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In This Issue

The Latam PE Fundraising Environment

An Exclusive Interview with Tim Cohan and Mary Frederickson of Stanwich Advisers LLC

By Alyson Sheehan

VELA: Stanwich Advisers helped Southern Cross Group raise its third Latin America Private Equity Fund in 2007 and its fourth in 2010. Did you see a change in investor appetite between the two funds?

TIM: Similar to its third fund, Southern Cross's fourth fund was a global fundraise. We saw interest from investors in Australia, Asia, the Middle East, Europe, Latin America, and certainly in North America. With respect to the investor base, there was appetite from a diversified group of investors, including sovereign wealth funds, state and local pension funds, insurance companies, fund of funds, endowments and

See Fundraising on page 6

Round Up

By Alyson Sheehan

Actis Invests $58 Million in Brazil's XP Investimentos

Actis, a private equity firm focused on investment in emerging markets, has invested $58 million in Brazil-based independent brokerage firm, XP Investimentos ("XP"), according to a press release on Actis's website. The firm's investment in XP was made through the Actis Emerging Markets Fund III, valued at $2.9 billion.

According to Actis's press release, XP, which began operations in 2001, has led the way in providing Brazilians with access to financial education, training individuals in topics ranging from investment basics to advanced portfolio management strategies. Now the company has the largest capital markets educational program in the country. Currently XP has over 70,000 customers and 215 branches in over 100 Brazilian cities. Actis believes that XP's work pertains to a rising sector,

See Round Up on page 4

Taxation

Tax Liabilities in Brazil

Continued from page 5

Nonetheless, if the past can provide any indication of the future, any forthcoming regulation of such a vague provision will probably share the same fate of countless other similar administrative regulations that are still being disputed in Brazilian courts.

Everything considered, PM No. 510 might just be a first step to adequate Brazilian legislation to a more intensive use of JV arrangements in the near future as domestic companies are now actively seeking greater levels of flexibility and cooperation with view to carry out the infrastructure work required for the upcoming '14 World Soccer Cup and '16 Olympic Games. Nonetheless, with complex legislation quickly accumulating with respect to such ambitious projects, taxpayers are well advised to exert great caution in such ventures.

Renato Henrique Caumo (rcaumo@pn.com.br) is an Associate in the Tax Practice of Pinheiro Neto Advogados, in São Paulo.

Interview

Fundraising

Continued from page 1

foundations, family offices, and advisors. In terms of change, we saw more interest from local investors; due to regulatory changes, many were now permitted to invest in the asset class. Globally, we saw increased interest from pension funds, sovereign wealth funds, and advisors.

However, generally, regardless of geography or type, we saw an increased interest in and comfort with Latin America from investors who either did not have it on their radar screen a few years ago or were still getting comfortable with the macro.

VELA: What kinds of strengths or weaknesses do you look out for when choosing a general partner as a client?
TIM: In terms of General Partners (GPs), we look for a team that has been together a long time, has a strong track record, and has maintained a consistent strategy over the years. We look for a track record where there are no attribution issues. When you have a team that has been investing together for a long time, then that is not a concern. With newer groups, firms that have had team departures, or "spin-outs", attribution becomes a potential concern. Investors want to make sure that the team they are backing is the same team responsible for the track record and that they can replicate their past performance going forward.

There also has to be chemistry. Private equity is certainly a much different asset class than a public equity strategy. You are evaluating people who will be managing your money for a long period of time, a period of at least ten years. You have to be able to look them in the eye and trust them and view them as a partner. Given the fact that it is a blind pool of money, you are never 100% certain as to where it's going. Sure, you have a sense, and investment guidelines are outlined in the LPA, but for Limited Partners, as well as us, we need to have a great deal of comfort that the team is trustworthy and that the story they are telling is true. As a result, we do a tremendous amount of due diligence upfront. We talk to portfolio companies' management teams – including current companies (ones that they still own) as well as former companies (ones that they have sold). We talk to their competitors; we talk to attorneys, accountants, consultants, co-investors, board members, existing investors, etc. We talk to people in the local market to get a better sense of their reputation, and how they are perceived.

MARY: It is a very extensive process, which is intended to mirror the most thorough institutional investor's processes. Prior to coming to market, our goal is to ask any question that a potential investor may have, which helps ensure that we will be successful and also makes the fundraise more efficient.

