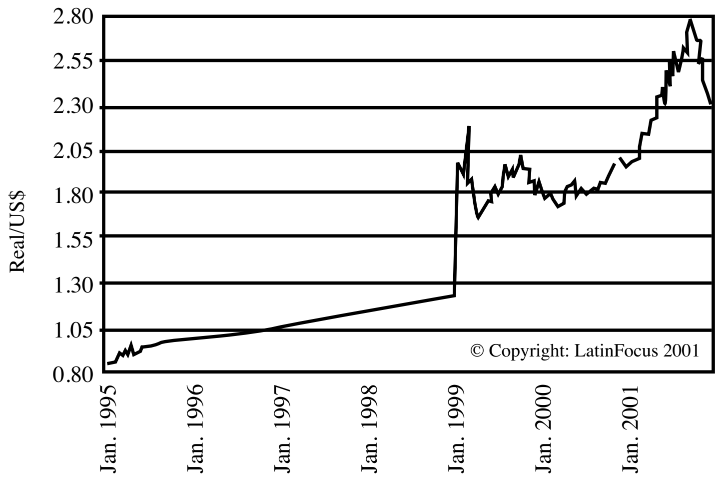
Exchange rate development is a crucial parameter for returns on investments from abroad. As the capital of most investment funds is denominated in U.S. dollars and investments are made in the local currency, with most cash flows also denominated in pesos or reals, the effective returns are affected to a great extent by the development of the currency.

Brazil

Exchange Rate

The Brazilian investment community was especially affected by the unexpected development of their currency. Until January 1999, the central bank had defined a corridor for the exchange rate but was unable to defend it. In the following three months, the real depreciated by about 80%, decreasing returns significantly.

Figure 6: Brazil – Exchange Rate Development 1995 - 2001 (9)



Source: Banco Central do Brasil.

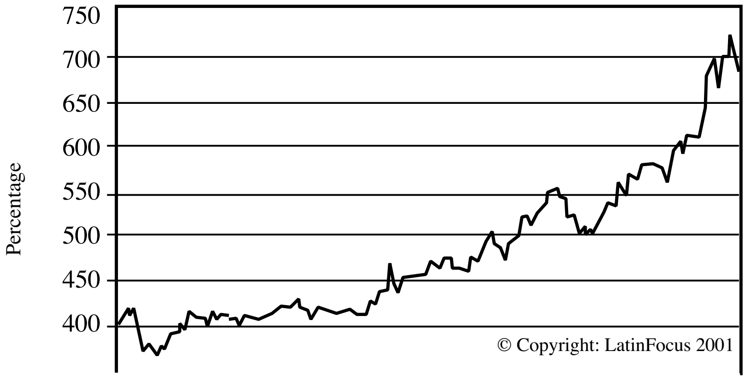
Chile

Exchange Rate

Chile has seen a stable development of its currency until mid-1998, when the effects of the Asian crisis caused the start of a devaluation trend, which in different phases and for different reasons has continued until today.

(9) Note: End-of-day commercial exchange rate (Selling).

Figure 7. Chile – Exchange Rate Development 1995-2001 (10)



Source: Banco Central de Chile.

Mexico

Exchange Rate

After adopting a floating peso, the Mexican exchange rate has been relatively stable, but always at a relatively high level.

Figure 8. Mexico – Exchange Rate Development 1995-2001 (11)

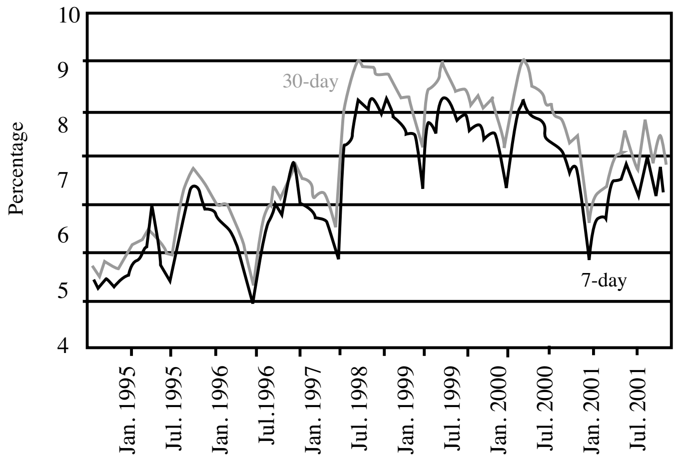
Source: Banco de México.

Unemployment

Brazil (7.1%) and Chile (9%) both face a relatively high unemployment rate, while Mexico reported unemployment of about 2.4%.

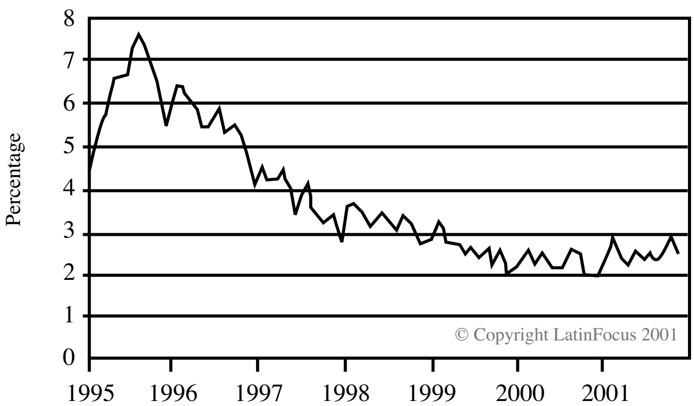
(10) Note: Observed market exchange rate.
(11) Note: Closing level of interbank selling rate (48 hours).

Figure 9. Brazil – Unemployment 1995-2000 (12)



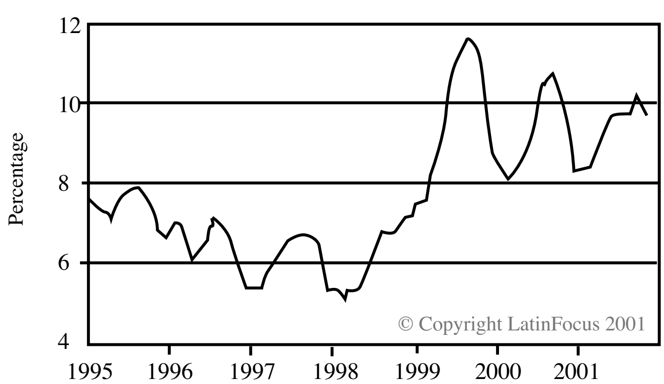
Source: Instituto Brasileiro do Geografia y Estadistica.

Figure 10. Mexico – Unemployment 1995-2000 (13)



Source: Instituto Nacional de Estadística, Geografía e Informática, Mexico.

Figure 11. Chile – Unemployment 1995-2000 (14)



Source:Instituto Nacional de Estadísticas, Chile (INE).

(12) Note: End of period. Monthly unemployment rate as percentage of total labour force (30- versus 7-day).
(13) Note: Open urban unemployment as a percentage of the economically active population.
(14) Note: Moving quarterly averages.

The relatively poor provision by social security in these countries makes the unemployment rates only partly comparable with the unemployment figures in developed countries, where the effects of unemployment are less harshly felt by those affected. The rate of unemployment has some effects on the portfolio companies of private equity firms. For instance, increasing unemployment slows domestic spending, which means that revenue milestones, required by most of the investors, may not be reached. On the other hand, an oversupplied labour market offers opportunities to start up companies. Unemployed entrepreneurial individuals may consider setting up their own business while looking for a new job, which is one of the reasons why Brazil just recently was cited in a Global Entrepreneurship Monitor as the country with the highest level of entrepreneurial activity. On the other hand, in times of high unemployment already existing companies are better able to find cheap and highly qualified employees.

Stock Markets

Because of the high prevailing interest rate, debt financing is not available to most Latin American companies and so equity remains the only logical source of financing.

However, over the last few years Latin American stock markets have been illiquid and highly volatile: many companies were sold to international companies and consequently delisted from exchange, while other liquid stock was transferred to the NYSE as ADRs, diverting most of the trading volume to the U.S.

With these developments, liquidity and daily trading volumes have declined considerably. Average daily trading volume in June 2001 on the BOVESPA in Brazil was only R$660 million (approximately US$260 million), down 22% from the previous year. In Mexico and Chile the picture is similar, with trading volumes declining on average between 20% and 30% per year for the last four years (ii).

Several “blue-chip” companies are able to access international debt or equity markets to cover their financing needs, but there are only some 50 such firms in each of the three countries under consideration. For many thousand medium-size firms, access to the international markets is impossible and local long-term capital is also unavailable, as the local stock markets are too weak, corporate bond markets are only just starting to evolve and bank credit is extremely expensive.

However, getting listed on a local stock market is also out of question for the majority of these companies. On Brazil’s main stock exchange, the BOVESPA, a limited number of companies gained a listing during the last few years, although the growth of listed companies has stagnated and market capitalization has declined. The Chilean stock market has not seen an IPO since 1997.

The lack of shareholder culture among the Latin American public has contributed to the lack of liquidity on the stock markets. Reasons for the absence of such culture are manifold, two of the most significant being the unequal income distribution and the lack of protection of minority shareholders’ rights. The unequal income distribution leads to a situation where a large part of the population simply does not have the necessary financial resources to invest in the stock market, whereas a number of extremely rich individuals often park their capital outside of the country. Apart from making stock market investments unfavourable among the general public, the lack of minority shareholder protection means that financial investors have to incur increased costs. They must negotiate individual shareholder agreements and often even amend company by-laws to make sure that their rights are protected.

Nonetheless, the IPO dream is currently seeing a revival as the BOVESPA has set the framework for a new market, the Novo Mercado, which has strict regulations and transparency rules, following U.S. and European examples (see: Brazil, Novo Mercado).

Evolution of private equity in Latin America

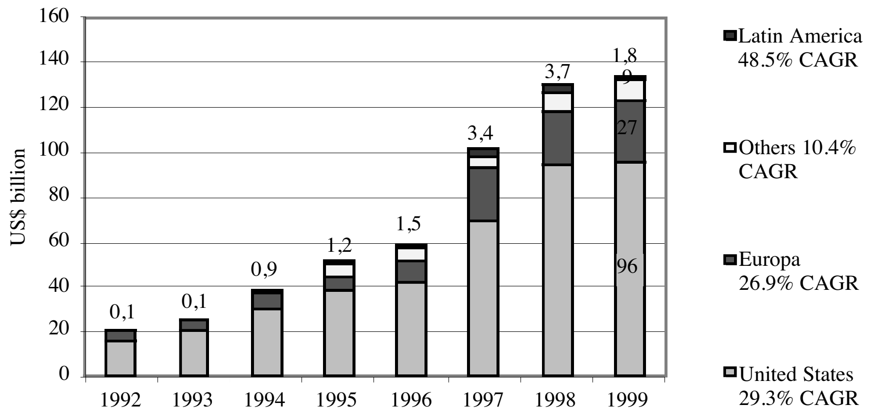
Total Amount of Private Equity Placements per year
(in million US$)

Country	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**Total**
Brazil	82.1	39.6	468.5	NA	884.3	391.7	319.2	2185
Chile	60.0	3.5	1288.4	12.3	192.8	80.4	20.3	1658
Mexico	98.6	473.3	360.8	47.5	345.1	336.0	22.5	1684
Total	240.7	516.4	2117.7	59.8	1422.2	808.1	362.0	5526.9

Source: Schmeider, Frank: Videgaray, Luis: 1999.

Before 1992 there was no private equity commitment in the Latin American region. The concept of equity participations in private businesses by financial agents was practically non-existent in Latin America during the first three quarters of the 20th century and there had been no equivalent to the buy-out model, which was adopted much later. When private equity commitments first started in this region, amounting to the small total of US$ 0.1 billion in 1992, the U.S. had already committed around US$ 16 billion to this specific form of financing. The growth of Latin American commitment, with an annual compounded growth rate (CAGR) of 48.5% during the following eight years to reach the total of US$ 2.6 billion committed in 2000, demonstrates a clear acceptance of this region as an investment opportunity. But as the following graph illustrates, Latin American private equity investing represents only a very small part of the worldwide commitment.

