BROOKINGS PCRI

The Brookings Institution, Private Capital Research Institute, Brazilian Private Equity & Venture Capital Association, Financiadora de Estudos e Projetos, Ministério da Ciência, Tecnologia e Inovação, and the Government of Brazil

How will Private Capital Develop in Brazil?

September 16, 2013
Rio de Janeiro, Brazil

Event Summary

Private capital – private equity and venture capital – is an increasingly important part of the financial sector. The global private capital sector grew from $900 billion a decade ago to $3.2 trillion in mid-2012. Many academics and investors believe that much of the future growth of private capital is likely to take place in emerging markets, and that the aftermath of the financial crisis of 2008 is likely to accelerate this trend, as the recovery occurred more quickly in advanced emerging markets.

Against this backdrop, the Brookings Institution and the Private Capital Research Institute (PCRI) recently collaborated with the Brazilian Private Equity and Venture Capital Association (ABVCAP) and the Brazilian Government to promote a better understanding of the future of private capital in emerging markets, with a special emphasis on Brazil. The result was a day-long discussion featuring institutional investors, private equity investors, entrepreneurs, policymakers, and academics from the United States, the European Union, and Brazil.

Introduction

In his opening remarks at the conference, Dr. Martin Baily, Senior Fellow and Director of the Private Capital Project at the Brookings Institution explained that understanding private capital's development in Brazil would, by extension, give insight into private capital's development in other emerging markets. Dr. Baily was followed by Clovis Meurer, President of ABVCAP, who introduced the day's discussions, which focused on adding clarity and depth to our understanding of why institutional investors are increasingly seeking opportunities in Brazil, the role of private capital in stimulating economic growth, and the likely future growth of the sector in Brazil.

Paulo Guedes, Chairman of the Board of Bozano Investments, provided an overview of why the global economy is in the 'Age of Private Equity', and why Brazil in particular is a critical market. Mr. Guedes described how the conventional banking model is failing, how serial bubbles have created an excess money supply, how developed markets will have substantially lower growth in the coming years, and how private capital in Brazil is uniquely suited for such an environment. Mr. Guedes explained that in a world of cheap money and worldwide inflationary policies, an opportunity for arbitrage exists. That is, as interest rates and inflation increase in developed markets, it will be harder to get attractive returns from listed companies. Brazil is a special case, though, because of the large number of mid-market unlisted companies. Brazil currently has 400 listed companies, but 15,000 mid-market unlisted companies. Mr. Guedes concluded that Brazil presents a unique opportunity for private equity firms, because higher growth plus more opportunities plus better pricing plus less competition equals superior returns.

Panel One | Private Capital in Brazil: The Way Forward

Greg Gooding, co-head of Debevoise & Plimpton LLP's mergers and acquisitions group, moderated the discussion between private equity fund managers and institutional investors focusing on how these key actors think about the future of private capital in Brazil. Mr. Gooding opened the discussion by commenting on how private capital investment in Brazil has grown explosively in the last decade. He also added, however, that in 2012 Brazil's economic performance was weak and fundraising for private equity funds decreased in general for Latin America and in particular for Brazil. He invited the panelists to offer their remarks on the promises and challenges of investing in Brazil today, and their view of the way forward.

Susan Carter, CEO of Common Fund Capital (a Connecticut-based institutional investment firm), was the first panelist. Ms. Carter spoke about her organization's experience in Latin America and shared some of the lessons she has learned from investing in the region. She explained that although investments must take into consideration both macro and micro conditions, private equity is a very micro-oriented business, and is very specific to the company itself. Ms. Carter mentioned the common metrics of analysis that her fund analyzes, but emphasized the importance of there being an appropriate level of talent relative to the amount of capital raised as well as finding general partners with the ability to grow earnings and add value. Another insight that Ms. Carter shared is that although investments take place in different countries with varying conditions, the process of due diligence in Latin America is more similar than different to the processes used in the United States.