VELA: Can you please describe what goes into, and comes out of, a "diagnostic review" of a general partner?
TIM: A "diagnostic review" involves spending a significant amount of time with the General Partner in trying to understand and distill their strategy, including: how they operate; what their investment process consists of; and what their investment selection and criteria are when they look at companies. We'll spend a lot of time reviewing the track record and digging into each company and why it represented an ideal deal for that particular general partner. For a deal that may have under-performed, we will want to know what went wrong, what were the lessons learned, and how these lessons have been reflected in their process and strategy going forward.

Also, are they consistent in the way they have invested over the past? For example, some groups will start out in the venture space and then began to position themselves as a growth equity or buyout firm. Or a group will start out focused on technology investments and gravitate to the healthcare sector, with no real experience in the latter. We also spend a lot of time with the team, both as a group as well as with each individual to better understand how they operate internally and how their investment process works. As Mary said, our due diligence process is intended to ensure that we will be successful, and the best way to do this is by speaking with people that know and have worked with them.

We also spend time meeting with their competitors. This is extremely helpful in trying to determine exactly what makes our client unique. In this fundraising market, which is very competitive, you have to be able to differentiate one group from the next. Limited Partners are time constrained, have a limited amount of capital to invest, and their existing managers are also looking for support. Many investors are trying to cut back on their number of managers. As a result, trying to get a new General Partner considered, a new fund considered, is extremely difficult.

VELA: How do you go about prioritizing investors? What criteria do you use?
MARY: We do not always have the benefit of prioritizing investors, but in general, GPs are looking for long-term partners, where it is truly a partnership based on trust and open communication between the two parties. As a long-term business, GPs also need to make sure an investor has a stable pool of capital for this fund and will have the ability to participate in subsequent funds. That is one of the criteria.

TIM: You also do not want too much concentration with any one group or geography. For instance, you may raise your next fund and all of a sudden someone decides to get out of the business; then you have a hole to fill. You are looking for investors who are long-term in the asset class and who you can partner with beyond a five, ten-year horizon. To make the process more efficient for our clients, we are constantly speaking with Limited Partners. We know what their current interests are and what their short and medium term investment plans look like. We try to match their plans with what we have in the way of offerings.

As a private market, Brazil historically did not have a lot of opportunities to acquire control positions, but that has changed.

MARY: Some GPs will also take into account whether a Limited Partner has a co-investment program and could participate in investment opportunities that may arise.

The core difference between the fundraising process around the first fund we worked with Southern Cross on (Fund III) and the most recent (Fund IV) is that the appeal for Latin America has increased dramatically. Macroeconomic trends have and continue to improve in Latin America, as evidenced by how well Brazil and the rest of Latin America faired during the economic downturn. Brazil is a great growth story.

Institutional investors look around the world to diversify their holdings. They will look at areas where

See Fundraising on page 8

Fundraising

Continued from page 7

there is growth. If you look at what is happening in the U.S. and Europe, there is not terribly strong growth expected over the next couple years. When you look at emerging markets, such as China and India, where a lot of capital has gone, even though you are seeing growth rates coming down, they are still north of 5 percent. You are also seeing those types of rates certainly in Brazil, which makes people feel more comfortable about allocating more towards emerging markets

MARY: Despite the fact that more private equity players are emerging in Brazil, private equity still accounts for a minimal percentage of Brazil's GDP. Relative to other markets, including mature ones such as the US as well as other emerging markets, such as China and India, Brazil is less penetrated from a private equity perspective.

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VELA: Why do you believe that the small/mid-cap space in Brazil is underpenetrated from a private equity perspective?

MARY: As a percentage of overall capital being raised, the majority of capital is being committed to funds focused on transactions in the large cap space. There are longstanding local managers focused on this space, who have raised larger funds over the years, plus, more recently, an inflow of international managers now establishing a presence in Brazil.

We see fewer private equity managers in the market that are focused on the small to mid-cap space. The investment opportunity in the small and mid cap market is driven by family-owned companies, which account for somewhere between 13,000 and 14,000 businesses. These companies are actively seeking capital for a variety of reasons. They recognize that if they "professionalize" their business, they will be more attractive acquisition targets – both domestically and internationally. They also recognize the amount of wealth that has been created for families who were successful in doing this over the past five to ten years. This is particularly important if a seller is looking to maintain a stake in the business. In essence, there actually has been a shift in attitude among family-owned companies, where they are now willing to partner with investors, assuming they have the right skill set to implement and manage this process.