Figure 12. International Private Equity Commitment



21.1	25.1	38.9	51.7	59	101.9	130.2	133.8		World 27.0% CAGR

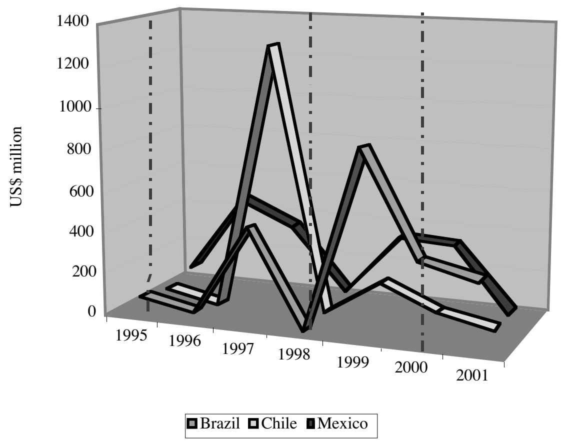
Source. Schneider, Frank; Videgaray, Luis, 1999.

The graph shows that the Latin American region was discovered nearly at the same time as private equity investing became significant in Europe. This was, on the one hand, the result of an overcrowded and highly competitive market in the U.S, where in the year 2000 investors had up to US$ 154 billion of capital committed to private equity, and on the other hand, a reflection of investors' interest in participating in the opportunities afforded by the nations' high growth and the huge privatisation programs being implemented by Latin American governments. Today, U.S. investors are quite confident about the outlook for Latin American private equity, carefully evaluating economic and political stability as well as the quality of the workforce when deciding about their regional focus. Based on this consideration, they are currently citing Brazil (44%) and Mexico (22%) as their most popular investment destinations, as emerged from a recent survey by PriceWaterhouseCooper.

Three Phases (15)

It is possible to divide the evolution of Latin American private equity into three distinctive phases which can observed in all the countries considered:

Figure 13: Total Amount of Private Equity Placements per Year



Source: Schneider, Frank; Videgaray, Luis, 1999.

Phase I: privatisation (1980 – 1994)

One reason for the lack of buyout related activity in Latin America until the 1980s can certainly be found in the limed number of opportunities during the preceding decades: the existence of large monopolies and state-owned enterprises in many economies throughout Latin America did not leave much room for private acquisitions in the region.

(15) Mainly adapted from Philipp Bell and Mathias Baltin: *Venture Capital in South America – Unlocking the Potential for Venture Creation in an Emerging Market*. Sources: A field study in Latin America and the book *Latin America Private Equity Review and Outlook* 2000-2001 edition.

Privatisation program

This impediment began to fall when governments decided to privatise many of their state-owned activities. This took place in sectors such as insurance and mining, and in utilities like petroleum, electricity and telecommunications. Previously state-owned conglomerates were often split up into their former business units and sold off to private investors in pieces, thereby creating more liquidity from the interested buyers.

As many of these formerly state-owned companies were hugely inefficient, the privatisation programs undertaken by Latin American governments created abundant opportunities for turnarounds. Insurance companies and banks were among the first to exploit these opportunities in the market, because their strategic business interests in the region made them more comfortable with the associated risks. Also, influential local family groups, often controlling large industrial conglomerates, engaged in the acquisition of privatised small and medium-sized companies. Their acquisition activities were driven mainly by the strategic intention to diversify their industrial conglomerates, but in hindsight their involvement has clearly had the effect of building expectations regarding the development of private equity investing in Latin America by setting an example in the practice of taking a considerable stake in private companies.

Improving Economic Environment

During the 1980s and early 1990s, many Latin American countries were stifled by economic crisis, most visible in rampant hyperinflation. At the same time as privatisation programs were implemented in the region, however, the longer-term foundation for increased political and economic stability was laid. Brazil returned to civilian rule in 1985, and Chile saw its first free elections since the Pinochet dictatorship in December 1989. The return to democratic rule in the region was an important requirement for foreign investors to consider this region for business. One of the most substantial macroeconomic shifts was the 1998 Brady Plan, which allowed several Latin American countries to restructure their external debt. The enormous reduction in debt service led to a substantial boost in the economic health of these markets. The successful reform process led to an increase in major investors' confidence in Latin America, as seen, for instance, in the increase in the market prices of these nations' debt, as Pacanins points out in his note about private equity in developing countries. At the same time, Latin American governments have worked to dismantle the legal and regulatory discrimination against foreign capital. In Brazil, for example, international investors have been allowed into the stock market since 1991 (iii). One of the drivers of the growth in foreign private equity in this region has been innovation in information and communication technologies, which has allowed foreign investors to better monitor their investments and has thus helped to lower the costs of investing in these countries.

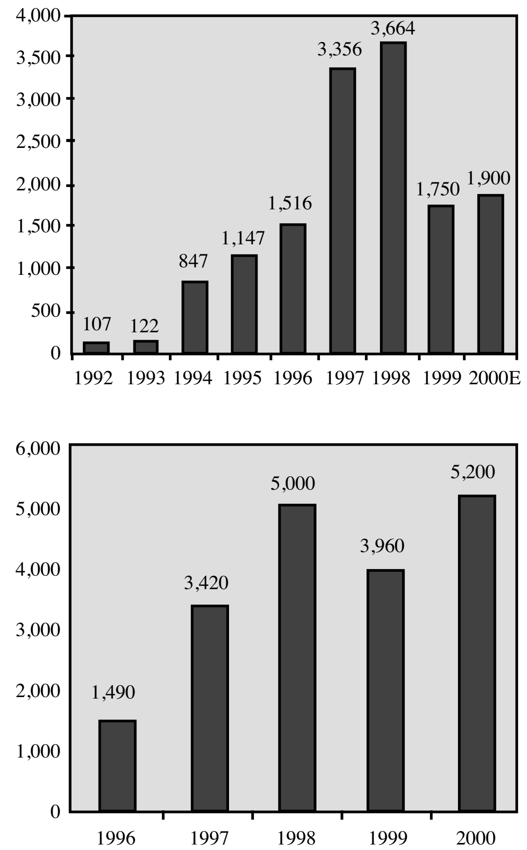
Towards the end of this phase, the first private equity players appeared on the scene, specialized in tapping into the opportunities provided by the improvement potential of privatised companies. A number of local companies were the first to get involved, such as CRP Investments in Brazil in 1982, while later, in 1992 and 1993 respectively, "two management firms in particular set the tone for investing in the region: Argentina's Exxel Group and Brazil's GP Investimentos. Both attracted U.S. institutional investors by offering a combination of U.S.-style buyout techniques and a thoroughly local market presence.

"Many of these U.S. institutions were banks that already had a presence in the Latin American market, either in retail or commercial banking. In some cases, they had simply realized the investment opportunity and set up private equity investment funds to exploit it. In other cases, these banks already owned equity stakes in private companies through debt-for-equity swaps and other schemes designed to pull banks and companies out of the depths of the debt crisis that befell the region during the 1980s. These accidental portfolios exposed banks (…) to the opportunities for developing a private equity business in the region (iv)."

The Role of Family Businesses

Many small and medium-sized family businesses embraced the chance to cash out or to grow with the help of equity investors. Globalisation had put considerable pressure on these companies on the dimensions of price and quality, while at the same time debt financing was available only at high prices. In addition, raising money through stock markets was out of the question for many companies. Access to international capital markets required a certain minimum size that was unattainable for many Latin American family businesses and would often require the loss of control, while local stock markets were already suffering from a lack of liquidity. This set of circumstances made equity investors the most viable option for Latin American family business owners to develop their companies.

Figures 14 and 15. Latin American Private Equity Fundraising and Investing



Source: Asset Alternatives.

Phase II: Private equity (1995 – 1998)

The privatisation phase had laid the groundwork for private equity investments in Latin America.

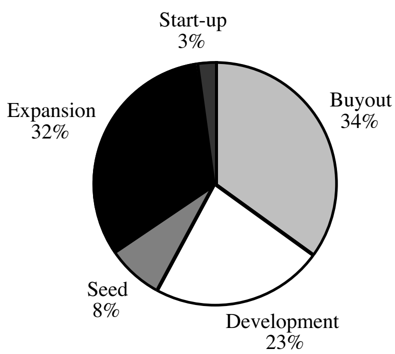
During this ensuing second phase, the private equity model proliferated throughout Latin America, with the increased presence of U.S. American institutions and greater professionalism.

Arguably, 1995 marked the beginning of real private equity activity in Latin America. More U.S. American banks took an interest in Latin America's strongest economies in terms of size and stage of development, making Mexico, Argentina and Brazil the preferred targets. While most of the investment activities in Mexico and Chile were carried out by U.S. investors, the proportion was significantly lower (around 50%) in Brazil, where the remaining 50% was invested by European and local investors (v). Apart from opportunities arising from privatisation programs in these countries, private equity firms continued to invest in other growth companies, restructuring opportunities and industry consolidations, often family-owned businesses.

Consolidation

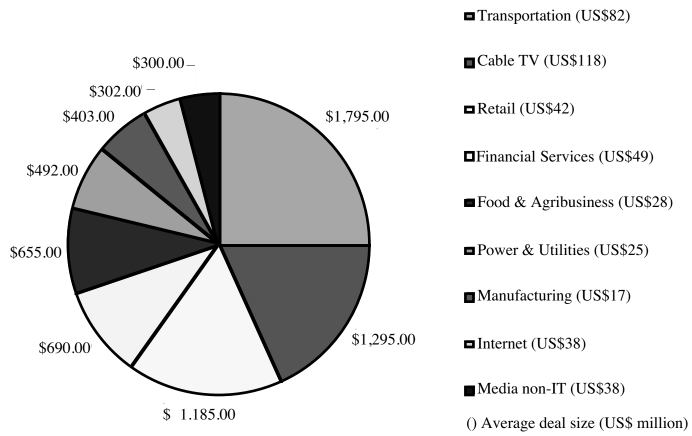
This strategy involves the merging of small companies into an organization that, in theory at least, equals more than the sum of its parts. The acquirer of the small companies generally uses the MBO as the underlying transaction form. Buyout firms pursuing consolidations have any number of ways of increasing their returns – through leverage, cost-cutting measures, or internal growth. They also can benefit from the fact that small companies, because they attract fewer potential buyers, generally command lower purchase multiples than large companies. Consolidators can therefore pay low multiples of cash flow on the companies they buy, but sell the large company they create at high multiples – depending, of course, on market conditions.

Figure 16. Private Equity Disbursements in Latin America 1998



In the eyes of many investors, there were many middle-sized companies in Latin America at that time that needed funding to face the prevailing challenges. Beyond that, "only the region's blue chip companies have consistent access to raising long-term financing from international financial institutions, or on local or overseas stock markets. However, beginning in the mid-1990s, many of the region's companies were facing deregulation and competition, and needed capital to invest and compete" (vi).

Figure 17. Private Equity Investments by Major Industries 1996 – 1998 (US$ million)



Source: Asset Alternatives.

Difficulties encountered

In their field study, Bell et al. (2001) found that private equity investors had encountered unexpected problems in their attempt to exploit investment opportunities in Latin America. Rather than one central reason, this negative performance was based on an array of causes, the most important, according to Bell and his colleagues, being those listed below (vii).

Unfamiliarity

When the buyout targets did not originate from privatisation, they were mainly from family businesses, where the family members, albeit looking for the inflow of additional capital, would often be unwilling to give up control of their business. Apart from tradition and the pride of sole ownership, this behaviour also originated from the circumstance that the Latin American business community was largely unfamiliar with the concept of equity participations in private companies. Accordingly, the number of investment opportunities was smaller than initially anticipated, and the process of educating family business owners in the region drove up the required duration to close a deal and the associated costs.

Legacy Systems

Further difficulties arose because of specific Latin American structures in the target companies. Quite often, the management in place was a challenge as it often was formed from close family networks, which were difficult to overcome. Frequently, the problem was not only to remove old management, but also to find good new local management to replace it. Sometimes the management insisted on following the traditional model of closed ownership, which made educational efforts necessary in order to open up the opportunity to create incentives for employees through stock ownership. Still, for many Latin American countries, the concept of employee stock options is foreign to the local codes, which therefore makes it very expensive to create this key incentive structure. "Mexico needs to move from a cash-bonus-based culture to an options-performance-based one," argues R. Andrew de Pass from CVC Latin America, cited in the *Venture Capital Journal* (viii), discussing the lack of a modern equity culture in Latin America. Besides that, regulatory hurdles still conspire against fully installing stock incentive programs like the ones that are common in the U.S. For example, stock compensation in Mexico is tax-deductible only if the equity is listed locally, which makes a listing on foreign exchanges not very attractive from this point of view.