Jorge Nobre, Private Equity Manager for FUNCEF (the third largest pension fund in Brazil), spoke next about his experience working for a pension fund in Brazil. He explained that FUNCEF has developed a selection process that includes an evaluation of managers, exit strategies, relevant sectors, and the cashflows of the companies. In addition, they also make technical visits (almost like a due diligence process). Lastly, they rank the companies, offer a negotiation period, and take all the results to FUNCEF's board. The process takes about four to five months. Mr. Nobre mentioned that FUNCEF has been particularly interested in the infrastructure and technology sectors. Private equity comprises between 10-11% of FUNCEF's portfolio, but they have plans to increase it to 15% by 2018. FUNCEF invests directly, but also has been partnering with private equity funds in "co-investment" opportunities, which Mr. Nobre believes will be an area of growth as pension funds develop in Brazil. Finally, Mr. Nobre said that investment committees have added value to the pension; but, as the ability to select better managers' increases, FUNCEF is studying the alternative option of working without committees.

Christopher Meyn, Managing Partner at Gavea Investments (a Brazilian-based asset management company), began his remarks by describing the Brazilian market for private equity, which he believes offers a unique environment today that has evolved from the previous conditions of capital protection and macroeconomic instability. Mr. Meyn highlighted the relatively small size of this market, its volatility, selectivity, and dependence on outside investors. He believes this presents a lot of room for growth. With respect to choosing sectors to invest, Mr. Meyn said that at Gavea they try to diversify and stay away from the industrial and manufacturing sectors, which still have many vestiges of a closed and protected economy and where productivity is still lagging. In addition, Mr. Meyn said they do not select high credit-driven industries and have found opportunities in the logistics and transportation sectors. In general, Mr Meyn mentioned that they look for areas in which a private market has taken over and where the government was not effective.

Luiz Leonardo Cantidiano, Partner at Motta Fernandes Rocha Advogados, focused his remarks on the legal context of private equity in Brazil. He explained that the current challenges with respect to the regulatory concerns in Brazil are understanding the responsibilities of funds when companies are unsuccessful and when there are problems with taxation and labor obligations. Mr. Cantidiano also discussed the difficulties associated with exiting. Because of this, the two parties usually include two or three clauses in their agreement. For example, the 'drag-along' clause forces shareholders of the company to sell their shares if there is a strategic investor who wants to acquire the whole company. There are questions as to the legality of this clause, as it can be understood as a protective clause. Another clause is a 'put option' from the fund against the controlling shareholder of the company. In this case, there is discussion of the possibility of having the fund not participate in the risk of the company if it is not doing well. An alternative to the 'put option' is the option to convert shares into redeemable shares and sell them back to the company. This alternative would require a special fund with the company to make the acquisition possible. Auditors, however, point to the risk associated with creating debt problems for the company. Finally, Mr. Cantidiano spoke about the issue of investment committees and their validity, especially when there are foreign investors in the fund. Some funds are moving away from this model and now have compliance committees, instead of investment committees.

BROOKINGS PCRI

Panel Two | Private Capital's Role in Stimulating Economic Growth

The conference now turned to the macro issue of the connection between private equity and economic growth. Moderated by Dr. Baily, this panel included David Robinson, Professor of Finance, Duke University; Antonio Botelho, Chairman of the Board, Gavea Angels; Cristiana Pereira, Issuer Development Officer, BM & FBovespa; Marco Andre Almeida, Partner, KPMG; Robert W. van Zwieten, President, Empea. Dr. Baily first asked Professor Robinson how he viewed the relationship between private equity and growth, especially in light of new legislation in the United States. Professor Robinson responded that the Jumpstart Our Business Startups Act (JOBS Act) greatly expands opportunities for investors to get into early-stage investments. He stated that an important question for academics is whether emerging markets will follow this trend from the United States. He added that that there were a lot of open questions about whether the rules in the JOBS act that expanded investor access to startups would backfire because startup investing required a degree of sophistication that many ordinary investors lacked.

Mr. van Zwieten added an interesting perspective that an important task for practitioners in the private capital field will be preemptive advocacy of the role of private capital on society. He argued that practitioners need to persuade policymakers and the general public, especially in frontier markets, that private capital leads to long-run value creation, increases capital flows into these countries, and has a positive economic impact on these countries. When asked about the difference between private capital in emerging markets in Asia and in Latin America, Mr. van Zwieten responded that Asia is further evolved, and that Latin American countries should adopt international standards to allow limited partners easier access to private equity firms.

Panel Three | Private Capital: A Catalyst for Constructive Change?

