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Latin America: Sobriety test

Market conditions improved for private-equity investors in 2004, although prospective deal quality remains well below expectations

Latin America's GDP expanded by an estimated 5.6% in 2004, the strongest performance in more than 15 years. Yet, private-equity investors have become less confident of short-term business prospects than they were one year ago, when such investment was starting to recover from several difficult years. A lack of quality deals and unexpectedly long investment periods have been most sobering.

Expectations for investment growth in Latin America over the next three years are lower than they were a year ago. Forty-three percent of the participants in an Economist Conferences Latin America Private Equity meeting held in February expected foreign investment in the region to grow by some 25-50% over the next three years, according to a KPMG survey of this group of mainly institutional investors and fund managers. In February 2004, 56% of those polled by the US audit, tax and advisory firm at the annual Miami meeting had expected as much expansion.

The relatively poor quality of available deals in the region is the largest barrier to growth in private-equity activity, according to 37% of the KPMG survey respondents. A shortage of exit alternatives (18%) and continued political instability (18%) also constitute significant obstacles. Devaluation and unreliable due diligence have hurt sentiment as well. Two thousand four was a good year but not as good as [the participants] expected, says JP Trouillot, director of KPMG's Transaction Services practice.

Slim pickings

Indeed, the volume of private-equity and venture-capital transactions conducted in Brazil last year stalled at the same number 26 recorded in 2003, according to Stratus Investments (Brazil). However, the average investment or transaction size nearly doubled, growing from US\$6.5m in 2003 to US\$11.3m in 2004. (Deal size and number remained well below their annual peaks of US\$74.1m in 1998 and 87 in 2000 respectively.)

As a result, those surveyed may have expressed more disappointment than doubt when asked about their expectations, says Mr Trouillot. Most (59%) reckoned that it likely would take five or more years to extricate themselves from an investment. Just a year ago, a shorter timeframe of four to five years was most commonly envisaged by investors. Yet the latest survey indicated that 77% of respondents still believe the level of fundraising for investments in Latin America will increase next year.

A clear majority (67%) also expect to focus the lion's share of their outlays on Mexico and Brazil over the next two years. Latin America's largest economies have dominated investment strategies since the KPMG survey was started in 2001 (see graph).

The two countries' attractiveness to private-equity investors should strengthen into the medium term. In Brazil, legislation passed last year will encourage so-called public-private partnerships (PPPs) in infrastructure. Transport (highways and railways) is expected to dominate PPPs initially, although utilities will play a significant role.

Several private-equity and venture-capital funds are invested in the country's underdeveloped railways. JP Morgan Capital Partners (US) and Laif, a Washington, DC-based private-equity fund, have minority stakes in Brasil Ferrovias, a critical line linking the port of Santos with Sao Paulo and on to the farmland of the central western plains and to the Bolivian border.

Brazil's national development bank (BNDES) has just announced that it will lead a capitalisation of Brasil Ferrovias, taking equity in the system in the process with plans to prepare one of three subsidiaries for a public listing within three years. The official impetus is on building out the country's railways as fast as possible in order to

facilitate cheaper and faster transport of commodities, including soya and iron-ore.

Not surprisingly, the Miami survey's respondents perceive infrastructure as the industry offering the most opportunity to private-equity investors in the region (see table). Argentina, Chile, Peru and Uruguay should also generate ventures in roads, railways and electricity.

The Economist Intelligence Unit forecasts increasingly stable economic growth in several Latin American countries over the medium term. Consequent rising incomes and the concurrent development of consumer credit in several markets notably Brazil, Mexico and Chile will fuel heady consumer-market opportunities, including manufactured goods, imported items and retailing operations.

Strong economic recovery and growth in consumer demand added significant value to Brazil's packaging industry last year. Consequently, Darby Overseas Investment (US) was able to sell its stake in Dixie Toga, a family-run company, to US-based Bemis, a flexible packaging group.

In January, Darby's Darby-BBVA Latin American Private Equity Fund acquired a 53.3% controlling equity interest in Laboratorios Kendrick, a leading generic drug manufacturer in Mexico. The deal represents Darby's first foray into pharmaceuticals (see box, page 5).

Multinational companies committed themselves heavily to Brazil last year, with outlays totalling some US\$18.2bn, according to Brazil's central bank. The Economist Intelligence Unit forecasts that foreign direct investment (FDI) in the country will stay strong, amounting to US\$16.4bn this year and US\$17.7bn in 2006.

A consumer-credit boom is bolstering opportunity in financial services, especially in **Brazil. Foreign and local banks are partnering with retailers to target further the country's huge unbanked populace.** Growing ATM, credit- and debit-card transactions are driving more promising deals across the region.

Last year Darby purchased a stake in EWI Holdings, a privately held US company with a Mexico City office that is well positioned to become a major payments processor in the rapidly growing cash and prepayments sector in Latin America as well as the US. In November, Boston-based Advent International closed on the acquisition of Proservvi, a Brazilian back-office processing operation for financial institutions.

Outsourcing services for banks are nascent in Latin America. Existing relationships with large banks in Mexico as well as Brazil have great potential for expansion. Advent is already exploring a partnership with a large US company to serve as a likely investment exit.

Private-equity investors seeking opportunity in Latin America may still have to ferret through a host of unattractive deals and stick with investments longer than they might ordinarily have planned but investment and growth in the region will gradually supply better candidates. More exit alternatives are also surfacing.

New and seasoned strategic investors alike are looking to buy, sell or expand, fostering healthier deal flows. Local investors are playing a stronger role as well. Some 75% of the survey respondents said they had sold an equity stake outright to locally based companies or funds, up from 48% a year ago.

Stock and securities markets throughout much of Latin America posted large advances last year and remain robust. These include those in Brazil, Mexico, Colombia and Argentina. Twenty-five percent of the Miami meeting participants reported having implemented initial public offerings (IPOs) as an exit strategy more than double last year's level (12).

Notable local exit IPOs in 2004 included ZN MexicoFund's sale of Mexican home builder Homex on the Mexican and New York stock exchanges, as well as AIG CapitalPartners's (US) launch of Brazil's Gol Linhas Aereas Inteligentes (Gol airlines) on Brazilian and New York exchanges.

Which industries offer the greatest opportunity to private equity investors in Latin America?
(%*)

Infrastructure	59
Consumer markets	49
Financial services	34
Industrial markets	29
Communications	10
Other	24

Source: KPMG survey of Economist Conferences Latin America Private Equity meeting participants, February 2005