Corporate governance controls

Another obstacle, which needs to be taken into account, is the relaxed control of corporate governance in Latin America. Many Latin American countries lack rules regarding corporate transparency for private companies, and laws and enforcement mechanisms relating to the protection of minority shareholders. Latin American entrepreneurs also need to get culturally comfortable with the idea of minority shareholders controlling, through contractual rights, many of the key business and financial decisions affecting their companies. This is important, as the majority of participations in the portfolio companies is made by a minority ownership but with the clear attempt to maximize control and influence on decisions. Additionally, the established business control systems are frequently inadequate, which becomes particularly apparent in the widespread lack of sound accounting systems to base decisions on.

Participation of investors in the portfolio company
(number of transactions)

	Brazil	**Chile**	**Mexico**
Minority	29	12	13
Majority	8	7	4

Source: Schneider, Frank; Videgaray, Luis; 1999.

Regulatory hurdles and legal impediments

Some Latin American countries still strongly regulate the inflows and outflows of capital. Most notable is Brazil, whose central bank regulates private transactions heavily. For instance, US investors must register their investment with the Foreign Capital Register of the central bank. If the investment is not registered with the Foreign Capital Register, prior approval from the central bank is required for repatriating the money. This difficulty can chill foreign investment in a climate that is subject to rapid and dramatic fluctuations. Chile also regulates the inflow and outflow of capital and profits. According to Decree Law No. 600 of Chile's Foreign Investment Law, an equity investment in Chile needed to remain in the country for at least one year. In April of 2000, however, the central bank modified certain internal rules, which now permit capital to enter and leave freely without the one-year holding requirement. While Mexico and Argentina do not control the flow of capital, foreign investment laws and certain industry-specific regulations reserve several key sectors to nationals and restrict others to a certain percentage of foreign participation. Investors need therefore to be very familiar with each country's foreign investment laws before investing.

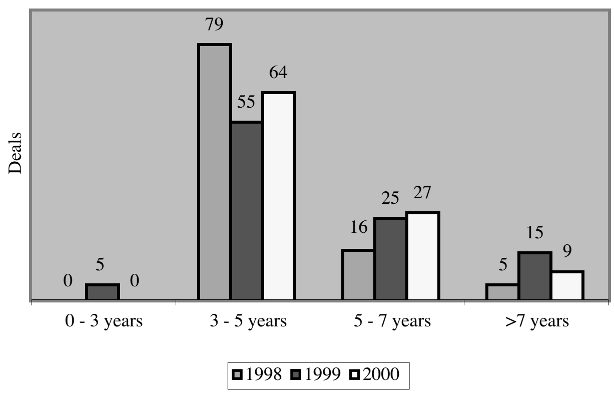
Hidden Contingencies

Covert fiscal or labour contingencies often existed in the companies eyed by private equity firms, making these investments considerably more risky. The private equity companies faced an additional challenge from the lack of organized, easily obtainable industry information, which increased transaction costs. In order to face these challenges successfully, a fruitful combination of local experience and experience in managing a private equity fund was needed. However, purely local funds often lacked the experience of how to successfully manage a fund, while the U.S. institutions, albeit experienced in private equity, placed the management of the fund in local hands and only operated from a 'remote control' position from abroad.

Missing Exit Opportunities

As if it was not already difficult enough to successfully manage private equity investments in Latin America, as investing continued it became obvious that it was much more difficult to exit from the investments than anticipated. Exits in public financial markets were extremely difficult, given the lack of liquidity at the local stock exchanges, leaving sales to strategic partners as the most important remaining option. Apart from the heavy dependence on third parties, this option required a much longer time horizon than planned. One problem of this lack of exit options was the fact that the profitability of the private equity concept in Latin America in general was not proven; in fact, it never has been since the very beginning of the private equity concept in Latin America. As the *Latin American Private Equity Analyst* reported, "Limited partners had been willing to take on the added risk of emerging markets, coupled with an investment strategy as yet unproven in Latin America, in hopes of achieving exceptional returns. However, many of their basic assumptions –such as increasing macroeconomic stability, expanding capital markets, and the adoption of internationally acceptable standards in accounting and disclosure– were not borne out. Private equity firms had achieved so few successful exits that there was no proof that returns would justify the additional risk (ix)."

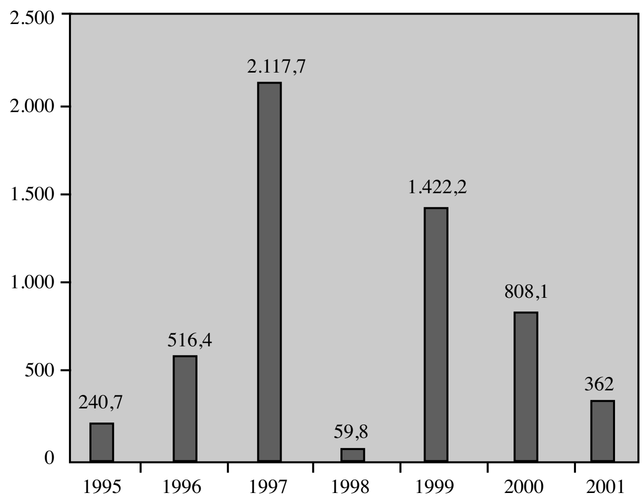
Figure 18. Exits in Latin America



Adverse Macroeconomic Development

The Russian bond crisis in 1998 caused an abrupt slowdown in all emerging-market investments, lowering the yearly amount of private equity placements from its peak of US$ 2117.7 million (for the three countries studied) in 1997 to the relatively small amount of US$ 59.8 million in 1998.

Figure 19. Total Amount of Private Equity Placements per Year



Many funds were put on hold as investors were expecting a domino effect in the whole of Latin America.

Phase III : high-tech frenzy (1999–5/2000)

1999 saw the beginning of an investing frenzy throughout the region, focusing on the Internet and high technology businesses. Typical investments in this phase were considerably smaller in size than previous private equity participations, ranging from sums as low as U$ 50,000 to amounts of up to US$10 million. The year 1999 "marked a turning point in the kind of funds institutions were backing. Five venture capital funds –a category that barely existed in the region before that year– accounted for US$194 million of the funding raised, about 11% of the total. The development reflected the surge of Latin American Internet start-ups, and the enthusiastic reception they received after StarMedia and ElSitio went public on NASDAQ. This success clearly fuelled the investment frenzy in the Internet businesses in the region" (x). The development of the Internet sector in Latin America took place in a similar fashion to the situation in the U.S. during the preceding years, though at a much faster pace.

Current situation

Investigating the current investment climate, PriceWaterhouseCooper found that 67% of U.S. funds have met their expectations concerning the return on their investment in Latin America. Most of the private equity funds that have set up funds for smaller investments, i.e. in the venture capital range, have retreated to their original larger investment categories. In most cases, they have redirected the capital that they had reserved for venture capital investments to their traditional fields, and fundraising for Latin American activities is not expected to be the bottleneck for the industry in the near future.

This is accompanied by a general shift in the origin of funds, which earlier came mostly from abroad or were state-sponsored, whereas nowadays there is a higher proportion and a growing involvement of local sponsors.

For 29% of U.S. investors in Latin America the media/communications/IT/ entertainment sector is currently the most attractive investment destination, followed by the financial services and energy sectors, where, respectively, 25% and 8% of the respondents are focusing their activities. With regard to exit, most U.S. funds expect to exit through a strategic trade sale, while only a minority (40%) is seeking to sell to a domestic strategic buyer.

References

(i) Latin American Private Equity Survey by PriceWaterhouseCoopers, 1999.

(ii) From: Bell, Philipp; Baltin, Mathias; *Venture Capital in South America –Unlocking the Potential for Venture Creation in an Emerging Market*, Koblenz 2001.

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(v) Schneider, Frank; Videgaray, Luis; *Private Equity in Mexico*, Stanford University 2001.

(vi) Latin American Private Equity Review & Outlook 2000/2001 Edition P.51 –cited in Bell, Philipp; Baltin, Mathias; *Venture Capital in South America –Unlocking the Potential for Venture Creation in an Emerging Market*, Koblenz 2001.

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(viii)Werner, Holly M.; New Year, A New Latin American Strategy, In: *The Venture Capital Journal*, P. 44–P.46, March 2001,

(ix) Latin American Private Equity Review & Outlook 2000/2001 Edition P.41 –cited in Bell, Philipp; Baltin, Mathias; V*enture Capital in South America –Unlocking the Potential for Venture Creation in an Emerging Market*, Koblenz 2001.

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Chapter III: Private equity in Brazil

Historical development (i)

In 1995, after 21 years of military rule, a corruption-ridden Collor government and the weak presidencies of Sarney and Franco, Brazil, plagued by hyperinflation, weak economic growth and social inequalities, was in need of deep reform.

President Cardoso, re-elected for a second term in October 1998, has gone a long way towards entrenching democracy and political stability as well as reforming the state and opening and restructuring the economy. While social questions were considered important and real progress in education, health and human rights was made, the emphasis during the first term was on reforms that would bring economic stabilization and growth, for the benefit of all Brazilians. Hyperinflation was brought under control, which, considering that previous plans survived for no more than a few months, was a major achievement.

The second part of the plan was to take advantage of the rapid stabilization of the currency to achieve long-term reforms to improve the efficiency of both the economy and the state apparatus. While the privatisation effort has been very successful, progress to increase productivity and export performance has been limited. The reform of the state has progressed very slowly because it requires numerous constitutional amendments.

Economic overview (1)

Having Latin America's highest GDP (2000: US$ 595.5; Brazil accounts for 40% of Latin American GDP), largest population, broadest landmass and strongest industrial base, Brazil commands respect in its economic and political relations, both in the region and as an influential player on the world stage. Possessing large and well-developed agricultural, mining, manufacturing, and service sectors, Brazil's economy outweighs that of all other Latin American countries and is expanding its presence in world markets. With its estimated 175 million inhabitants and an area of 8.5 million square kilometres, Brazil is the world's sixth largest country in size and population and, additionally, Brazil is the ninth largest economy in terms of purchasing power. The majority of the population lives in the south-central area, which includes industrial cities such as Sao Paulo, Rio de Janeiro and Belo Horizonte. Approximately 80% of Brazilians now live in urban areas. Rapid growth in the urban population has aided economic development but has also created serious problems for major cities.

The Brazilian socio-economic environment is characterized by an extremely unequal income distribution, with 10% of the population controlling more than half the national wealth, and other large disparities in education, health and technology usage. Those inequalities are present not only on a demographic level but also at regional levels, with the southern part of the country concentrating most of the manufacturing and value-added services, while the poorer northern and central regions still rely largely on agricultural production and other commodities.

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(1) This general discussion of Brazil is based on material provided by various institutions, such as country reports from banks, governmental organisations and industry associations (e.g. Deutsche Bank Research, Worldbank, CIA – Factbooks, Department of Foreign Affairs and International Trade//Canada), and information supplied by Brazilian MBA students at IESE.

Economic development

The World Bank accounts for Brazil's "miracle year", the period between the late 1960s and the early 1970s, when double-digit annual growth rates were recorded and the structure of the economy underwent rapid change. In the 1980s, however, Brazil's economic performance was poor in comparison to its potential. Annual GDP growth averaged only 1.5 percent over the period from 1980 to 1993. This reflected the economy's inability to respond to international events in the late 1970s and the 1980s: the second oil shock; increases in international real interest rates; the Latin American external debt crisis and the ensuing cut-off of foreign credit and foreign direct investment. This lack of responsiveness reflected the largely inward-looking policy orientation that had been in place since the 1960s.

Economic flexibility was further impaired by provisions of the 1988 constitution, which introduced significant rigidities in budgeting and public expenditure. An outcome of these pressures was a steady rise in the rate of inflation, which reached monthly rates of 50% by the middle of 1994. While widespread indexation limited the damage caused by such inflation, it also made reduction of such inflation technically difficult to achieve.