TIM: These are complex companies. You have sensitive succession issues; you have companies that do not have a management team capable of taking the business to the next step. These companies are looking for financing. Private equity was considered a new source of funding a few years ago, but its presence as well as acceptance by family-run companies has increased over the last couple of years. For these smaller, family-owned companies, it provides them with a source of liquidity, both immediate and in the future. For example, instead of a founder selling out 100 percent of his business, he will sell out 50 percent, or 60-70 percent, and maintain a minority stake in the business to participate in future value while generating some degree of immediate liquidity.

MARY: However, being able to "partner" with family-owned companies is difficult. You have to have a local presence, a unique skill set, and a track record that can confirm this. Once again, trust plays a critical role when family-owned companies consider partnering with an investor.

TIM: As a private market, Brazil historically did not have a lot of opportunities to acquire control positions, but that has changed. Some companies, particularly those at the upper end, are exclusively seeking capital rather than any sort of operating experience that a GP may have to offer. I think when you are a family-owned business, and you are selling your business, it is a different decision-making process when you want to sell 100 percent than if you want to maintain a stake in the business. You are looking for a partner, rather than just capital.

VELA: Would you say these family-owned companies are becoming a lot more receptive towards foreign investors?
TIM: Absolutely.

VELA: Could you highlight some attractive sectors for investment in Brazil and/or across Latin America?
MARY: Two sectors that investors are focused on are infrastructure and energy services. On the infrastructure side, this is largely being driven by public policies focused on increasing investment in infrastructure to improve current conditions as well as to prepare for future capacity needs, due to events such as the 2016 Olympics and 2014 World Cup. On the energy side, growth is being driven by recently discovered oil reserves as well as increased investment in renewable energy.

MARY: With Brazil being one of the largest suppliers of commodities, agriculture is another attractive sector. There are many private equity managers with dedicated funds focused on agriculture, infrastructure, and energy. Within the "generalist" PE market, investment opportunities continue to be driven by the emergence and growth of Brazil's middle class, which now accounts for the majority of its total population.

TIM: Healthcare is also becoming more popular, and obviously as Mary said, any of the services that cater to the middle-class provide attractive investment opportunities.

VELA: Can you please compare the legal environments of Brazil, Chile and Mexico?
TIM: If you look at the different markets, some people would say that Chile is definitely one where there is more comfort. It is incredibly business-friendly, the rule of law is strong, and in general, people feel very comfortable doing business there, which is not so much the case in some other countries in Latin America.

TIM: I think that if you had to rank them, Chile would be at the top in terms of the receptivity to any legal issues and regulatory issues. Chile is like the U.S. Mexico is also pretty good. It drops off when you start to go to Argentina, Venezuela, Bolivia. In Brazil there are still some concerns. I think people would like to get a little bit more of a risk premium in Brazil – For now, the growth story in Brazil is so great that people are willing to take the risk. A country that is approaching a population of two hundred million people with rising discretionary income is a pretty good story.

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VELA: Is there a chance that because Brazil is so hot right now, the competition there will become so sharp that it will actually deter investors in the future?
TIM: Yes, that is always a possibility. We have seen a lot of money flow into China and India, but investors are still bullish on these markets. Brazil has gotten hot in the past and then cooled off. Policymakers recognize this; earlier this fall Brazil raised the IOF tax in an attempt to contain FX appreciation from heavy cash inflows. At the higher end of the market, we have seen the emergence of new groups, who are going to provide more competition for local managers. As companies see more interest from private equity, they are going to need to decide whether they sell out 10 percent or seek immediate liquidity and sell out 100 percent.

Tim Cohan is a Partner at Stanwich Advisors. Mr. Cohan spent 20 years with Morgan Stanley in its Fixed Income Division, where he held several senior sales and management positions and was responsible for distributing a wide variety of domestic and international fixed income products. Mary Frederickson joined Stanwich Advisors in 2007 and is responsible for market research and providing support to the firm's origination, due diligence and distribution activities.