Álvaro Gonçalves, Co-Founder and Partner of the Stratus Group and former Chairman of the Brazilian Private Equity Association, moderated the third panel and started the discussion by emphasizing how private equity is still incipient in Brazil.

Thomas Franco, Partner at Clayton, Dubilier & Rice (CD&R), spoke about the importance of knowing one's way around in investing in Latin America. He also described what he sees as a generational shift in private equity, as the pioneers of the field leave the industry. He also explained that there have been some unfortunate public relations problems, and some issues around the misunderstanding of what private equity really is. He added that besides returns, private equity firms should also concentrate on having good relationships with governments and other constituencies. Additionally, Mr. Franco sees a shift in organizational practices from focusing on team building and not just one strong CEO.

Glauco Arbix, President of FINEP (a Brazilian governmental organization devoted to funding of science and technology in Brazil), spoke next and explained his agency's recent initiative called Inova Empresa, which together with various other government institutions are allocating approximately 15 billion dollars to develop technology and improve productivity. The Inova Empresa program has four instruments, including highly supported loans, subsidies, grants to companies that enter into a partnership with a university or research institute, and venture capital. Dr. Arbix highlighted the importance of the combination of these instruments. The program focuses on the industries of ethanol, health, military and aerospace, agriculture, petroleum, and sustainability. With respect to the area of private equity, Dr. Arbix acknowledged they have done little compared to the needs, and he explained that FINEP, unlike traditional private equity firms, does not interfere with the management decisions, but focuses on developing technologies. He clarified that FINEP's role is to stimulate growth in an area that will eventually be taken over by the market.

Thiago Rocha, Investor Relations Director for Senior Solution, shared his company's successful experience of going from private equity funding to becoming a publicly traded business. He explained that what was essential in Senior Solution's development was having the support from private equity investors, which allowed the company to mature and be ready to launch its IPO. He asserted that the path Senior Solution took could serve as an example for many other companies.

Panel Four | Private Capital in the Institutional Pension Portfolio

David Robinson moderated this next panel which included Josh Lerner, Professor of Investment Banking, Harvard Business School and Director of the Private Capital Research Institute (via videoconference); Mauricio da Rocha Wanderley, Technical Committee Coordinator, ABRAPP; Brad Thawley, Investment Manager at Teacher Retirement System of Texas; and Par Nuder, former Finance Minister of Sweden, Chairman of AP3. The panel focused on the challenges and opportunities to private capital in Brazil from the perspective of the limited partners.

Mr. Nuder described recent changes to the Swedish pension fund, and argued that it will become trickier in the future for public pension funds to invest in private capital unless the industry becomes more transparent. He noted that while returns are important for public pension fund managers, these returns need to be in line with people's hopes for the future. Mr. Thawley explained why his group has increased its allocation to alternative assets, and private equity specifically; and Mr. da Rocha Wanderley provided his perspective of private equity as a Brazilian limited partner, where he hit on the fact that LP's in Brazil had limited incentives to participate in private equity investing because they had easy access to government debt vehicles that paid relatively high, inflation-hedged returns and that their incentives were to maximize coverage, not maximize returns.

A key theme that has emerged in the thinking of limited partners towards private equity investments is the tradeoff between risk and return. Professor Robinson asked Professor Lerner how he thinks about this tradeoff. Professor Lerner answered that there is strong evidence supporting the view that returns from private equity are attractive compared to the public markets. He continued that academics do not have a definitive answer how risky private equity is. He added that academics are at an early stage in understanding how much risk limited partners take on in investing with private equity firms.

Closing Keynote

Luciano Coutinho, President of the Brazilian Development Bank (BNDES) concluded the conference by providing an overview of the future of the Brazilian economy, and offering predictions on the future of private capital in Brazil. Dr. Coutinho noted that the fundamentals of the Brazilian economy are in and will continue to be in good shape, that the Brazilian economy is significantly improving economic equality, that Brazil will be the fifth largest global market in 2020, and that financing infrastructure in Brazil will remain important for the country's development.

Dr. Coutinho predicted an increase in the participation of corporate debt in investment funding in Brazil, and that Brazilian growth will be led by energy and infrastructure investments. He highlighted infrastructure investments in particular as offering many high-return opportunities. He concluded that BNDES will play an important role in fostering small and medium enterprises in Brazil in conjunction with private equity and venture capital firms and the capital markets.