The Real Plan

Important reforms in liberalization of external trade and in developing a framework for privatisation were introduced in the early 1990s. Building upon these initiatives, Brazil underwent a major change in economic regime with the introduction of the Real Plan in mid-1994. The Plan's principal goal and achievement was to reduce inflation and inflationary expectations in Brazil in a durable way. It achieved this mainly through a managed exchange rate by pegging the real to the US dollar, and a de-indexation. Besides this key enabler, following his election in 1994, the government of Fernando Henrique CARDOSO contributed significantly to the creation of an overall macroeconomic environment that was more receptive to a private equity industry. Stein et al. (2001) lists the constitutional reforms that had been approved so far:

– Privatisation and deregulation of important sectors like energy and telecoms, the latter being absolutely critical to the dissemination of the Internet among private individuals and businesses.

– The abolition of inequalities in the treatment of foreign investors as opposed to local ones, which was critical to expanding the exit options for private equity investments.

– A simpler and more effective taxation system was established, crucial to enable macroeconomic stability and reduce inflation levels. The passing of the Fiscal Responsibility Law, which established civil and criminal liabilities for overstepping the limits on public expenditure, is expected to play a major role in maintaining macroeconomic stability.

– Liberalization of foreign trade, with average import tariffs falling from 32% in 1990 to 14% in 1994, and the elimination of non-tariff barriers. Previously, the Brazilian economy was so protected that imports of computers and software were either outrageously expensive or simply illegal.

Figure 20. Brazil – Overview of Macroeconomic Data

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
GDP (US$ billion PPP)	755	793	808	868	938	999	1.047	1.101	1.109	1.137	1.202
Population (MM)	144	146	149	151	153	155	157	160	162	164	166
Growth (%)	-4,3	1,3	-0,5	4,9	5,9	4,2	2,8	3,2	-0,5	1	4,2
Inflation (%)	2948	433	952	1927	2076	66	15,8	6,9	3,2	4,9	7
Interest rates (%)	15778	848	1574	3284	4821	53,4	27,5	25	29,5	26,3	7,6
FDI (US$ billion)	1	1,1	2,1	1,3	3,1	4,9	11,2	19,7	31,9	27,2	n.a.

Figure 21. Brazil - Basic Indicators

Export destination	USA 19%, Europe 29%, Argentina 13%
Export structure	Cars & parts 15%, soy 11%, chemical products 7%, coffee 5%

Source: wwww.dbresearch.com, last update 12/11/01.

The results in the area of inflation were dramatic: annual consumer price inflation dropped sharply to reach an annual rate of only 2.7% in 1998, as compared to over 2,000 percent in 1994.

The Real Plan has raised the income of the poor by eliminating the inflation tax and increasing real wages. Moreover, thanks to labour market flexibility, price stabilization in Brazil was not accompanied by a large increase in unemployment, as it was in some other countries in Latin America. Inflation was brought down to single-digit annual figures, but not fast enough to avoid substantial real exchange rate appreciation during the transition phase of the “Real Plan”. This appreciation meant that Brazilian goods were now more expensive relative to goods from other countries, which contributed to large current account deficits. However, no shortage of foreign currency ensued thanks to the financial community’s renewed interest in Brazilian markets as inflation rates stabilized and the debt crisis of the eighties faded from memory. The maintenance of large current account deficits via capital account surpluses became problematic as investors became more risk averse to emerging market exposure as a consequence of the Asian financial crisis in 1997 and the Russian bond default in August 1998. In January 1999, the Brazilian Central Bank announced that the real would no longer be pegged to the US dollar. This devaluation helped moderate the downturn in economic growth in 1999 that investors had expressed concerns about during the summer of 1998. After crafting a fiscal adjustment program and pledging progress on structural reform, Brazil received a $41.5 billion IMF-led international support program in November 1998. Brazil’s debt-to-GDP ratio for 1999 beat the IMF target and helped reassure investors that Brazil would maintain tight fiscal and monetary discipline even with a floating currency. International investors welcomed this wave of change, with FDI increasing from only US$ 3 billion in 1994 to more than US$ 27 billion in 1999. With inflation under control, interest rates have progressively decreased and the economy –after two consecutive years of stagnation, themselves a reflection of the recession in Argentina– is now growing by close to 4%, with annual unemployment at around 7%.

In May 2001, Brazil entered into an energy crisis because of its 90% dependence on water power and the lack of rainfall. Everyone, from households to companies, had to lower energy consumption by 20% relative to the level of consumption in the corresponding month the previous year, the effect of which on GDP growth is still uncertain. The fact that

Argentina is Brazil's third biggest export destination, and the psychological effect of having a major partner close to collapse, must be taken into consideration when discussing Brazil's current situation. Besides this problem, structural deficiencies such as a distorted tax system, unaccounted-for fiscal liabilities and an unfavourable public-sector debt structure are the main threats to stability and growth in the medium and longer run.

The private equity cycle in Brazil

The purpose of the following section is to provide a solid insight into the private equity activities in Brazil. In every private equity market, these activities can be broken down into three distinctive phases: 1. Fundraising, 2. Investing, and 3. Exiting of the investments. As the initially raised fund needs to be invested in order to produce the promised return, and as the final distribution to the limited partners in the form of cash or shares can only be done when the investment is liquidated through an exit, these three phases determine the pattern of the private equity industry. All this happens in an agreed timeframe, determined by the contractually fixed lifetime of each partnership, which tends to be around ten years.

During the first three to five years of this lifetime, the partnership's capital is in general fully invested and from then on the general partner focuses on monitoring and eventually exiting the investments. The partnership managers will typically form a new partnership fund at about the time when the investment phase of an existing partnership has been completed. Thus, the managers will raise new partnership funds approximately every three to five years, and at any one time may be managing several funds, each at a different phase of its life. Each partnership is legally separate, and is managed independently of the others. This process occurs in a regular pattern and determines the movement of the industry. This private equity cycle can be observed in every country, and its structure is therefore used to describe the Brazilian private equity industry in the following chapter. To offer a good insight into Brazilian private equity activities, each distinctive phase of this circle is divided into three sections, the first one focusing on the history, the second on the current situation and the third on a comprehensive outlook for each specific activity.

Fundraising

Fundraising: history

The history of modern private equity fundraising in Brazil is quite short. Before the 1990s there were no private equity deals or players in Brazil investing through a limited partnership structure such as is used in the U.S.

This structure was first adopted in 1994, when GP Investimentos created the first Brazilian private equity fund. Prior to that, the Brazilian development bank, BNDES (Banco Nacional de Desenvolvimento e Economico e Social), and BRASILPAR (2) initiated investments in private companies.

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(2) See: www.brasilpar.com.br

BNDES (3)

In 1974, BNDES formed three companies, IBRASA, EMBRAMEC and FIBASE (4), in order to capitalize Brazilian companies that needed risk capital but were unable to obtain financing on the capital markets. Today these companies are part of the BNDESpar (5) (Banco Nacional de Desenvolvimento Econômico e Social Participações S.A), an integral subsidiary of BNDES, whose primary goals are to:

> …strengthen the assets and financial structure of the companies; reorganize industrial sectors, through merger and acquisition operations aimed at increasing competitiveness; support private equity investments in infrastructure; develop the capital markets, encouraging companies to go public and promoting greater liquidity for the stocks of such companies, with the aim of making these markets important mechanisms for private companies to raise funds.

To understand the work of BNDESpar it is important to note that its holdings in private companies are always temporary (on average five years) and minority (up to 33% of total capital, mostly in preferred shares).

In the 1970s and 1980s, BNDESpar made a series of investments of government capital, but it is said (Nino et al. 2001) that these investment decisions were politically influenced, with a focus on developing national industries. In the private sector, on the other hand, some investment companies were founded but without the explicit intention to invest only on a temporary basis in a company and to actively promote fund-raising as part of their activities. All these efforts were conducted without a legal structure for anything resembling a holding company or partnership.

Brasilpar

In the mid-1970s, several banks, an insurance company and an individual French investor founded BRASILPAR as a participation company. However, during its first years of operation, BRASILPAR faced great difficulties: first, because of the economic problems of hyperinflation and recession, and second, because of the lack of an appropriate fiscal and juridical structure . After a restructuring by some new domestic and international investors, in 1981 BRASILPAR became the first company to really apply the principles of private equity in Brazil. Since then, with a total initial capitalization of 15 US$ million, BRASILPAR has acquired minority and majority stakes in several companies. The expertise developed in 15 years in the market has helped BRASILPAR to rise in partnership with New York headquartered WESTSPHERE (6), a first private equity fund in 1995. Informed by these early experiences of partnership with Brazilian activities, today WESTSPHERE claims to be the firm "[…] with one of the largest networks of private equity professionals, investment advisors and offices in Latin America".

For the specific situation of fund-raising in Brazil, a distinction between foreign funds and local funds clarifies the evolution of this activity in this region:

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(3) See: www.bndes.gov.br
(4) Investimentos Brasileiros SA, Mecanica Brasileira S.A., Entidades Publicas BNDE
(5) See: www.bndes.gov.br/english/Bpar1.htm
(6) See: www.westsphere.com

Foreign funds (iii)

Foreign funds: *Global Funds*

These are managed by international funds having little or no local presence in Brazil. They are not focused exclusively on Brazil but rather on Latin America. Sometimes, they are global funds whose objective is to deploy part of the fund to Brazil, but concentrating the decision-making and professionals mostly abroad. The initial strategy was to establish a contact with the country, but without a longer commitment. The main problems faced by these funds were the lack of knowledge of Brazil and the distance. The latter slowed the decision-making process and made it difficult to supervise investments. Darby Emerging Market Fund (7) can be named as an example. The investment patterns of these funds vary, with presence in buyouts, early-stages and growth financing (iv).

Foreign funds: Dedicated Regional Funds

Some of the foreign funds, after an initial period of overseeing the market from abroad, started reinforcing their local presence by hiring executives and associates with strong local market knowledge and expertise. Most of these funds are managed by investment banks' private equity arms, and sometimes they invest only their own capital.

These international funds "were the key providers of capital in the formative years of the private equity industry in Brazil and still account for the largest share of funds invested in the country", as Enio (v) et al. found. They came primarily from the U.S., where a constant increase in domestic fund commitment met with a stable amount of good opportunities, leading to fierce competition and declining returns in an overcrowded market (vi). A second driver for the involvement of foreign capital in Brazil is noted by John Barham (vii), who points out that many companies are shifting their focus to Brazil because the collapsing currency has made already attractive valuations even more compelling.

Concerning the young age of Brazilian fund-raising, Enio et al. point out that "those funds have been adding to an unproven investment class, since few exits took place in that period", and infer that "since the bulk of the resources came mostly from American institutional investors, the motivation was more like a leap of faith than based on results obtained, following a shift towards higher capital allocation for private equity in the US, even towards an apparent over-funding…"

> "Being a venture capitalist in Latin America largely involves adapting what has worked in the United States to what is realistic in countries like Mexico and Brazil."
>
> Susan Segal, head of Latin American operations for Chase Capital Partners.
>
> In: A New Breed of Venture Capitalist Scouts Latin America, *New York Times.*

(7) See: www.darbyoverseas.com

Local funds

Local funds: Internationalised Funds

These funds usually are formed through partnerships between international funds and local general partners. They initially focused on buyouts, privatisations and family-owned businesses located in Brazil, but in recent years they have added early-stage and technology deals. Their major advantages are excellent local market expertise and access to a qualified management pool, since the management company usually is linked to a Brazilian investment bank (viii).

Local Management Companies: GP Investimentos

The most cited general partner or management firm, in this respect, is GP Investimentos (GPI) (8), which in 1994 was the first Brazilian institute to raise a private equity fund that focused primarily on the Brazilian market. The controlling partners and shareholders of Lojas Americanas S.A. (9), Companhia Cervejaria Brahma (10) and Banco de Investimentos Garantia S.A. (11) founded GP Investimentos (GPI). In 1998, Banco Garantia was sold to CSFB, but its former partners kept running their private equity funds. From 1979, GPI partners began investing their own capital in companies acquired by the bank, and thanks to some successful acquisitions in the market such as Brahma and Lojas Americanas, GPI established a track record that helped attract capital from limited partners (ix). In order to demonstrate commitment to the fund and reduce credibility problems, GP Investimentos committed 20% of its first fund's capital –a fund that totalled US$ 50 million. Among their first backers were AIG Global Investment Corp., Cornell University and Yale University endowments, all long-time believers in the private equity asset class in the U.S., as Enio et al. have noted. Their investments include Wal-Mart, Se Supermercados, Centro-Atlantica and Sul-Atlantica railroad, Multicanal (cable television), and Telemar (telecom) (xi).

Even though partners abroad participate in the investment decision-making process, most of the due diligence, opportunity analyses, and supervision of the deals is executed by local partners. A second well-known example of this specific combination is CVC/Opportunity Brazilian Equity Partners (12).

Local funds: Funds for Brazilian Investors

The categorization of this group of funds is based on its major source: pension funds. Until the early 1990s, Brazil had been a closed economy with very little competition. With privatisation of many state-owned companies and the opening of the country to foreign investments, this had to change, creating a big need for change also in the mindset of the traditional industry and the family owners, and thus huge opportunities for private equity investments. So when the privatisation process began, it brought a different perspective to

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(8) See: www.gp.com.br
(9) Lojas Americanas was a publicly traded general merchandise retail chain acquired in 1992 and largely improved by new controlling investors. See: www.americanas.com.br
(10) Brahma, now Ambev, was a family-owned brewery bought in 1989 and is currently one of the five largest beverage companies in the world. See: www.ambev.com.br
(11) The largest Brazilian investment bank, currently CSFB Garantia. See: www.csfb.com
(12) See: www.opportunity.com.br

the allocation of pension funds' assets (xii). Before 1997 pension funds were not allowed to invest in private equity funds, and until recently, no more than 5% of their assets could be allocated to private equity or venture capital investments. One of the first companies to be privatised was ACESITA, a steel manufacturing company. After the company's successful turnaround, Brazilian pension funds started becoming active players in the privatisation process. Michael Kepp reported in 1999:

> "A few large [Brazilian] pension funds have invested about $450 million of their assets –less than 1% of the total $52 billion in all Brazilian pension fund assets– in four domestic private equity funds since they were first allowed to in 1997…"

Those investing included, among others: Fundação Sistel de Seguridade Social, the pension fund of recently privatised telecom company Telebras; the Fundação de Assistencia e Previdencia Social do BNDES, the pension fund of the government's Development Bank; and Previ-Caixa de Previdencia da Fundação do Banco do Brasil, the pension fund of the state-owned Banco do Brasil, which is currently Brazil's largest pension fund. According to Kepp, Funcef, Brazil's second-largest pension fund, had in 1999 only a small part of its US$3.7 billion assets invested in private equity: $63 million in CVC/Opportunity Equity Partners (a joint venture between the local Opportunity Asset Management firm and New York's Citicorp Venture Capital, which has $160 million in commitments) and $5.2 million in a fund by Credit Suisse First Boston-Garantia.

THE EVOLUTION OF FUNDRAISING AT A GLANCE

It is possible to distinguish three periods of private equity fundraising in Brazil:

Pioneering

From 1992 to 1994 the first formal partnerships targeting the region emerged. The total funds raised in the region were $1.1 billion. GP Investimentos was the only regional player in this phase, with US$500 million raised in 1994, enabled through their successful investment in controlling stakes in companies such as Brahma and Lojas Americanas. The focus of the funds, as in the U.S. model, was on buyouts, where 80% of invested capital came from outside investors. No venture capital funds were raised in this period. The main reason for this development was the nascent growth of the region, while governments deregulated several previously protected sectors such as telecommunications, energy, and other utilities. The opportunity to diversify their portfolio and add emerging market exposure, combined with increasing macroeconomic stability and openness to foreign trade and investments, made Brazil an attractive environment for international investors.

Growing

The second period, from 1995 to 1998, was characterized by a growing acceptance of the Latin American private equity industry. Large regional funds raised by Advent International, AIG Capital Partners, Darby International and WestSphere were important in 1995 and 1996. They were driven by the increasing competition in the U.S. markets. This period was characterized by large-scale privatisation programs, giving rise to deals far from the typical private equity investment profile in terms of the stage of the companies being privatised, degree of regulatory oversight and commitment towards several non-profit maximizing goals such as universal access for telecommunication providers. The first billion-dollar fund was raised in 1997 by CVC/Opportunity to focus on the Brazilian privatisation process. Following that, Hicks, Muse, Tate & Furst raised a US$964 million fund in 1998. Fund-raising grew from US$ 825 million in 1995 to US$ 3.7 billion in 1998, a 343% increase in that period alone, certainly a boom for fund-raising activity in the region.

Currency devaluation & the Internet

From 1999 to 2001, the fund-raising process changed course. Mainly due to the Brazilian devaluation, fund-raising dropped dramatically. The problem of investing in Reals (BR$) and expecting returns in Dollars arose in January 1999, when Brazil was forced to devaluate its currency. Between January 1999 and March 1001, the US$/BR$ conversion rate increased by 75% for accumulated inflation slightly above 15%, "[…] which means that funds invested prior to that date would have to yield an additional IRR in excess of 30% just to account for currency depreciation" . Many firms postponed the fund-raising process, particularly as their first fund had not yet distributed any returns. Almost a third of the funds raised in 1999 was raised by UBS Capital Americas, thus demonstrating a lack of interest in the region. Two developments mitigated the impact of this change: a shift in the investment pattern towards venture capital, requiring smaller amounts, and the growing presence of local capital as a source of funds. Venture capital funds, previously almost absent in the region, raised US$ 194 million (11% of the total) in 1999 and 1.1 billion in 2000 (42% of the total). This trend followed the positive results achieved by the StarMedia and ElSitio IPOs and the possibilities of focusing on the concept arbitrage models.

Mainly adopted from: Checa et al.
"The Venture Capital and Private Equity Industry in Brazil"

Brazilian pension fund participants, who were guaranteed a 6 1/2 % minimum fixed return on their contributions, had been receiving on average 9% return, with the assets mainly invested in fixed-income instruments (50%), equities and real estate investments. But as private equity fund managers promised far greater returns, of at least 20% to 25% a year, Sistel, Brazil's third largest pension fund, invested also a small part of its $3.15 billion in assets in private equity –$52 million in the CVC/Opportunity fund and $26 million in the CSFB-Garantia fund. This tiptoeing of Brazilian pension funds into the private equity industry was exactly the opposite of the American model, where at least 80% of private equity investments came from pension funds via a limited partnership (xiv).

However, before the removal of restrictions on pension funds' commitments to private equity in 1997, their investments were always made directly, mainly through consortia. In order to attract the pension funds as primary source of capital, Brazilian management companies structured their funds for local investors as mutual funds. But this structure had its drawbacks: The fund was obliged to invest only in public companies, or to open the capital of the invested companies. In addition, the fund had the obligation to report daily stock quotes, which is incompatible with the nature of private equity funds holding illiquid investments.

> "Prior to September 1997, OPPORTUNITY created specific groups of investors each time it identified investment opportunities in the private equity field. With effect from September 1997, all investment opportunities have been channelled

to the funds managed by CVC/Opportunity, a company formed exclusively to manage private equity funds (13)."

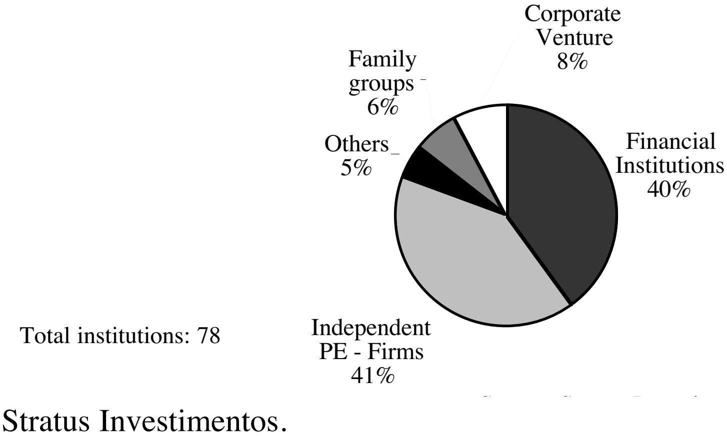
Still, Enio sees this advent of local investors as one of the most important developments in the Brazilian private equity industry, because it indicates the potential for sustainable growth and makes it less reliant on the portfolio allocation by foreign investors.

All the same, other local providers of considerable amounts of capital, such as banks and insurance companies, faced the same situation as the pension funds: the continuing high level of interest rates did not promote asset classes other than local bonds.

Regulations

When talking about the history of fund-raising, it is useful to take a short look at the history of the regulations which govern these activities, especially as, in the early 1990s, various groups became active in trying to promote the sector and making the business community aware of their concern. These efforts were revealed in 1996 in Law no. 2,287, which was designed by entrepreneurs and companies, the Securities Commission (CVM) and several lawyers, all attempting to give a corporate structure and fiscal regulation to all risk capital entities which had not existed before. The law provided new private equity and VC companies with tax benefits, including an exemption from capital gains tax, which was a heavily debated issue. However, the new law was badly timed, as, despite the fiscal advantages, the young venture capital sector in particular was doomed by the difficult political and economic environment of the time, and in 1998 a new law revoked even these fiscal benefits, leaving the industry without legal incentives to invest. Finally, in 1999, CVM instruction no. 209 was introduced to the market. The new instruction contains a regulation for the creation of mutual funds for emerging companies (FIEEM – Fundos Mútuos de Investimento em Empresas Emergentes), granting them special advantages, and was considered to be "very well designed" (xvi). With the macroeconomic environment evolving from the Real Plan, a new scenario has emerged, especially for venture capital investors, and the industry has reached a new level of professionalism. Instruction no. 209, however, still covers only investments in companies with revenues up to RS$ 60 million, so private equity players cannot assume the corporate structure of a FIEEM. In fact, to date there is no corporate structure suitable for a private equity fund in Brazil, although the securities commission (CVM) is trying to develop a new instruction to change that situation.

Figure 23. Active Private Equity Players in Brazil (2001)



Source: Stratus Investimentos.

Fundraising: current situation

According to a statistic developed by Stratus, the *Venture Capital Journal* (xvii) reports that recently, of the most active fund managers who invest in Brazil, 63% are international companies, 31% are Brazilian and 6% represent joint ventures or cross-border alliances based in Brazil. Concerning the investment focus of these funds, the study found that 41% of them have a global focus, 23% have a Latin American regional focus and 35% are focused specifically on Brazil. 41% of the market players are currently independent private equity firms, followed by venture capital and private equity arms of banks and insurance companies as the second biggest group of investors (40%).

The graph above illustrates the fund managers' profile for the first half of the year 2001. In its Newsletter for August and September 2001, Stratus states: "Fund raising activities have been above expectations this year, despite the low realization of investment and uncertain returns of existing funds. The funds with regional focus, which dominated the scene in previous years, were less active than the 'country specific' vehicles."

Because some of the surviving funds that arose during the Internet boom with a clear dedication to the new economy are still not fully invested, the focus of the main funds active on the Brazilian market is certainly still on growth and start-up. The following table lists the recent main players and their focus in the Brazilian market:

Figure 24. List of main funds on the market

Funds	**Profile/Focus**
BISA – Natexis	Generic/Growth
Brascan	Oil and Gas /PE and Project Finance
e-plattform	Technology/Start-up
GP Fundo de Investimento	Technology/Growth
HMTF (Latin America)	Generic/Media
Mercatto	Technology/Start-up
Pactual NE	Northeast region/Start-up
Pegasus	Technology/Growth
Stratus VC	Technology/Growth

Nino et al. (xviii) mention the challenge these funds in Brazil are currently facing, given the early stage of local fund-raising. "The industry still does not have gatekeepers or investment advisers with expertise in private equity, and even the most experienced local groups are still too young to show a consistent, long-term track record."

Recently, some companies that used the limited partnership model have chosen to organize themselves as corporate entities in which investors acquire stakes. By giving up the limited partnership structure, these companies make it possible to raise additional capital by calling for a capital increase rather than launching a full-fledged fund-raising campaign. They also create the possibility of taking themselves public, as IP.com (14), a fund dedicated to Internet investments, recently did.

(14) See: www.investidorprofissional.com.br

With respect to the relatively small amount of capital the local pension funds are still committing to Brazilian private equity, the National Monetary Council (CMN) issued, in August 2001, a new resolution (CMN 2850), setting new standards both for the benefits, namely the actuarial liabilities, and for the investment allocations of the pension funds, which completely redefine their operational parameters. The good news for the venture capital and private equity sector is the explicit consideration of this asset class as a standard segment of pension assets, with relatively high allocation limits, which, depending on the type of pension fund, can now be as much as 20% of total assets. But because of the depth of this new framework, it is expected that the concrete effects of such trends will not be fully realized until the next 2-4 years (xix).

Fundraising: outlook

The current reliance on international sources of funds for private equity investments in Brazil is seen as unsustainable, given their volatility and unpredictability due to their reaction to country risk factors and the lack of a history of returns (xx).

In addition, Enio et al. (xxi) show that very few countries have developed a private equity market without significant participation of domestic capital, and estimate that in the near future Brazil has no domestic sources of capital that are both sizable and reliable enough for private equity funds, at least at the current level of investment.

As one of the main findings of their field study, Enio et al. report that: "[…] local fund-raising with potential institutional investors still faces important regulatory, tax-related and credibility challenges". They assume that Brazilian pension funds, as the most important class of potential institutional investors, will likely stay away from large commitments to private equity until real interest rates drop substantially from their current level of 10%-15% per year. "These high interest rates are definitely one of the main hurdles in the way of more developed private equity investing or domestic fundraising," they say, referring to the absolute unfeasibility of leveraged buyouts and the commonly used mathematical asset allocation models, which promote allocation to private equity only when real short-term interest rates drop below 6%.

By suggesting that pension funds should start experimenting on a small scale with several private equity funds to develop a history of returns and solid relationships, Enio et al. (xxii) illustrate the situation this source of money has faced during the recent youth of Brazil's private equity industry. Their recommendation to fund managers to adopt the most stringent standards of transparency and information availability for local limited partners and to develop funds with a less diffuse investment strategy that facilitates their investment allocation decision reveals scope for an increasing future commitment and points out the concerns limited partners have recently had. Finally, in view of all the constraints on commitments by pension funds they identified during their research, they strongly advise the Brazilian general partners to diversify their sources of local capital by tapping into wealthy families, banks and insurance companies. "Potential partnership with the public sector, notably development banks, also offers an interesting although complex avenue for growth in capital commitments," they say. In general, a higher promotion of the whole industry, by leveraging the role of ABCR (Brazilian Venture Capital Association) will help to gain funds from the different sources.

Enio and his colleagues also mention that, within a still growing private pension system, most of the top ten pension funds in Brazil have a mature population and will decrease assets in the following years and therefore need a relatively liquid asset base. In that context, a healthy means of exit, either by sufficient trade sale opportunities or IPOs, will be carefully taken into consideration when they decide about their asset allocation. Considering this, Enio et al. encourage regulators like the SPC, the Private Pension Funds Secretariat, to adopt a more "American like" model of rules where the regulators set basic principles and interpret them in the light of actual facts, instead of setting fixed terms. This would offer some much needed legal incentives for the allocation of capital to private equity.

Investing

Investing: history

Since the important macroeconomic changes initiated through the implementation of the Real Plan, four additional factors made Brazil an attractive environment for private equity investing:

1. The absence of an alternative supply of capital in the form of low-cost debt or public offerings left the majority of Brazilian medium-sized companies, which had no access to international capital markets, with fewer options to finance their activities. Often, private equity-related investments were the only source of available capital and the accompanying management expertise and networks was a value-creating incentive.

2. Brazil's important economic role within the Latin American region and the remarkable size of its market made it a premium destination for Latin American investments.

3. The increasing openness of the market and the need to consolidate the Brazilian family-owned companies led them to become more reliant on professional managers. Large-scale privatisation programs and succession planning fostered this need for talented professionals.

4. The recent history of investments was characterized by the adoption of new technology and innovation from abroad at a remarkable speed. Most Internet-related investments went to business models copied from the United States and quickly implemented in the region, illustrating the Brazilian ability to quickly deal with previously unknown technology.

Management Buyout

A Management Buyout is the acquisition of a company by its management, often with the assistance of a leveraged buyout (LBO) firm. LBO firms are specialized in helping entrepreneurial managers to finance the purchase of an established company or a single division of a bigger conglomerate. The approach of such firms is to provide a management team which has enough equity to make a small down payment on the purchase of the business, with borrowed money which they then use to pay the rest of the purchase price. The assets of the company are used as collateral for the loans, and the cash flow of the company is used to pay off the debt. The companies acquired are usually divisions being sold by corporations that are refocusing on their core businesses, or businesses owned by families who wish to cash out. To earn an attractive return on their investment, LBO firms must build value in the companies they acquire. Typically, they do this in partnership with the management, by improving the acquired company's profitability, growing the acquired company's sales, purchasing related businesses and combining the pieces to make a bigger company, or some combination of those techniques.

The development of Brazilian private equity investment is divided into two waves, which can be observed throughout the entire Latin American region:

Phase I: Buyouts 1994 - 1998

Between 1994 and 1998, most of the private equity investments were focused on privatisation. However, these investments diminished to only one transaction in 1999 and none in 2000. Privatisation accounted for 69% of the dollars invested in 1996, 57% in 1997 and 79% in 1998. This first wave was dominated by buyout transactions. The major industry targets were largely traditional economic sectors such as telecommunications, transportation, utilities and retail. In these early years, besides privatised companies, family-owned businesses and industry consolidation potential served as targets for private equity investments (xxiv).

Challenges for Buyout Investments

According to Enio et al. (xxv), there are several important issues which make it significantly harder for the Brazilian buyout scene to earn high returns. First of all, due to the high interest rate, the absence of leverage leaves investors dependent solely on equity returns and operational improvement, which severely limits the price that can be paid in an acquisition. In addition, the volatility of interest rates is so high as to make any long-term indexed debt unfeasible. Finally, the know-how and institutional framework to supply debt for leveraged transactions is still emerging, which makes classical leveraged buyouts virtually impossible in Brazil.

A subtler impact of the absence of leverage is the relative insulation that middle-market companies in Brazil enjoy when times get tougher. Since they usually have very limited debt, or debt with state-owned banks that can be more easily rolled out, they are not as pressured as American companies to find new equity investors in bad times. Thus, in recession periods, the owners just cash less from the company but can still hold control. This reduced pressure to sell adds to a general unfamiliarity with private equity as a source of capital, which also influences the deal flow.

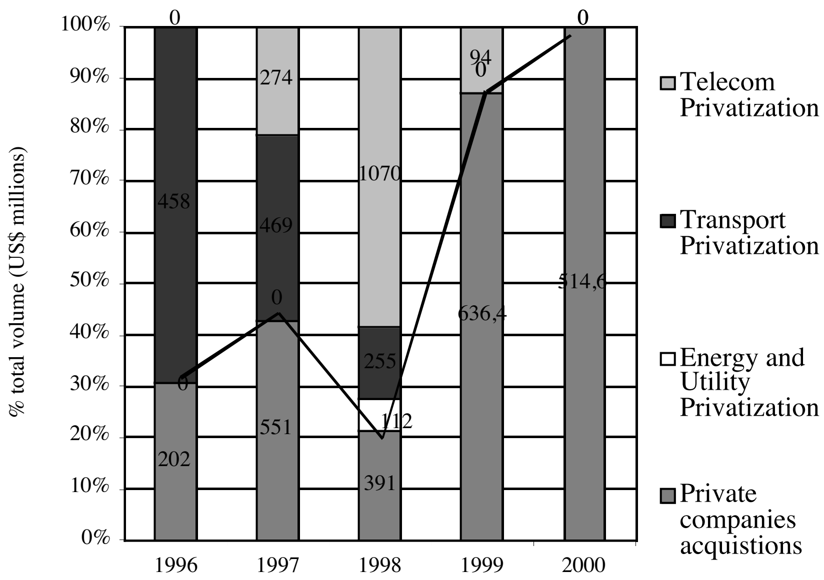
Another challenge of doing buyouts in Brazil is the lack of trustworthy information on the financial and accounting practices of later-stage companies, which makes due diligence a longer and less predictable exercise. In addition, the shortage of management teams willing to leave a "safe" job for a riskier proposition in an acquired company, combined with the unfamiliarity with incentive systems based on stock options, makes it harder for investors to attract outstanding managers to add value in acquired companies.

Finally, the lack of protection for minority shareholders limits the investor's ability to influence a company's management and exert control over important decisions. In some cases, investors circumvent this lack of protection by acquiring majority stakes or by creating foreign-based controlling entities which recognize U.S. law as applicable.

Phase II: Adding Technology Deals 1999-2001

This second phase was characterized by the investment frenzy in young, technology-based, internet-related venture capital. Between 1998 and 2000, the average deal size dropped significantly, from US$ 7.429 million in 1998 to US$ 1.609 million in 2000.

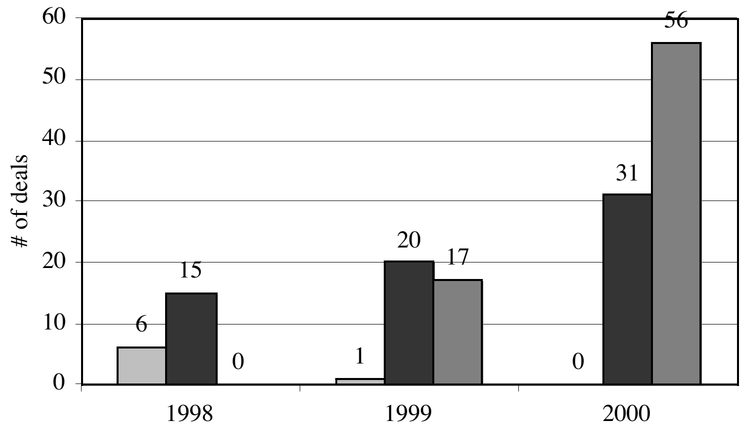
Figure 25. Private Equity Investments in Privatisation and Private Company Acquisitions in Brazil



Source: Monitor do Brasil; Asset Alternatives.

Large deals (above US$ 15 million) which in 1999 still represented 45% of the total invested, accounted for only 16% of the total in the first semester of 2001, while the share of smaller deals (below US$ 5 million) grew from 29% to 54% during the same period. This development was accompanied by a sharp increase in the total number of transactions, from 21 in 1998 to a peak of 87 in 2000.

Figure 26. Investment Activities in Brazil

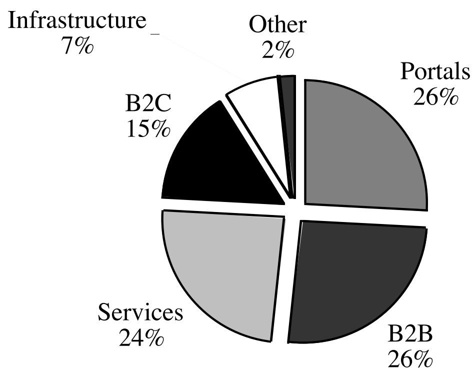


Source: Stratus.

These figures show the fast evolution of a new venture capital sector and the massive shift in the industry, in which even traditional private equity firms now started to invest in internet-related start-ups and early-stage finance. Checa et al. comment with an interview partner on this trend of private equity towards venture capital, driven by the Internet fever: "Large private equity funds overvalued many Internet companies clearly with a private equity mentality. They did not have any experience in venture capital types of deals, paid a higher valuation, and hired expensive CEOs, CFOs, and other staff for those companies. Instead of paying US$2 million for some deals, they ended up paying US$30 million."

The major areas preferred by investors in 2000 were telecommunications, new media, enterprise services and software, which together accounted for 70% of the total disbursement in 2000. During 1999, the devaluation of the currency slowed the investment activities, but dozens of young Internet start-ups were created during the second half of 1999 and the first months of 2000. The investments in that period were extraordinarily concentrated from a geographic standpoint, with 98% of the funds being invested in the southeast region of Brazil (xxvi). The main drivers in this development were venture capitalists, mainly from the U.S., who saw Brazil as a good domestic market and adopted a copy & paste philosophy, trying everything that had worked in the U.S. Investments specifically targeted at Internet-based business models were also fairly concentrated in the region, with the "established" U.S. business models being replicated in Brazil, including portals, B2B and services accounting for more than 70% of total disbursements .

Exhibit 27. Internet Investment by Sector



The Brazilian private equity market was not used to dealing with these early-stage investments, and the foreign funds in particular did not have the structure to support these deals, which resulted in bad investments. One VP at a local office of an international US fund is quoted as saying: "We started doing many deals on the Internet, and we did not have enough experience. By the end of the year [2000], we realized that we had taken the wrong strategy, we were a little late in the game…." The failure of many investments made during these early days led many investors to pull out of the market –which was characterized by general opportunistic behaviour– and purified the whole environment, as Bell and his colleagues confirmed. Also, the NASDAQ correction in March 2000 had its effect on the Latin American environment, investments collapsing by 83% from this time, according to the *Latin American Private Equity Analyst*.

Investing: current situation

As the continuous monitoring and management of all these relatively small Internet-related investments was too costly for the private equity sector, most of the private equity players who had heavily invested during the Internet hype and who then went through the aftermath of the crash have now retreated from the venture capital space, report Bell et al. (xxviii). As the number of Internet deals dropped from 74% to 35% of total closed transaction, for 2001 Stratus calculated a reduction of 30% in the total number of transactions. They reported, that, affected by the current uncertainties of local and international macroeconomic scenarios, most of the private equity funds are concentrating on consolidating their previous investments rather than on generating new ones. *Latin Finance* reports in October 2001: "Disenchantment with new technology and Argentina has forced [Latin American] private equity firms to look elsewhere. Many are turning to safe, but old technology firms based preferably in Brazil. The belief these days is that Brazil's sliding real, which is down 40% this year against the dollar, has priced in a lot of the risk of further volatility […] which means that Brazilian assets are cheap". Boring but safe investments are popular now, since they offer a lower risk profile, although they have lower growth prospects than more glamorous businesses. Mining, manufacturing, agribusiness, supermarkets, pharmacy chains and entertainment are seen as a better bet. These are cash-generative businesses that respond quickly to new, more decisive management introduced by private equity investors. *The New York Times* (xxix) noticed an increasing interest by financiers (15) in non-traditional investments in environmentally friendly companies, doing business in "originally produced and custom-selected hearts of palms", for example. This search for alternative investment focuses that investors are currently engaged in is taking place because most of their funds are still not fully invested, yet they are still noticing a demand for this investment class. This might be also illustrated by the actual announcement of a fund for "dekassegui companies". This special fund, launched by IDB, SEBRAE and Banco Sudameris, focuses solely on businesses started by Brazilians returning from work experience in Japan (dekasseguis).

As a reflection of the current limited degree of competition among private equity funds in the region, syndication of deals to a dominant practice is common (Enio et al. (xxx)). According to them, currently the major obstacles for investments are the absence of leverage, an unfavourable legal framework, the cultural resistance of the business community towards outside investors and a lack of transparency in disclosing information by Brazilian companies.

In their remaining participations in start-ups, investors are currently seeking to increase control. Uncertainty and the lack of exprience of the founders call for a higher involvement by the investors, leading to a much more hands-on approach towards the company. According to Bain & Co., no investment is expected in new Internet start-ups, although a few breakthrough technology companies may be funded. Only some private investors will continue to selectively support some of their portfolio companies with follow-on investments.

Much of the current attractiveness of the Brazilian market is the potential for consolidating small and medium-sized companies that typically lack sound management, strong balance sheets or well-known brands. In this reespect, some investors are facing cultural problems, as Purcell, a General Partner at JP Morgan Capital, says (xxxi): "There are

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See as an example: www.terra-capital.com many small and mid-cap companies that are not very sophisticated and do not understand how [private equity investing] works". As qualified management is scarce, investors must take their chances with the current managers or seek out their own executives. This problem is confirmed by some key findings of the latest annual survey of U.S.-based private equity funds with Latin American activity, conducted by PriceWaterhouseCoopers. In this survey, as a new point compared to previous years' surveys, the issue of greatest importance to participants, besides economic and political stability, is the quality of the workforce and management, and so a brief look at this issue is of interest.

Issues concerning the treatment of property rights are also of the greatest importance, especially as early-stage capital nowadays goes to high-tech and biotech-related industries, where a secure legal framework is crucial for sustainable industry development.

> "Some entrepreneurs that are used to sealing deals with a handshake don't realize that a lot of rigorous detail is needed to put together a venture-capital deal."
>
> Lisa Krochmal, a lawyer in the Buenos Aires office of Morrison & Foerster, an American firm active in new technology deals.
>
> In: A New Breed of Venture Capitalist Scouts Latin America, *NY Times*

Human Capital (xxxii)

Education remains one of the main problems of Brazilian competitiveness. The average adult has spent less than four years in school, resulting in a highly unskilled workforce. However, this figure is highly influenced by poor training of existing workers. Recent data shows that 97% of people of school age are in school, suggesting that improvements have been achieved. In 1998, 300,761 people graduated in Brazil. The country has 644 schools of engineering/technology, from which 17,864 people graduated in 1998. There are also 776 schools of management and administration around the country, which graduated 34,025 people in the same period. Public and private colleges and universities characterize Brazil's education system. Private colleges charge tuition and grew up very rapidly during the 1990s to meet the great demand of a growing middle class. This proliferation of higher education institutes was accompanied by a decrease in teaching quality and only a small fraction of the graduates are really qualified to perform well. To deal with this problem, the Ministry of Education has established a yearly assessment program of all the colleges in the country in order to force the schools to improve and increase the quality of the overall system: only 30% of the institutions achieved A or B grades, indicating that most institutions provide low quality education. Considering the institutes in which top companies consistently recruit as providers of world class human capital, then there are only a thousand top tier new engineering and management graduates per year in the entire country, which therefore makes qualified human capital a scarce resource. An additional reason for the underdeveloped management pool is the dominance of family-owned enterprises, where ownership usually is not separated from management, hindering the development of an independent managerial class. This constraint is reinforced by the huge concentration of resources in the large cities of the southeastern region, which has nearly two-thirds of the country's colleges and universities.

Intellectual property rights law

In early 1999 a new property rights law was approved in Brazil. This new legal environment is intended to make the country's intellectual and industrial legal provisions consistent with Western standards. The agency in charge of the control and registration of intellectual property is Instituto da Propriedade Industrial (INPI), which between 1998 and 1999 granted over 3000 patents. Today the total number of patents in force is around 15,500. The main issue in Brazil regarding intellectual property rights is not the cost or bureaucratic complexity of obtaining a new patent or brand, but the difficulty the government has in enforcing the existing laws. The grey market is a reality for almost all products and so far the government has been unable to control it.

Besides this legal framework, some initiatives have been launched with the goal of fostering the experienced entrepreneurial spirit and taking macroeconomic advantage of the growing venture capital and private equity sector.

Initiatives: FINEP (16) and the INOVAR Program (17)

In 1999, FINEP (Financiadora de Estudos e Projetos), an arm of the Ministry for Science and Technology, and the Inter-American Investment Cooperation started the Inovar program to address the need for institutionalised action from the Brazilian government to help the development of the venture capital sector and the foundation of start-up companies. BNDES has arguably been doing just that, but it is in essence an investing company, whereas FINEP aims to create a framework to foster company foundation. The Inovar program consists mainly of the following dimensions of action: i. the website www.venturecapital.com.br, created to match investors with entrepreneurs in search of venture capital ii. the organization of a series of events called Venture Forum Brasil, with discussion panels of practitioners and business plan competitions/presentations, iii. a venture fund, iv. a technological investment facility for fund ranking, similar to www.pwcmoneytree.com, which is supposed to help investors to make their valuations.

Associação Brasileira de Capital de Risco (ABCR) (18)

During the year 2000, the Associação Brasileira de Capital de Risco was founded by 26 institutions, ranging from fund managers and investment banks to government agencies and universities. At present, it consists of 59 members, among them important international and local funds, consulting companies, the stock exchange, and some of the universities and incubators. The aim of the association is to generate data about the industry, fund-raising, investments and exits in order to publish them on the Internet. To that end, it catalogues the industry history and discloses benchmarks to its players. The organization seeks also to better educate Brazilian lawmakers about the nature of the venture capital and private equity industry in order to push for specific legislation from which its members would benefit. Finally, and as a general goal, the organisation seeks to promote a better capital market, which is crucial for exiting the members' investments.

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(16) See: www.finep.gov.br
(17) See: www.venturecapital.com.br/ShowItem.asp?ContentId =1018.
(18) See: www.abcr-venture.com.br

Brasil Emprendedor

The Brasil Emprendedor program was initially focused on helping micro enterprises and small and medium-sized enterprises, but has been refocused towards risk capital. Being a direct initiative of the presidency, the program shows a commitment and involvement on the part of the highest authorities to the issues facing the industry.

Investing: outlook

According to the fourth annual survey of U.S.-based private equity funds by PriceWaterhouseCoopers, U.S. investors are confident about a positive overall economic performance of Latin America and cite (44%) Brazil as their most popular investment destination (xxxiii).

In the scenario of high cost of debt caused through the persistently high interest rates and the absence of a liquid capital market, governments and the private sector often may turn to private equity to fill this investment gap.

"Small companies are the name of the game. They have high growth potential," said Alvaro Gonzales (xxxiv), a partner at Stratus Investimentos Ltda. Two factors should be closely monitored when it comes to assessing the scenario for private equity, he said. They are: the increasing presence of players who are not affiliated with financial institutions and the tendency toward small to medium-sized investments. These SME investments will replace the privatisations in 1997-98 and the pure Internet plays in 1999/2000. Camoes, another manager at Stratus Investimentos Ltda., sees still a lot of privatisation taking place, particularly in the banking and electricity sector, while Claudio Pecanha, director of Westphere Brasil, believes that new energy, such as co-generation and thermo energy, and the logistics sectors "have a lot room for improvement in Brazil" (xxxv). Generally speaking, globalisation and the upcoming trade agreement of the Americas (FTAA) will offer attractive opportunities for those private equity funds that can identify which sectors of the Brazilian economy will benefit most from that environment. This trend of reducing trade barriers will boost opportunities for export-oriented businesses and will be a driver of deal origination, but it will also be a major threat to businesses that are susceptible to competition from imports, predict Enio et al. (xxxvi) for the next 3-5 years of Brazilian private equity investment. In the near future, they see the limited level of competition for deals likely to remain in place, basing their argument on the given modest growth prospects for investment opportunities and the advantages of co-investments made by international firms with local funds.

"i. private equity firms should seek investment opportunities that offer exchange rate hedging by focusing on sectors that can derive substantial growth from exports,

ii. they should aim to differentiate themselves by developing sector expertise in order to develop a unique competitive advantage;

iii. the role of the newly created Brazilian Venture Capital Association (ABCR) can be increased in order to enhance the industry's reputation and serve as the industry voice and network institution" is a summary of the suggestions Enio and his colleagues give to the investment community, offering a good insight into the possible direction of future Brazilian investment activities. They see the significant reduction of economic activity in the US as an additional driver for investment in Brazil, and the *Venture Capital Journal* questions the current unpopularity of President Henrique Cardoso, asking what type of government can be expected after the presidential elections this year. As they see it as the next big source of uncertainty in the Brazilian economy and politics, some investors take this upcoming event into account in their plans.

Regulations

However, there remain substantial barriers to foreign investment in Brazil. Foreigners may not own or run media, broadcasting companies, airlines, some real estate, lotteries, atomic power or alternative energy. The Brazilian central bank regulates private transactions heavily by obliging foreign investors to register their investment in a Foreign Capital Register (xxxix).

The biggest challenge to a long-term view of Brazilian private equity remains the reform of the tax and social security systems, as is highlighted by the *Venture Capital Journal* in its February 2001 issue.

A still unsolved obstacle that needs to be taken into account is the lax corporate governance controls in Brazil. All Latin American countries lack rules regarding corporate transparency for private companies as well as laws and enforcement mechanisms to protect minority shareholders, says Reinaldo Pascual (xl).

As most of the investors will typically invest in "preferred" equity, the Brazilian capital structure must remain relatively simple, as complex preferred stock instruments are often not recognized by corporate codes.

"The pace of investment is in the hands of the government. We would probably increase our spending [in Brazil] if some of the restrictions were removed," confided Cesar Baez, a partner and head of Latin American investing at Hicks, Muse, Tate & Furst to the *Venture Capital Journal* (xli). He points out the need for future government actions to maintain a healthy investment climate in Brazil: "The next step would be to pass a telecom law to free up the sectors, such as media, and to change the percentage of foreign ownership."

Exiting

Exiting: history

According to the *Venture Capital Journal*, the exit situation in Latin America is the "single biggest issue" and concern for all participants in the young private equity industry, and its history is therefore unfortunately quite short. Only very few exits have actually taken place. According to a Latin American private equity survey conducted by KPMG, the *Venture Capital Journal* reported in 2001 (xliii):

> "…A full 33% of respondents said they had not executed an exit strategy to date. Another 33% said they had exited less than 10% of investments; 24% had left 10% to 19% of investments; and only 3% had divested 40% or more. Of the firms who exited investments, 67% have exited by means of a foreign strategic investor; 60% through a local sale; and only 6% through a local IPO." In Brazil, there were only two exits through a local IPO, and of the 227 deals closed since 1996, only 15 exits have been disclosed, most of them being sales to competitors and strategic

buyers. During the Internet boom, some companies such as StarMedia, ElSitio and Terra Networks were successfully listed on the Nasdaq and their outstanding early performance was one of the main drivers of the whole venture capital sector in Brazil. However, a trade sale to an international strategic buyer was the most realistic and preferred exit route for 68% of the respondents, as was revealed by PWC's second annual Latin American private equity survey in 1999 .

Figure 29. Selected Exits of Private Equity Investors in Brazil

Investors	Company	Sector	Buyer/type of exit
GP	Sé	Retail	Foreign entrant
GP	Supermar	Retail	Foreign entrant
GP	Mandic	ISP	Foreign entrant
GP	FCA	Railroads	Local conglomerate
GP/Macal/Globo	Globocabo	Pay – TV	NASDAQ IPO
Icatu	Saraiva	Bookstores, publishing	Local IPO
Unibanco	Zip.net	ISP/Portal	Foreign entrant
Dynamo	Ideias.net	Holding like CMGI	Local IPO

Exiting: current situation

"Concentrate on strategic buyers as an exit strategy," is the advice Marcos Rechtman (xlvi), a partner with AIG Capital Investments, gave his audience at a recent private equity conference in Sao Paulo. This illustrates the lack of IPOs as an alternative exit opportunity and calls for a closer look at the relevant institution, the Brazilian capital market.

Brazilian capital markets –the BOVESPA– Sao Paulo stock exchange

Investor Participation in the Sao Paulo Stock Exchange (Bovespa), November 2001

Investors	percentage of Total Volume
Individuals	22.2%
Institutional Investors	16.7%
Foreign Investors	26.7%
Companies	21.5%
Financial Institutions	31.6%
Others	0.2%

Source: Bolsa de Valores Sao Paolo.

With a market capitalization of US$ 181 billion at 10th January 2002 and 426 listed companies (xlvii), BOVESPA represents the vast majority (90%) of securities traded in Brazil and is the 15th largest stock exchange in the world (xlviii). Current legislation authorizes the exchange to trade stock and securities issued by publicly held companies registered with the CVM (Comissão de Valores Mobiliarios). In addition, stock call and put options, debentures (simple or convertible in stocks), and registered commercial paper for public placement are authorized. The daily average number of trades climbed from 27,853 in October 2001 to 33,740 in November 2001, with a record of 46,999 trades on the 7th of

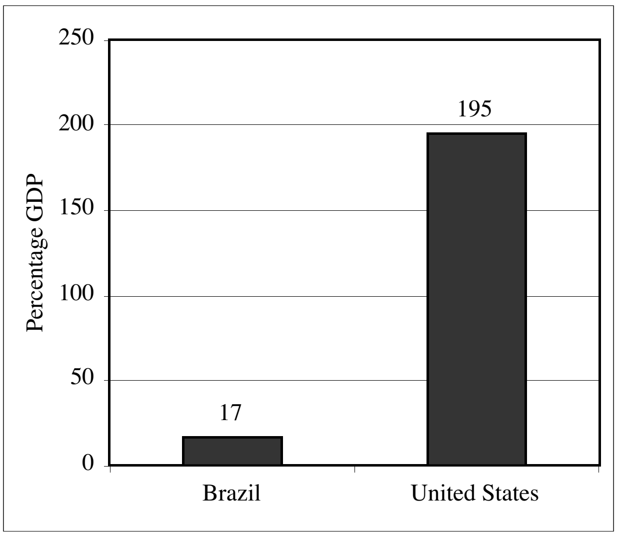
November 2001, representing a slight increase in volume traded. This is overlaid by a longer trend of de-listing waves, which are outstripping new flotations and are responsible for a fairly illiquid and underdeveloped exchange. Since 20 traded companies account for almost 90% of the trading volume, the stock market is very narrow and concentrated on a small number of Brazil's biggest companies, which in addition may prefer to issue American Depositary Receipts (ADRs) on the New York Stock Exchange or to trade on more developed and liquid markets. The closing of the capital of some privatised companies through their international acquirers and an increasing tendency for companies to buy back their own shares to prevent an unfair valuation in a fairly depreciated market has led to a decrease in market capitalization from almost US$ 270 billion in 1996 to US$ 205 billion in 2001 (l). One reason for the illiquid situation of the stock exchange is the relatively small participation of large investors such as pension funds and insurance companies, which, attracted by the high level of interest, put most of their money into fixed income instruments such as government bonds.

With regard to the participation in the traded value, in November 2001 the bulk of the investors was made up of financial institutions, which traded the equivalent of 31.6% of the total volume. Foreign investors also play an important role as the second most active group of players, with 26.7% of total volume. The following Exhibit describes investors' participation in BOVESPA.

Historically, the stock market has been extremely volatile and has not been a major vehicle for corporate financing. Despite the fact that returns on BOVESPA have been extraordinary in this period, Checa et al. (li) state that "due to economic stability and the development of the telecommunication industry, its volatility has been significantly higher than the volatility of the S&P 500 Index".

They calculate that "in terms of market capitalization as a percentage of GDP, the BOVESPA represents a relatively small portion. The total market capitalization of the BOVESPA at the end of April 2001 was US$ 208 billion, merely 17% of the country's GDP, whereas in the United States the market capitalisation of the NYSE as of March 30, 2001, was US$16.8 trillion. On the same date, the Nasdaq had a market capitalization of $2.7 trillion. As a percentage of the GDP, both stock markets combined represent 195% of the United States' GDP." Exhibit 30 illustrates these differences.

Figure 30. Market Capitalization as a Percentage of GDP in the U.S. and Brazil



A reason for the relative unattractiveness of the stock market is the current treatment of minority shareholders in Brazil, which gives rise to heavy under-pricing of listed companies. “As two thirds of a company’s capital can be preferred stocks, the company can be controlled by holding 17% of the total capital. If a company is sold, limited rights of minority shareholders for example lead to very different prices being paid, in one case US$ 600 for voting shares and only US$ 60 for non-voting. Thus, stocks traded at BOVESPA in many cases below equity value,” report Bell et al. (lii). Meanwhile, Enio (liii) points out that the upsides for traded companies are not very high: the average P/E Ratio at BOVESPA is 1.75 compared to 22.6 P/E on the NYSE.

Reflecting on the role of the general partner after exiting through a Brazilian IPO, Rick Schiffer, a partner with Newbridge Latin America, told the *Venture Capital Journal* (liv): “An IPO is not an exit. At best it’s a partial exit. It’s a slow process you have to sell down over time. In the U.S. you can feel reasonable when you take a company public you’re reducing your stake in it. The problem in Latin America is there’s no investor appetite [for public markets]”. In this context, local IPOs are not a reliable exit option for invested funds, and the scene is focusing on trade sales to strategic investors. This constraint limits the potential return on investment, since studies of the U.S. market suggest that the most profitable private equity investments have, on average, been disproportionately exited by IPOs. A study conducted by Venture Economics (1998) finds that US$ 1.00 invested in a firm that eventually goes public yields a 195% average return for an average holding period slightly longer that four years. Conversely, returns on investments exited through trade sales provided average returns of only 40% over an average holding period slightly shorter than four years (lv).

Relying on trade sales as the main avenue means that limited competition drives prices down and macroeconomic stability plays a larger role than it would play with a liquid stock market. Companies without likely acquirers become less attractive, even though there might be significant chances of substantially improving performance which limits the available investment opportunities for the private equity investor significantly.

Exiting: outlook

In their research into investment exits in Brazil, Enio et al. (lvi) expect that the current reliance on strategic investors as the main exit option will continue at least in the medium term. This will exact a heavy toll on the funds and will limit the development of the Brazilian private equity industry. The abovementioned authors point out, however, that following the introduction of the Real Plan in 1994, annual M&A transactions increased from 175 to 353 in 2000, which can be seen as a good indicator of a future increase in liquidity through exit from investments via strategic trade sales. This fits in with a finding from the recent Latin American Private Equity Survey, in which a majority (68%) of the respondents rank a trade sale as their most likely exit strategy, compared to 5% each for a domestic or international IPO (lvii).

Recently, the Brazilian congress approved a new corporate law for the governance of public companies which improves the rights of the shareholders and gives some incentives for public market investments. This is supposed to increase the market’s liquidity, but significant results are not expected in the short run. Three very relevant aspects of the new law are (lviii):

- Improvement of the financial reporting directives, increasing the alignment with the American GAAP provisions;

- Reduction of the maximum amount of non-voting shares from 66.7% (2/3) of total shares to 50%;

- Establishment of a minimum value of 80% of what was paid to the controlling shareholders for the acquisition of non-controlling voting shares in the event of change of control.

Novo Mercado (19)

Another initiative of the government is the creation of the BOVESPA –Novo Mercado, which, following the success of the German "Neue Markt", aims to create a new listing segment. This segment is designed for the trading of shares issued by companies that voluntarily undertake some corporate governance practices and disclosure requirements in addition to those already required under Brazilian legislation. These new rules, which are more rigid than those required by the current legislation in Brazil, increase shareholders' rights and enhance the quality of information commonly provided by companies. The main innovation of the Novo Mercado, when compared to the current legislation, is that non-voting shares may not be issued. In summary, a publicly listed company that trades in the Novo Mercado has the following additional obligations (lix):

- The holding of public share offerings through mechanisms which favour capital dispersion and broader retail access;

- Maintenance of a minimum free float equivalent to 25% of the capital;

- The same conditions provided to majority shareholders in the transfer of the controlling stake will have to be extended to all shareholders ("Tag Along" rights);

- Establishment of a single one-year mandate for the entire Board of Directors;

- The annual balance sheet to be made available in accordance with US GAAP or IAS GAAP;

- Introduction of improvement in the quarterly information report, among which is the requirement of consolidated financial statements and special audit revision;

- Obligation to hold a tender offer by the economic value criterion should a decision be taken to delist from the Novo Mercado;

- Adherence to disclosure rules on the negotiation of assets issued by the company in the name of the controlling shareholders or the company management.

The *Latin American Private Equity Analyst* has calculated that acceptance of these additional U.S. practices costs each newly floating company roughly US$ 300,000. Because

(19) See: www.novomercadobovespa.com.br

of the increased transparency and greater rights for shareholders, these companies hope for a significantly higher valuation. Additionally, the Development Bank, through BNDESPAR, has set up a program that covers part of the additional costs. Through transition programs, BOVESPA is aiming to move companies currently listed on BOVESPA markets to this new segment, with the long-term goal of making the Novo Mercado the main Brazilian stock exchange and not just a focused segment for high-tech or smaller companies.

This whole initiative might boost the dry capital market, attracting international investors and local capital. Greater liquidity would drive up valuations and provide the industry with the desired exit options.

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(xlix) Adopted from: Checa, Gonzalo; Leme, Ernesto; Schreier, Claudio; The Venture Capital and Private Equity Industry in Brazil. In: *The Journal of Private Equity*, Fall 2001.

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(li) Checa, Gonzalo; Leme, Ernesto; Schreier, Claudio; The Venture Capital and Private Equity Industry in Brazil. In: *The Journal of Private Equity*, Fall 2001.

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(lv) Adapted from: Stein, Enio; Trigueiro, Márcio Tabatchnik; Herndl Filho, Marcus; Field Study: Private Equity in Brazil –The Road Ahead, Harvard Business School.

(lvi) Stein, Enio; Trigueiro, Márcio Tabatchnik; Herndl Filho, Marcus; Field Study: Private Equity in Brazil –The Road Ahead, Harvard Business School.

(lvii) Second Annual Latin American Private Equity Investment Survey by PriceWaterhouseCoopers.

(lviii) From; Stein, Enio; Trigueiro, Márcio Tabatchnik; Herndl Filho, Marcus; Field Study: Private Equity in Brazil – The Road Ahead, Harvard Business School, P. 55.

(lix) From: www.novomercadobovespa.com.br

(lx) *Latin American Private Equity Analyst*, February 2001, P. 4.